

Double Tax Arrangement between Mainland China and Hong Kong – Latest Development

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China and Hong Kong have signed the Second Protocol (“Second Protocol”) to the China / Hong Kong Double Tax Arrangement (“DTA”) on 30 January 2008.

Why this Second Protocol is issued?

The DTA was concluded in August 2006, and subsequently in April 2007 both the Inland Revenue Department (“IRD”) of Hong Kong and the State Administration of Taxation (“SAT”) of China have issued guidelines to express their views on the interpretation of the various articles of the DTA, in which some of their interpretations were different from each other, for example:

- The interpretation of “month” when determining permanent establishment (“PE”) in respect of service projects – Article 5.3(2) of the DTA
- The relevant timing to determine whether the alienation of shares of a company represents a disposal of “immovable property holding company” – Article 13.4 of the DTA
- The interpretation to determine whether the alienation of shares of a company qualifies for capital gains exemption by applying the 25% shareholding limit – Article 13.5 of the DTA

The IRD and the SAT have then been working closely trying to narrow the gap. Finally they have reached an agreement and signed the Second Protocol on 30 January 2008.

What are included in the Second Protocol?

The Second Protocol includes the followings, which we will discuss in depth:

- PE for furnishing services – substituting “183 days” for “6 months”
- Further interpretations on “immovable property holding company”
- Capital gains on disposal of shares – 25% shareholding condition

1. PE for furnishing services – substituting “183 days” for “6 months”

According to Article 5.3(2) of the DTA, the furnishing of services, including consultancy services, by a Hong Kong company in China (or vice versa) will create a PE if the service project (for the same or connected project) continues for a period or periods totaling more than 6 months within any 12-month period. The DTA has not defined what the meaning of “month” is.

The guideline issued by the IRD, Departmental Interpretation and Practice Notes No.44 (Revised) (“DIPN 44”), interpreted the term “month” as a period of 30 days, so the PE threshold in Hong Kong was 180 days (Article 43 of DIPN 44).

The guideline issued by the SAT, *GuoShuiHan (2007) No.403* (“the Notice 403”), however, used “month” as the unit for counting PE. The Notice 403 indicated that the “relevant period” for PE would be counted from the month the first employee of a Hong Kong company started providing services in China to the month the last employee left China. Only if no service was provided in China for a consecutive 30 days “one month” could be excluded from the relevant period. The SAT’s interpretation on counting PE was tougher than the IRD’s interpretation, and under such interpretation many Hong Kong companies providing services in China may easily be exposed to PE risk.

For example, if a Hong Kong company sends employees to provide service in China for 1 day every 15 days over 6 consecutive months, it will be treated as having a PE in China, while in reality its employees have only provided service in China for 12 days over the 12-month period.

The Second Protocol substitutes “183 days” for “6 months”, and now both the IRD and the SAT use “day” instead of “month” for PE determination. In other words, a Hong Kong company providing services in China will only be considered as having a PE if it furnishes services in China for an aggregate of 183 days in any 12-month period.

Our observation:

This is a significant provision contained in the Second Protocol, and it is especially favorable for Hong Kong companies providing services in China. The use of “183 days” is clear and simple, and it significantly reduces the risk of Hong Kong companies having a PE in China.

2. Further interpretations on “immovable property holding company”

According to Article 13.4 of the DTA, gains derived from the alienation of shares of a company by a Hong Kong investor will be subject to corporate income tax in China, if the company’s assets are comprised, directly or indirectly, mainly of immovable properties situated in China.

According to the First Protocol of the DTA, the IRD and the SAT both agreed to take 50% as the benchmark when determining whether the assets of a company are comprised “mainly” of immovable property. According to the Notice 403 issued by the SAT, when applying the 50% benchmarking, the value of assets is calculated on the basis of book value.

However, the IRD and the SAT held different views on the timing when applying the 50% benchmarking. The IRD’s view was that the 50% benchmarking should only be considered at the time of the alienation of shares, while the SAT considered that it should be applied at any time during which the shares of the company were held.

The Second Protocol introduces a 3-year time bar when applying the 50% benchmarking test. It stipulates that a company will only be considered as an immovable property holding company if the value of its immovable properties has been equaled to at least 50% of its total assets at any time within 3 years prior to the alienation of shares.

Our observation:

The 3-year time bar is uncommon in other tax treaties signed by China with other countries. It makes the situation clear and simple.

However, there are still uncertainties surrounding the scope of “immovable property holding company”, which may have very significant impacts especially on Hong Kong residents. This will be further discussed under the section “Issues awaiting further clarification” below.

3. Capital gains on disposal of shares – 25% shareholding condition

According to Article 13.5 of the DTA, gains derived from the alienation of shares of not less than 25% of the entire shareholding of a Chinese company (other than those immovable property holding companies discussed above) will be subject to corporate income tax in China. The same will also apply to Chinese investors holding shares of a Hong Kong company. The IRD’s and the SAT’s interpretations on “25% of the entire shareholding” were different.

The IRD interpreted the word “shares” as referring to shares sold at the time of alienation, rather than the total shares in a company held or once held by the alienator. Therefore as long as the shares alienated were less than 25% of the entire shareholding of a company, gains derived from the alienation of shares would not attract corporate income tax.

The SAT, however, adopted a more stringent approach and accordingly the alienation of shares of a Chinese company would attract corporate income tax in China if the Hong Kong investor has ever held 25% or more of the total shares of that Chinese company during a specific period of time, even the percentage of shares disposed of during a particular transaction was less than 25% of the total shares. The duration of the “specific period of time” was not defined in the Notice 403.

The Second Protocol replaces Article 13.5 of the DTA and introduces a 12-month time bar, which is similar to the China / Singapore and China / Mauritius tax treaties. It stipulates that, from the viewpoint of a Hong Kong investor, gains derived from the alienation of shares of a Chinese non-immovable property holding company will not be subject to corporate income tax, unless the Hong Kong investor owns 25% or more shares of that company at any time during the 12 months period prior to the alienation of shares.

Our observation:

In practice, this provision may not be able to effectively help Hong Kong residents to reduce corporate income tax in China, since in most cases Hong Kong investors are holding more than 25% shares of their Chinese investment vehicles, usually in the form of Joint Ventures (“JVs”) or Wholly Foreign Owned Enterprises (“WFOEs”). Therefore the alienation of shares of their Chinese JVs or WFOEs will still be likely to attract corporate income tax in China.

Nevertheless, this provision may provide planning opportunities for Hong Kong residents investing in China.

Issues awaiting further clarification

The Second Protocol signifies the co-operation between the IRD and the SAT and their efforts are appreciated. Nevertheless, some issues in the DTA still have not yet been addressed to in the Second Protocol, in which without further clarification, may pose impact on Hong Kong residents. In this section, we will discuss in details the following 2 issues:

- Immovable property holding company – potential China tax impact on Hong Kong residents
 - The use of “rolling 12-month” period when ascertaining the China Individual Income Tax (“IIT”) position of a Hong Kong resident working in China
1. Immovable property holding company – potential China tax impact on Hong Kong residents

As discussed above, the Second Protocol has established a 3-year time bar, which is useful to ascertain whether a company is an “immovable property holding company”. However, when reading the relevant articles contained in the DTA, it seems further clarifications may be required.

Let’s take a deeper look at the relevant articles of the DTA and the Protocols:

- Article 13.4 of the DTA stated that:
“Gains derived from the alienation of shares in a company the assets of which are comprised, directly or indirectly, mainly of immovable property situated in One Side may be taxed in that Side.”
- Paragraph 2 of the First Protocol stated that:
“For the purpose of paragraph 4 of Article 13, the term “assets” shall be read as the value of the assets, and the term “mainly” shall be read as “not less than 50%”.”
- Article 4 of the Second Protocol stated that:
“The provision in paragraph 4 of Article 13 of the Arrangement, as read with paragraph 2 of the Protocol, which refers to a company the assets of which comprise not less than 50% immovable property situated in One Side, shall be implemented in accordance with the following provision:

Not less than 50% of the assets of the company must consist of immovable property at any time within the 3 years before the alienation of the shares of the company by the holder of the shares.”

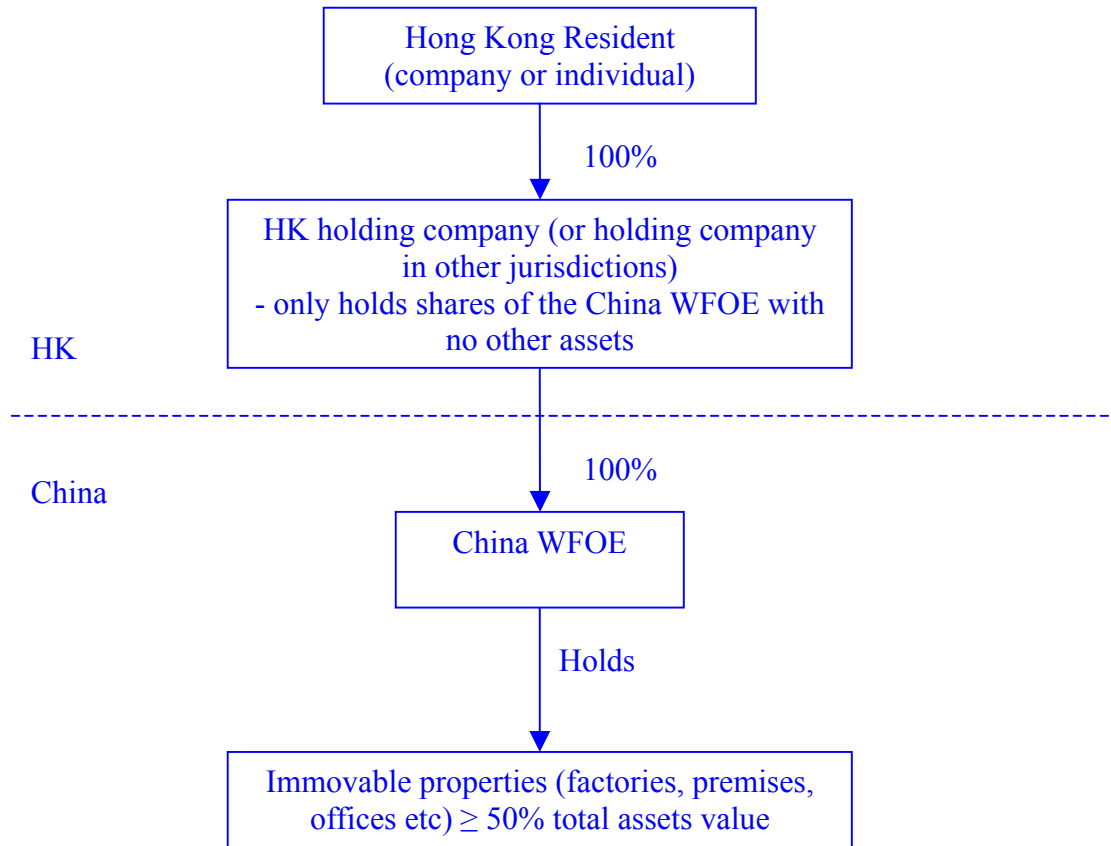
If we read Article 13.4 of the DTA carefully, it is noticed that the location / residency of “a company” is not specified. The First and Second Protocols did not address this issue either.

Rather, it seems that where the immovable properties are situated (i.e. Hong Kong or China) is the only relevant factor to determine whether Hong Kong or China has the right to tax the gains derived from the alienation of shares of an immovable property holding company.

Without further clarification from the IRD and the SAT, the above uncertainty may pose China tax exposure on Hong Kong residents (both corporations and individuals) investing in companies which hold immovable properties in China. We demonstrate such tax impact in the following 2 examples.

a. Traditional corporate structure when investing in China

For tax, administration and exit strategy purposes, when investing in China it is very common for Hong Kong investors to set up a 2-tier corporate structure similar to the one below:



Before the issuance of the DTA, the Hong Kong Resident can dispose of the investment in China by selling the shares of the HK holding company (or holding company in other jurisdictions) (i.e. indirect disposal). The gains derived from such indirect disposal in general would not attract Hong Kong Profits Tax (capital gains is exempt from tax in Hong Kong) and China corporate income tax. As long as the HK holding company (or holding company in other jurisdictions) is not selling the shares of the China WFOE directly, such disposal would not attract corporate income tax in China.

However, under the DTA, when the Hong Kong Resident above sells the shares of the HK holding company (or holding company in other jurisdictions) to the potential buyer, according to Article 13.4 of the DTA the gains may be subject to corporate income tax in China, since:

- i. Article 13.4 of the DTA uses the word “a company”. Therefore this Article is likely applicable to the alienation of shares of “a company”, which can be the HK holding company (or holding company in other jurisdictions) or the China WFOE, instead of “a company of the Other Side”, which only refers to the China WFOE.

- ii. The HK holding company (or holding company in other jurisdictions) is considered as an “immovable property holding company” since it indirectly holds immovable properties of which the value has at least equaled to 50% of the total assets value.
- iii. The immovable properties indirectly held by the HK holding company (or holding company in other jurisdictions) are situated in China, hence China has the right to tax the gains derived from the alienation of shares of the HK holding company (or holding company in other jurisdictions).

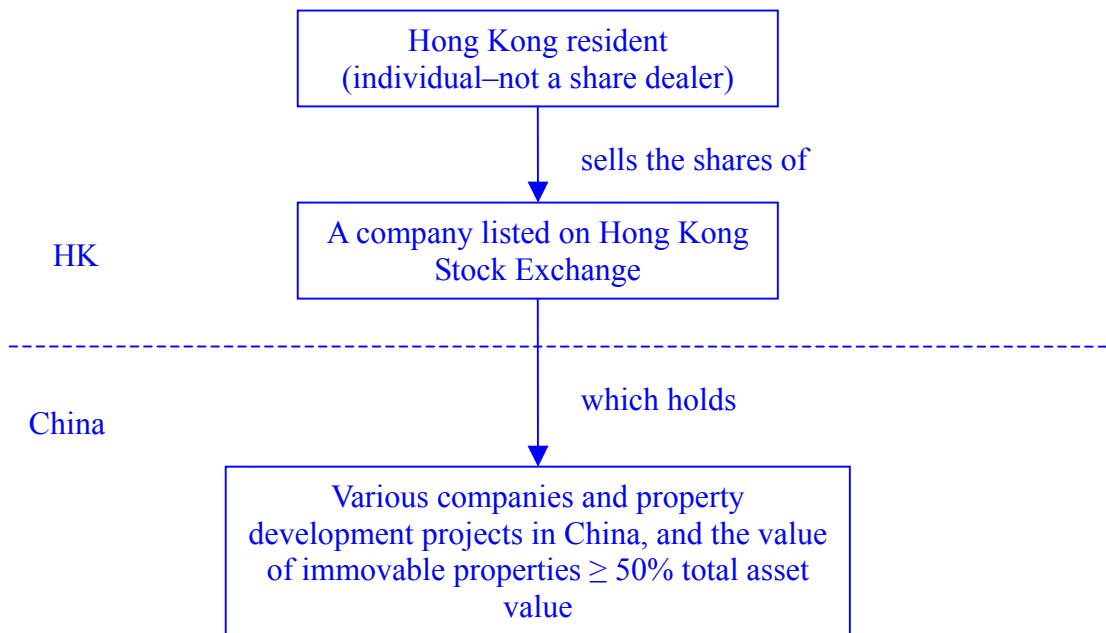
Even in the above case if the Hong Kong Resident has instead set up an offshore holding company (BVI, Cayman Islands etc), the situation would likely be the same.

It is because according to Article 3.1(4) of the DTA, the term “company” means any body corporate or any entity which is treated as a body corporate for tax purposes. Therefore under the DTA the “company” could be any company in the world.

b. Hong Kong individual trading shares of a company listed on Hong Kong Stock Exchange

In Hong Kong, when an individual (not a share dealer) buys and sells shares of companies listed on Hong Kong Stock Exchange, currently the IRD does not impose tax on such gains.

However, consider the situation below:



Currently there are a number of companies listed on Hong Kong Stock Exchange, in which their core businesses are either property development in China or holding properties in China for rental purposes [e.g. China Real Estate Investment Trustees (“REITs”)]. It is possible that some of these listed companies’ assets are mostly (directly and indirectly) consist of immovable properties situated in China.

If a particular property development company listed on Hong Kong Stock Exchange is regarded as an “immovable property holding company” [as its assets are mostly (directly and indirectly) consist of immovable properties situated in China], then gains derived from the alienation of its shares listed on Hong Kong Stock Exchange by a Hong Kong Resident (individual – not a share dealer) are exposed to tax in China.

Based on the above 2 examples, unless the uncertainties surrounding the applicability of Article 13.4 of the DTA are clarified, there would be China tax exposure to Hong Kong residents. The situation illustrated under example (b) above is especially of great concern since many Hong Kong residents (companies and individuals) are investing in these property development companies listed on Hong Kong Stock Exchange.

2. The use of “rolling 12-month” period when ascertaining the China Individual Income Tax (“IIT”) position of a Hong Kong resident working in China

Unlike many tax treaties that China have entered into (e.g. China / US tax treaty or China / Mexico tax treaty) which adopt a “calendar year” basis to determine the IIT taxability of expatriates working in China, the DTA instead adopts a “rolling 12-month” period. According to Article 14.2 of the DTA, it stipulates the 3 conditions that a Hong Kong employee should satisfy in order to be exempt from IIT in China:

1. The Hong Kong resident is present in China for a period or periods not exceeding in the aggregate 183 days in any 12 month period commencing or ending in the fiscal year concerned;
2. The remuneration is paid by, or on behalf of an employer who is not a resident of China; and
3. The remuneration is not borne by a permanent establishment that the employer has in China.

Condition (1) above was further explained with an example in the Notice 403 issued by the SAT. The example used a “rolling 12-month” period as the counting basis and it is noticed that, under certain scenarios, the DTA would not provide any benefit to Hong Kong residents when compared with the current IIT law.

Example

Mr B is a Hong Kong resident and works for a Hong Kong company. The Hong Kong Company has no establishment in China. Mr B's salary is fully borne by the Hong Kong Company.

Since 2008, Mr B is required to travel and work in China. He spends the following days in China during 2008 and 2009:

	<u>2008</u>	<u>2009</u>
January		
February	15	
March		31
April	10	30
May		31
June		
July		
August		31
September		
October	31	
November	30	
December		30
Total:	<u>86</u>	<u>153</u>

Each month, Mr B calculates his cumulative days stayed in China in a rolling 12-month period as follows:

	<u>Cumulative Days</u> <u>(Counting back 12 month)</u>	
	<u>2008</u>	<u>2009</u>
January		
February	15	
March		102
April	25	122
May		153
June		
July		
August		184
September		
October	56	
November	86	
December		153

For the 12-month period from September 2008 to August 2009, Mr B spends a total of 184 days in China. Because this 12-month period falls within two taxable years 2008 and 2009, according to the Notice 403 issued by the SAT, Mr B's salary received while he is in China in 2008 and 2009 are all subject to IIT, including February 2008, April 2008 and December 2009.

However, according to Article 7 of the Individual Income Tax Law Implementation Rules ("IITLIR"), a temporary visitor who lives in China for a total of 90 days or less during a calendar year is exempt from IIT if the employment income is paid by an overseas employer, and which is not borne by the overseas employer's permanent establishment in China. Therefore when applying Article 7 of the IITLIR, Mr B should not be subject to IIT for the calendar year 2008 since he only spends 86 days in China during 2008.

The above example indicates that under some circumstances the DTA is unable to provide any protection or benefits to Hong Kong residents working in China. It is therefore essential for the IRD and the SAT to come up with a viable solution with a view to minimize Hong Kong residents' IIT exposure under the DTA.

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