



稅務局

INLAND REVENUE DEPARTMENT

“Update on the Mainland of China and Hong Kong Double Taxation Arrangement”

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The Arrangement

- Entered into force on 8 Dec 2006
- Differences in the interpretation of some of the provisions
- Further negotiations
- Consensus was reached in Sep 2007



The Second Protocol

- Signed on 30 Jan 2008
- Section 49 of the IRO
- An order was made by CE in Council
- Legislative procedures completed
- Notification to the Mainland was sent in May 2008



3

Content

- Major issues covered by the Second Protocol
- Transitional arrangements
- Problems encountered in the interpretation of the Arrangement



4

Major Issues covered by the Second Protocol

- Permanent establishment
- Capital gains from the alienation of shares



5

Permanent Establishment

- Interpretation of “month” under Article 5, paragraph 3(2) -
furnishing of services, including consultancy services, for a period or periods aggregating more than 6 months within any 12-month period constitutes a PE



6

Permanent Establishment

The Mainland's view

- Relevant period = month of arrival to month of completion of project and employee left the Mainland
- If no services provided for a period of 30 consecutive days – one month can be deducted
- If total more than 6 months – PE in the Mainland
- “Original interpretation”



7

Permanent Establishment

Hong Kong's view

- Month = a period of 30 days
- If within any 12-month period, the cumulative number of days during which services have been provided in HK exceeded 180 days
- PE in HK



8

Permanent Establishment

The Second Protocol

- Amend paragraph 3(2) of Article 5 by repealing “6 months” and substituting “183 days”
- Method of counting the “183 days” not stated in the Second Protocol
- Both Sides will in practice use the “days of presence” method



9

Permanent Establishment

Example 1

For the purpose of a service project, Company A sent its employee Mr. Chan to the Mainland. Mr. Chan arrived in the Mainland on 1 Nov 2007 to commence a project. The project was completed on 4 May 2008 and Mr. Chan left the Mainland on the same day. During the relevant period from 1 Nov 2007 to 4 May 2008, Mr. Chan visited the Mainland for the first 4 days of each month and stayed in Hong Kong for the rest of the period.



10

Permanent Establishment

Example 1 - Question

Would Company A be regarded as having had a PE in the Mainland?



11

Permanent Establishment

Example 1 - Answer

- According to the **original interpretation**, Company A would be regarded as having had a PE in the Mainland as there was no period of continuous absence of 30 days or more from the Mainland.
- The services in the Mainland would have been regarded as having continued for 7 months.



12

Permanent Establishment

Example 1 – Answer (continued)

- Under the **new interpretation**, applying the “183 days” rule, Company A will not be regarded as having had a PE in the Mainland as Mr. Chan only stayed in the Mainland for a total of 28 days.



13

Capital Gains

Paragraph 4 of Article 13

- 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.



14

Capital Gains

Paragraph 4 of Article 13

- Benchmark in determining whether the assets of a company are comprised “mainly” of immovable property – 50%
- Both Sides held different views as to the relevant point in time for deciding whether the value of immovable property was equal to or exceeded 50% of the value of the total assets of the company

15

Capital Gains

Paragraph 4 of Article 13

Hong Kong's view :

- Time of the alienation of shares

The Mainland's view :

- Any time in the period during which the alienator held any shares in the company

16

Capital Gains

Paragraph 4 of Article 13

- Under the Second Protocol, both Sides agreed to set a time frame of “3 years”
- When not less than 50% of the assets of the company consisted of immovable property in the Mainland at any time within the 3 years before the alienation of the shares of a company, the Mainland may tax the gains derived from the alienation

17

Capital Gains

Paragraph 4 of Article 13

- In calculating the value of assets, both Sides have agreed to adopt the year-end book value of each accounting year
- Such agreement was confirmed by both Sides through an exchange of note executed on 11 Sep 2007

18

Capital Gains

Paragraph 5 of Article 13

- Gains derived from the alienation of “shares”, other than those referred to in paragraph 4 of Article 13, of not less than 25% of the entire shareholding of a company which is a resident of One Side, may be taxed in that Side
- What “shares” the 25% was referring to in this paragraph?

19

Capital Gains

Paragraph 5 of Article 13

Hong Kong's view :

- The 25% rule referred to the shares that are the subject of the alienation – the shares that were *sold*

The Mainland's view :

- Put emphasis on the phrase “shares of not less than 25% of the entire shareholding of a company”; i.e. refers to the shares *held*

20

Capital Gains

Paragraph 5 of Article 13

- Both Sides has now agreed that the “25%” applied to the shares *held* by the alienator
- Under the Second Protocol, both Sides agreed to set a time frame of 12 months for the purposes of deciding whether the alienator has “once held” at least 25% of the shareholding



21

Transitional Arrangements

- Look at different scenarios
- Assumption made for illustrative purposes
 - the Second Protocol has come into effect on 6 June 2008



22

Transitional Arrangements

Example 2 – Permanent Establishment

Mr. Chan, the employee of Company A in example 1, completed the service project on 4 Aug 2008, instead of 4 May 2008 and left the Mainland on the same day. During the relevant period from 1 Nov 2007 to 4 Aug 2008, Mr. Chan would have actually stayed in the Mainland for a total of 40 days only.



23

Transitional Arrangements

Example 2 – Question

Would Company A be regarded as having a PE in the Mainland?



24

Transitional Arrangements

Example 2 – Answer

Mr. Chan arrived in the Mainland on 1 Nov 2007 and provided services for a particular project. As at 1 May 2008, Mr. Chan had been in the Mainland for 6 months according to the original interpretation. Hence, Company A would have at that point been regarded as having a PE in the Mainland, i.e. as from 1 May 2008.



25

Transitional Arrangements

Example 2 – Answer (continued)

Once a PE is established, any subsequent movement of its employee would have no effect on such status, as would be the interpretation in the Second Protocol.



26

Transitional Arrangements

Example 2 – Answer (continued)

On the other hand, if Company A was not regarded as having a PE in the Mainland under the original interpretation (because, for example, Mr. Chan had several periods of 30 consecutive days not in the Mainland), Company A will be assessed again using the new rules.



27

Transitional Arrangements

Example 2 – Answer (continued)

In this case, as Mr. Chan stayed in the Mainland for less than 183 days, Company A will not be regarded as having a PE in the Mainland under the Second Protocol.



28

Transitional Arrangements

Example 3 – Capital Gains

On 1 May 2004, a HK resident Mr. Wong bought shares in Company B, which closed its accounts annually on 31 December. Company B held immovable properties in the Mainland, with the properties representing, as per the accounts, the following percentages of total company assets:

| | |
|------|-----|
| 2004 | 60% |
| 2005 | 40% |
| 2006 | 40% |
| 2007 | 40% |

Mr. Wong sold the shares of Company B on 15 June 2008 and made a profit.

29

Transitional Arrangements

Example 3 – Question

Would the gains received by Mr. Wong from the alienation of the shares be subject to tax in the Mainland under Article 13(4)?

30

Transitional Arrangements

Example 3 – Answer

- The 3 years rule would apply as the Second Protocol had become effective at the time of alienation. According to the year-end accounts for 2005 to 2007, the assets of Company B were not at any time comprised mainly of immovable property (40% only in all 3 years).
- Therefore, not subject to tax under Article 13(4).



31

Transitional Arrangements

Example 4 – Capital Gains

If instead, Mr. Wong had in example 3 sold the shares of Company B on 1 May 2008 and made a profit.



32

Transitional Arrangements

Example 4 – Question

Would the gains received by Mr. Wong from the alienation of shares be subject to tax in the Mainland under Article 13(4)?



33

Transitional Arrangements

Example 4 – Answer

The Second Protocol was not yet effective at the time of alienation. Therefore, all accounts of Company B during which Mr. Wong held any shares in the company would be scrutinized.



34

Transitional Arrangements

Example 4 – Answer (continued)

According to the year-end accounts of 2004, the assets of Company B has once comprised mainly of immovable property (60%). The gains on alienation received by Mr. Wong would therefore be subject to tax in the Mainland under Article 13(4).



35

Transitional Arrangements

Example 5 – Capital Gains

On 1 April 2006, a HK resident, Mr. Cheung acquired 35% of the entire shareholding of a Mainland company, Company C. He sold the shares on the following occasions and made a profit :

On 1 May 2007, 20% shares of Company C;

On 8 June 2008, 15% shares of Company C.



36

Transitional Arrangements

Example 5 – Question

Would Mr. Cheung's gains derived from the alienation of shares be subject to tax in the Mainland?



37

Transitional Arrangements

Example 5 – Answer

Paragraphs 1 to 4 of Article 13 would not apply. However, Mr. Cheung's gains received from the alienation on 1 May 2007 would still be subject to tax in the Mainland as he once owned 25% or more of the entire shareholding of Company C.



38

Transitional Arrangements

Example 5 – Answer (continued)

The position would be different for the sale on 8 June 2008. The Second Protocol would have come into effect and the new 12 months rule would apply. As Mr. Cheung only had a participation of less than 25% of the capital of Company C during the 12 months prior to the alienation, his gain would not be subject to tax in the Mainland.



39

Interpretation of the Arrangement

Certifications of resident status

- Where a company is incorporated in HK, or outside HK but is normally managed or controlled in HK, it will be considered to be a resident of HK under the Arrangement



40

Interpretation of the Arrangement

Certifications of resident status

- In general, for a company that is incorporated in HK,
 - a Certified Extract of Information on the Business Register; or
 - a copy of Certificate of Incorporation of the company,would be accepted by the Mainland authority as sufficient evidence for the purpose

41

Interpretation of the Arrangement

Certifications of resident status

- A certificate of resident status would generally only be required where,
 - there is possibility that the person is a resident of both Sides; or
 - there is a need to verify the resident status of the company

42

Interpretation of the Arrangement

Permanent Establishment

- Whether a HK enterprise furnishing services in the Mainland should be regarded as having a PE there
- Interpretation of the term “connected project”
- Whether in the following situations a company would be regarded as having a PE in the Mainland:



43

Interpretation of the Arrangement

Permanent Establishment

- (a) Where different HK companies providing services in the Mainland for a particular project –
- Commentary on the OECD Model Tax Convention
 - “a coherent whole, commercially and geographically”
 - Apart from tax planning, the time spent by different HK companies should be considered and counted separately in deciding whether a PE exists for each of the HK companies



44

Interpretation of the Arrangement

Permanent Establishment

(b) Where different units or divisions within the same HK company rendering services in relation to a particular project in the Mainland –

- The services are performed by the same company. Therefore, they form a coherent whole, commercially and geographically
- Time spent by different units or divisions should be added together in deciding whether a PE exists for the HK company



45

Interpretation of the Arrangement

Permanent Establishment

(c) Where the same HK company renders services for different stages of a project, for example, a construction project –

- The different stages of a project should also form a coherent whole, commercially and geographically
- Time spent in different stages should be added together in deciding whether a PE exists for the HK company



46

Interpretation of the Arrangement

Permanent Establishment

A HK company sent its employee to perform a feasibility study for the company's proposed investment in the Mainland. The employee stayed in the Mainland for more than 183 days.

Whether the HK company should have been regarded as having a PE in the Mainland?



47

Interpretation of the Arrangement

Permanent Establishment

- An employee performs a feasibility study for his own employer, theoretically,
 - no client services;
 - preparatory work only;
 - involving neither any profit nor any tax liability
- Potential individual tax liability of the employee in respect of his services rendered in the Mainland



48

Interpretation of the Arrangement

Permanent Establishment

- If this employee were to have also conducted a feasibility study for a related or associated company, then,
 - he would have provided services; and
 - there would be a profit element involved
- Depend on the facts of each case
- The Competent Authority should be the SAT in the Mainland

49



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Thank You

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50