



## New Protocol to the Double Tax Arrangement between Mainland China and Hong Kong

The Central Government of the People's Republic of China ("Mainland") and the Government of Hong Kong Special Administrative Region signed the Second Protocol ("Protocol") to the China/Hong Kong Double Tax Arrangement ("DTA") on 30 January, 2008. The Protocol will take effect upon notification by both sides after their completion of the necessary ratification procedures respectively.

The China State Administration of Taxation ("SAT") and the Hong Kong Inland Revenue Department ("IRD") had different views on the interpretation of some of the articles upon implementation of the DTA. These different views were reflected in Departmental Interpretation & Practice Notes No.44 (revised) issued by the IRD and Circular Guo Shui Han [2007] No. 403 issued by the SAT. Since then, both the SAT and IRD received numerous feedbacks from the business community and professional practitioners on their diverged interpretation. The SAT and IRD have been working very closely and diligently in the past year to resolve these differences after taking those feedbacks into consideration. Finally they reached a consensus and signed the Protocol.

The main features of the Protocol are set forth as follows from the perspectives of Hong Kong tax residents:

### Service Permanent Establishment ("PE")

The DTA defines a PE to include provision of services by a Hong Kong company in the Mainland if the service project continues (for the same or a connected project) for a period or periods aggregating more than 6 months within any 12-month period. Profits attributed to that PE shall then be treated as business profits and taxed in the Mainland. If this time threshold is not breached, then the Hong Kong service provider may be exempt from China corporate income tax in respect of the profits attributed to that PE.

The SAT and IRD adopted different methods in counting the "6-month" period. The IRD treated a "month" as 30 days, so a "6-month" period meant 183 days. The SAT's approach was that it would take the period from the month in which the first employee of a Hong Kong company arrived in the Mainland to provide services until the month in which the project was completed and the last employee of that company left the Mainland as the relevant period. If no service was provided for a period of 30 consecutive days, "one month" could be deducted from the relevant period. Under this approach, the provision of services in the Mainland even only for a day within one calendar month might be counted as "one month". The SAT's interpretation was harsher than the IRD's and might expose more Hong Kong service providers to PE risks in the Mainland.

The term "6-month" is now replaced with "183 days". The use of "day" is clear and simple. So far, only four double tax agreements (India, Thailand, Sri Lanka and Nepal) concluded by the Mainland use this "day" criteria. This change will undoubtedly be welcomed by many Hong Kong companies which provide services in the Mainland as this would reduce their PE risks and, consequently, corporate income tax exposure in the Mainland.

## **Interpretation of "Immovable Property Holding Company"**

Under the DTA, capital gains derived by a Hong Kong investor from the alienation of shares in a Mainland company whose assets are comprised, directly or indirectly, mainly (defined in the first Protocol to the DTA to mean "not less than 50%") of immovable properties situated in the Mainland (so called "Immovable Property Holding Company") would not be exempt from China corporate income tax. The SAT and IRD held different views as to the relevant point in time for deciding whether the value of the immovable properties exceeds the 50% threshold. The IRD looked at the time when the shares are disposed of, whereas the SAT considered that it should mean any time during which the shares were held.

The Protocol now provides a limited look-back period of 3 years which means that a Mainland company will only be considered to be an Immovable Property Holding Company if its immovable properties value has ever exceeded 50% of its total assets within three years prior to the alienation of its shares by the Hong Kong investor. In addition, book value shall be used as the basis for calculating the value of assets.

This new provision will basically help those Hong Kong investors whose core investment in China is not on property development to be exempted from China tax on capital gains, where the criteria are met. This also improves Hong Kong competitiveness as the preferred location for investing into China as it is the only double agreement concluded by China which has such limited look-back period.

## **25% Shareholding Threshold for Capital Gain Exemption**

Another article of the DTA also provides China corporate income tax exemption for capital gains derived by a Hong Kong company from the alienation of shares representing a less than 25% interest of the total shareholding of a Mainland company which is not an Immovable Property Holding Company. The SAT and IRD also had diverged views on the interpretation of the 25% threshold under this article. The IRD took a more literal interpretation of the provision and considered that as long as the shares disposed of is less than 25% of the total shares, the gain should be exempt regardless of the historical total shareholding of the Hong Kong seller in the Mainland company. However, the SAT had a more stringent interpretation and would not grant exemption in cases where the Hong Kong seller had ever held 25% or more of the total shares in the Mainland company being disposed of, even if the shares disposed of at that time is less than 25% of the total shares.

The Protocol amends the relevant article in the DTA by putting in a 12-month look-back period. This is similar to that in the China/Mauritius and the new China/Singapore double tax agreements. After the Protocol comes into effect, capital gains derived by a Hong Kong seller from the alienation of shares in a Mainland company which is not an Immovable Property Holding Company will be exempt from China corporate income tax unless the Hong Kong seller owns not less than 25% shareholding in that Mainland company at any time during the 12-month period preceding the alienation.

The provisions in the Protocol on "Immovable Property Holding Company" and "25% shareholding threshold for capital gain exemption" would generally only affect Hong Kong residents. It should not have any reciprocal impact on Mainland residents investing in Hong Kong since Hong Kong does not levy tax on capital gains under its domestic tax legislations, unless they are seen as carrying on share trading business in Hong Kong.

## **PwC Observations**

Technically, this Protocol helps to clarify a few unclear positions in the interpretation and implementation of the DTA taken by the SAT and IRD previously. Their collaboration effort is reflected in this Protocol which is well appreciated by taxpayers on both sides.

This clarity will undoubtedly be welcomed by many Hong Kong companies as they can now estimate their China tax profiles with increased certainty.

Last but not least, it is still important to follow up on the development of the applicability of the SAT Circular 403. That circular states that the interpretation of the various articles in the DTA (before this new Protocol) is similarly applicable to other tax treaties that the Mainland has concluded with other jurisdictions if the contents of the relevant articles are the same as that in the DTA and no other interpretation and implementation guidelines have been provided before. In light of the new Protocol to the DTA between the Mainland and Hong Kong, it remains to be seen how the SAT will apply their interpretation as set forth in Circular 403 to other double tax agreements.

In the context of this article, China refers to the People's Republic of China but excludes Hong Kong Special Administrative Region, Macao Special Administrative Region and Taiwan Region.

The information contained in this publication is for general guidance on matters of interest only and is not meant to be comprehensive. The application and impact of laws can vary widely based on the specific facts involved. If you are interested in learning more about the new arrangement and its impacts on your company, please contact your PricewaterhouseCoopers client service team or any of the following tax partners at PricewaterhouseCoopers.

## China Tax

### Beijing

Cassie Wong  
Tel: (86) (10) 6533 2222  
Fax: (86) (10) 6533 8800  
cassie.wong@cn.pwc.com

### Beijing

Edward Shum  
Tel: (86) (10) 6533 2866  
Fax: (86) (10) 6533 8800  
edward.shum@cn.pwc.com

### Chongqing

Tony Kwan  
Tel: (86) (21) 6123 2515  
Fax: (86) (21) 6123 8800  
tony.kwan@cn.pwc.com

### Dalian

Edward Shum  
Tel: (86) (10) 6533 2866  
Fax: (86) (10) 6533 8800  
edward.shum@cn.pwc.com

### Guangzhou

Charles Leung  
Tel: (852) 2289 5605  
Fax: (852) 2810 9888  
charles.leung@hk.pwc.com

### Qingdao

Steven Wong  
Tel: 86 (10) 6533 3113  
Fax: 86 (10) 6533 8800  
steven.wong@cn.pwc.com

## China Tax

### Shanghai

Tony Kwan  
Tel: (86) (21) 6123 2515  
Fax: (86) (21) 6123 8800  
tony.kwan@cn.pwc.com

### Shenzhen

Charles Lee  
Tel: (86) (755) 8261 8899  
Fax: (86) (755) 8261 8800  
charles.lee@cn.pwc.com

### Suzhou

Billy Hsieh  
Tel: 86 (21) 6123 3013  
Fax: 86 (21) 6123 8800  
billy.hsieh@cn.pwc.com

### Tianjin

Alan Wu  
Tel: 86 (10) 6533 2889  
Fax: (86) (10) 6533 8800  
alan.wu@cn.pwc.com

### Xian

Elton Huang  
Tel: 86 (21) 6123 3029  
Fax: 86 (21) 6123 8800  
elton.huang@cn.pwc.com

## China Tax

### Hong Kong

Petrina Tam  
Tel: (852) 2289 3669  
Fax: (852) 2810 9888  
petrina.tam@hk.pwc.com

## Hong Kong Tax

### Hong Kong

Peter SH Yu  
Tel: (852) 2289 3122  
Fax: (852) 2289 9888  
peter.sh.yu@hk.pwc.com

### Hong Kong

Tim Leung  
Tel: (852) 2289 3055  
Fax: (852) 2289 9888  
tim.leung@hk.pwc.com

### Hong Kong

Reynold Hung  
Tel: (852) 2289 3604  
Fax: (852) 2289 9888  
reynold.hung@hk.pwc.com

### Hong Kong

Guy Ellis  
Tel: (852) 2289 3600  
Fax: (852) 2289 9888  
guy.ellis@hk.pwc.com

### Hong Kong

Marcellus Wong  
Tel: (852) 2289 1822  
Fax: (852) 2289 9888  
marcellus.yk.wong@cn.pwc.com

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