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**Report of the Subcommittee on Specification of Arrangements
(The Mainland of China) (Avoidance of Double Taxation and the Prevention
of Fiscal Evasion with respect to Taxes on Income) (Fourth Protocol) Order**

Purpose

This paper reports on the deliberations of the Subcommittee on Specification of Arrangements (The Mainland of China) (Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income) (Fourth Protocol) Order ("the Subcommittee").

Background

Comprehensive Agreements for Avoidance of Double Taxation

2. Double taxation refers to the imposition of comparable taxes in more than one tax jurisdiction in respect of the same taxable income. The international community generally recognizes that double taxation hinders the exchange of goods and services, movements of capital, technology and human resources, and poses an obstacle to the development of economic relations between economies. As a business facilitation initiative, it is the Government's policy to enter into Comprehensive Agreements for Avoidance of Double Taxation ("CDTAs") with Hong Kong's trading and investment partners.

3. Hong Kong adopts the territorial basis of taxation whereby only income sourced from Hong Kong is subject to tax. A local resident's income derived from sources outside Hong Kong will not be taxed in Hong Kong and hence will not be subject to double taxation. Double taxation may occur where a jurisdiction outside Hong Kong taxes its own residents' income derived from Hong Kong. Although many jurisdictions do provide their residents with unilateral tax relief for the Hong Kong tax they paid on income derived

therefrom, the existence of a CDTA will provide enhanced certainty and stability in respect of the elimination of double taxation. Besides, the tax relief provided under a CDTA may exceed the level provided unilaterally by a tax jurisdiction. For the implementation of the agreement between the two contracting parties, a CDTA normally includes an article that provides for the exchange of information ("EoI") necessary.

Arrangement between the Mainland and the Hong Kong Special Administrative Region for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income

The Mainland Arrangement and its previous protocols

4. The Mainland and Hong Kong signed the Arrangement between the Mainland and the Hong Kong Special Administrative Region for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income ("the Mainland Arrangement") and its First Protocol¹ on 21 August 2006. The Second Protocol² and the Third Protocol³ were signed in 2008 and 2010 respectively.

The Fourth Protocol

5. In order to facilitate better implementation of the Mainland Arrangement, the Mainland and Hong Kong signed the Fourth Protocol on 1 April 2015 ("the Fourth Protocol"). The Fourth Protocol seeks to –

- (a) clarify the conditions under which an investment fund will be qualified in the Mainland for Hong Kong resident status, thus giving certainty to the application of the tax avoidance arrangements on investment funds;
- (b) provide a new provision to clearly set out the tax liabilities of residents of one side in relation to the gains derived from the purchase and sale of shares in listed companies on the other side;

¹ According to the Administration, in some CDTAs, the contracting parties may prefer to set out in greater detail the agreed arrangements in the form of a protocol to the CDTA. The protocols, if any, should be read together with the CDTA and form integral parts of it.

² The Second Protocol was signed on 30 January 2008 to clarify some post-implementation issues of the Mainland Arrangement in order to provide certainty in the interpretation of certain provisions of the Arrangement.

³ The Third Protocol was signed on 27 May 2010 to upgrade the EoI Article in the Mainland Arrangement to the 2004 version of the EoI Article in the model text set by the Organization for Economic Cooperation and Development.

- (c) reduce the cap on the withholding tax imposed by the Mainland on royalties paid to aircraft and ship leasing businesses from 7% to 5%; and
- (d) expand the coverage of tax types under the EoI arrangement of the Mainland Arrangement, so as to bring it in line with Hong Kong's commitment to meeting global standards for enhancing tax transparency.

The Order gazetted on 2 October 2015

6. The Specification of Arrangements (The Mainland of China) (Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income) (Fourth Protocol) Order ("the Order") is made by the Chief Executive in Council under section 49(1A) of the Inland Revenue Ordinance (Cap.112) ("IRO")⁴ to give effect to the arrangements under the Fourth Protocol. The Order will come into operation on 4 December 2015.

The Subcommittee

7. At the House Committee meeting held on 9 October 2015, Members agreed to form a subcommittee to study the Order. Hon CHAN Kam-lam was elected chairman of the Subcommittee, and the membership list of the Subcommittee is in the **Appendix**. The Subcommittee held one meeting on 20 October 2015 to meet with the Administration and scrutinize the Order.

Deliberations of the Subcommittee

8. In examining the Order, the Subcommittee has focused on the qualifying conditions for the double taxation relief arrangements under the Fourth Protocol.

⁴ Under section 49(1A) of IRO, if the Chief Executive in Council by order declares that arrangements specified in the order have been made with the government of any territory outside Hong Kong, and that it is expedient that those arrangements should have effect, those arrangements shall have effect. Under section 49(1B) of IRO, only arrangements made for the purposes of affording relief from double taxation and/or exchanging information in relation to any tax imposed by the laws of Hong Kong or the territory concerned may be specified in an order under section 49(1A).

Tax liabilities in respect of gains derived from the sale and purchase of shares in Mainland listed companies on the same stock exchange

Purpose and negotiation of the tax liability arrangement

9. The Subcommittee notes that according to the new provision introduced by the Fourth Protocol to replace the existing paragraph 6 of Article 13 (Capital Gains) of the Mainland Arrangement, the gains derived by a Hong Kong resident from the purchase and sale on the same stock exchange of shares in a Mainland listed company shall not be taxable in the Mainland. This arrangement of tax liability is also applicable to investment funds that fulfill the requirements for residence set out in the new provision.

10. As capital gains tax is currently taxable in the Mainland but not in Hong Kong, some members are concerned whether this may have put Hong Kong in an inequitable and unfavourable position when negotiating with the Mainland on the tax liability arrangement in relation to the gains derived from the purchase and sale of shares in listed companies on the other side. The Administration points out that currently, both the Mainland and Hong Kong do not levy any tax in relation to the gains in question (which is distinct from the concept of "capital gains" in the relevant common law context), and the new provision in Article 13 is meant to clearly set out the tax liabilities if such gains are taxable by either side in future. As with the negotiation of other CDTAs, the tax liability arrangement under the Mainland Arrangement and its protocols is reached after due negotiation between the tax authorities of the Mainland and Hong Kong (i.e. the State Administration of Taxation ("SAT") and Inland Revenue Department ("IRD")), taking into account relevant international standards including the model CDTA set by the Organization for Economic Cooperation and Development.

Qualifying conditions

11. Members have sought clarification on how the purchase and sale of shares in a Mainland listed company are to be regarded as being conducted on the same stock exchange, given that the shares of a company may be purchased before the company is listed and sold after the listing. The Administration explains that the provision substituting the current paragraph 6 of Article 13 of the Mainland Arrangement (as set out under Article 3 of the Fourth Protocol) only provides that the relevant arrangement is for alienation limited to "cases where the shares are bought and sold in the same stock exchange". On the basis of the text of the provision, the shares in the suggested scenario are expected not to be regarded as being purchased and sold on the same stock exchange because the shares purchased before the listing of the company are not

bought from a stock exchange. On the other hand, if the shares of a Mainland listed company are purchased before the company is de-listed (or before suspension of trading of its shares), and are subsequently sold on the same stock exchange after the company is re-listed (or after trading of such shares has been resumed), the text of the provision itself does not provide for anything which denies the status that the purchase and sale of the shares are conducted on the same stock exchange.

12. The Administration stresses that the tax liability for each case should be considered on its own merits. If a Hong Kong resident (an individual or entity) considers that the actions of the Mainland will result in taxation not in accordance with the new provision in Article 13 of the Mainland Arrangement, the resident should present the case to IRD for further communication with SAT, with a view to resolving the issues by mutual agreement between the tax authorities.

13. Members have requested the Administration to clearly inform the public of the details of implementing the tax liability arrangement under the new provision in Article 13, including the statutory or administrative procedures, if any, for determination and declaration of Hong Kong resident status, and the related obligations on the part of brokers/securities firms engaged by the investors to conduct stock trading. This will protect the tax interests of the investing public under the law. The Administration advises that IRD will publish on its website information relating to the implementation of the Fourth Protocol for the public's reference.

Dividends paid by Mainland listed company

14. As regards members' enquiry about the tax liabilities in relation to dividends paid by a Mainland listed company to a Hong Kong resident, the Administration points out that the scope of the new provision in Article 13 of the Mainland Arrangement only covers the tax liabilities in respect of gains derived from the purchase and sale of shares in Mainland listed companies on the same stock exchange whereas the tax treatment for dividends is provided for in Article 10 of the Mainland Arrangement, which is outside the scope of the Fourth Protocol.

Conditions for investment fund to be qualified in the Mainland for Hong Kong resident status

15. The Subcommittee notes that the Fourth Protocol seeks to clarify the conditions under which an investment fund will be qualified in the Mainland for Hong Kong resident status, thus giving certainty to the application of the tax avoidance arrangements to investment funds. Under the new provision in

Article 13 of the Mainland Arrangement, an investment fund meeting the following conditions shall be regarded as an investment fund that is a resident of one side (i.e. the Mainland or Hong Kong) –

- (a) the investment fund is one established under the relevant laws of the side in which the investment fund is situated, and is recognized by an industry regulatory body of that side and subject to the supervision of the body;
- (b) the manager of the investment fund shall either be a company registered and incorporated in that side or other persons constituted in that side, and shall manage the investment fund in accordance with the requirements of the industry regulatory body of that side; and
- (c) more than 85% of the funds are raised through the market of that side⁵.

16. The Subcommittee has enquired whether IRD will issue tax resident certificate for an investment fund qualified in the Mainland for Hong Kong resident status. The Administration indicates that it will consider issuing such a certificate if the investment fund is regarded as a tax resident of Hong Kong.

Withholding tax rate on royalties paid to aircraft and ship leasing business

17. While appreciating the Administration's efforts to achieve a reduction in the cap on the withholding tax imposed by the Mainland on royalties paid to aircraft and ship leasing businesses from 7% to 5% under the Fourth Protocol, members have queried why IRD has not taken the opportunity in the negotiation leading to the Fourth Protocol to discuss with SAT to reduce the existing caps on the withholding tax imposed by the Mainland in respect of dividends and interest, which are currently fixed at 10% and 7% respectively .

18. The Administration points out that while it will make the best endeavour to attain the most favourable terms for Hong Kong residents in the Mainland Arrangement (and its protocols) and other CDTAs for the avoidance of double taxation, the outcome of negotiation will also hinge on other factors, especially the taxation policies of other tax jurisdictions and in the current context, the Mainland's taxation policy. At the request of the Subcommittee, the

⁵ Investment funds that raise funds in the following manners shall be regarded as raising funds through the market of that side: (a) being listed for trading on the stock exchange of that side; (b) by sale or placement in that side through a financial institution that carries on a substantive business; (c) by sale or placement in that side directly to investors; and (d) any other manner as agreed by the tax authorities of both sides.

Administration has provided supplementary information for members' reference of the caps on withholding tax imposed by the Mainland in respect of dividends and interest under the agreements signed by the Mainland with other tax jurisdictions.

Determination of resident status

Dual-resident status and mutual agreement procedure

19. As determination of resident status (i.e. Mainland or Hong Kong resident) is pivotal to the applicability of the double taxation relief arrangements, including those under the Fourth Protocol, the Subcommittee has examined the arrangements if an individual is a resident of both sides (i.e. having a dual-resident status).

20. The Administration points out that the meanings of "resident of one side" in the case of the Mainland or Hong Kong are set out in paragraph 1(1) and (2) of Article 4 (Resident) of the Mainland Arrangement, and the Fourth Protocol does not seek to amend Article 4. If an individual is a resident of both sides according to the specified meanings, his/her status shall be determined by considering the individual's permanent home and centre of vital interest, as set out in paragraph 2(1) to (3) of the Article. If necessary, the tax authorities of both sides should resolve the resident status by the mutual agreement procedure laid down in Article 23 of the Mainland Arrangement.

21. Regarding members' enquiry as to when and how the mutual agreement procedure will be triggered in practice, the Administration has explained that an individual may present his/her case to the tax authority of the side of which he/she is a resident, within three years from the first notification of the action resulting in taxation which the individual considers not in accordance with the provision of the Mainland Arrangement and its protocols, including any disagreement on the determined resident status.

22. Hon James TO has expressed concern whether, after consideration of the acceptability and relevance of the information and supporting documents presented by an individual for ascertaining his/her resident status, IRD may not forward all such information/documents to SAT for the mutual agreement procedure. Mr TO considers that the subject person should be notified of the scope of the information to be provided by IRD to SAT such that the person can take appropriate actions (including legal actions) early in case of any disagreement with IRD's views before the mutual agreement procedure has commenced. The Administration stresses that it is incumbent upon IRD as the tax authority of Hong Kong to protect the interests of Hong Kong residents in the avoidance of double taxation. It is unlikely that IRD will withhold from

SAT any information presented by the subject person. In any case, the mutual agreement procedure is transparent in that the subject person will be informed of, amongst others, the scope of information to be provided by IRD to SAT for resolving the resident status.

Resident status of the Hong Kong branch of a company incorporated in the Mainland

23. The Subcommittee has sought clarification on the resident status of the Hong Kong branches of Mainland incorporated companies such as banks. The Administration has advised that in accordance with paragraph 1(2)(iii) of Article 4 of the Mainland Arrangement, the Hong Kong branches in question will not qualify for Hong Kong resident status since such branches are normally managed or controlled by their headquarters in the Mainland.

Departmental Interpretation and Practice Notes

24. In view of the impending implementation of the Fourth Protocol, and as IRD's Departmental Interpretation and Practice Notes ("DIPNs") have not been updated for a few years, Hon Kenneth LEUNG has requested IRD to update the relevant DIPNs timely for taxpayers' reference. The Administration has agreed to update the DIPNs where appropriate.

Recommendation

25. The Subcommittee supports the Order. The Subcommittee and the Administration have not proposed any amendment to the Order.

Advice sought

26. Members are requested to note the deliberations and recommendation of the Subcommittee.

Appendix

Subcommittee on Specification of Arrangements (The Mainland of China) (Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income) (Fourth Protocol) Order

Membership list

Chairman Hon CHAN Kam-lam, SBS, JP

Members Hon James TO Kun-sun
Hon Jeffrey LAM Kin-fung, GBS, JP
Hon Andrew LEUNG Kwan-yuen, GBS, JP
Hon Kenneth LEUNG
Hon Christopher CHEUNG Wah-fung, SBS, JP
Hon SIN Chung-kai, SBS, JP
Hon CHUNG Kwok-pan

(Total : 8 members)

Clerk Ms Angel SHEK

Legal Adviser Miss Carrie WONG

Date 20 October 2015