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Tax Analysis

Hong Kong Tax

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New protocol for Hong Kong-China double taxation arrangement signed

On 1 April 2015, Hong Kong (HK) and Mainland China (PRC) signed a new protocol to amend their double taxation arrangement (HK-PRC DTA) entered into in 2006. This is the 4th protocol for the HK-PRC DTA, with the 2nd and 3rd protocols signed in 2008 and 2010 respectively. The new protocol covers various areas, including (1) capital gains on listed shares (2) aircraft and ship lease rentals (3) anti-avoidance (4) exchange of information (EoI). It will come into force after the completion of ratification procedures and notification by both sides.

Capital gains on listed shares

The new protocol provides exemption from PRC tax for capital gains on disposal of shares listed in the PRC, provided that such shares are purchased and sold on the same exchange, for HK tax residents and HK investment funds meeting the following conditions:

- The investment fund is incorporated according to the laws of HK, and is recognized and regulated by the Securities and Futures Commission of Hong Kong (SFC);
- The fund manager is a company incorporated in HK which manages the fund according to the regulations stipulated by the SFC;
- More than 85% of the capital of the fund are raised through the market in HK. For example, the fund is publicly traded on the HK stock exchange, the fund is sold or placed through financial institutions in HK, the fund is directly sold or placed to investors in HK, etc.

Our analysis

Under the existing HK-PRC DTA, gain on alienation of shares (excluding land-rich entities[1]) will not be taxed in the PRC if the HK resident seller owned, directly or indirectly, less than 25% of the entire shareholding of the PRC entity at any time within 12 months before the alienation. On the other hand, with effect from 17 November 2014, capital gains from trading of listed shares derived through the Shanghai-HK Stock Connect are temporarily exempt from PRC tax. Capital gains on the shares of land-rich entities are not excluded from such exemption. In addition, QFIIs and RQFIIs have been temporarily exempt from PRC tax for gains derived from trading of equity investment assets in the PRC.

[1] "land-rich entities" refer to companies with not less than 50% of the assets comprised of immovable property situated in the PRC

As the above existing exemption regime has already covered most of the cases, the new protocol under the HK-PRC DTA can only extend the exemption to certain cases. The additional benefits brought by the new protocol under the HK-PRC DTA are believed to be HK tax residents and HK investment funds exempting from PRC tax on gains from trading in stocks of PRC companies listed on the Shenzhen or HK Stock Exchange, even though the PRC companies are land-rich and / or the shareholding is not less than 25%.

For example, a HK company owns not less than 25% of the shares in a PRC entity which is listed on the Shenzhen Stock Exchange. Under the existing regime, the capital gains on disposal of such PRC shares derived by the HK company would be subject to tax in the PRC. With the new protocol, the HK company can be benefited by having the PRC tax exempted. However, as very few investors would hold 25% or more in a listed company, this additional benefit is not of much significance.

Another example is trading of shares in land-rich PRC entities listed on the Shenzhen or HK Stock Exchange. Currently, a HK company deriving gain on trading of land-rich PRC entities shares, regardless of whether the shareholding is less than 25% or not, is not entitled to the PRC tax exemption under the existing HK-PRC DTA. The exemption provided in the new protocol does not exclude land-rich companies. Therefore, HK investors will be benefited from the new protocol if the shares being traded are of land-rich PRC entities listed on the Shenzhen or HK Stock Exchange. Those listed on the Shanghai Stock Exchange are already covered under the Shanghai-HK Stock Connect exemption with effect from 17 November 2014. Therefore, this additional benefit is also not of too much significance.

One more example, perhaps being most of the real cases to be benefited, is HK company or HK investment funds trading of H shares (i.e. shares of companies incorporated in the PRC that are listed on the HK Stock Exchange). HK tax residents and HK investment funds will be exempt from PRC tax on the disposal gains on H shares according to the new protocol.

Note that to enjoy the exemption under the protocol, the shares must be purchased and sold on the same exchange. The exemption does not apply to shares that are acquired by private placement.

The new protocol also clarifies the conditions under which an investment fund would be qualified for HK tax resident status. While this reduces uncertainty for investment funds' tax position, it appears that more conditions are required for an investment fund, in addition to the general definition of HK tax resident for a company, to enjoy the PRC tax exemption for capital gains on listed shares.

Aircraft leasing and ship chartering

The new protocol lowers the withholding tax (WHT) rate for lease rentals derived by aircraft leasing and ship chartering business from the current cap of 7% to 5%.

This benefits HK aircraft leasing and ship chartering business deriving lease rentals from the PRC. The reduced WHT rate of 5% for lease rentals is the most beneficial one amongst all the tax treaties signed by the PRC. This facilitates HK's aircraft leasing and ship chartering businesses with the PRC and is in line with the positioning of HK as the international maritime services hub for China as mentioned in the latest Policy Address.

Anti-avoidance & Exchange of information (EoI)

The new protocol introduces an anti-avoidance provision under which the treaty benefits for dividends, interest, royalties and capital gains would not apply if the main purpose for entering into the arrangement was to take advantage of these benefits.

On the other hand, the new protocol extends the coverage of the EoI arrangement to other PRC taxes, including Value-added tax, Consumption Tax, Business Tax, Land Appreciation Tax and Real Estate Tax.

These two provisions strengthen anti-treaty abuse and fulfil HK's international obligation to meet global standards for enhancing tax transparency. These measures are also in line with the international trend of Base Erosion and Profit Shifting (BEPS).

Deloitte's comments

Deloitte welcomes the provisions of the new protocol for the HK-PRC DTA. Although the capital gain exemption only provides benefits to limited cases in addition to the existing exemption regime, to a certain extent it promotes asset management businesses in HK. In addition, the lowering of WHT rate for lease rentals for aircraft and ship will encourage HK's aircraft financing business with the PRC. Nevertheless, taxpayers should be aware of the strengthening of anti-avoidance measures and the expansion of the scope of EoI at the same time.

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