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Hong Kong signs multilateral instrument to modify bilateral tax agreements

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Representatives covering 76 countries and jurisdictions, including Hong Kong, signed[1] or formally expressed their intention to sign the widely-anticipated Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI) on 7 June 2017. Additional jurisdictions subsequently have signed or announced their commitment to sign the MLI.

This article summarizes Hong Kong's progress in implementing internationally agreed standards relating to Base Erosion and Profit Shifting (BEPS) and the exchange of information, and its MLI position.

Progress in implementing internationally agreed standards

Hong Kong has been moving forward toward implementing the international standards recommended under the BEPS project, as well as the automatic exchange of financial account information (AEOI) under the OECD common reporting standard. Given that the OECD and the EU have kicked off their respective exercises aiming to draw up lists of "noncooperative" tax jurisdictions by the end of 2017, in the absence of a wide AEOI network and participation in the MLI, Hong Kong could risk falling onto these lists. A tax jurisdiction listed as noncooperative could be subject to counter-measures that would make it a less attractive place for investment and business. Therefore, Hong Kong has indicated its commitment to the BEPS project to the OECD and passed legislation to implement the AEOI in June 2016, with the

[1] 68 jurisdictions signed the MLI

first exchanges scheduled to commence in 2018.

Thus far, Hong Kong has relied on a bilateral approach to execute various agreements with other jurisdictions, e.g. comprehensive double taxation agreements (CDTAs), tax information exchange agreements (TIEAs), agreements related to the AEOI, etc. In other words, Hong Kong has had to negotiate, sign and amend the agreements with its counterparties one-by-one to keep pace with international standards. The bilateral approach no longer is efficient or effective in view of the expanding network of agreements and the new international standards introduced to combat BEPS, so the Hong Kong government considers that there is a practical need to adopt a multilateral approach.

In view of the above, with the endorsement of the Chinese Government to apply the MLI to Hong Kong by way of territorial extension, China signed the MLI on behalf of Hong Kong on 7 June 2017.

Background on the MLI

BEPS refers to tax planning strategies of multinational enterprises that exploit the gaps and mismatches in the tax rules of different jurisdictions to artificially shift profits to low or no-tax locations where there is little or no economic activity, resulting in little or no overall corporate tax being paid. The abuse of tax treaties is a significant source of BEPS.

The MLI, under BEPS action 15, should help in the fight against BEPS by facilitating the implementation of the tax treaty-related measures developed through the G20/OECD BEPS project. The MLI seeks to modify existing bilateral tax treaties of signatory jurisdictions in a synchronized and efficient manner. It will not function in the same way as an amending protocol to an existing bilateral treaty because it will not directly change the underlying treaty text; rather, it will be applied alongside the existing treaty to modify its application.

Treaty measures that are included in the MLI include those on hybrid mismatch arrangements, treaty abuse, permanent establishments and mutual agreement procedures. While certain provisions of the MLI establish minimum standards that are required to be implemented, jurisdictions may choose whether and/or how to apply the optional provisions of the MLI by filing technical reservations and notifications ("MLI positions").

Hong Kong's MLI position

Hong Kong has concluded 37 CDTAs and the MLI will apply to all of these, except for the Double Taxation Arrangement (DTA) with Mainland China. In other words, 36 CDTAs concluded by Hong Kong will be covered by the MLI ("covered tax agreements"). Hong Kong and China would need to negotiate any modifications to their existing DTA separately, if necessary.

As mentioned above, other than the mandatory provisions, jurisdictions have the discretion as to which provisions of the MLI they will accept or reserve against. The general rule is that if one treaty partner reserves against a provision of the MLI, that provision will not apply to its covered tax agreements. To ensure clarity and transparency regarding the application of the MLI, jurisdictions are required to issue notifications on the existing provisions of covered tax agreements to be modified.

Hong Kong intends to implement the mandatory provisions of the MLI, including the provisions addressing two minimum standards of the BEPS package (action 6 (preventing treaty abuse) and action 14 (improving cross-border dispute resolution mechanisms)), while opting out of the remaining articles so as to minimize the unintended impact to Hong Kong. The significant provisions are as follows:

<u>Treaty abuse</u>

Purpose of a covered tax agreement

The minimum standard for protection against the abuse of tax treaties under BEPS action 6 requires countries to include an express statement in their tax treaties that their common intention is to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including through treaty-shopping arrangements.

Therefore, in accordance with article 6 of the MLI, preamble text stating the intent "to eliminate double taxation with respect to the taxes covered by this agreement without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided in this agreement for the indirect benefit of residents of third jurisdictions)" will be added to or will replace certain preamble language in most of the covered tax agreements concluded by Hong Kong.

Principal purpose test (PPT)

In addition to including an express statement in preamble text, the MLI requires jurisdictions to implement provisions reflecting the common intent to prevent treaty abuse by adopting one of the following rules: (a) a principal purpose test (PPT) rule; (b) a simplified limitation-on-benefits (LOB) rule supplemented with a PPT; or (c) a detailed LOB rule supplemented by a mechanism to deal with conduit arrangements.

Hong Kong has opted to adopt a PPT only. Under the PPT, a person will not be granted benefits under a tax treaty if obtaining such benefits is one of the principal purposes of the transactions or arrangements involved. This rule provides a general way to address treaty shopping situations, including those not covered by an LOB rule, such as certain conduit financing arrangements.

In view of the low corporate tax rate, Hong Kong is less vulnerable to treaty abuse by residents of treaty partner jurisdictions. In addition, some of the existing CDTAs concluded by Hong Kong already contain specific provisions to prevent treaty abuse under specific articles (e.g. those on dividends, interest and royalties), based on whether one of the main purposes of the arrangement or transaction is to obtain treaty benefits. Hong Kong's domestic tax law also contains general anti-avoidance provisions to deny a tax benefit if a transaction is entered into for the sole or dominant purpose of enabling the taxpayer to obtain the tax benefit. Therefore, the Hong Kong government considers that it should not be difficult to apply the broader provisions of the PPT to covered tax agreements and hence chooses the PPT-only option.

The PPT will apply to most of the covered tax agreements concluded by Hong Kong. Although Hong Kong's treaty partners Canada and Kuwait have accepted the PPT-only option as an interim measure, both have indicated in their MLI positions that they intend to adopt LOB provisions through bilateral negotiation.

Dispute resolution mechanism

A CDTA may provide that a taxpayer that is exposed to double taxation or taxation not in accordance with the CDTA may request the relevant competent authority to discuss the case with the competent authority of the other treaty partner jurisdiction to try to resolve the case in accordance with the CDTA. This process is known as a Mutual Agreement Procedure (MAP).

While most of the existing CDTAs concluded by Hong Kong already contain provisions on an MAP, the existing MAP text of some covered tax agreements will be modified based on the MLI.

The modified MAP mechanism will allow taxpayers to apply for MAP in accordance with the CDTA, notwithstanding any objection or claim procedures at the domestic level. An MAP case can be presented to either Hong Kong or the treaty partner. Regarding the timing, for example, the current Hong Kong-Italy CDTA provides that an MAP case must be presented within two years from the first notification of the action resulting in taxation not in accordance with the CDTA. Under the MLI, the two-year period will be changed to three years, which is in line with other covered tax agreements. In addition, the existing MAP clause of the Hong Kong-Italy CDTA does not specify a time limit for implementing the agreement reached under the MAP. Accordingly, the text "Any agreement reached shall be implemented notwithstanding any time limits in the domestic law of the Contracting Jurisdictions" will be added, based on the MLI. In effect, if an MAP agreement is reached, it will override the time limit under domestic law.

Next step for Hong Kong

The Hong Kong government will proceed with the necessary legislative procedures to give effect to the MLI at the domestic level. The timing of the entry into effect of modifications to the covered tax agreements will largely depend on the completion of the MLI ratification procedures by both treaty partners. The Hong Kong government plans to introduce the relevant amendment bill into the Legislative Council before mid 2018. On the other hand, it plans to incorporate the relevant provisions of the MLI in CDTAs to be signed in the future, to ensure that they are BEPS-compliant.

Effect on Hong Kong businesses

The MLI seeks to implement tax treaty-related BEPS measures to tackle aggressive tax planning strategies. Theoretically speaking, enterprises not involved in such strategies should not be affected. Nevertheless, when the MLI enters into effect, existing CDTAs must be read together with the MLI. Careful analysis will be needed, since the relevant information (i.e. the text of MLI, plus the MLI positions of Hong Kong and its treaty partners) is extensive and complex.

Businesses that currently benefit from existing bilateral tax treaties should begin to analyze the impact of the relevant changes. The OECD's Multilateral Instrument (MLI) Matching Database (currently available in a beta version) may facilitate the analysis of how the MLI will modify a specific tax treaty. It is anticipated that the MLI will lead to an additional burden for both taxpayers and Hong Kong's Inland Revenue Department in relation to claims for treaty benefits going forward.

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