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Tax Analysis

Fifth protocol to Mainland China-Hong Kong double taxation arrangement signed

Authors:

Beijing
Jennifer Zhang
Partner
Tel: +86 10 8520 7638
Email: jenzhang@deloitte.com.cn

Apple Tang
Director
Tel: +86 10 8520 7603
Email: aptang@deloitte.com.cn

Jessica Shi
Senior Tax Consultant
Tel: +86 10 8512 5577
Email: jessshi@deloitte.com.cn

On 19 July 2019, the mainland of the People's Republic of China (Mainland China) and the Hong Kong Special Administrative Region (HK) signed the fifth protocol to further amend the 2006 Arrangement for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income (the Arrangement).[1] The fifth protocol amends the Arrangement in the following areas: (1) preamble; (2) dual resident entity; (3) agency permanent establishment (PE); (4) capital gains; (5) teachers and researchers; and (6) principal purpose test (PPT). The fifth protocol will enter into force after the completion of ratification procedures by both Sides[2] of the Arrangement and the exchange of written notifications.

The fifth protocol largely is based on the relevant provisions of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (the MLI), except for the new article on teachers and researchers.[3] The MLI is a multilateral instrument designed to facilitate the "swift, co-ordinated and consistent" implementation of the treaty-related measures recommended under the OECD/G20 base erosion and profit shifting (BEPS) project on a global scale. As of 17 July 2019, 89 countries or jurisdictions had signed the MLI.[4] Both Mainland China and HK[5] signed the MLI on 7 June 2017, but neither has completed its

[1] The first, second, third and fourth protocols were signed in 2006, 2008, 2010 and 2015, respectively.
[2] The terms "One Side" and "the Other Side" are used in the English version of the Arrangement to refer to Mainland China or HK, as the context requires, and the term "both Sides" collectively refers to Mainland China and HK.
[3] For a detailed introduction to the MLI, see Deloitte's Tax Analysis issued on 1 August 2017, "China Signs MLI to Modify Tax Treaties" and on 16 August 2017, "Hong Kong signs multilateral instrument to modify bilateral tax agreements".
[4] For detailed information on the signatories and parties to the MLI, see the OECD website: http://www.oecd.org/tax/treaties/beps-mli-signatories-and-parties.pdf.
[5] Mainland China signed the MLI on behalf of HK.

internal ratification procedures.

Among the MLI-based amendments, the PPT and the anti-tax avoidance language added to the preamble are to incorporate the minimum standards required under the MLI, both of which are the results of BEPS Action 6, Preventing the Granting of Treaty Benefits in Inappropriate Circumstances.

Summary and analysis of the fifth protocol

Preamble

The fifth protocol amends the preamble of the Arrangement to read as follows:

> "The mainland of China and the Hong Kong Special Administrative Region, desiring to further develop their economic relationship and to enhance their co-operation in tax matters, and intending to eliminate double taxation with respect to taxes on income 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 arrangement for the indirect benefit of residents of third jurisdictions), have agreed as follows:"[6]

It should be noted that treaty-shopping is only one example of "tax evasion or avoidance", so the fact that it is specifically mentioned in the amended preamble will not prevent the preamble from covering a broader scope of tax evasion or avoidance arrangements.

Based on the explanations in the 2015 final report on BEPS Action 6 (BEPS Action 6 Report), the explicit inclusion of the prevention of tax evasion and avoidance in the preamble as one of the objectives and purposes of the Arrangement indicates that this factor should be taken into account when interpreting the provisions of the Arrangement.

Dual resident entity[7]

The fifth protocol amends the tiebreaker rule for determining the residence of dual resident entities. According to the current provisions of the Arrangement, an entity that is a tax resident of both Sides shall be deemed to be a resident only of the Side in which its place of effective management is situated. Under the fifth protocol, "the competent authorities of the two Sides shall endeavor to determine by mutual agreement where the entity shall be deemed to be a resident for the purposes of the Arrangement, having regard to its place of effective management, the place where it is incorporated or otherwise constituted and any other relevant factors." This amendment reflects the results of BEPS Action 6. According to the explanations of the BEPS Action 6 Report, because dual resident entities may involve tax avoidance arrangements, it is better to have the competent tax authorities assess the situation on a case-by-case basis, to prevent the improper granting of treaty benefits. The amendment may increase the uncertainty of whether a dual resident entity can obtain benefits under the Arrangement.

In the absence of an agreement between the competent authorities, a dual resident entity "shall not be entitled to any relief or exemption

[6] Neither Mainland China nor HK has published an English version of the fifth protocol. The articles referred to in this tax analysis are translated from the Chinese version by Deloitte, i.e. this is not an official English translation of the protocol.

[7] Based on article 3 of the Arrangement, the term "entity" refers to a company, a trust, a partnership and any other body of persons for tax purposes.

For more information, please contact:

International Tax and Merger & Acquisition Tax Services National Leader
Shanghai
Vicky Wang
Partner
Tel: +86 21 6141 1035
Email: vicwang@deloitte.com.cn

Northern China
Beijing
Jennifer Zhang
Partner
Tel: +86 10 8520 7638
Email: jenzhang@deloitte.com.cn

Eastern China
Shanghai
Ye Hong
Partner
Tel: +86 21 6141 1171
Email: hoye@deloitte.com.cn

Southern China
Hong Kong
Sharon Ka Suet Lam
Partner
Tel: +852 2852 6536
Email: shalam@deloitte.com.hk

Western China
Chengdu
Tony Zhang
Partner
Tel: +86 28 6789 8008
Email: tonzhang@deloitte.com.cn

from tax provided by the Arrangement except to the extent and in such manner as may be agreed upon by the competent authorities of the two Sides." Under such circumstances, Mainland China and HK may levy tax in accordance with their respective tax laws, which may create uncertainty as to whether the tax paid by such entity in One Side can be credited against the tax payable in the Other Side.

Agency PE

The fifth protocol amends the definitions of agency PE and independent agent.

Amendment of the definition of agency PE

According to the current provisions of the Arrangement, where a person (including an individual or an entity) other than an independent agent is acting in One Side on behalf of an enterprise of the Other Side, and the person has, and habitually exercises, an authority to conclude contracts in the name of the enterprise, that enterprise shall be deemed to have a PE in that One Side, unless the activities carried out by that person fall within the scope of article 5(4) of the Arrangement (i.e. preparatory or auxiliary activities).

The fifth protocol extends the scope of an agency PE to include situations where a person "habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise, and these contracts are:

a) in the name of the enterprise; or
b) for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use; or
c) for the provision of services by that enterprise."

The amendment to the definition of agency PE aims at combatting the artificial avoidance of agency PE under the current provisions of the Arrangement, for example, where a contract is substantially negotiated in One Side and merely formally concluded in the Other Side. From the perspective of Mainland China, this situation already is covered within the scope of an agency PE through a broad interpretation of the current provisions relating to agency PEs, as reflected in the existing guidance on the interpretation of tax treaty provisions (Guoshuifa (2010) No. 75). [8] The fifth protocol further clarifies this interpretation by amending the definition of agency PE in the Arrangement.

Amendment of the definition of independent agent

Under the current provisions of the Arrangement, when the activities of an agent are wholly or almost wholly performed on behalf of an enterprise, the agent shall not be deemed to be an agent with an independent status. Under the fifth protocol, "where a person acts exclusively or almost exclusively on behalf of one or more enterprises to which it is closely related, that person shall not be considered to be an independent agent within the meaning of this paragraph with respect to any such enterprise." In line with the explanations in the 2015 final report on BEPS Action 7, Preventing the Artificial Avoidance of Permanent Establishment Status (BEPS Action 7 Report), these provisions do not indicate that an agent acting on behalf of one or more enterprises to which it is *not* closely related will automatically be considered as an independent agent. Rather, all facts and circumstances should be taken into consideration in determining whether the agent is an agent with an independent status conducting commercial activities in the ordinary course of its business.

The concept of "closely related" enterprises introduced in the amended definition of an independent agent overlaps with the definition of "associated enterprises"[9] under article 9 of the Arrangement to some extent, but the two definitions are not the same. A person is closely related to another if one has control of the other or both are under the control of the same person. In any case, a person is considered to be closely related to another if either holds directly or indirectly more than 50% of the beneficial interests in the other, or if another person holds directly or indirectly more than 50% of the

[8] "Notice on Interpretations on the Agreement between the Government of the People's Republic of China and the Government of the Republic of Singapore for the Avoidance of Double Taxation and the Prevention of Tax Evasion with Respect to Taxes on Income and the Protocols." Although this guidance was issued in the specific context of the China-Singapore treaty, it generally has been applicable to all of China's treaties/arrangements that contain similar provisions.

[9] According to article 9(1) of the Arrangement, where (1) an enterprise of One Side participates directly or indirectly in the management, control or capital of an enterprise of the Other Side; or (2) the same person participates directly or indirectly in the management, control or capital of an enterprise of One Side and an enterprise of the Other Side, and the commercial or financial relations between the two enterprises are different from those between independent enterprises, the two enterprises are considered associated for the purposes of article 9.

beneficial interests in both persons. In the case of a company, more than 50% of the beneficial interests means more than 50% of the aggregate vote and value of the company's shares or of the beneficial equity interests in the company.

In line with the explanations in the BEPS Action 7 Report, the situation where a holding of beneficial interests exceeds 50% is only one example of a closely related relationship, and there may be other scenarios representing the "control" required under the amended PE article. Hence, there will be uncertainties under the amendment of the definition of an independent agent as to when a person may constitute an agency PE.

Capital gains

The fifth protocol amends the provision on capital gains from the alienation of shares deriving their value principally from immovable property. The Arrangement currently provides that gains derived from the alienation of shares in a company where, at any time within three years before the alienation, no less than 50% of the value of the company's assets is comprised directly or indirectly of immovable property situated in One Side may be taxed in that One Side.

The fifth protocol mainly makes the following amendments to this provision:

(1) It expands the scope of the provision to include interests comparable to shares (such as interests in a partnership or a trust). The amendment is consistent with the MLI and mainly aims at preventing enterprises from holding real estate through forms other than a company (such as a partnership or a trust) to avoid tax obligations.
(2) It refers to article 6 of the Arrangement (Income from Immovable Property) for the definition of "real estate" to be used for purposes of the capital gains article. The amendment is consistent with the 2017 OECD model tax convention.
(3) It adjusts the threshold of "no less than 50%" to "more than 50%".
(4) It rewords the basis for calculating the 50% ratio from the "value of assets" of the company whose shares are alienated, to the "value" of the alienated shares or comparable interests.

Teachers and researchers

The fifth protocol introduces a new article on teachers and researchers into the Arrangement, which could strengthen the communications of teachers and researchers between the two Sides and encourage the development of science, technology and cultural education of both Sides. If the prescribed conditions are satisfied, teachers and researchers from One Side working in the Other Side for the purposes of undertaking teaching or research activities will be entitled to claim a tax exemption for certain income for a period of time.

For example, assume that an individual employed by a HK university, college, school or other accredited educational or scientific research institution is present in Mainland China for the primary purpose of teaching or conducting research at a university, college, school or other accredited educational or scientific research institution in Mainland China. The individual is, or immediately before visiting Mainland China was, a tax resident of HK. The portion of the individual’s remuneration related to carrying out such teaching or research activities in Mainland China that is either directly paid by the HK employer or paid on behalf of the HK employer would be exempt from tax in Mainland China for three years, to the extent that such salaries are taxed in HK.

As HK levies tax on a territorial basis, remuneration obtained by a HK tax resident for providing services entirely outside HK generally is exempt from HK salaries tax. However, it is noteworthy that HK previously amended its domestic legislation (the Inland Revenue Ordinance) to avoid double non-taxation. As from assessment year 2019/20, no exemption from HK salaries tax will be available if the remuneration of a HK tax resident for providing services outside HK as a visiting teacher or researcher is exempt from local tax under an applicable tax agreement (or arrangement). Therefore, HK teachers and researchers visiting Mainland China cannot be exempt from salaries tax in HK if their income is exempt from tax in Mainland China under the fifth protocol, even if the relevant services are provided entirely outside HK.

It also is noteworthy that the existing articles on teachers and researchers in Mainland China’s tax treaties generally do not require an individual to be employed by One Side before visiting the Other; however, the fifth protocol explicitly introduces such a requirement.

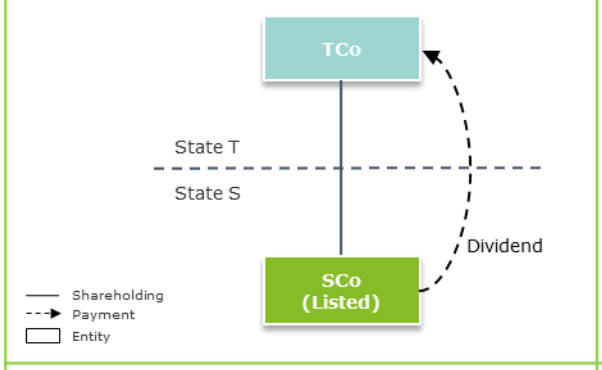
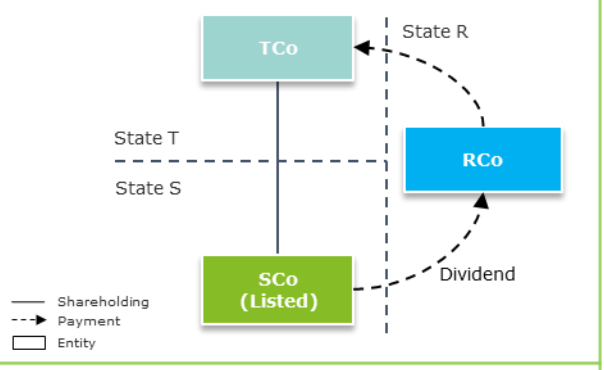
PPT

The fourth protocol to the Arrangement signed in 2015 incorporated the PPT concept to some degree, and the fifth protocol further refines it by providing that "a benefit under the Arrangement shall not be granted if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of the Arrangement."

The amended provision on the PPT is consistent with that in the MLI, and similar provisions have been used in some other agreements signed by Mainland China and HK with other jurisdictions.[10] The BEPS Action 6 Report states that the reference to "one of the principal purposes" under the provision means that obtaining the benefit under a tax treaty need not to be the sole or dominant purpose of a particular arrangement or transaction; it is sufficient that at least one of the principal purposes is to obtain the benefit. Therefore, the amendment in the fifth protocol is more restrictive as compared to the PPT provision in the fourth protocol. However, the exception added in the amended provision leaves room for taxpayers to demonstrate that they should not be denied treaty benefits where granting the benefits would be in accordance with the object and purpose of the relevant provisions of the Arrangement.

The BEPS Action 6 Report includes examples that illustrate the application of the amended PPT provision, including situations in which treaty benefits would be denied (an unfavorable result) and situations in which treaty benefits could be granted (a favorable result):

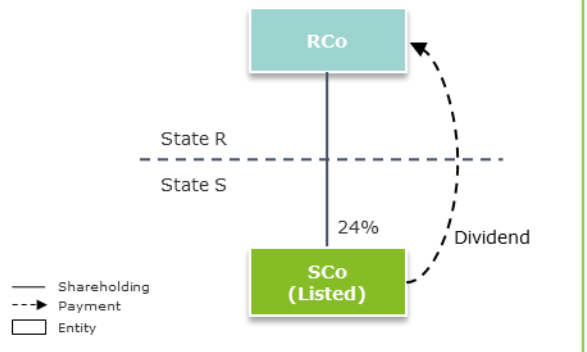
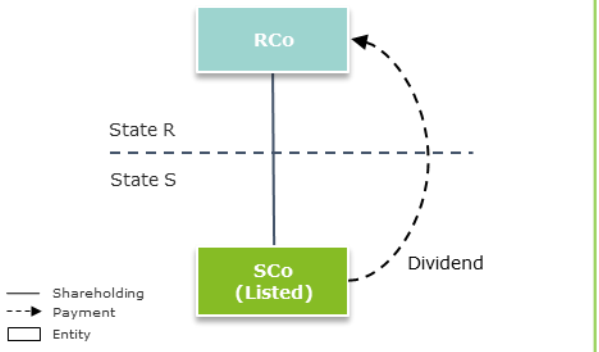
Unfavorable result:

<table>
<tr><th>Original structure</th><th>Target structure</th></tr>
<tr><td> 
</td><td> 
</td></tr>
<tr><td>State T does not have a tax treaty with State S and, therefore, any dividend paid by SCo to TCo is subject to a 25% withholding tax in accordance with the domestic law of State S</td><td>Under the State R-State S tax treaty, however, there is no withholding tax on dividends paid by a company resident in a Contracting State and beneficially owned by a company resident in the other Contracting State, provided relevant conditions are satisfied</td></tr>
</table>

In this example, TCo enters into an agreement with RCo, an independent financial institution resident of State R, under which TCo assigns to RCo the right to the payment of dividends that have been declared but have not yet been paid by SCo. "In this example, in the absence of other facts and circumstances showing otherwise, it would be reasonable to conclude that one of the principal purposes for the arrangement under which TCo assigned the right to the payment of dividends to RCo was for RCo to obtain the benefit of the exemption from source taxation of dividends provided for by the State R-State S tax convention and it would be contrary to the object and purpose of the tax convention to grant the benefit of that exemption under this treaty-shopping arrangement."

[10] For example, the tax treaties between Mainland China and Chile, Italy, New Zealand, Spain, etc., and the tax agreements between HK and Belarus, Finland, Pakistan, etc.

Favorable result:

Original structure	Target structure
	
RCo is a company resident in State R that, for the last five years, has held 24% of the shares of SCo, a company resident in State S	Following the entry into force of a tax treaty between States R and S, RCo decides to increase to 25% its ownership of the shares of SCo, primarily to obtain the benefit of a lower dividend withholding tax rate under the State R-State S tax treaty

In this example, although one of the principal purposes for the transaction through which the additional shares are acquired is clearly to obtain the benefit of the treaty, the PPT would not necessarily prevent the granting of treaty benefits because it may be established that granting the benefits in these circumstances would be in accordance with the object and purpose of the provision. The dividends article in the treaty uses an arbitrary threshold of 25% for the purposes of determining which shareholders are entitled to the benefit of a lower withholding tax rate, and it is consistent with the intent of the provision to grant the benefits of the rate reduction to a taxpayer that genuinely increases its participation in a company to meet this requirement.

Observations and comments

The fifth protocol incorporates into the Arrangement relevant results of the BEPS project that has been carried out by the international community in recent years and is in line with the latest developments in international tax. It should facilitate the promotion of economic and investment exchanges between Mainland China and HK. From a tax practice perspective, the amendments in the fifth protocol may add uncertainties to transactions between Mainland China and HK persons, e.g. regarding the feasibility and efficiency of determining the tax residence of dual resident entities through mutual agreement, the risk of constituting an agency PE, how to apply the PPT in practice, etc. As Mainland China gradually incorporates the relevant provisions of the MLI into more of its tax treaties, such uncertainties may arise more frequently, and the future implementation of treaties may become more complex, which will pose greater tax administration and compliance management challenges for multinational corporations or companies with cross-border transactions.

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Beijing
Andrew Zhu
Partner
Tel: +86 10 8520 7508
Fax: +86 10 8518 7326
Email: andzhu@deloitte.com.cn

Chengdu
Frank Tang / Tony Zhang
Partner
Tel: +86 28 6789 8188 / 8008
Fax: +86 28 6500 5161
Email: ftang@deloitte.com.cn
tonzhang@deloitte.com.cn

Chongqing
Frank Tang / Tony Zhang
Partner
Tel: +86 23 8823 1208 / 1216
Fax: +86 23 8859 9188
Email: ftang@deloitte.com.cn
tonzhang@deloitte.com.cn

Dalian
Jihou Xu
Partner
Tel: +86 411 8371 2888
Fax: +86 411 8360 3297
Email: jihxu@deloitte.com.cn

Guangzhou
Victor Li
Partner
Tel: +86 20 8396 9228
Fax: +86 20 3888 0121
Email: vicli@deloitte.com.cn

Hangzhou
Qiang Lu/ Fei He
Partner
Tel: +86 571 2811 1901
Fax: +86 571 2811 1904
Email: qilu@deloitte.com.cn
fhe@deloitte.com.cn

Harbin
Jihou Xu
Partner
Tel: +86 451 8586 0060
Fax: +86 451 8586 0056
Email: jihxu@deloitte.com.cn

Hong Kong
Sarah Chin
Partner
Tel: +852 2852 6440
Fax: +852 2520 6205
Email: sachin@deloitte.com.hk

Jinan
Beth Jiang
Partner
Tel: +86 531 8518 1058
Fax: +86 531 8518 1068
Email: betjiang@deloitte.com.cn

Macau
Raymond Tang
Partner
Tel: +853 2871 2998
Fax: +853 2871 3033
Email: raytang@deloitte.com.hk

Nanjing
Frank Xu / Rosemary Hu
Partner
Tel: +86 25 5791 5208 / 6129
Fax: +86 25 8691 8776
Email: frakxu@deloitte.com.cn
roshu@deloitte.com.cn

Shanghai
Maria Liang
Partner
Tel: +86 21 6141 1059
Fax: +86 21 6335 0003
Email: mliang@deloitte.com.cn

Shenyang
Jihou Xu
Partner
Tel: +86 24 6785 4068
Fax: +86 24 6785 4067
Email: jihxu@deloitte.com.cn

Shenzhen
Victor Li
Partner
Tel: +86 755 3353 8113
Fax: +86 755 8246 3222
Email: vicli@deloitte.com.cn

Suzhou
Kelly Guan
Partner
Tel: +86 512 6289 1297
Fax: +86 512 6762 3338
Email: kguan@deloitte.com.cn

Tianjin
Bill Bai
Partner
Tel: +86 22 2320 6699
Fax: +86 22 8312 6099
Email: bilbai@deloitte.com.cn

Wuhan
Gary Zhong
Partner
Tel: +86 27 8526 6618
Fax: +86 27 6885 0745
Email: gzhong@deloitte.com.cn

Xiamen
Jim Chung
Partner
Tel: +86 592 2107 298
Fax: +86 592 2107 259
Email: jichung@deloitte.com.cn

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National Tax Technical Centre
Email: ntc@deloitte.com.cn

National Leader/Northern China
Julie Zhang
Partner
Tel: +86 10 8520 7511
Fax: +86 10 8518 1326
Email: juliezhang@deloitte.com.cn

Eastern China
Kevin Zhu
Partner
Tel: +86 21 6141 1262
Fax: +86 21 6335 0003
Email: kzhu@deloitte.com.cn

Southern China (Hong Kong)
Sarah Chan
Partner
Tel: +852 2852 1628
Fax: +852 2520 6205
Email: sarahchan@deloitte.com.hk

Southern China (Mainland/Macau)
German Cheung
Director
Tel: +86 20 2831 1369
Fax: +86 20 3888 0121
Email: gercheung@deloitte.com.cn

Western China
Tony Zhang
Partner
Tel: +86 28 6789 8008
Fax: +86 28 6317 3500
Email: tonzhang@deloitte.com.cn

If you prefer to receive future issues by soft copy or update us with your new correspondence details, please notify Wandy Luk by either email at wanluk@deloitte.com.hk or by fax to +852 2541 1911.

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