

Arrangement between the Mainland of China and the HKSAR for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion

**BUSINESS PROFITS
INCOME FROM IMMOVABLE PROPERTY
INCOME FROM INVESTMENT
GAINS FROM ALIENATION OF PROPERTY**



Inland Revenue Department
Hong Kong Special Administrative Region of the
People's Republic of China

Introduction

This pamphlet is applicable to the “Arrangement between the Mainland of China 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 Comprehensive Arrangement”) signed on 21 August 2006, and provides a brief explanation of how the Comprehensive Arrangement applies to the taxation of business profits, income from immovable property, income from investment and gains from alienation of property.

In Hong Kong, the Comprehensive Arrangement applies to income derived in any year of assessment commencing on or after 1 April 2007; and in the Mainland, in any year commencing on or after 1 January 2007.

The Comprehensive Arrangement performs the function of allocating taxing rights over income between Hong Kong and the Mainland. Both Sides will still refer to their respective domestic taxation legislation to decide whether and how to exercise such rights.

Additional Pamphlets

- **Certification of Resident Status**

Provides information on the definition of Hong Kong and Mainland residents under the Comprehensive Arrangement and how to verify their resident status.

- **Income from Personal Services**

Provides information on how the Comprehensive Arrangement applies to the taxation of income from personal services.

BUSINESS PROFITS

Taxing principle

1. The profits of an enterprise of the Mainland shall be taxable only in the Mainland unless the enterprise carries on business in Hong Kong through a permanent establishment situated in Hong Kong. In the latter case, its profits may be taxed in Hong Kong, but only so much of them as is attributable to that permanent establishment. Likewise, the profits of an enterprise of Hong Kong shall be taxable only in Hong Kong unless it carries on business in the Mainland through a permanent establishment situated therein.

Permanent Establishment

Concept of a permanent establishment

2. A permanent establishment is a fixed place of business through which the business activities of an enterprise are carried on. There is no qualification on the scale or the form of the place of business. A permanent establishment will normally have the following features:

- (1) it must be a place of business;
- (2) it must be a fixed place of business with a certain degree of permanence;
- (3) the enterprise must carry on the whole or a part of its business through this fixed place of business.

3. The term “permanent establishment” includes especially “a place of management; a branch; an office; a factory; a workshop; a mine, an oil or gas well, a quarry or any other place of extraction of natural resources”.

A building site, a construction, assembly or installation project

4. Pursuant to the Comprehensive Arrangement, chargeability of profits in respect of contracting work will be governed by the duration of the work. An enterprise of the Mainland will be deemed to have a permanent establishment in Hong Kong only if the contracting work carried out in Hong Kong lasts more than six months. Profits attributed to that permanent establishment will be subject to tax in Hong Kong. Profits in respect of contracting work of a shorter duration will not be subject to tax in Hong Kong. Similarly, an enterprise of Hong Kong will not be regarded as having a permanent establishment in the Mainland if the contracting work carried out in the Mainland does not last more than six months and accordingly will not be subject to tax there.

Provision of services by an enterprise

5. An enterprise of One Side (i.e. an enterprise of the Mainland or an enterprise of Hong Kong) is regarded as having a permanent establishment in the Other Side if it furnishes

services, including consultancy services, directly (e.g. a sole proprietor) or through employees or other personnel engaged by it, in that Other Side (for the same or a connected project) for a period or periods aggregating more than 6 months within any 12-month period. In such a case, profits attributed to that permanent establishment will be subject to tax in that Other Side.

Preparatory or auxiliary activities

6. The following business activities are not permanent establishments, even if the activity is carried on through a fixed place of business:

- (1) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;
- (2) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;
- (3) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;
- (4) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, or of collecting information, or of carrying on any other activity of a preparatory or auxiliary character, for the enterprise;
- (5) the maintenance of a fixed place of business solely for any combination of the activities mentioned in subparagraphs (1) to (4) above, provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.

Business agent

7. An enterprise of Hong Kong will be deemed to have a permanent establishment in the Mainland if a dependent agent (i.e. an agent acting under the control and leadership of that enterprise) is acting in the Mainland on behalf of that enterprise and has, and habitually exercises, an authority to conclude contracts in the name of that enterprise.

8. An enterprise of the Mainland will be deemed to have a permanent establishment in Hong Kong if a dependent agent is acting in Hong Kong on behalf of that enterprise and has,

and habitually exercises, an authority to conclude contracts in the name of that enterprise. Furthermore, if the dependent agent is not a final signatory to a contract but participates in detailed negotiations and formulates the contract provisions on behalf of the Mainland enterprise, the Mainland enterprise will still be deemed to have a permanent establishment in Hong Kong.

9. An enterprise of One Side will not be deemed to have a permanent establishment in the Other Side if its activities in that Other Side are conducted through an independent agent who is acting in the ordinary course of its business.

Computation of business profits

10. Provided that the principles as set out in the Comprehensive Arrangement are followed, both the Mainland and Hong Kong may compute profits in accordance with their own relevant domestic law. In Hong Kong, assessable profits are based on profits computed by enterprises in accordance with the prevailing generally accepted principles of commercial accounting as adjusted in conformity with the provisions of the Inland Revenue Ordinance.

INCOME FROM IMMOVABLE PROPERTY

11. A resident of One Side (i.e. a resident of the Mainland or a resident of Hong Kong) who derived income from immovable property (including income from agriculture or forestry) situated in the Other Side may be taxed in that Other Side.

12. “Income from immovable property” means the income derived from the use of immovable property without transfer of ownership. The income may be derived from the direct use of immovable property by the owner, or from letting or use in any other form of immovable property.

SHIPPING, AIR AND LAND TRANSPORT

13. Revenue and profits derived by an enterprise of One Side (i.e. an enterprise of the Mainland or an enterprise of Hong Kong) from the operation of ships, aircraft or land transport vehicles in shipping, air and land transport businesses (except when the ship,

aircraft or land transport vehicle is operated solely between places in the Other Side) shall be exempt from tax in the Other Side. The taxes exempted in the Mainland include Enterprises Income Tax and Business Tax.

INCOME FROM INVESTMENT — DIVIDENDS, INTEREST AND ROYALTIES

14. Investment income arising in Hong Kong derived by a resident of the Mainland may be taxed in Hong Kong. Yet, the taxing right of the Mainland remains unaffected. In other words, both the Mainland and Hong Kong are given the right to tax the same item of investment income. Likewise, investment income arising in the Mainland derived by a resident of Hong Kong may be taxed both in the Mainland and Hong Kong.

15. The Comprehensive Arrangement has set limits on the tax rates that the Side of source of investment income may impose. More particularly, notwithstanding the provisions of any domestic laws of the Side of source, the tax imposed on investment income derived by a resident of the Other Side (being a “beneficial owner” as described below) should not exceed the amount provided for in the Comprehensive Arrangement.

16. “Beneficial owner” may be an individual, a company or a trust, and is the person who actually receives the benefit and fully controls the income. For example, if the investment income is received by a unit trust, the beneficial owner is the unit trust itself, and is not the individual beneficiary of the unit trust. Where the recipient of the investment income does not actually receive the economic benefit of the income concerned, but only collects it in the capacity of an agent or a nominee and will subsequently transfer the income to the actual owner in accordance with a contract or law, such an agent or a nominee will not be deemed to be the beneficial owner of the income.

17. It should be noted that if the beneficial owner of an investment income carries on business in the Side of source through a permanent establishment situated therein and the right or property in respect of which that investment income is paid is effectively connected with that permanent establishment, that investment income will be taxable as part of the profits of that permanent establishment in accordance with the provisions relating to Business Profits. Accordingly, the limitation of tax rates as provided for that investment income in the Comprehensive Arrangement will have no application.

Dividends

18. Dividends paid by a Mainland resident company to a resident of Hong Kong may be taxed both in Hong Kong and the Mainland. However, the tax so charged in the Mainland shall not exceed:

- (1) where the Hong Kong resident is a company directly owning at least 25% of the capital of the Mainland company, 5% of the gross amount of the dividends;
- (2) in any other case, 10% of the gross amount of the dividends.

19. As dividends are not chargeable to tax in Hong Kong, the limitation of tax rates has no practical application in cases where Hong Kong resident companies pay out dividends.

Interest

20. Interest arising in the Mainland and received by a resident of Hong Kong may be taxed both in Hong Kong and the Mainland. The limitations of tax rates in the Mainland are as follows:

- (1) the tax charged will not exceed 7% of the gross amount of the interest, except in the following situation;
- (2) interest is exempt from tax in the Mainland if it is received by the Government of Hong Kong or any other institutions mutually recognized by the competent authorities of both Sides.

21. As Hong Kong only taxes interest arising in Hong Kong from business carried on in Hong Kong, the limitation of tax rates does not have any practical application in Hong Kong.

Royalties

22. The taxation principles and the criteria for determining the locality of the source of royalties are the same as those for interest. Regarding the limitation of tax rate in the Side of source, it is 7% of the gross amount of the royalties in all cases.

23. Where a resident of the Mainland receives royalties which are deemed to be chargeable to tax under paragraphs (a), (b) and (ba) of section 15(1) of the Inland Revenue Ordinance, the Mainland resident is taxed at the following rates by virtue of section 21A (1)(b);

- (1) corporations – at a tax rate of 17.5% on 30% of the gross amount, i.e. 5.25% of the gross amount;
- (2) persons other than corporations – at a tax rate of 16% on 30% of the gross amount, i.e. 4.8% of the gross amount.

Since the tax limit of 7% under the Comprehensive Arrangement is higher than the rates mentioned above, royalties arising in Hong Kong and received by the Mainland resident will be taxed at the effective rate (i.e. 5.25% or 4.8%) instead of the rate as provided for in the Comprehensive Arrangement.

24. Where a resident of the Mainland receives royalties which are deemed to be chargeable to tax under section 15(1)(d) of the Inland Revenue Ordinance (for example, hire charges for the use of or the right to use industrial, commercial and scientific equipment in Hong Kong), the taxation of such a resident may be affected by the Comprehensive Arrangement. Examples are as follows:

Example 1

Company A, a resident of the Mainland, derives from Hong Kong royalties of \$900,000 during the year from 1 April 2007 to 31 March 2008. After deduction of allowable expenses and depreciation allowances in respect of the relevant equipment, the amount of assessable profits of Company A is \$500,000 and the tax payable thereon is \$87,500 (i.e. 9.7% of the gross amount), calculated at the rate of 17.5%.

As the tax rate provided for in the Comprehensive Arrangement is 7% of the gross amount of royalties (i.e. \$900,000 x 7%), the tax payable by Company A will be reduced to \$63,000.

Example 2

Same as Example 1 except that the amount of assessable profits of Company A is \$300,000 and the tax payable thereon is \$52,500 (i.e. 5.8% of the gross amount), calculated at the rate of 17.5%.

As the tax rate provided for in the Comprehensive Arrangement is 7% of the gross amount of royalties, the tax payable remains as \$52,500, unaffected by the Comprehensive Arrangement.

GAINS FROM ALIENATION OF PROPERTY

25. The Comprehensive Arrangement does not distinguish as to the nature of the gains from the alienation of property. Accordingly, gains may include gains of a capital nature and gains of a revenue nature (speculative gains).

Immovable property and movable property forming part of the business property of a permanent establishment

26. Gains derived by a resident of the Mainland from the alienation of immovable property situated in Hong Kong may be taxed in Hong Kong. Likewise, gains derived by a resident of Hong Kong from the alienation of immovable property situated in the Mainland may be taxed in the Mainland.

27. Gains derived from the alienation of movable property forming part of the business property of a permanent establishment which an enterprise of One Side (i.e. an enterprise of the Mainland or an enterprise of Hong Kong) has in the Other Side, including such gains from the alienation of such a permanent establishment, may be taxed in that Other Side.

Ships, aircraft or land transport vehicles and movable property pertaining to the transport business

28. Gains derived by an enterprise of One Side (i.e. an enterprise of the Mainland or an enterprise of Hong Kong) from the alienation of ships or aircraft or land transport vehicles operated in shipping, air and land transport or movable property pertaining to the operation of such ships, aircraft or land transport vehicles, shall be taxable only in that Side.

Shares

29. Where the assets of a company are comprised, directly or indirectly, mainly of immovable property situated in Hong Kong, gains derived from the alienation of shares in

that company may be taxed in Hong Kong. Likewise, gains from the alienation of shares in a company the assets of which are comprised, directly or indirectly, mainly of immovable property situated in the Mainland may be taxed in the Mainland. In determining whether the assets of a company are comprised “mainly” of immovable property, both the Mainland and Hong Kong take 50% as the benchmark. Where the value of immovable property is not less than 50% of the value of the total assets of a company, the assets of that company will be deemed to be comprised mainly of immovable property.

30. Gains derived from the alienation of shares, other than shares referred to in paragraph 29 above, of not less than 25% of the entire shareholding of a company which is a resident of Hong Kong may be taxed in Hong Kong. If that company is a resident of the Mainland, then such gains may be taxed in the Mainland.

Any other property

31. Gains derived from the alienation of any property, other than those referred above, shall be taxable only in the Side of which the alienator is a resident.

HONG KONG ENTERPRISE CARRYING ON BUSINESS IN THE MAINLAND UNDER CONTRACT PROCESSING ARRANGEMENT

32. In accordance with paragraphs 13 to 19 of Departmental Interpretation & Practice Notes No. 21 (Revised 1998), a Hong Kong manufacturer who concludes a contract processing arrangement with a Mainland entity, may have 50% of his profits regarded as arising outside Hong Kong and not chargeable to Profits Tax in Hong Kong. This method of apportioning profits that arise both inside and outside Hong Kong on a 50:50 basis remains applicable after the Comprehensive Arrangement is effective.

Additional Information Available

- For more detailed information, please refer to the Departmental Interpretation & Practice Note No. 44, which is available at the website of the Department: “www.ird.gov.hk”.
- For further enquiries, please call the Department on 2594 1500.