Inland Revenue Department
Hong Kong

DEPARTMENTAL INTERPRETATION AND PRACTICE NOTES

NO. 44(REVISED)

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

These notes are issued for the information of taxpayers and their tax representatives. They contain the Department's interpretation and practices in relation to the law as it stood at the date of publication. Taxpayers are reminded that their right of objection against the assessment and their right of appeal to the Commissioner, the Board of Review or the Court are not affected by the application of these notes.

These notes replace those issued in April 2007.

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Commissioner of Inland Revenue

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INTRODUCTION

On 11 February 1998, representatives of the Mainland of China ("the Mainland") and the Hong Kong Special Administrative Region ("Hong Kong") signed a Memorandum that detailed an "Arrangement between the Mainland of China and the Hong Kong Special Administrative Region for the Avoidance of Double Taxation on Income" ("the Limited Arrangement"). The Limited Arrangement covers mainly business profits of an enterprise operating through a permanent establishment, shipping, air or land transport income, as well as income from personal services. Some two years later, on 2 February 2000, the Mainland and Hong Kong signed the "Air Services Arrangement between the Mainland of China and the Hong Kong Special Administrative Region" ("the Air Services Arrangement").

2. However, with China's subsequent accession to the World Trade Organisation and the increasingly close economic ties between the Mainland and Hong Kong, both the Mainland and Hong Kong considered it necessary to expand the Limited Arrangement into a comprehensive arrangement for the avoidance of double taxation, i.e. one on a par with international standards. Accordingly, on 21 August 2006, the Mainland and Hong Kong signed an "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"), to eliminate any situation of double taxation that might otherwise be faced by a Mainland or Hong Kong investor in the conduct of cross-border economic activities. In the lead up to the signing, differences in the interpretation of some of the provisions of the Comprehensive Arrangement were identified by both Sides during the course of negotiations. However, neither the Mainland nor Hong Kong had any desire to engage in prolonged discussions that could hinder the early implementation of the Comprehensive Arrangement. Hence, the differences were put aside for further deliberation in the post implementation stage. Both Sides then resumed discussions and consensus was reached on the interpretation and implementation of the outstanding issues. The Mainland and Hong Kong exchanged letters ("the exchange letters") and formally signed the "Second Protocol 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 Second Protocol") on 11 September 2007 and 30 January 2008 respectively.

ARRANGEMENT FOR THE AVOIDANCE OF DOUBLE TAXATION

3. For the purpose of giving effect to the Comprehensive Arrangement, an Order ("Specification of Arrangements (the Mainland of China) (Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income) Order") was made by the Chief Executive in Council on 27 October 2006, under section 49 of the Inland Revenue Ordinance (Cap. 112) ("the Ordinance"). The Order was published in the Gazette as Legal Notice 234 of 2006. For the purpose of giving effect to the Second Protocol, an Order ("Specification of Arrangements (the Mainland of China) (Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income) (Second Protocol) Order") was made by the Chief Executive in Council on 15 April 2008. The Order was published in the Gazette as Legal Notice 89 of 2008.

4. The purpose of the Comprehensive Arrangement is to allocate the right to tax between the two Sides on a reasonable basis so as to avoid double taxation of the same item of income in both Sides. The provisions of the Comprehensive Arrangement have been made by reference to those contained in the Model Tax Conventions of the Organisation for Economic Co-operation and Development (the "OECD") and the United Nations. Appropriate modifications have been made to cope with the particular requirements of the Mainland and Hong Kong. In the interpretation and application of the provisions of the Comprehensive Arrangement, both Sides will refer to the Vienna Convention on the Law of Treaties (1969), the Commentaries on the relevant Articles of the Model Tax Conventions of the OECD and the United Nations, as well as to their respective principles of interpretation of taxation law.

RELATIONSHIP BETWEEN THE COMPREHENSIVE ARRANGEMENT AND THE ORDINANCE

5. The Comprehensive Arrangement has been implemented in accordance with section 49 of the Ordinance and accordingly has legal effect. The Comprehensive Arrangement and the Ordinance (including subsidiary legislation) are interrelated and complement each other. For matters falling within its scope, the Comprehensive Arrangement performs the function of allocating the right to tax between the two Sides. When the right to tax has been allocated, both Sides will continue to refer to their respective domestic taxation legislation to resolve problems of tax administration and enforcement, such as in deciding whether certain income should be subject to tax, and in the computation of assessable income and tax payable.

6. In handling problems arising from any inconsistency between the Comprehensive Arrangement and the Ordinance, priority will be accorded to the Comprehensive Arrangement to ensure compliance with its provisions. Hong Kong adopts the "preferential treatment" principle, i.e. where the Comprehensive Arrangement and the Ordinance contain different provisions relating to the same matter, preference will be given to the provisions that are most beneficial to the taxpayers. For example, if a Mainland resident renders employment services in Hong Kong but does not meet the exemption conditions stipulated in Article 14 (e.g. his remuneration is paid by a Hong Kong employer), he will still be exempt from tax under the Ordinance if his visit to Hong Kong in the year of assessment concerned does not exceed a total of 60 days.

7. The Comprehensive Arrangement should not affect existing concessional practices in Hong Kong. Take for example the case of a Hong Kong manufacturer who concludes a contract processing arrangement with a Mainland entity. In accordance with paragraphs 13 to 19 of Departmental Interpretation and Practice Notes No. 21 (Revised 1998), 50% of his profits may be regarded as profits 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. According to the provisions of the Comprehensive Arrangement, the Hong Kong manufacturer could be regarded as having a permanent establishment in the Mainland and is therefore liable to tax there. However, it is noted that it is

not the present intention of the Mainland to change the way it taxes profits derived from this type of operation. Nevertheless, the possibility that in future profits attributable to the permanent establishment may be taxed in accordance with the Comprehensive Arrangement cannot be ruled out.

EFFECTIVE DATES AND APPLICABLE TEXT

8. The Comprehensive Arrangement entered into force on 8 December 2006. In the Mainland, the provisions of the Comprehensive Arrangement shall apply to income derived in taxable years beginning on or after 1 January 2007; and in Hong Kong, in years of assessment beginning on or after 1 April 2007. The exchange letters became effective on 11 September 2007 that was the date of signature and the Second Protocol became effective on 11 June 2008.

9. A Hong Kong enterprise may adopt the end date of a year of assessment as its accounting date, i.e. 31 March, or any other date falling within that year of assessment. The "basis period" for the enterprise will be the year ending on the accounting date that falls within that year of assessment. The basis period for the year of assessment 2007/08 may therefore commence as early as 2 April 2006 (i.e. the period from 2 April 2006 to 1 April 2007 as the basis period for the year of assessment 2007/08). Income derived during that basis period will be dealt with in accordance with the provisions of the Comprehensive Arrangement.

10. In Hong Kong, since the policy of bilingual legislation is in place, both the English and the Chinese texts of the Comprehensive Arrangement are legally binding. It stands to reason, however, since the Comprehensive Arrangement is written in the Chinese language only, that any negotiation between the Mainland and Hong Kong on the implementation of the Comprehensive Arrangement would be conducted with reference to the Chinese text.

Article 1 PERSONS COVERED

11. The stated purpose of the Comprehensive Arrangement is for the avoidance of double taxation in both Sides. The Comprehensive Arrangement only applies to persons who are residents of One Side or both Sides. The terms "resident of the Mainland" and "resident of Hong Kong" are defined in paragraph 1 of Article 4.

Article 2 TAXES COVERED

12. In contrast to the Limited Arrangement, the Comprehensive Arrangement adds property tax as one of the taxes of Hong Kong under its coverage. More particularly, the existing taxes covered by the Comprehensive Arrangement are profits tax, salaries tax and property tax, whether or not the tax is charged under personal assessment, in Hong Kong; and individual income tax, foreign investment enterprises income tax and foreign enterprises income tax in the Mainland. According to Article 1 of the Second Protocol, in the Mainland the existing taxes covered by the Comprehensive Arrangement starting from 2008 are individual income tax and enterprise income tax. Other taxes do not come within the scope of the Comprehensive Arrangement (except that business tax is included in the Mainland for the purposes of Article 8 of the Comprehensive Arrangement, see paragraph 67 below).

13. The Comprehensive Arrangement applies to all income that is subject to the abovementioned taxes, including taxes on gains from the alienation of movable and immovable property and taxes on capital appreciation. As such, receipts of capital nature come within the scope of the Comprehensive Arrangement. However, it is left to the domestic law of each Side to decide whether receipts of capital nature should be taxed.

14. The Comprehensive Arrangement will also apply to any identical or substantially similar taxes that are imposed after the date of signature of the Comprehensive Arrangement in addition to, or in place of, the existing taxes as well as any other taxes falling within Article 2 which may be imposed in future.

Article 3 GENERAL DEFINITIONS

15. To facilitate the accurate interpretation and implementation of the Comprehensive Arrangement by both Sides, definitions of some of its key terms have been included in Article 3.

16. The term "person" has been defined widely in the Comprehensive Arrangement to include an individual, a company, a trust, a partnership and any other body of persons.

17. The term "enterprise" applies to the carrying on of business activities of any form. The term "business" includes the performance of professional services and other activities of an independent character. The terms "enterprise of One Side" and "enterprise of the Other Side" mean respectively "an enterprise carried on by a resident of One Side", and "an enterprise carried on by a resident of the Other Side". An enterprise carried on by a resident includes an enterprise carried on by a resident company, a resident individual, a resident partnership, or a resident body of persons.

18. Paragraph 3 of Article 3 expressly states that as regards the application of the Comprehensive Arrangement by One Side (e.g. tax is imposed in accordance with the Comprehensive Arrangement), any term not defined therein shall, unless the context otherwise requires, have the meaning which it has at the time of the application under the laws of that Side concerning the relevant taxes.

Article 4 RESIDENT

19. In view of the differences between the taxation systems in the Mainland and Hong Kong, both Sides define the term "resident of One Side" differently.

20. The Mainland basically follows the Model Tax Convention of the OECD with its definition of the term "resident of the Mainland"[1]. Since Hong Kong adopts a territoriality concept of taxation, tax is only imposed upon income derived from Hong Kong. No one is liable to tax in Hong Kong merely because of his resident status. As such, Hong Kong is not in a position to adopt the definition provided in the OECD Model Tax Convention. Instead, a detailed definition of "resident of Hong Kong" has been included in the Comprehensive Arrangement to enable taxpayers to ascertain whether they are entitled to the benefits of the Comprehensive Arrangement. It should be noted, however, that the definition of "resident of Hong Kong"(香港居民) in the Comprehensive Arrangement is different from the meaning given to "a resident person"(居港者) in section 20AB of the Ordinance. With regard to the latter, the Ordinance makes it clear that the meaning applies only to the interpretation of provisions relating to offshore funds.

(I) Resident individual

21. In Hong Kong, a resident individual means:

(1) an individual who ordinarily resides in Hong Kong;

(2) an individual who stays in Hong Kong for more than 180 days during the relevant year of assessment or for more than 300 days in two consecutive years of assessment (one of which is the relevant year of assessment).

22. It is generally considered that an individual "ordinarily resides" in Hong Kong if he has a permanent home in Hong Kong where he or his family lives. Other relevant factors include the duration of his stay in Hong Kong, whether he has a permanent place of residence in Hong Kong, whether he owns any property overseas for residential purposes, and whether he is primarily resident in Hong Kong or overseas.

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[1] According to Article 4(1) of the Comprehensive Arrangement and the amendment in Article 2 of the Second Protocol, in the Mainland "resident of One Side" refers to any person who, under the laws of the Mainland, is liable to tax therein by reason of his/its domicile, residence, place of establishment, place of effective management or any other criterion of a similar nature. This term, however, does not include any person who is liable to tax in the Mainland in respect of income from sources in the Mainland.

23. In calculating the 180 or 300 days of stay in Hong Kong, an individual will be considered to be a Hong Kong resident if he stays in Hong Kong for a period or a number of periods amounting to more than 180 days in the relevant year of assessment, or for a period or periods amounting to more than 300 days in two consecutive years of assessment (one of which is the relevant year of assessment). However, where the individual concerned is also a permanent resident of a third State and makes investment or carries on business in the Mainland, it is known that the Mainland will apply any treaty signed between China and the State of which that individual is a permanent resident. If there is no such treaty, the Mainland would consider to apply its relevant domestic laws.

24. Where, under the Comprehensive Arrangement, an individual is a resident of both Sides, his status will be determined in accordance with the order of priority set out in paragraph 2 of Article 4:

(1) he shall be deemed to be a resident only of the Side in which he has a permanent home available to him; if he has a permanent home available to him in both Sides, he shall be deemed to be a resident only of the Side with which his personal and economic relations are closer ("centre of vital interests");

(2) if the Side in which he has his centre of vital interests cannot be determined, or if he does not have a permanent home available to him in either Side, he shall be deemed to be a resident only of the Side in which he has an habitual abode;

(3) if he has an habitual abode in both Sides or in neither of them, the competent authorities of both Sides shall resolve the issue by mutual agreement.

25. If an individual who is a resident of both Sides, but deemed in accordance with the abovementioned provisions to be a resident of Hong Kong, the tax authorities will treat him as a resident of Hong Kong when applying the provisions of the Comprehensive Arrangement. The term "permanent home" in paragraphs 22 and 24 above refers to a home owned or possessed by an individual that is permanent in nature. In other words, this home must be

retained for permanent use as opposed to being for temporary stays. If the individual has a permanent home in both Sides concurrently, it is necessary to ascertain with which of the two Sides his personal and economic relations are closer. Regard will be had to his family and social relations; his occupations; his political, cultural and other activities; his place of business; and the place from which he administers his property, etc. The circumstances must be examined as a whole, but it is nevertheless obvious that considerations based on the personal acts of the individual must receive special attention.

(II) Resident company

26. Where a company is incorporated in Hong Kong, or if incorporated outside Hong Kong is normally managed or controlled in Hong Kong, it will be considered to be a resident of Hong Kong under paragraph 1(2)(iii) of Article 4. A company incorporated in Hong Kong includes a company that is incorporated as a legal entity in accordance with the Companies Ordinance (Cap. 32) of Hong Kong.

27. The concept of "normally managed or controlled in Hong Kong", as compared to that of "central management and control" established in common law, has a broader meaning as it does not require that both management and control be exercised in Hong Kong. "Management", in this context, refers to management of daily business operations, or implementation of the decisions made by top management, etc. "Control", on the other hand, refers to control of the whole business at the top level, including formulating the central policy of the business, making strategic policies of the company, choosing business financing, evaluating business performance, etc. The board of directors usually exercises "control". In other words, if the business of the company is normally managed or controlled in Hong Kong, including the management of its daily business operations, or the implementation of the decisions made by top management, or the making of top-level policies, in Hong Kong, the company will be considered to be a resident of Hong Kong. The "management" or "control" of a company may, of course, be conducted in more than one place. However, so long as a company is normally managed or controlled in Hong Kong, it will be considered to be a resident of Hong Kong. If the Hong Kong branch of an overseas bank is managed in Hong Kong, the bank will be regarded as a resident of Hong Kong. The Mainland, however, takes the view that in deciding whether an overseas bank is "normally managed

or controlled in Hong Kong"; one should consider the management or control of the bank instead of that of the branch in Hong Kong only. Hong Kong will continue to discuss with the Mainland on this point with a view to reaching a consensus.

28. While the term "normally managed or controlled" has a broader meaning than that of "central management and control", in principle, a company will only be a resident of the place in which it actually exercises its business operations or control. The conclusion is wholly one of fact. Regard will be had to factors such as the nature of business operated by the company, mode of operation, whether it has a permanent office or employs staff in Hong Kong, and whether Hong Kong is the place where its board of directors meets to formulate policy.

29. Where by reason of the definitions adopted by both Sides, a company is a resident of both Sides, its resident status will be determined in accordance with paragraph 3 of Article 4, that is, the company shall be deemed to be a resident only of the Side in which its place of effective management is situated.

30. The term "place of effective management" refers to the place where key management and strategic decisions that are necessary for the conduct of the company's business are in substance made. Under normal circumstances, it is the place where the most senior persons of a company formulate the direction and work plans of the company. A company can have only one place of effective management at any one time.

(III) Resident persons other than individuals and companies

31. It is stated in paragraph 1(2)(iv) of Article 4 that any other person constituted under the laws of Hong Kong, or if constituted outside Hong Kong, being normally managed or controlled in Hong Kong, will be considered to be a resident of Hong Kong. In Hong Kong, partnerships are the mode most likely to be encountered. In determining whether a trust, partnership or any other body of persons is normally managed or controlled in Hong Kong, the criteria are the same as those adopted in determining the resident status of a company.

Certification of resident status

32. In applying the Comprehensive Arrangement, the tax authority of the Mainland may require an individual, a company, or a body of persons to produce a certificate from the Hong Kong Inland Revenue Department certifying that the person is a "resident" of Hong Kong. This would generally only be required where there is a possibility that the person is a resident of both Sides, or there is a need to verify the resident status of the person. The relevant application forms and procedures are published on the Inland Revenue Department website (*www.ird.gov.hk*).

33. Upon receipt of an application, the Inland Revenue Department will examine the information supplied by the person, and if it is sufficient, issue a Certificate of Hong Kong Resident Status for the purposes of the Comprehensive Arrangement and the processing time normally requires 21 working days. Where the evidence available is insufficient, the Department will request the applicant to supply the additional information required.

34. In general, for a company that is incorporated in Hong Kong, a Certified Extract of Information on the Business Register or a copy of the Certificate of Incorporation of the company is sufficient evidence. An application for a Certified Extract of Information on the Business Register may be made online or in person.

35. On the other hand, where the Inland Revenue Department is unable to ascertain that a person is a resident of the Mainland from the available information, it will issue a letter referring the person to the Mainland tax authorities to issue a certificate of resident status for him. If the person is unable to produce proof of his status, he will not be entitled to the benefits of the Comprehensive Arrangement.

Article 5 PERMANENT ESTABLISHMENT

The concept of a permanent establishment

36. Three criteria, namely, space (a fixed place of business), time (continuous or aggregate periods), and function (activities of a preparatory or

auxiliary character), are used to ascertain whether the activities of an enterprise of One Side constitute a permanent establishment in the Other Side. Paragraph 1 of Article 5 generally explains that a permanent establishment is a fixed place of business through which the business activities of the 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. This may include a house, a site, equipment or facilities (such as machinery and equipment), a warehouse, and a stall used for carrying on the business of the enterprise, whether owned or rented by the enterprise.

(2) It must be a fixed place of business with a certain degree of permanence. The temporary interruption or suspension of business activities conducted at a fixed place of business will not affect the existence of a permanent establishment.

(3) The enterprise must carry on the whole or a part of its business through this fixed place of business.

37. Paragraph 2 of Article 5 provides that 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". It is clear from the words "includes especially" that the paragraph does not preclude the determination of any other place of business as a permanent establishment in accordance with the general definition of the term. It should be noted that the "place of management" mentioned in the list refers to a place of work or an office where some of the supervisory activities for an enterprise may be exercised. This is in contrast to the criteria in Article 4, i.e. the "normally managed or controlled in Hong Kong" criterion used for determining whether a person is a Hong Kong resident; the "head office" criterion used for determining whether a person is a resident of the Mainland prior to the effective date of the Second Protocol; and the "place of effective management" criterion used for resolving the issue of dual residence of both Sides. Paragraph 7 of Article 5 is also pertinent, providing that the fact that a company which is a resident of One Side controls or is

controlled by a company which is a resident of the Other Side, or which carries on business in that Other Side, will not of itself constitute either company a permanent establishment of the other.

A building site, a construction, assembly or installation project

38. The term "permanent establishment" also includes "a building site, a construction, assembly or installation project or supervisory activities in connection therewith, but only if such site, project or activities last more than 6 months". The Ordinance imposes tax on income derived from contracting work carried out in Hong Kong in accordance with the territoriality principle. The duration of the work is not a relevant factor. However, pursuant to the Comprehensive Arrangement, chargeability of profits in respect of contracting work carried out in Hong Kong by an enterprise of the Mainland 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 in accordance with the provisions of Article 7 (Business Profits) (see paragraphs 55 to 66 below). 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 contracting work carried out in the Mainland does not last more than six months and accordingly will not be subject to tax there.

39. The period for which a project is carried out is counted from the date the contractor commences work (including any preparatory activities) up until the date on which the work is totally completed and handed over to the user. If the period covers two years, the period is counted on a continuous basis straddling over the years in question. In a case where two or more sub-projects are contracted for by a person at the same site or for the same project, the period is counted from the date of commencement of the first sub-project to the date of completion of the last sub-project of that person. In other words, the respective sub-projects would not be counted separately. "Two or more sub-projects contracted for at the same site or for the same project" refers to sub-projects that would form a coherent whole commercially and geographically. Where sub-projects are situated at different localities and are contracted for in relation to different projects, the respective periods would

be counted separately. In such a case a permanent establishment would not be considered to exist in relation to a particular sub-project if it does not last more than 6 months. A project that does not last more than 6 months would not be regarded as a permanent establishment even if another project of the enterprise constitutes a permanent establishment.

40. Where, after the commencement of work, a project is suspended (but not terminated or ended) pending, for example, the arrival of equipment and materials or because of bad weather, and the persons, equipment and facilities as well as materials involved have not been completely moved out, the duration of the project will, in such a case, be counted continuously without any deduction for the days on which the project is suspended.

41. If the enterprise subcontracts part of a project to a subcontractor who commences work earlier than the contractor, then in accordance with paragraph 39 above, the duration of the entire project would be counted from the date the subcontractor commences work up to the date on which the work is totally completed and handed over to the user. This method of counting the project period does not affect the separate and independent calculation of the duration of continuous work by the subcontractor. Where a subcontractor is an enterprise of the Mainland, its subcontracted work in Hong Kong will not constitute a permanent establishment if it does not last more than six months. In such a case, exemption from profits tax in Hong Kong would be granted under the Comprehensive Arrangement to the subcontractor. On the other hand, if the subcontractor is a resident of Hong Kong operating in the Mainland, exemption from tax in the Mainland would likewise be granted under the Comprehensive Arrangement.

Provision of services by an enterprise

42. A permanent establishment also includes "the furnishing of services, including consultancy services, by an enterprise of One Side in the Other Side, directly or through employees or other personnel engaged by the enterprise, but only if such services continue (for the same or a connected project) for a period or periods aggregating more than 6 months within any 12-month period". The scope of consultancy services includes:

(1) improvement of existing production facilities and products, selection of technical know-how, or enhancement of supervisory and management skills, etc.;

(2) feasibility studies of investment projects and selection of design plans.

43. The counting of "a period or periods aggregating more than 6 months within any 12-month period" may commence with any month during the course of a service contract. Where services have been furnished by an enterprise directly or through employees or other personnel in the Other Side for a continuous or cumulative period of more than 6 months within any 12-month period, the enterprise will be considered to have a permanent establishment in the Other Side. Profits attributed to that permanent establishment will be subject to tax in the Other Side in accordance with the provisions of Article 7 (Business Profits) (see paragraphs 55 to 66 below). In the determination of whether a Mainland enterprise furnishing services should be regarded as having a permanent establishment in Hong Kong, the criterion is whether services are furnished by the enterprise directly (e.g. a sole-proprietor) or through employees or other personnel in Hong Kong for a continuous or cumulative period of more than 6 months (within any 12-month period). There is no definition of the term "month" in the Comprehensive Arrangement. The Commentary of the United Nations Model has not given further explanations of the relevant provision and has not specified clearly how the 6 months are to be counted. Hence the Mainland and Hong Kong have adopted different counting methods. The Mainland considers that since only "month" is provided as a counting unit under the Comprehensive Arrangement, she is entitled not to consider the number of days in its implementation. The Mainland adopts the following method of counting the months: the Mainland will take the period from the month in which an employee of a Hong Kong enterprise arrived in the Mainland for furnishing services up until the month in which the project was completed and the employee left the Mainland as the relevant period. If during this relevant period, no service was provided by the employee in the Mainland for a period of 30 consecutive days, 1 month can be deducted. If it results in more than 6 months by using this counting method, the Hong Kong enterprise will be considered to have a permanent establishment in the Mainland. For a project that lasts for more than 12 months, any 12-month period commencing from the month the employee

arriving in the Mainland or ending in the month leaving the Mainland during the course of the project shall be adopted for the purposes of applying the counting method. In Hong Kong, the term "month" is defined in the Interpretation and General Clauses Ordinance (Cap. 1) as "calendar month". In its ordinary meaning, month (calendar month) means a period of time between the same dates in successive calendar months; a period of around 30 days (365 days divided by 12); a period of 28 days or a period of 4 weeks. For the purposes of paragraph 3(2) of Article 5, Hong Kong considers that the term "month" to be a period of 30 days. In counting whether a Mainland enterprise has furnished services in Hong Kong "for a period or periods aggregating more than 6 months within any 12-month period", Hong Kong will add together each time period that services have been provided in Hong Kong by the Mainland enterprise directly or through its employees (irrespective of the length of the time period) within any 12-month period. If the cumulative number of days during the time period or time periods during which services have been provided in Hong Kong within that 12-month period exceeds 180 days, Hong Kong would consider that the Mainland enterprise has a permanent establishment in Hong Kong. With effect from 11 June 2008, the term "6 months" was repealed and substituted by "183 days" under Article 3 of the Second Protocol. In other words, if within any 12-month period the cumulative number of days during which services have been provided by an enterprise of One Side in the Other Side exceeds 183 days, that enterprise will be regarded as having a permanent establishment in the Other Side. For the transitional arrangement, Hong Kong agreed with the Mainland that the new "183 days" rule will only apply to those services which commenced after, and for which the employees rendering such services arrived at Hong Kong after, the effective date of the Second Protocol. For those enterprises which have commenced to provide services in Hong Kong prior to the effective date of the Second Protocol, the original "6 months" rule will still be adopted in determining whether they have a permanent establishment in Hong Kong.

Whilst the method of counting the "183 days" was not stated in the Second Protocol, both Sides will in practice use the "days of physical presence" method. The day when one is in the Other Side, and the day of arrival or departure, irrespective of the duration and the purpose of the stay, will be counted as one day. This is because it is difficult if not impossible for the tax authority to ascertain, and for the taxpayers to prove, whether services were rendered on any particular day of presence in the jurisdictions concerned.

The place where preparatory or auxiliary activities are conducted

44. In defining a permanent establishment, the Comprehensive Arrangement excludes a fixed place of business whose activities, for the enterprise, are purely of a preparatory or auxiliary character. This is because such activities, even if carried on through a fixed place of business, are of a preparatory or auxiliary character and do not themselves directly generate profits.

45. Paragraph 4 of Article 5 lists various activities of a preparatory or auxiliary character that may be carried out for the enterprise without constituting a permanent establishment. They include:

(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, for the enterprise;

(5) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;

(6) the maintenance of a fixed place of business solely for any combination of the activities mentioned in subparagraphs (1) to (5) above, provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.

46. The purpose of paragraph 4 of Article 5 is to clarify what are accepted as genuine "representative offices" and not regarded as permanent establishments subject to tax. However, attention should be drawn to the following:

(1) the activities should be for the enterprise itself;

(2) the activities should not directly generate profits; and

(3) the function of the place of business should only be of a supportive nature. If the place of business conducts certain supervisory management functions for the enterprise or manages certain business operations, its activities would not be regarded as being of the required character. In this event, the place of business would be regarded as a place of management and would therefore constitute a permanent establishment.

Where the activities carried out in the Other Side by a representative office go beyond the exceptions set out in paragraph 4 of Article 5, the representative office would be regarded as a permanent establishment. Profits attributed to that permanent establishment would be taxed in the Other Side in accordance with the provisions of Article 7 (Business Profits) (see paragraphs 55 to 66 below).

Business agent

47. Paragraph 5 of Article 5 of the Comprehensive Arrangement expressly points out that a dependent agent (i.e. an agent acting under the control and leadership of an enterprise of One Side), who regularly acts on behalf of that enterprise in the Other Side and has, and habitually exercises, an authority to conclude contracts in the name of that enterprise, that enterprise will be deemed to have a permanent establishment in the Other Side. In Hong Kong, if a dependent agent is not a final signatory to a contract but participates in detailed negotiations and formulates the contract provisions on behalf of the relevant Mainland enterprise, that Mainland enterprise will still be deemed to have a permanent establishment in Hong Kong. Paragraph 6 of Article 5 states that 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. However, when the activities of such an agent are wholly or almost wholly performed on behalf of that enterprise, he would not be regarded as an independent agent. The scope of his duties and responsibilities and whether he has the right to conclude contracts on behalf of the enterprise would determine whether or not that enterprise has a permanent establishment in that Other Side.

Article 6 INCOME FROM IMMOVABLE PROPERTY

48. "Income from immovable property" means the income derived from the use of immovable property without transfer of ownership. Income derived from alienation of immovable property will be dealt with in accordance with the provisions of Article 13 (Capital Gains).

49. It is specifically provided in paragraph 1 of Article 6 that income derived by a resident of One Side from immovable property (including income from agriculture or forestry) situated in the Other Side may be taxed in that Other Side.

50. According to the elaboration in paragraph 3 of Article 6, income derived from immovable property may be income derived from the direct use of immovable property by the owner, such as running a farm or carrying on animal husbandry, or income derived from letting or use in any other form of immovable property.

51. To avoid possible disputes over differences in interpretation, the term "immovable property" is given the meaning which it has under the laws of the Side in which the property in question is situated. In Hong Kong, under the Interpretation and General Clauses Ordinance (Cap. 1), "immovable property" means:

(1) land, whether covered by water or not;

(2) any estate, right, interest or easement in or over any land; and

(3) things attached to land or permanently fastened to anything attached to land.

52. Apart from defining the meaning of immovable property according to the respective laws of each Side, it is specifically provided in paragraph 2 of Article 6 that certain assets and rights must always be regarded as immovable property. These assets and rights include property accessory to immovable property, livestock and equipment used in agriculture and forestry, and rights to which the provisions of general laws in respect of real estate apply. However, ships and aircraft shall never be regarded as immovable property.

53. The term "property accessory to immovable property" does not mean a simple storage in or in connection with immovable property, but refers to a component part of an essential function of the immovable property, such as an air-conditioning system or elevator of a building.

54. Paragraphs 1 and 3 of Article 6 also apply to income derived by an enterprise from immovable property. According to the rules set out above, income derived by an enterprise of One Side from immovable property situated in the Other Side may be taxed in that Other Side, regardless of whether it has a permanent establishment in that Other Side, whether the immovable property is part of that permanent establishment, or whether the income is derived through that permanent establishment.

Article 7 BUSINESS PROFITS

Allocation of taxing rights

55. Business profits refer to profits derived by an enterprise from its business activities. Under the provisions of paragraph 1 of Article 7, the profits of an enterprise of One Side shall be taxable only in that Side (i.e. the Other Side has no right to tax) unless the enterprise carries on business in the Other Side through a permanent establishment situated therein, in which case its profits may be taxed in that Other Side, but only so much of them as is attributable to that permanent establishment.

Computation of business profits

56. The Comprehensive Arrangement does not expressly specify the method for computing business profits, but instead sets out some principles which must be followed. Both Sides may compute profits in accordance with their own relevant domestic law, provided that such principles are followed. 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 Ordinance.

57. The principles stipulated in the Comprehensive Arrangement are set out in paragraphs 2 and 3 of Article 7. Paragraph 2 stipulates that a permanent establishment will be considered as a distinct and separate enterprise, while paragraph 3 contains provisions in relation to the deduction of expenses and the treatment of income.

58. Where a permanent establishment situated in the Other Side carries on business with the head office or other offices of the enterprise of which it is a permanent establishment, it should do so in accordance with the arm's length principle as between two entirely independent enterprises engaged in the same or similar activities. There will in each Side be attributed to that permanent establishment the profits which it might be expected to make under such conditions. For information concerning transfer pricing and the arm's length principle, see the relevant Departmental Interpretation and Practice Notes issued by the Inland Revenue Department.

59. In computing the profits of a permanent establishment, there will be allowed as deductions expenses (wherever incurred) that are incurred for the purposes of producing the relevant profits, including executive and general administrative expenses so incurred (including a reasonable share of the administrative expenses of the head office). Relevant expenses which can be clearly attributed to that permanent establishment can be deducted. Otherwise, an allocation of the relevant expenses should be made. The allocation can be based on the proportion of the business turnover or gross profit of the permanent establishment to that of the enterprise. The resultant expenses will be considered as the expenses actually incurred by the permanent establishment, though possibly not the amount actually paid by it.

60. A permanent establishment and its head office are one and the same legal entity. Therefore, a permanent establishment should not pay any amount to the head office for its investments or services. Paragraph 3 of Article 7 specifically sets out three categories of amounts which will not be deducted in determining the profits of a permanent establishment, whether they are paid to the head office of the enterprise or any of its other offices (other than reimbursement of actual expenses):

(1) by way of royalties, remuneration, fees or any other similar payments in return for the use of patents or other rights; or

(2) by way of commission for specific services performed or for management; or

(3) by way of interest on moneys lent to the permanent establishment, except in the case of a banking enterprise, i.e. relevant interest is deductible in such a case.

61. Likewise, the above provisions will also apply to the income of a permanent establishment, i.e. the amounts falling within the above three categories (other than reimbursement of actual expenses) charged by the permanent establishment to the head office of the enterprise or any of its other offices would not be included in determining its profits, except that in the case of a banking enterprise the relevant interest income would be included in determining the profits of the permanent establishment.

Other methods of computing profits

62. If the financial statements prepared by an enterprise can give a true view of the state of affairs of the permanent establishment, they should be used to determine the profits attributed to that permanent establishment. However, insofar as it has been customary in One Side to determine the profits to be attributed to a permanent establishment by apportioning the total profits of the enterprise to its various units or by any other methods provided for in the laws of the Side concerned, the enterprise may continue using that method. However, the result of using such a method must be in accordance with the principles contained in Article 7.

63. For banks and other persons whose head offices are situated outside Hong Kong, Rules 3 and 5 of the Inland Revenue Rules provide methods for determining the profits of their branches and permanent establishments[2] in Hong Kong. Those methods are, however, only applicable where the financial statements of the branches and permanent establishments in Hong Kong do not disclose their true profits arising in or derived from Hong Kong.

(1) Under Rule 3, the same proportion of the total profits of the bank as the assets of the Hong Kong branch bear to the total assets of the bank would be treated as profits of the Hong Kong branch. For the purposes of determining the total profits of the bank, similar adjustments for tax purposes would be made in the accounts of the bank as would have been necessary had the whole of those profits been liable to tax under the Ordinance. If the assessor is of the opinion that the above method would be inappropriate, he may estimate the amount of the profits of the Hong Kong branch.

(2) Under Rule 5, the same proportion of the total profits of the enterprise as the turnover in Hong Kong bears to the total turnover of the enterprise would be treated as profits of the permanent establishment in Hong Kong. For the purposes of determining the total profits of the enterprise, similar adjustments for tax purposes would be made in the accounts of the enterprise as would have been necessary had the whole of those profits been liable to tax under the Ordinance. If the assessor is of the opinion that the above method would be inappropriate, he may compute the amount of the profits derived from Hong Kong on a fair percentage of the turnover in Hong Kong.

Other principles

64. Paragraph 5 of Article 7 of the Comprehensive Arrangement stipulates that no profits will be attributed to a permanent establishment by reason of the

[2] "Permanent establishment" for the purposes of Rule 5 is defined to mean a "branch, management or other place of business, but does not include an agency unless the agent has, and habitually exercises, a general authority to negotiate and conclude contracts on behalf of his principal or has a stock of merchandise from which he regularly fills orders on his behalf".

mere purchase by that permanent establishment of goods or merchandise for the enterprise. This is because purchasing activities do not directly generate profits in the overall business activities. In fact, it is very difficult to compute the part of the total business profits that is attributable to such purchasing activities.

65. The profits to be attributed to the permanent establishment must be determined by the same method year by year unless there is good and sufficient reason for a change. More particularly, the method should not be changed merely because some other method would produce more favourable results.

66. "Business profits" may include, apart from profits derived from business activities, income such as that from immovable property, dividends and interest. The taxation of these categories of income is governed by other Articles of the Comprehensive Arrangement. To clarify the application of Article 7 in relation to other Articles, paragraph 7 of Article 7 provides that where profits include items of income which are dealt with separately in other Articles of the Comprehensive Arrangement, then the provisions of those Articles will not be affected by the provisions of Article 7. It should be noted, however, that some Articles contain provisions stating that the provisions of Article 7 shall apply if the relevant property in respect of which the income is paid is effectively connected with a permanent establishment. Those provisions are paragraph 4 of Article 10, paragraph 5 of Article 11, paragraph 4 of Article 12, and paragraph 2 of Article 20.

Article 8 SHIPPING, AIR AND LAND TRANSPORT

67. Article 8 provides that 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 enterprise income tax and business tax. Enterprise income tax is calculated by reference to profits whereas business tax is calculated by reference to revenue. Accordingly, the Article specifically includes revenue and profits in the scope of the exemption. Revenue and profits refer to revenue and profits derived by

an enterprise from cross-border shipping, air and land transport businesses. Revenue and profits of an enterprise derived from services provided in the Other Side (other than those from cross-border shipping, air and land transport) will not be exempt in that Other Side if such services are provided through a permanent establishment situated in that Other Side. This Article also applies to revenue and profits derived from participation in a partnership business, joint venture business or international business agency.

Shipping transport

68. Under Article 8, profits derived by a Hong Kong shipping enterprise from its shipping business will be taxed in Hong Kong alone. In this regard, the exercise of the taxing rights is subject to the provisions of section 23B of the Ordinance. For example, where an enterprise is deemed to be carrying on a business in Hong Kong as an owner of ships, "relevant sums" (as defined in section 23B(12)) does not include any sums derived from any relevant carriage shipped aboard a "registered ship" (as defined in section 23B(12)) at any location within the waters of Hong Kong and proceeding to sea therefrom. The ratio of the relevant sums to the total shipping revenue is used to apportion the worldwide shipping profits of the Hong Kong ship-owner and calculate the assessable shipping profits derived from Hong Kong. Accordingly any sums from relevant carriage shipped aboard a registered ship at any location within the waters of Hong Kong and proceeding to sea therefrom by a Hong Kong shipping enterprise will continue to be exempt from tax in Hong Kong.

Air transport

69. Likewise, profits derived by a Hong Kong air transport enterprise from its air transport business will be taxed in Hong Kong alone. According to section 23C of the Ordinance, "relevant sums" (as defined in section 23C (5)) includes any sums derived from any relevant carriage shipped in Hong Kong and any relevant charter hire. The proportion of the relevant sums to the total revenue is used to apportion worldwide aircraft profits and calculate assessable aircraft profits derived from Hong Kong. By virtue of section 23C(2A), sums from relevant carriage and charter hire from the Mainland derived by a Hong Kong air transport enterprise, that are exempt from tax in the Mainland under the Comprehensive Arrangement, are included as relevant sums in calculating profits chargeable to profits tax in Hong Kong.

Land transport

70. Article 8 is regarded as having application to a Hong Kong enterprise that carries on a business of land transport. A land transport business is subject to tax under section 14 of the Ordinance. That is, any person who carries on a land transport business in Hong Kong is chargeable to tax on the profits arising in or derived from Hong Kong.

71. According to Article 8, a Hong Kong land transport enterprise will only be subject to tax in Hong Kong and will be exempt from enterprise income tax and business tax in the Mainland. Similarly, revenue earned by a Mainland land transport enterprise from Hong Kong uplifts to the Mainland will be exempt from profits tax in Hong Kong.

72. A cross-border land transport business between the Mainland and Hong Kong usually takes the form of a cooperative enterprise. Typically the Hong Kong participant would make his investment in the form of vehicles and capital. The Mainland participant would be responsible for obtaining permits and licences, tax compliance and other management services. The Hong Kong participant would be responsible for Hong Kong uplifts and the Mainland participant for uplifts in the Mainland. Occasionally, the Hong Kong participant could enter into a contract with the customer for the return trip. This kind of cooperative enterprise is regarded as a joint business of cross-border transport operated by residents of both Sides. It follows, pursuant to paragraph 2 of Article 8, that the respective shares of profits derived by each participant from the joint business operation would be exempt from tax by the Other Side and would be taxed in the Side of which the participant is a resident in accordance with its taxation laws.

Article 9 ASSOCIATED ENTERPRISES

73. For the purpose of relieving its total tax burden, a cross-border group may, by means of altering the pricing or business charges (i.e., the transfer pricing method), attempt to transfer the profits derived by an enterprise of the group from cross-border business activities to an associated enterprise. Article 9 provides that taxation authorities may make adjustments to profits where transactions between associated enterprises have not been entered into on an arm's length basis.

Adjusting the profits of an enterprise of One Side

74. Paragraph 1 of Article 9 provides that in the following two different situations, if the commercial or financial relations between the two enterprises are different from those between independent enterprises, any profits which would have accrued to one of the enterprises but have not done so by reason of those relations, may be included in the profits of that enterprise and taxed as such. The two situations are:

(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.

Making an appropriate adjustment to the profits of an enterprise of the Other Side

75. Under the provisions of paragraph 1 of Article 9, where One Side includes in the profits of an enterprise of that Side profits of an enterprise that have been charged to tax in the Other Side, the Other Side shall make an appropriate adjustment to the amount of the tax charged on those profits in accordance with the provisions of paragraph 2.

76. Insofar as Hong Kong is concerned, "appropriate adjustment" means where the Inland Revenue Department agrees fully with the calculation of the Mainland, the Hong Kong enterprise can get an adjustment of the full amount; where the Department agrees with an amount less than that worked out by the Mainland, the Hong Kong enterprise can get an adjustment of that smaller amount; where the Department disagrees with the Mainland on the adjustment, no adjustment will be made. The competent authorities of both Sides will, if necessary, consult each other in determining such adjustment.

77. The Hong Kong enterprise can present its case to the Inland Revenue Department under Article 23 (Mutual Agreement Procedure) if its taxation treatment is not in accordance with the provisions of the Comprehensive

Arrangement. The competent authorities of both Sides would endeavour to resolve the case by mutual agreement. However, such a case must be presented within 3 years from the first notification of the action resulting in taxation not in accordance with the provisions of the Comprehensive Arrangement.

78. As the issue of transfer pricing arising from the provisions on "associated enterprises" is complicated, the Inland Revenue Department intends to publish a Departmental Interpretation and Practice Note on the subject. The Note will provide information and guidance on the time limit for claims, factors to be taken into consideration in relation to appropriate adjustments, the tax adjustment methods, etc.

INCOME FROM INVESTMENT – DIVIDENDS, INTEREST AND ROYALTIES

79. Income derived from investment activities is indirect or passive income, and is different from profits from business activities. The taxation of such income (including dividends, interest and royalties) is governed by specific Articles of the Comprehensive Arrangement.

80. Under the Comprehensive Arrangement, the key principle in relation to business profits is that an enterprise of One Side will not be taxed in the Other Side unless it carries on business in that Other Side through a permanent establishment situated therein. On the other hand, if the enterprise does carry on business in the latter manner, the profits attributable to that permanent establishment may be taxed in that Other Side. However, for investment income, the Side where the income arises has the taxing rights even if there is no permanent establishment situated therein.

81. Although the Side of the source of investment income has the taxing rights, this does not mean that the Side of which the recipient is a resident has no taxing rights. In other words, both the Side of source and the Side of residence are given the right to tax the same item of investment income (the Side of residence is required to give double taxation relief to its residents for any income doubly taxed, see paragraphs 128 to 140 below). It is specifically stipulated in the relevant provisions of the Comprehensive Arrangement that

the investment income should be taxed in the Side of source according to its laws. Thus, where the domestic laws of the Side of source provide tax relief or special tax treatment, the Comprehensive Arrangement does not affect the application of such laws. In addition, the relevant provisions of the Comprehensive Arrangement set limits on the tax rates that the Side of source 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 ("beneficial owner" that satisfies the following conditions) should not exceed the amount provided for in the Comprehensive Arrangement.

82. The Side of source will only limit its right to tax if a condition is met: the beneficial owner of the investment income must be a resident of the Other Side. "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. In other words, even though an agent or a nominee is a resident of the Other Side, the Side of source need not apply the tax limitation if the beneficial owner is not a resident of the Other Side.

83. On the other hand, as long as the "beneficial owner" is a resident of the Other Side, the limitation of tax on the income in the Side of source remains applicable, regardless of whether the agent or nominee is a resident of the Other Side at the time of the receipt of the relevant income.

Article 10 DIVIDENDS

84. Paragraph 1 of Article 10 provides that dividends paid by a company which is a resident of One Side to a resident of the Other Side, may be taxed in that Other Side, that is, the Side of residence has the right to tax the dividends. The meaning of the term "pay" is not limited to actual payment but will include

the fulfillment of the obligation to put funds at the disposal of the shareholder in the manner required by contract or by custom.

85. Paragraph 2 of Article 10 provides that such dividends may also be taxed in the Side of which the company paying the dividends is a resident (i.e. the Side of source) and according to the laws of that Side. The tax so charged, in 2 tiers, shall not exceed:

(1) where the beneficial owner is a company directly owning at least 25% of the capital of the company which pays the dividends, 5% of the gross amount of the dividends;

(2) in any other case, 10% of the gross amount of the dividends.

86. As dividends are not chargeable to tax in Hong Kong, the limitation of tax rates has no practical application in Hong Kong. It is also stipulated in paragraph 2 of Article 10 that the limitation of tax rates on dividends will not affect the taxation of the company in respect of the profits out of which the dividends are paid.

87. Paragraph 3 of Article 10 defines the term "dividends" to mean "income from shares or other rights, not being debt-claims, participating in profits" and "income from other corporate rights which is subjected to the same taxation treatment as income from shares under the laws of the Side of which the company making the distribution is a resident". The first part of the meaning makes it clear that the relevant income must be derived from shareholding rather than debt-claims. The second part links the definition to the laws of the Side of which the company paying the dividends is a resident.

88. The provisions of Article 7 (Business Profits) shall apply if the beneficial owner of the dividends, being a resident of One Side, carries on business in the Other Side (of which the company paying the dividends is a resident) through a permanent establishment situated therein, and the shareholding in respect of which the dividends are paid is effectively connected with that permanent establishment.

89. In respect of the taxation on dividends, paragraph 5 of Article 10 further provides that dividends paid by, or undistributed profits of, a company

which is a resident of One Side may not be taxed by the Other Side even if the dividends paid or the undistributed profits consist of profits or income arising in that Other Side. For example, where a Hong Kong resident company carries on business through a permanent establishment situated in the Mainland and makes profits, the relevant profits may be taxed in the Mainland under the provisions of Article 7 (Business Profits). When the Hong Kong resident company pays dividends out of its profits, the Mainland may not impose any tax on the dividends, except insofar as such dividends are paid to a resident of the Mainland, or insofar as the shareholding in respect of which the dividends are paid is effectively connected with a permanent establishment situated in the Mainland.

Article 11 INTEREST

90. The taxation principles laid down in paragraphs 1 and 2 of Article 11 are the same as those in paragraphs 1 and 2 of Article 10. What differs is that the source of interest is "the Side in which the interest arises". Under the provisions of paragraph 6 of Article 11, interest will be deemed to arise in a Side when the payer is the Government of that Side, a local authority thereof or a resident of that Side. However, where the person paying the interest has in a Side a permanent establishment in connection with which the indebtedness on which the interest is paid was incurred, and such interest is borne by that permanent establishment, then such interest will be deemed to arise in the Side in which the permanent establishment is situated. In other words, the source of interest is the Side in which the payer who effectively bears the interest is situated.

91. The limitations of tax rates in the Side in which the interest arises are in 2 tiers 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 Side of source if it is received by the Government of the Other Side or any other institutions mutually recognized by the competent authorities of both Sides. (Currently, the institutions mutually

recognized by the competent authorities of both Sides are: in the case of the Mainland, China Development Bank, The Export-Import Bank of China and Agricultural Development Bank of China, and with effect from 11 September 2007 the National Council for Social Security Fund and China Export & Credit Insurance Corporation; and in the case of Hong Kong, the Hong Kong Monetary Authority.)

92. The term "interest", as defined in paragraph 4 of Article 11, means "income from debt-claims of every kind, whether or not it is secured by mortgage or whether or not it carries a right to participate in the debtor's profits" (i.e. interest is limited to income derived from debt-claims). In addition, "income from bonds, debentures and Government securities, including premiums and prizes attaching to such bonds, debentures or securities" are interest within the meaning of the definition. Generally speaking, the difference between the amount paid to and received from an issuing institution by a subscriber is the interest on debentures. Penalty charges for late payment will not be regarded as interest.

93. The provisions of paragraphs 1, 2 and 3 of Article 11 will not apply if the beneficial owner of the interest, being the Government of One Side, a local authority thereof or a resident of that Side, carries on business in the Other Side in which the interest arises through a permanent establishment situated therein and the debt-claim in respect of which the interest is paid is effectively connected with that permanent establishment. In such a case, the provisions of Article 7 (Business Profits) will apply.

94. In a situation of the kind provided for in paragraph 7 of Article 11, the provisions of Article 11 will have limited application. Such a situation is one where, by reason of a special relation between the payer and the beneficial owner of the interest or between both of them and some other person, the amount of interest paid exceeds, for whatever reasons, the amount which would have been agreed upon in the absence of such relation. In such a case, the provisions of Article 11 will apply only to the last-mentioned amount. The excess part of the payments will remain taxable according to the laws of each Side, but due regard will still be had to the other provisions of the Comprehensive Arrangement.

95. 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.

Article 12 ROYALTIES

96. The provisions of Article 12 and the criteria for determining the locality of the source are the same as those for Article 11. Regarding the limitation of the tax rate, it is 7% of the gross amount of the royalties in all cases.

97. The definition of "royalties" as provided for in paragraph 3 of Article 12 is wide enough to cover the provisions of paragraphs (a), (b), (ba) and (d) of section 15(1) of the Ordinance.

98. 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 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% (the tax rate for the year 2007/08 is 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% (the tax rate for the year 2007/08 is 16%) on 30% of the gross amount, i.e. 4.8% of the gross amount.

Since the Comprehensive Arrangement has entered into force, as the applicable tax rate is 7% which is higher than the rates mentioned above, royalties arising in Hong Kong and paid to a resident of the Mainland 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. However, if royalties arising in Hong Kong and paid to a resident of the Mainland are part of a scheme directed at exploiting section 21A of the Ordinance, the Comprehensive Arrangement will not prejudice the right of Hong Kong to apply its laws and measures concerning tax avoidance (see paragraph 158 below).

99. Where a resident of the Mainland receives royalties which are deemed to be chargeable to tax under section 15(1)(d) of the Ordinance (for example, hire charges for the use of or the right to use industrial, commercial and scientific equipment in Hong Kong), such a resident will be taxed subject to the provisions of the Comprehensive Arrangement 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% (the tax rate for the year 2007/08 is 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% (the tax rate for the year 2007/08 is 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.

100. The provisions of Article 12 will not apply if the beneficial owner of the royalties, being the Government of One Side, a local authority thereof or a resident of that Side, carries on business in the Other Side in which the royalties arise through a permanent establishment situated therein, and the right or property in respect of which the royalties are paid is effectively connected with that permanent establishment. In such a case, the provisions of Article 7 (Business Profits) will apply. In other words, if the abovementioned

Mainland residents have a permanent establishment situated in Hong Kong, and the right in respect of which the royalties are paid is effectively connected with that permanent establishment, the royalties concerned will be included in the computation of the profits of that permanent establishment. The profits of that permanent establishment will be taxed in accordance with the provisions of Article 7 (Business Profits). The limitation of tax rate as provided for in Article 12 would have no application.

Article 13 CAPITAL GAINS

101. Article 13 allocates the right of tax on the gains from the alienation of property. It should be noted that Article 13 does not distinguish as to the nature of the capital gains. Accordingly, "capital gains" may include gains of a capital nature and gains of a revenue nature (speculative gains).

102. Paragraph 1 of Article 13 deals with gains derived by a resident of One Side from the alienation of immovable property situated in the Other Side. Paragraph 2 of Article 13 deals with gains derived from the alienation of movable property forming part of the business property of a permanent establishment which an enterprise of One Side has in the Other Side, including gains from the alienation of such a permanent establishment. Both paragraphs allow the Other Side to impose tax. This is consistent with the principle on the allocation of taxing rights as provided for in Article 6 (Income from Immovable Property) and Article 7 (Business Profits). The term "movable property" means all property other than immovable property, including intangible assets such as goodwill.

103. Gains derived by an enterprise of One Side 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 under the provisions of paragraph 3 of Article 13. This is consistent with the principle on the allocation of taxing rights as provided for in Article 8 (Shipping, Air and Land Transport).

104. Paragraphs 4 and 5 of Article 13 deal with gains derived from the alienation of shares in a company.

105. Under the provisions of paragraph 4 of Article 13, gains derived from the alienation of shares in a company the assets of which are comprised, directly or indirectly, mainly of immovable property situated in One Side may be taxed in that Side. Both Sides, pursuant to paragraph 2 of the Protocol, take 50% as the benchmark in determining whether the assets of a company are comprised "mainly" of immovable property. 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. In calculating the value of the total assets of a company, debts of that company (including liabilities secured by mortgages on the relevant immovable property) must not be deducted. Both Sides hold different views as to the relevant point in time for deciding whether the value of immovable property equals or exceeds 50% of the value of the total assets of the company. Hong Kong holds the view that it means the time of the alienation of shares, whereas the Mainland holds the view that it means any time in the period during which the alienator held any shares in the company. The State Administration of Taxation has discussion with the Hong Kong Inland Revenue Department and then concluded the Second Protocol. Both Sides agreed to set a time frame of "3 years" for the purposes of deciding whether the value of immovable property equaled or exceeded 50% of the value of the total assets. Though the State Administration of Taxation has not adopted Hong Kong's interpretation, the specification of a time frame has already provided more certainty in the interpretation of this provision. Hong Kong would continue to discuss with the Mainland on this issue.

106. Before the Second Protocol became effective, Hong Kong will calculate the value of assets on the basis of market value as at the time of the alienation of the shares concerned; whereas the Mainland will calculate the value on the basis of historical cost. In general, Hong Kong Inland Revenue Department will accept the last available audited financial statements of the company whose shares are alienated, supplemented by its management accounts up to the date of alienation of the shares (the latter may be unaudited), for the purposes of calculating the value of assets. In the Mainland, the value of assets is calculated at present on the basis of historical cost. The State Administration of Taxation has, however, agreed that notwithstanding the different bases adopted by the two Sides for their respective calculations, where the calculation satisfies the taxing conditions and tax is imposed in both Sides, the Side of residence should give credit to its resident for income doubly taxed.

For the alienation of shares on or after 11 June 2008 (effective date of the Second Protocol), both Sides will calculate the value of assets by reference to the book value at the end of any of the 3 taxable years prior to the alienation. The calculation will base on generally accepted accounting standards which include normal depreciation and revaluation provisions. The following example shows how the new calculation method is applied:

Example 3

On 1 May 2004, a Mainland resident Mr. Wong bought shares in Company B, which closed its accounts annually on 31 December. Company B held immovable properties in Hong Kong, with the properties representing, as per the accounts at the end of the taxable year, the following percentages of total company assets:

(a) for 2004, 60%;
(b) for 2005, 40%;
(c) for 2006, 40%;
(d) for 2007, 40%.

Mr. Wong sold the shares of Company B on 23 June 2008 and made a profit.

The new rule will apply as the Second Protocol has become effective at the time of alienation, 23 June 2008. The book value at the end of the 3 taxable years prior to the alienation will be used in determining whether the assets of Company B are comprised "mainly" of immovable property. According to the year-end accounts for 2005 to 2007, the immovable properties only accounted for 40% of the total assets of Company B. Hence, the assets of Company B were not at any time comprised "mainly" of immovable property. According to paragraph 4 of Article 13 of the Comprehensive Arrangement, Hong Kong does not have the taxing rights on the gains on alienation received by Mr. Wong.

In Hong Kong, the taxable year refers to the period from 1 April to 31 March of the next year. Hence, strictly speaking the Department should require Company B to provide annual accounts as at 31 March for each year from 2005 to 2007. In general, the Department would adopt a more flexible approach and would accept the relevant

company's accounting year-end accounts (with the exception of tax planning cases).

107. Before the Second Protocol became effective, gains derived from the alienation of "shares", other than shares referred to in paragraph 4 of Article 13, of not less than 25% of the entire shareholding of a company which is a resident of One Side may be taxed in that Side under the provisions of paragraph 5 of Article 13. Hong Kong interprets the word "shares" as referring to shares sold at the time of alienation, rather than the total shares in a company held or once held by the alienator. In other words, it is only when shares alienated are not less than 25% of the entire shareholding of a company may gains derived from the alienation be taxed in that Side. It is understood that the Mainland interprets "25%" as referring to 25% or more of the shares in a company once held by the alienator. That is, if shares representing 25% or more of the entire shareholding of a Mainland company were once held by a Hong Kong resident, gains derived by the Hong Kong resident from the alienation of all or part of his/its shareholding may be taxed in the Mainland. After negotiation, the State Administration of Taxation and the Hong Kong Inland Revenue Department reached a consensus that the "25%" applied to the shares held by the alienator. Under the Second Protocol, both Sides agreed to set a time frame of 12 months for the purpose of deciding whether the alienator has "once held" at least 25% of the shareholding. However, the alienation of shares prior to the effective date of the Second Protocol (i.e. 11 June 2008) would not be affected by this new provision. According to Article 5 of the Second Protocol, gains derived by a resident of One Side from the alienation of shares in the capital of a company which is a resident of the Other Side may be taxed in that Other Side if, at any time within the 12 months before the alienation, the recipient of the gains had a participation, directly or indirectly, of not less than 25% of the capital of the company.

Example 4

On 1 April 2006, a Mainland resident, Mr. Cheung, acquired 35% of the entire shareholding of a Hong Kong company, Company C. Mr. Cheung made a profit in selling 25% and 10% shares of Company C on 1 May 2007 and 23 June 2008 respectively.

Paragraphs 1 to 4 of Article 13 of the Comprehensive Arrangement will not apply. However, Hong Kong has the taxing rights on Mr. Cheung's gains received from the alienation of 25% shares of Company C on 1 May 2007 (i.e. before the effective date of the Second Protocol), according to paragraph 5 of Article 13. Even though Hong Kong has the taxing rights, whether the gains would be taxed still depends on other factors, like whether the gains were capital or revenue in nature.

By the time Mr. Cheung sold the 10% shares of Company C on 23 June 2008 the Second Protocol has come into effect. As Mr. Cheung only had a participation of less than 25% of the capital of Company C during the 12 months prior to the alienation, his gains from the second sale of shares will not be subject to tax in Hong Kong according to the new rule under paragraph 5.

108. Gains derived from the alienation of any property, other than that referred to in paragraphs 1 to 5 of Article 13, shall be taxable only in the Side of which the alienator is a resident.

Article 14 INCOME FROM EMPLOYMENT

109. Paragraph 1 of Article 14 provides that salaries, wages and other similar remuneration derived by a resident of One Side in respect of an employment shall be taxable only in that Side unless the employment is exercised in the Other Side. If the employment is exercised in the Other Side, such remuneration as is derived therefrom may be taxed in that Other Side. However, remuneration derived by a resident of One Side in respect of an employment exercised in the Other Side will be exempt from tax in that Other Side if all the following three conditions are satisfied:

(1) the recipient is present in the Other Side for a period or periods not exceeding in the aggregate 183 days in any 12-month period commencing or ending in the taxable period concerned;

(2) the remuneration is paid by, or on behalf of, an employer who is not a resident of the Other Side;

(3) the remuneration is not borne by a permanent establishment which the employer has in the Other Side.

In addition, it is provided in paragraph 3 of Article 14 that remuneration derived in respect of an employment exercised aboard a ship, an aircraft or a land transport vehicle operated in shipping, air and land transport by an enterprise of One Side shall be taxable only in that Side.

"Present for not exceeding 183 days" exemption condition

110. Under the provisions of paragraph 2(1) of Article 14, where an employment is exercised by a resident of One Side in the Other Side, one of the conditions for tax exemption is satisfied only when he is present in the Other Side for a period or periods not exceeding in the aggregate 183 days in any 12-month period commencing or ending in the taxable period concerned. "Any 12-month period commencing or ending in the taxable period concerned" denotes two concepts, namely, that the number of days of presence may straddle over 2 years, i.e. the days of presence can be calculated continuously or in the aggregate irrespective of the year; and that a floating calculation method may be adopted. The 12-month period can commence or end at any day within the taxable period concerned. The taxable period in the Mainland is the calendar year, whereas the taxable period (i.e. the year of assessment) in Hong Kong is the period from 1 April to 31 March of the next year.

111. Take the year of assessment 2008/09 as an example, the time period that should be taken into account, based on the two concepts mentioned above, is between 2 April 2007 and 30 March 2010. If a Mainland resident is not present in Hong Kong for more than 183 days in any 12-month period in the time period identified above, he has met the "present for not exceeding 183 days" exemption condition for the year of assessment 2008/09. However, if the Mainland resident is present in Hong Kong for more than 183 days in any 12-month period in the time period identified above, remuneration derived by him in respect of the employment exercised in Hong Kong is chargeable to Hong Kong salaries tax for the year of assessment 2008/09.

112. In the year when Article 14 of the Comprehensive Arrangement became effective (the year 2007 for the Mainland and the year of assessment 2007/08 for Hong Kong), the Mainland adopts 1 January 2007 as the commencement date for the purposes of ascertaining the number of days a Hong Kong resident is present in the Mainland; whilst Hong Kong adopts 1 April 2007 as the commencement date for the purposes of ascertaining the number of days a Mainland resident is present in Hong Kong. In other words, in the first year of Article 14's application, the Mainland regards any 12-month period to be any 12-month period commencing in the period from 1 January 2007 to 31 December 2007; and Hong Kong regards any 12-month period to be any 12-month period commencing in the period from 1 April 2007 to 31 March 2008.

113. The "days of physical presence" method is adopted in deciding whether a resident is present in the Other Side for a period or periods exceeding 183 days. Under this method, the day of arrival or departure and each day in the period during which he stays in the Other Side, however brief and for whatever reasons, will be counted as one day respectively.

Hong Kong residents working across the Mainland border

114. If a resident of Hong Kong provides services both in the Mainland and in Hong Kong, the tax treatment in both Sides is as follows:

(1) <u>Tax liabilities in Hong Kong</u>

- the income derived from his Hong Kong employment will be wholly assessable irrespective of whether it has been paid by the Hong Kong employer or a Mainland establishment. However, if the Hong Kong resident has paid individual income tax in respect of the income attributable to services rendered by him in the Mainland, he may apply for tax exemption for that part of the income under section 8(1A)(c) of the Ordinance, or for a tax credit under the provisions of Article 21 of the Comprehensive Arrangement. Application may be made on his tax return for the year of assessment concerned, and supported with evidence of the Mainland tax payment. In general, tax

exemption provides greater tax relief than that provided by tax credit. A Hong Kong resident who has declared and paid salaries tax on his employment income, and who has subsequently paid individual income tax on all or part of his employment income in the Mainland because he has rendered services there, can apply, under section 70A of the Ordinance, to have his assessment revised in accordance with the provisions of section 8(1A)(c).

- the income derived from his non-Hong Kong employment will be assessed according to the number of days in Hong Kong irrespective of whether it has been paid by an overseas employer or a Mainland establishment, provided that his visit(s) to Hong Kong exceed 60 days and during which he renders services.

(2) Tax liabilities in the Mainland

- If, under his employment, a Hong Kong resident renders services in the Mainland only (i.e. services are not rendered whilst in Hong Kong), all his income from that employment will be regarded as attributable to services rendered in the Mainland. Such income is wholly chargeable to Mainland tax, irrespective of whether it is paid by a Mainland establishment or an overseas employer (including a Hong Kong employer) unless he satisfies the three conditions mentioned in paragraph 109 above.

- If, under his employment, a Hong Kong resident renders services both in the Mainland and in Hong Kong, and his aggregated periods of stay in the Mainland do not exceed 183 days, income paid or borne by the Mainland establishment will be chargeable to individual income tax. Tax will be calculated on the chargeable income and then apportioned on time basis. Income paid by an overseas employer (including a Hong Kong employer) is not chargeable.

- If, under his employment, a Hong Kong resident renders services both in the Mainland and in Hong Kong, and his aggregated periods of stay in the Mainland exceed 183 days, the total income received from the Mainland establishment and the overseas employer (including Hong Kong employer) will be chargeable to individual income tax. Tax will be calculated on the total income and then apportioned on time basis.

(3) Counting of days of stay for calculating tax liabilities

- For tax computation purposes, the aggregated periods of stay in a year of assessment is the aggregate of the days in each period of stay where the number of days is counted under the rule of the "days of physical presence" minus one day.

- The Mainland and Hong Kong are geographically so close to each other that a taxpayer may travel between the Mainland and Hong Kong on a particular day and provides services in both Sides. As such, it is not appropriate to apply the rule of the "days of physical presence" minus one day. However, serious double taxation could occur if both Sides apply the rule of "days of physical presence". To address such cases, the State Administration of Taxation and the Hong Kong Inland Revenue Department have reached consensus. If a taxpayer travels between the Mainland and Hong Kong on a particular day and provides services in both Sides, he would be counted as present in the Mainland for half a day and in Hong Kong for half a day. However, if he only provides services either in the Mainland or Hong Kong on that day, he would be counted as having been present for one day in the Mainland or Hong Kong, as the case may be.

Article 15 DIRECTORS' FEES

115. Article 15 provides that directors' fees and other similar payments derived by a resident of One Side in his capacity as a member of the board of directors of a company which is a resident of the Other Side may be taxed in that Other Side. In other words, directors' fees received by a resident of either Side in his capacity as a director of a company may be taxed in the Side of which the company is a resident, irrespective of the period of his stay in either Side or the place where the services are actually rendered. Therefore, directors' fees derived by a Hong Kong resident in his capacity as a director of a Mainland company will all be subject to the individual income tax in the Mainland. Likewise, directors' fees derived by a Mainland resident in his capacity as a director of a Hong Kong company will all be subject to salaries tax in Hong Kong. "Directors' fees and other similar payments" include benefits in kind (such as share options, the use of a residence or car, health or life insurance coverage and club memberships). "Directors' fees and other similar payments" do not include wages, salaries and other remunerations paid to a director on account of his other functions with the company (e.g. as an employee or consultant). Such wages, salaries and other remunerations will be dealt with in accordance with Article 14 (in the case of income from employment) and Article 7 (in the case of business profits).

Article 16 ARTISTES AND SPORTSPERSONS

116. Paragraph 1 of Article 16 provides that income derived by a resident of One Side as an entertainer, a musician or a sportsperson, from his personal activities as such exercised in the Other Side, may be taxed in that Other Side. A theatre artiste, a musician or a sportsperson who performs in the Other Side may derive substantial amounts of income, yet his stay may only be for a short period of time, usually not exceeding 183 days. Therefore, paragraph 1 of Article 16 provides that the relevant income may be taxed in the Side where his activities are exercised. In addition, paragraph 2 of Article 16 stipulates that income in respect of personal activities exercised by an artiste or a sportsperson may be taxed in the Side in which the activities are exercised, irrespective of whether the income accrues ultimately to the artiste or sportsperson himself or to another person (including a company or any other legal entity). This is to ensure that all income derived by an entertainer or a sportsperson in respect of

his personal activities may be taxed in the Side in which the activities are exercised.

Article 17 PENSIONS

117. Regarding pensions and other similar remuneration paid to a resident of One Side in consideration of past employment, Article 17 stipulates a taxation principle that is different from that on which income from employment is taxed. The term "pensions and other similar remuneration" includes annuities paid in respect of past employment, lump sum payments in lieu of pensions received at the time of or after leaving services, sums received by way of commutation of pensions and pensions received by widows and orphans. However, Article 17 does not apply to a lump sum payment made upon cessation of an employment or termination of a contract. Such a payment falls within the meaning of income from employment and therefore will be taxed in accordance with the provisions of Article 14.

118. According to the provisions of paragraph 1 of Article 17, pensions received by an individual shall be taxable only in the Side of which the individual is a resident, except that government pensions will be taxed in accordance with paragraph 2 of Article 18. Paragraph 2 of Article 17 also stipulates that notwithstanding the provisions of paragraph 1, pensions and other payments made under the following pension schemes shall be taxable only in the Side in which the schemes are implemented:

(1) a public scheme which is part of the social security system implemented by the Government of One Side or a local authority thereof;

(2) an arrangement in which individuals may participate to secure retirement benefits and which is recognized for tax purposes in One Side.

119. According to the provisions of paragraph 2 of Article 17, pensions and other similar payments made under a public scheme which is part of the social security system implemented in the Mainland shall be taxable only in the Mainland; whilst pensions and other similar payments made under a

"recognized retirement scheme" in Hong Kong shall be taxable only in Hong Kong. In Hong Kong, a "recognized retirement scheme" means a "recognized occupational retirement scheme" and a "mandatory provident fund scheme".

Article 18 GOVERNMENT SERVICE

120. According to the principle of Article 18, remuneration and pensions paid by the Government of One Side to an individual (other than an individual who is a resident of the Other Side and renders services in that Other Side) in respect of services rendered to that Government, in the discharge of government functions shall be taxable only in that Side.

121. There are three paragraphs in Article 18. Paragraph 1 applies to remuneration other than pensions. Sub-paragraph (1) states that salaries and wages paid by the Government of One Side or a local authority thereof to an individual in respect of services rendered to that Government or authority, in the discharge of government functions, shall be taxable only in that Side. Sub-paragraph (2) applies to cases which are exceptions to those covered by sub-paragraph (1). Sub-paragraph (2) stipulates that salaries and wages paid by the Government of One Side or a local authority thereof to an individual in respect of services rendered to that Government or authority, in the discharge of government functions shall be taxable only in the Other Side if the services are rendered in that Other Side and the individual is a resident of that Other Side who did not become a resident of that Other Side by reason only of the rendering of such services. The expression "a resident of that Other Side who did not become a resident of that Other Side by reason only of the rendering of such services" in sub-paragraph (2) refers to an individual who is originally a resident of that Other Side and does not become the resident of that Other Side only because he is employed by the Government of One Side or a local authority thereof to render services in that Other Side.

122. For example, the income of a Hong Kong resident employed by the Hong Kong Government to work in its office in Beijing shall be taxable only in Hong Kong. On the other hand, the income of a Mainland resident employed by the Hong Kong Government to work in the Beijing office shall be taxable only in the Mainland. The income of a Mainland resident employed by the Central People's Government to work in the Hong Kong office shall be taxable

only in the Mainland. If a Hong Kong resident is employed by the Central People's Government to work in the Hong Kong office, his income shall be taxable only in Hong Kong.

123. Paragraph 2 of Article 18 applies to pensions and its taxation principle is the same as that laid in paragraph 1. The expression "or paid out of funds created or contributed as employer" in sub-paragraph (1) makes it clear that pensions include the pensions directly paid by the Government of One Side or a local authority thereof and the pensions paid out of funds created or contributed as employer by the Government of One Side or a local authority thereof. Sub-paragraph (2) provides for cases which are exceptions to those covered by sub-paragraph (1), which is the situation covered in sub-paragraph (2) of paragraph 1, as stated in the foregoing paragraph 121 above.

124. Paragraph 3 of Article 18 states clearly that paragraphs 1 and 2 do not apply if the services are rendered in connection with a business carried on by the Government of One Side or a local authority thereof. In such cases the ordinary rules apply: Article 14 (Income from Employment) for salaries and wages; Article 15 (Directors' Fees) for directors' fees and other similar payments; Article 16 (Artistes and Sportspersons) for income derived by artistes and sportspersons; and Article 17 (Pensions) for pensions and other similar remuneration.

Article 19 STUDENTS

125. Article 19 gives limited tax exemption to students so as to assist and nurture talents as well as to take care of students' living expenses. The Article provides that "payments which a student who is or was immediately before visiting One Side a resident of the Other Side and who is present in the One Side solely for the purpose of his education receives for the purpose of his maintenance and education shall not be taxed in that One Side, provided that such payments arise from sources outside that One Side." Qualifying payments include tuition fees, student grants and scholarships from sources outside that One Side.

Article 20 OTHER INCOME

126. Article 20 is written by reference to the United Nations Model. It provides that items of income of a resident of One Side, wherever arising, not dealt with in the Articles of the Comprehensive Arrangement shall be taxable only in that Side. However, the abovementioned income, if arising in the Other Side, may also be taxed in that Other Side.

127. Article 20 also provides that the provisions of Article 7 (Business Profits) shall apply to income, other than income from immovable property as defined in paragraph 2 of Article 6, if the recipient of such income, being a resident of One Side, carries on business in the Other Side through a permanent establishment situated therein and a right or property in respect of which the income is paid is effectively connected with such permanent establishment.

Article 21 METHODS FOR ELIMINATION OF DOUBLE TAXATION

128. Under the Comprehensive Arrangement, both Sides eliminate double taxation by the allowance of a tax credit. In accordance with the provisions of the Comprehensive Arrangement, Mainland tax paid in the Mainland in respect of any item of income derived by a resident of Hong Kong will be allowed as a credit against the Hong Kong tax payable on that income by that resident. However, the amount of tax credit will not exceed the amount of tax payable in respect of that item of income, computed in accordance with the provisions of the Ordinance.

129. In processing an application for tax credit, One Side will consider whether the relevant tax is imposed by the Other Side under the laws of that Other Side (and such laws being in accordance with the provisions of the Comprehensive Arrangement). A tax credit will be granted only if the answer is in the affirmative.

130. The Comprehensive Arrangement provides that the method for elimination of double taxation adopted in Hong Kong will be subject to the provisions of the Ordinance relating to the allowance of a deduction and a credit. Section 50 of the Ordinance provides for the allowance of a tax credit in respect of arrangements having effect under section 49. This section

provides the basis for the granting of a tax credit in relation to an item of income stipulated in the Comprehensive Arrangement and in respect of which tax has been paid in the Mainland. Only tax paid in the Mainland can be allowed as a credit under the Comprehensive Arrangement against Hong Kong tax. In accordance with section 50(2), an applicant for a tax credit must be resident in Hong Kong during the year of assessment in which the income is earned. However, if income derived by a Hong Kong resident from the Mainland does not arise in Hong Kong, it will not be chargeable to tax in Hong Kong. The tax paid in the Mainland in respect of that item of income cannot be allowed as a credit because the question of double taxation does not arise. In the case of a Hong Kong manufacturer whose profits are apportioned on a 50:50 basis, only half of the profits will be taxed in Hong Kong. The other half is regarded as having been derived from the Mainland and is thus not chargeable to tax in Hong Kong. Under such circumstances, where tax has been paid in the Mainland in respect of half or less than half of the profits, such tax will not be allowed as a credit against the Hong Kong tax payable. If more than one half of the profits are regarded by the Mainland as profits derived therefrom according to the Comprehensive Arrangement, then the tax paid in the Mainland in respect of such profits, in excess of one half of the total profits, will be allowed as a credit against the tax payable in Hong Kong.

131. According to the abovementioned tax credit method, the tax credit in respect of tax paid in the Mainland allowable for set off in Hong Kong is computed in accordance with sections 50(3) and 50(5) of the Ordinance as follows:

Example 5

	Hong Kong	The Mainland
	$	$
Total assessable income (Gross)	1,500	
Including income in respect of which tax has been paid in the Mainland in accordance with the Comprehensive Arrangement		500
Tax rate (Partnership business)	16%	33%

Tax payable				
Hong Kong : $1,500 x 16%		240		
The Mainland : $500 x 33%				165
Total tax liabilities of the two Sides before allowance of tax credit $240 + $165 = $405				
Less : Tax credit				
- Tax paid in the Mainland	$165			
or				
- The tax credit limit (Note 1)				
$500 x 16% =	$80			
(whichever is smaller)		(80) (Note 2)		
Total tax liabilities of the two Sides after allowance of tax credit	$325	160	+	165

(Note 1) In accordance with section 50(5), the amount of tax paid in the Mainland not allowed as a tax credit, i.e. $102 ($165 – $63), can be allowed as a deduction as shown in the detailed computation below:

	$	$
Mainland tax paid		165
Net income from the Mainland after tax (grossed up at effective Hong Kong tax rate) $335 x $\frac{100\%}{100\% - 16\%}$	398	
Less: Net Income from the Mainland after tax $(500 – 165)	(335)	
Less: Tax credit limit for tax paid in the Mainland		(63)
Tax paid in the Mainland not allowed as a tax credit		102

Hong Kong tax payable before tax credit $[1,000 + (500 – 102)] x 16% =$(1,000 + 398) x 16%	223
Less: Tax credit limit for tax paid in the Mainland	(63)
Hong Kong tax payable after allowance of tax credit	160

(Note 2) The formula of the credit limit is based on sections 50(3) and 50(5) of the Ordinance. If the tax payable by a taxpayer is computed at flat rate, the following simplified formula can be used to compute the credit limit:

$$\text{Tax credit limit for tax paid in the Mainland} = \text{Taxable income from the Mainland} \times \frac{\text{Tax payable in Hong Kong}}{\text{Total assessable income}}$$

	$
Taxable income in the Mainland	500
Tax payable in Hong Kong before allowance of tax credit	240
Total assessable income	1,500

Tax credit limit for tax paid in the Mainland $= \$500 \times \frac{240}{1,500}$

$= \underline{\$80}$

132. In the case of an individual taxpayer whose tax is computed at progressive tax rates, the tax credit is computed as follows:

Example 6

	$
Total Hong Kong assessable income	200,000
Including gross income from the Mainland before tax	120,000
Tax paid in the Mainland	10,000
Tax rate in the Mainland	8.33%
Net income after tax from the Mainland	110,000

The effective tax rate in Hong Kong and the tax credit are computed as follows:

	$
Total Hong Kong assessable income	200,000
Less: Deductible items	(12,000)
Net assessable income	188,000
Less: Personal allowance	(100,000)
Net chargeable income	88,000

Tax payable on:

The first	$30,000	x	2%	600
The second	$30,000	x	7%	2,100
The remaining	$28,000	x	13%	3,640
	$88,000			6,340

$$\text{The effective tax rate in Hong Kong} = \frac{\text{Tax payable}}{\text{Net assessable income}} \times 100\%$$

$$= \frac{6{,}340}{188{,}000} \times 100\%$$

$$= 3.37\%$$

Net income from the Mainland after tax
(grossed up at the effective tax rate in Hong Kong) (Note 1)

	$
$110,000 x $\frac{100\%}{(100\% - 3.37\%)}$	113,836
Less: Net income from the Mainland after tax	(110,000)
Tax credit limit for tax paid in the Mainland	3,836

Under section 50(5), the actual tax payable in Hong Kong is computed as follows:

	$	$
Assessable income (Hong Kong)		80,000
Assessable income (the Mainland) after deduction of tax	110,000	
Add: tax deducted in the Mainland	10,000	
Gross income from the Mainland before tax		120,000
Total Hong Kong assessable income		200,000
Less: amount not allowed as a tax credit (Note 1)		(6,164)
		193,836
Less: Deductible items		(12,000)
		181,836
Less: Personal allowance		(100,000)
Net chargeable income		81,836

Tax payable on:				
The first	$30,000	x	2%	600
The second	$30,000	x	7%	2,100
The remaining	$21,836	x	13%	2,838
	$81,836			5,538
Less: tax credit allowed				(3,836)
Hong Kong tax payable				1,702

(Note 1) Under section 50(5), tax paid in the Mainland which is not allowed as a tax credit can be deducted from the income

Amount not allowed as a tax credit $10,000 – $3,836 = $6,164

Net income from the Mainland after tax	$120,000 – $6,164
(grossed up at effective tax rate in Hong Kong)	= $113,836

133. The computation of tax credits where profits are attributed to a permanent establishment situated in the Mainland:

Example 7

Hong Kong Resident Company			$
Total business receipts			15,000,000
(from the Mainland and Hong Kong)			
Assessable profit			1,000,000
Profits tax rate (company) 17.5%			
Tax payable	$1,000,000 x 17.5%	=	175,000

Mainland Contract

Sales of machinery and equipment including installation (which takes more than 6 months to complete) to the Special Economic Zone of the Mainland (Tax rate : 15%)

Total price		$2,000,000
Profits attributed to the permanent establishment	=	$10,000
Enterprise income tax in the Mainland	=	$10,000 x 15%
	=	$1,500

Tax credit in respect of profits attributed to the permanent establishment in the Mainland

$$= \text{Profits attributed to the permanent establishment in the Mainland} \times \frac{\text{Tax payable}}{\text{Assessable profits}}$$

$$= \$10{,}000 \times \frac{175{,}000}{1{,}000{,}000}$$

= $1,750

Actual tax credit allowed is to be restricted to the actual tax paid in the Mainland, i.e. $1,500

134. The computation of tax credit for royalties received by Hong Kong residents:

Example 8

Hong Kong resident Company D prepares its accounts annually for the year ending 31 December. For the year ended 31 December 2007, Company D receives royalties of $90,000 from the Mainland and the tax withheld in the Mainland is $6,300 (i.e. $90,000 x 7%). Such royalties are income arising in Hong Kong. The amount of expenses allowable for deduction under the Ordinance (excluding the tax withheld) is $70,000. Company D does not have any other income or expenses during the relevant year.

		$
Assessable income for the year of assessment 2007/08 $(90,000 – 70,000)		20,000
Tax payable before allowance of tax credit (the tax rate for the year 2007/08 is 17.5%)		3,500
Less: Tax credit		
- Tax paid in the Mainland	$6,300	
or		

- The tax credit limit [Note 1])	
$20,000 x 17.5% = $3,500)	
(whichever is smaller)	(3,500) [Note 2]
Tax payable after allowance of tax credit	0

[Note 1] In accordance with section 50(5), tax paid in the Mainland which is not allowed as a tax credit, i.e. $3,394 ($6,300 – $2,906), can be allowed as a deduction as shown in the detailed computation below:

	$	$
Mainland tax paid		6,300
Net income from the Mainland after tax (grossed up at effective Hong Kong tax rate) $13,700 x $\frac{100\%}{100\% - 17.5\%}$	16,606	
Less: Net income from the Mainland after deduction of tax $(20,000 – 6,300)	(13,700)	
Less: Tax credit limit for tax paid in the Mainland		(2,906)
Tax paid in the Mainland not allowed as a tax credit		3,394
Hong Kong tax payable before tax credit $(20,000 – 3,394) x 17.5%		2,906
Less: Tax credit limit for tax paid in the Mainland		(2,906)
Hong Kong tax payable after allowance of tax credit		0

[Note 2] The formula of the credit limit is based on sections 50(3) and 50(5) of the Ordinance. As the tax payable by Company D is computed at flat rate, the following simplified formula can be used to compute the credit limit:

$$\text{Tax credit limit for tax paid in the Mainland} = \text{Taxable income from the Mainland} \times \frac{\text{Tax payable in Hong Kong}}{\text{Total assessable income}}$$

	$
Taxable income from the Mainland	20,000
Tax payable in Hong Kong before allowance of tax credit	3,500
Total assessable income	20,000

Tax credit limit for tax paid in the Mainland $= \$20,000 \times \frac{\$3,500}{\$20,000}$

$= \underline{\$3,500}$

Example 9

Following Example 8, assume Company D, in addition to the royalties from the Mainland, receives royalties of $80,000 from Thailand and the tax withheld in Thailand is $8,000 (i.e. $80,000 x 10%). Company D incurs expenses of $20,000 (excluding the tax withheld in the Thailand) in the production of royalties from Thailand and such expenses are allowable for deduction under the Ordinance. Company D does not have other income or expenses during the relevant year.

		$
Assessable income for the year of assessment 2007/08		
$(90,000 + 80,000 – 70,000 – 20,000)		80,000
Tax payable before allowance of tax credit (the tax rate for the year 2007/08 is 17.5%)		14,000
Less: Tax credit		
- Tax credit limit for tax paid in the Mainland, see Example 8 above		(3,500)
- Tax paid in Thailand	$8,000	
or		
- The tax credit limit [$(80,000 – 20,000) x 17.5%] (whichever is smaller)	$10,500	(8,000)
Tax payable after allowance of tax credit		2,500

Since the Comprehensive Arrangement applies to years of assessment beginning on or after 1 April 2007 in Hong Kong, the tax withheld in the Mainland in respect of the royalties received by Hong Kong resident Company

D from 1 January 2007 to 31 March 2007 will be allowed as a credit against its Hong Kong tax payable, see paragraph 9 above.

135. Section 50(4) of the Ordinance provides that the total tax credit to be allowed to a Hong Kong resident for a year of assessment in respect of foreign tax paid shall not exceed the total tax payable in Hong Kong for that year of assessment. Therefore, if a Hong Kong resident suffers a loss in a year of assessment and does not pay any Hong Kong tax (i.e. tax credit allowed is zero), the tax paid by him in the Mainland will not be allowed as a credit.

136. Under section 50(5), the amount of tax paid in the Mainland is included in computing profits or income subject to tax in Hong Kong. However, due to the differences in tax rates between the Mainland and Hong Kong, the tax paid in the Mainland may exceed the amount of the credit limit. In such circumstances, the excess is allowed as a deduction. Any tax paid in the Mainland that is not allowed as a credit is not available to be carried forward to subsequent years of assessment.

137. A claim for a tax credit is required, in accordance with section 50(9) of the Ordinance, to be made within 2 years after the end of the relevant year of assessment. The claim can be submitted with the tax return for the relevant year of assessment or made separately in writing. Any dispute over the allowance of a tax credit is to be dealt with in accordance with the objection and appeal provisions of the Ordinance.

138. Under the provisions of section 50(10) of the Ordinance, a Hong Kong resident who considers that the tax credit allowed for a year of assessment is excessive or insufficient because of a subsequent adjustment to the amount of tax payable by either Side can make a claim within 2 years from the time when the assessment, adjustment or other determination by either Side has been made. The period for lodging the claim will not be limited by the time for raising an assessment or for lodgement of any other claim under the Ordinance. The relevant assessment, adjustment or determination must be material in determining whether and to what extent a tax credit is allowable. It should be noted that those provisions do not apply to any new claim for a tax credit, as the application for such claim should be made in accordance with section 50(9).

139. Paragraph 3 of Article 21 provides that where dividends received by a resident company of One Side which controls not less than 10% of the shares of a resident company of the Other Side, the credit that the resident company of that One Side is entitled to will include the tax paid by the company which pays the dividends in respect of the profits from which such dividends are derived. As dividends are not chargeable to tax in Hong Kong, this provision will have no practical application to Hong Kong resident companies.

140. Before a tax credit is allowed, it will need to be established to the satisfaction of the Inland Revenue Department that the tax has been paid by the person in the Mainland. The person will need to submit the tax computation issued by the tax authority of the Mainland (showing details of the relevant income and tax paid thereon) together with documentary evidence to the effect that the tax has been paid and is not subject to any further adjustment.

Article 22 NON-DISCRIMINATION

141. Paragraph 1 of Article 22 establishes the principle that, for purposes of taxation, discrimination based on the actual situs of an enterprise is forbidden. This paragraph provides that the taxation on a permanent establishment which an enterprise of One Side has in the Other Side shall not be less favourably levied in that Other Side than the taxation levied on enterprises of that Other Side carrying on the same activities.

142. Paragraph 2 of Article 22 aims at eliminating discrimination on the grounds of the resident status of the persons receiving payments. This paragraph provides that interest, royalties and other disbursements paid by an enterprise of One Side to a resident of the Other Side shall, for the purpose of determining the taxable profits of such enterprise, be deductible under the same conditions as if they had been paid to a resident of that One Side, except under specified circumstances.

143. Paragraph 3 of Article 22 forbids One Side to give less favourable treatment to enterprises of that Side where the capital of the enterprise is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the Other Side. This paragraph provides that enterprises of One Side shall not, by reason of their capital being owned or controlled by residents

of the Other Side, be subjected in the One Side to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the One Side are or may be subjected.

Article 23 MUTUAL AGREEMENT PROCEDURE

144. The Comprehensive Arrangement is a bilateral arrangement made between the State Administration of Taxation and the Hong Kong Inland Revenue Department after consultation which allocates the right to tax between the two jurisdictions. It sets out mainly matters of principle. In the course of applying the Comprehensive Arrangement, it is possible that problems relating to the specific interpretation of the provisions and uncertainties may arise and need to be addressed. For this reason, Article 23 provides that the competent authorities of both Sides shall endeavour to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Comprehensive Arrangement, and may also consult together for the elimination of double taxation in cases not provided for in the Comprehensive Arrangement. For the purposes of reaching an agreement, representatives of the competent authorities of both Sides may meet and exchange their opinions verbally. Consultation in respect of the Comprehensive Arrangement shall be dealt with centrally between the State Administration of Taxation and the Hong Kong Inland Revenue Department, and not be conducted separately between the Hong Kong Inland Revenue Department and different local taxation authorities of the Mainland.

145. Paragraph 1 of Article 23 states clearly that where a person considers that the actions of One Side or both Sides result or will result for him in taxation not in accordance with the provisions of the Comprehensive Arrangement, he may present his case to the competent authority of the Side of which he is a resident. The case must be presented within 3 years from the first notification of the action resulting in taxation not in accordance with the provisions of the Comprehensive Arrangement.

146. The competent authority receiving the claim shall endeavour, if the objection appears to it to be justified, and if it is not itself able to arrive at a satisfactory solution, to resolve the case by mutual agreement with the

competent authority of the Other Side, with a view to the avoidance of taxation which is not in accordance with the Comprehensive Arrangement. Any agreement reached shall be implemented notwithstanding any time limits in the respective domestic laws of both Sides.

147. Hong Kong residents presenting to the Commissioner of Inland Revenue a case which satisfies the requirements set out in paragraph 145 above, should also provide all information relevant to the case (e.g. details of activities that give rise to taxation carried out in the Mainland or in Hong Kong, details of negotiations with the competent authority of the Mainland including copies of documents, letters, notices of assessment and demand notes), so that the Inland Revenue Department may examine the case and consult with the competent authority of the Mainland.

Article 24 EXCHANGE OF INFORMATION

148. In line with international practice, the Comprehensive Arrangement contains provisions on the exchange of information. Paragraph 1 of Article 24 states that the competent authorities of both Sides shall exchange such information as is necessary for carrying out the provisions of the Comprehensive Arrangement or of the domestic laws of both Sides concerning taxes covered by the Comprehensive Arrangement. Paragraph 1 also makes it clear that the exchange of information is not restricted by Article 1 (Persons Covered), i.e. information relating to persons who are not residents of One Side or both Sides may be exchanged, provided that the exchange of information is for purposes compatible with this Article.

149. In order to ensure that information relating to taxpayers will not be misused, the Comprehensive Arrangement provides that any information received by One Side from the Other Side shall be treated as secret in the same manner as information obtained under the domestic laws of that Side. In other words, both the Mainland and Hong Kong shall keep information obtained from the other party confidential and such information shall be disclosed only to persons or authorities concerned with the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes covered by the Comprehensive Arrangement. Such persons or authorities shall use the information only for such purposes. They

may disclose the information in public court proceedings or in judicial decisions, including, in case of Hong Kong, the decisions of the Board of Review. Both Sides also specify in the Protocol to the Comprehensive Arrangement that information may not be disclosed to any other jurisdiction without the consent of the Side which furnished the information in the first place.

150. Information received by the Mainland from the competent authority of Hong Kong will not be used by the Mainland to impose taxes which are not taxes covered by the Comprehensive Arrangement, such as custom duties and value-added taxes.

151. Paragraph 2 of Article 24 specifies that in no case shall the provisions of paragraph 1 in relation to the exchange of information be construed so as to impose on One Side the obligation to carry out administrative measures at variance with the laws and the administrative practice of either Side; to supply information which is not obtainable under the laws or in the normal course of the administration of either Side; or to supply information which would disclose any trade, business, industrial, commercial or professional secret or trade process, or information, the disclosure of which would be contrary to public policy.

152. The power conferred on the Inland Revenue Department by virtue of the provisions of the Ordinance in relation to the seeking of information is restricted to cases where any matter relating to any liability or obligation of any person under the Ordinance is at issue.

153. Currently the Department would, in general, not provide automatic exchange of information, such as supply of bank interest information on a periodic basis. Nor would the Department spontaneously provide information which it supposes to be of interest to the Mainland. The Department will only supply information upon specific requests received from the competent authority of the Mainland in justifiable cases, and only where such requests are in compliance with the conditions as laid down in the Comprehensive Arrangement. These general rules will also be adopted by the Mainland. It is understood that the means of seeking information available under the internal taxation procedures should be exhausted in the first place before any request for information would be made to the Other Side.

154. Article 24 provides that the exchange of information shall be conducted by the competent authorities of both Sides. Paragraph 1(8) of Article 3 of the Comprehensive Arrangement provides that "competent authority" means, in the case of the Mainland, the State Administration of Taxation or its authorized representatives; and in the case of Hong Kong, the Commissioner of Inland Revenue or his authorized representative. Therefore, all requests for exchange of information should be put forward by the State Administration of Taxation (unless the State Administration of Taxation has authorized a representative). The Hong Kong Inland Revenue Department will not exchange information with unauthorized local tax authorities of the Mainland.

155. Section 49(5) of the Ordinance stipulates that "where any arrangements have effect by virtue of this section, the obligation as to secrecy imposed by section 4 shall not prevent the disclosure to any authorized officer of the government with which the arrangements are made of such information as is required to be disclosed under the arrangements". In addition, according to paragraph (c) of section 58(1) of the Personal Data (Privacy) Ordinance (Chapter 486), disclosure of relevant information to the competent authority of the Mainland by the Commissioner of Inland Revenue or his authorized representative for the purposes of implementing the Comprehensive Arrangement does not violate the information protection principles of the Personal Data (Privacy) Ordinance.

156. The Commissioner of Inland Revenue has obtained legal advice on the Exchange of Information Article of the Comprehensive Arrangement. Provided that the Inland Revenue Department complies with the rules as laid down in the Comprehensive Arrangement when carrying out the relevant provisions, there would be no contravention of the Basic Law or the International Covenant on Civil and Political Rights. Hong Kong's existing legislation (including the Personal Data (Privacy) Ordinance) does not provide that the Inland Revenue Department should inform the taxpayer concerned if it has passed on information relating to him to the competent authority of the Mainland. Accordingly, the Department would not provide taxpayers with details of any such exchanges.

157. Information exchange is carried out only after the Comprehensive Arrangement is in force. Where information that existed prior to the entry

into force of the Comprehensive Arrangement is exchanged, such information should not be used in the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes for the following years:

(1) In the Mainland: any taxable years before 1 January 2007;

(2) In Hong Kong: any years of assessment before 1 April 2007.

Article 25 MISCELLANEOUS PROVISIONS

158. Article 25 states clearly that nothing in the Comprehensive Arrangement shall prejudice the right of either Side to apply its domestic laws and measures to prevent tax avoidance. "To prevent tax avoidance" shall be construed as including the prevention of the abusive use of the Comprehensive Arrangement. In the case of Hong Kong, the laws and measures concerning tax avoidance include sections 5B, 9(1A), 9A, 15(1)(j), 15(1)(k), 15(1)(l), 16(2), 16(2A), 16(2B), 16(2C), 16(2D), 16(2E), 16(2F), 16E(2A), 16E(2B), 18D(2A), 20, 20AE, 21A(1)(a), 22B, 38B, 39E, 61, 61A and 61B of the Ordinance.

Article 26 ENTRY INTO FORCE

159. In Hong Kong, the provisions of the Comprehensive Arrangement shall apply to income derived in the years of assessment beginning on or after 1 April 2007; and in the Mainland, in the taxable years beginning on or after 1 January 2007. The relevant provisions of the Air Services Arrangement (paragraph 6 of Article 11) signed between the Mainland and Hong Kong and the Limited Arrangement (see paragraph 1 above) shall cease to have effect on the date on which the Comprehensive Arrangement applies to the relevant types of tax. The provisions of the Comprehensive Arrangement shall apply in the Shenzhen Bay Port Hong Kong Port Area from its commencement of operation on 1 July 2007.

Article 27 TERMINATION

160. The Comprehensive Arrangement shall remain in force indefinitely, but One Side may give the Other Side written notice of termination on or before 30 June in any calendar year beginning after the expiration of a period of 5 years from the date of its entry into force. In such event, the Comprehensive Arrangement shall cease to have effect from:

(1) in the Mainland: the taxable year beginning on or after 1 January in the calendar year next following the year in which the notice is given;

(2) in Hong Kong: the year of assessment beginning on or after 1 April in the calendar year next following the year in which the notice is given.

CONCLUSION

161. The Comprehensive Arrangement is intended to effectively resolve problems of double taxation faced by residents of the Mainland and Hong Kong and to promote commercial and trading activities between the two Sides. The explanations concerning Mainland taxation treatment mentioned in this Note (in the Chinese version) have been vetted by the International Taxation Department of the State Administration of Taxation. This would contribute to the effective implementation of the Comprehensive Arrangement.