Hong Kong Tax Alert

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Hong Kong starts legislative process to give effect to the Multilateral Instrument (MLI) to implement tax treaty related measures to prevent base erosion and profit shifting

The Inland Revenue (Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting) Order (the Order) was gazetted on 30 September 2022 and will be tabled at the Legislative Council on 19 October 2022 for negative vetting[1].

The MLI seeks to facilitate the implementation of tax-treaty-related measures to counter base erosion and profit shifting (BEPS).

Hong Kong has designated 39 of its existing comprehensive avoidance of double taxation agreements (CDTAs) as covered tax agreements (CTAs) to be amended through the MLI. The remaining six signed CDTAs are not listed because they have already incorporated BEPS-compliant provisions.

To avoid any unintended impact on taxpayers, Hong Kong adopts a minimalist approach and save for one minor option, only implements the mandatory provisions of the MLI, all other optional provisions being left to future bilateral discussions with the parties concerned where necessary. That means Hong Kong has opted out all the remaining substantive optional articles of the MLI.

The mandatory provisions of the MLI that will be incorporated into the CTAs that Hong Kong has designated in the MLI are: (i) preventing treaty abuse by way of adopting certain general anti-abuse rules, including incorporating a "principal purpose test" (PPT) clause or a combination of the PPT and a "limitation of benefit" (LOB) clause in a CDTA. In this regard, Hong Kong only adopts the PPT in the MLI; (ii) incorporating a preamble statement to set out the purpose of a CDTA is intended to eliminate double taxation or reduced taxation through tax evasion or avoidance, including through treaty-shopping arrangements, without creating opportunities for non-taxation, the minor additional option under this provision being stating the desire of the contracting parties "to further develop their economic relationship and to enhance their co-operation in tax matters". In this regard, Hong Kong adopts the additional option under this provision; and (iii) amending the "mutual agreement procedure" (MAP) clause of a CDTA to facilitate more effective resolution of disputes.

The provisions of the MLI will have effect in Hong Kong with respect to a CTA on 1 April 2023 (for taxes withheld at source), or on 1 April 2024 (for other taxes), at the earliest, the exact dates of which are subject to the completion of the legislative and other relevant procedures of the MLI by Hong Kong's CDTA partners.

Taxpayers should review the potential changes to be introduced by the MLI and evaluate whether new business models should be adopted in light of the tighter anti-avoidance measures. Professional tax advice should be sought where necessary.

1. The Order can be downloaded from: https://www.gld.gov.hk/egazette/pdf/20222639/es220222639182.pdf

Overview of the MLI

The Organisation for Economic Cooperation and Development (OECD) released a package of 15 actions in October 2015 to counter BEPS by multinational enterprises. The MLI is an agreement negotiated under Action 15 of BEPS. It is intended to allow jurisdictions to swiftly amend their tax treaties to implement the tax-treaty-related BEPS recommendations.

The MLI includes both mandatory provisions (i.e., the minimum standards under BEPS) as well as non-mandatory provisions. Jurisdictions have the flexibility to determine how its treaty network would be amended by the MLI. In addition, signatories to the MLI are required to provide a notification for the specific provisions of a CTA that are to be replaced or modified by the MLI. The relevant provisions in a CTA will be modified only if the contracting parties concerned adopt the same position in the MLI.

Implementation of MLI in Hong Kong

In June 2016, Hong Kong indicated to the OECD its commitment to implementing the BEPS package. As Hong Kong is a special administrative region, the government has obtained the endorsement of the Central People's Government to extend the application of its MLI to cover Hong Kong's CDTAs.

On 25 May 2022, Mainland China deposited its instrument of approval for the MLI with the OECD. The Mainland's instrument of approval also contains reservations and notifications applicable to Hong Kong under the MLI[2].

To bring the MLI into effect, the Order will be tabled at the Legislative Council on 19 October 2022 for negative vetting. The provisions of the MLI will take effect in Hong Kong after completion of the domestic legislative procedures.

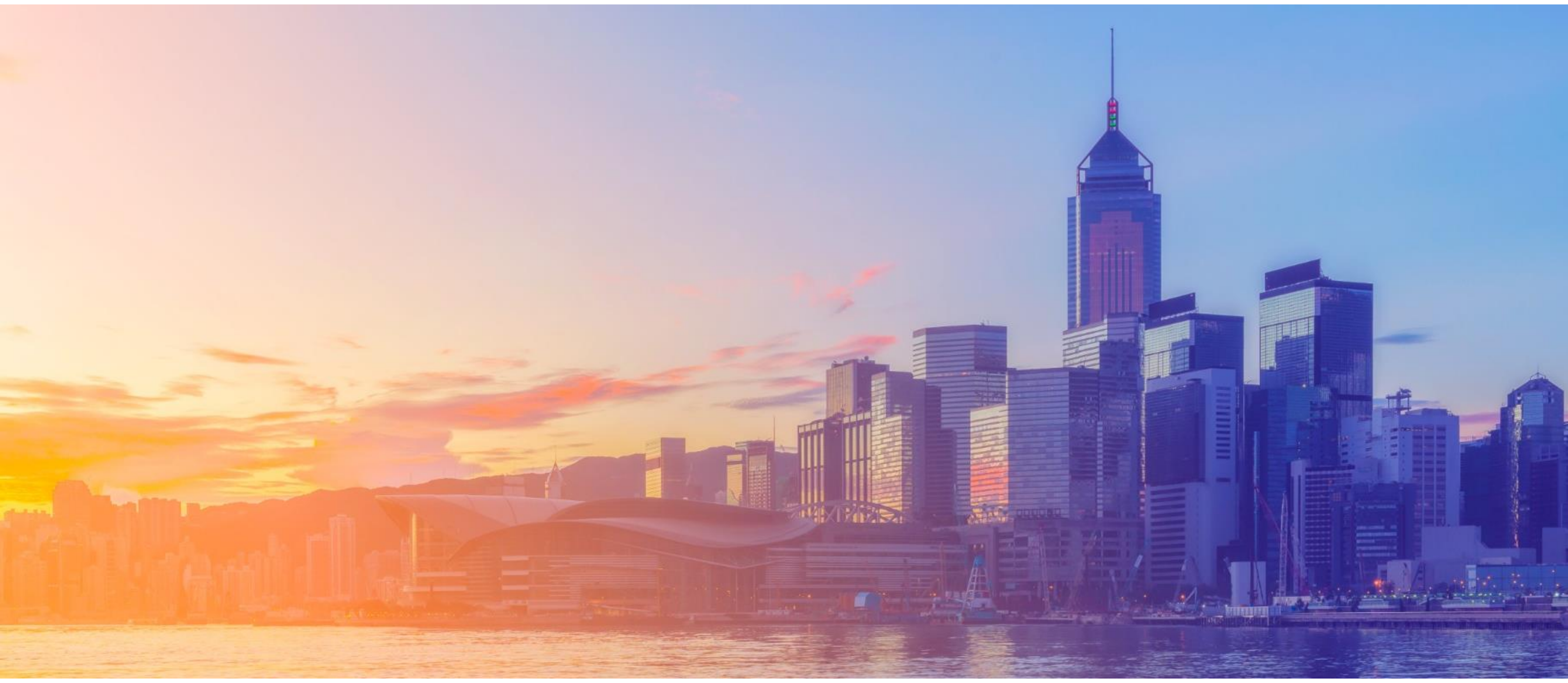
Hong Kong's approach to MLI

Hong Kong has designated 39 of its CDTAs as CTAs to be amended through the MLI. However, six existing CDTAs will not be modified by the MLI: Mainland China, Macau SAR, Estonia, Finland, Georgia and Serbia are however not covered as they have already contained BEPS-compliant provisions.

To avoid any unintended impact on taxpayers, Hong Kong has opted a minimalist approach and only implemented the mandatory provisions in the MLI to: (i) include a statement of intent that a CDTA is to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance; (ii) adopt a general anti-abuse rule, commonly known as the PPT; and (iii) implement a more effective tax treaty-based dispute resolution procedure. Hong Kong has opted out the remaining substantive optional articles.

As regards CDTAs to be signed in future, the government has indicated that it will incorporate the relevant provisions of the MLI in those CDTAs to ensure that they are BEPS-compliant.

2. Hong Kong's notification of its adoption positions at ratification: https://www.oecd.org/tax/treaties/beps-mli-position-hong-kong-instrument-deposit.pdf



Implications of the adoption of mandatory articles of MLI

Article 6 of the MLI – Purpose of a covered tax agreement

Article 6 of the MLI provides for the preamble statement to clarify that tax treaties are not intended to create opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including through treaty-shopping arrangements.

Hong Kong will adopt Article 6, including the optional text indicating a desire to further develop its economic relationships with other signatories and enhance cooperation in tax matters.

As the CDTA with Belarus already contains such preamble statement, the effect of the adoption is on the remaining 38 CTAs.

Article 7 – Prevention of treaty abuse

This article requires jurisdictions to implement provisions reflecting the common intent to prevent treaty abuse by adopting one of the following rules: (i) a PPT only; (ii) a PPT and either a simplified or detailed LOB rule; or (iii) a detailed LOB rule, supplemented by a mechanism that would deal with conduit arrangements not already dealt with in tax treaties. The PPT is the default option which enables jurisdictions to satisfy the minimum standards.

Hong Kong has opted to adopt a PPT only. Specifically, the PPT seeks to deny treaty benefits in cases where one of the principal purposes of the arrangements or transactions is to secure a benefit under the treaty in a manner that is contrary to the object and purpose of the treaty.

As the CDTAs with Belarus and Pakistan have already contain the PPT, the effect of the adoption is on the remaining 37 CTAs.

Article 16 of the MLI – Mutual agreement procedure

Article 16 specifies new rules as regards the resolution of disputes regarding the interpretation or application of tax treaties.

While most of the existing CDTAs concluded by Hong Kong already contain the MAP article with similar descriptions as in the MLI, the relevant clause of a few Hong Kong's CDTAs does not align with the minimum standards of BEPS:

- The first sentence of Article 16(1) of the MLI allows a taxpayer to present its case for MAP to the competent authority of either contracting jurisdiction (instead of only to the competent authority of the contracting jurisdiction where the taxpayer is a resident). Except for the CDTA with Belarus and Cambodia which already permit presenting a case to the competent authority of either contracting jurisdiction, the other CDTAs will need to be amended accordingly.
- The second sentence of Article 16(1) of the MLI requires that MAP access should be allowed where an MAP application is presented within three years from the first notification of the action resulting in taxation not in accordance with a tax treaty. The existing Hong Kong's CDTA with Italy, which only provides a shorter period of two years for presenting a MAP case, will need to be changed to three years.
- Article 16(2) of the MLI requires that MAP agreements are to be implemented notwithstanding any time limits under domestic laws. Hong Kong's CDTAs with Mexico and Italy, which lack such a provision, will therefore need to be modified to add the relevant provision. In other words, if an MAP agreement is reached, it will override the time limit under domestic laws.
- Similarly, Hong Kong's CDTAs with Belgium and New Zealand will need to be modified to include the statement that "They may also consult together for the elimination of double taxation in cases not provided for in the Covered Tax Agreement." based on Article 16(3) of the MLI.

The enhanced dispute resolution under the MLI will provide taxpayers with a more effective tax treaty-based dispute resolution.

Entry into effect of a CDTA by the MLI

The provisions of the MLI will have effect in Hong Kong with respect to a CTA on 1 April 2023 (for taxes withheld at source), or on 1 April 2024 (for other taxes), at the earliest, the exact dates of which are subject to the completion of the legislative and other relevant procedures of the MLI by Hong Kong's CDTA partners.

To facilitate stakeholders' understanding of the effect of the MLI on individual CTAs of Hong Kong, the Inland Revenue Department will update its website from time to time to provide information as to when the relevant provisions of the MLI will come into effect in respect of the CTA and the extent to which the CTA concerned will be modified.

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