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United States-Hong Kong International Shipping Agreement suspended or terminated

The U.S. Department of State yesterday informed the Hong Kong authorities that the United States-Hong Kong International Shipping Agreement (Shipping Agreement) has been suspended or terminated—the exact treatment is not yet clear.

The State Department made its [announcement](#) pursuant to Executive Order 13936 (July 14, 2020), which reflects growing tensions between the United States and the People's Republic of China (PRC) regarding the PRC's rule over Hong Kong.

The Shipping Agreement was enacted by an exchange of diplomatic notes and provides that Hong Kong has an "equivalent exemption" under section 883(a)(1) of the Code, which exempts certain gross international shipping income from U.S. income taxation.^[1] As a result of the termination or suspension of the Shipping Agreement, Hong Kong residents and Hong Kong corporations will be subject to U.S. income taxation to the extent such income is from U.S. sources under section 863(c)(2).

The precise effective date of this action and the particulars of its effect remain unclear, leaving the U.S. Department of Treasury with the obligation to provide more detailed guidance.

Background

Hong Kong has had and continues to have unique treatment under U.S. tax law—the Code generally treats Hong Kong as a separate sovereign, notwithstanding Hong Kong's continuous status as being subject to the laws of another country. Hong Kong was a British colony until the U.K. transferred its sovereignty to the PRC on July 1, 1997, pursuant to an 1898 treaty entered into by Great Britain and the Qing dynasty.^[2]

The U.K., Hong Kong, and the PRC in the early 1980s began negotiations for Hong Kong's transition to the PRC, culminating in the 1984 "Draft Agreement between the Government of Great Britain and Northern Ireland and the Government of the People's Republic of China on the Future of Hong Kong" (the "Joint Declaration").^[3] The Joint Declaration established the principles upon which Hong Kong's sovereignty would transfer to the PRC. Pursuant to its obligations under the Joint Declaration and adhering to its principle that the new relationship would consist of "one country, two systems," the

PRC in 1990 enacted the Hong Kong “Basic Law,” which established the “Hong Kong Special Administrative Region” and guaranteed the region’s own independent executive, legislative, and judicial powers, and also guaranteed the region a “high degree of autonomy” until July 1, 2046.

The U.S. Congress passed the United States-Hong Kong Policy Act of 1992 (the “Hong Kong Policy Act”) in preparation for the re-unification of Hong Kong with the PRC.^[4] Congress in the Hong Kong Policy Act determined that the Joint Declaration and the Basic Law provided Hong Kong with a “high degree of autonomy”^[5] and provided that:

Notwithstanding any change in the exercise of sovereignty over Hong Kong, laws of the United States shall continue to apply with respect to Hong Kong, on and after July 1, 1997, in the same manner as the laws of the United States were applied with respect to Hong Kong before such date, unless otherwise expressly provided by law or Executive order under section 202.^[6]

The foreign policy rule stated above will be hereinafter referred to as the “General Policy Rule.”

As referenced in the General Policy Rule, Congress also provided the president the authority to suspend application of the General Policy Rule, in whole or in part, if the president determines that “Hong Kong is not sufficiently autonomous to justify [General Policy Rule] treatment under a particular law of the United States[.]”^[7] The president in making such determination is directed “to consider terms, obligations, and expectations expressed in the Joint Declaration with respect to Hong Kong.”^[8]

Section 301 of the Hong Kong Policy Act creates a monitoring regime that requires the Secretary of State to submit a report to Congress not later than March 31 of each year (“Section 301 Reports”). The Section 301 Reports must list and discuss any developments regarding U.S. relations with Hong Kong and any other matters relevant to the high degree of autonomy exercised by Hong Kong pursuant to the Joint Declaration and the Basic Law. Congress in 2018 expanded this monitoring regime by amending the Hong Kong Policy Act to include a section 205 certification procedure that requires the Secretary of State, in conjunction with the Section 301 Reports, to certify “whether Hong Kong continues to warrant treatment under United States law in the same manner as United States laws were applied to Hong Kong before July 1, 1997[.]”^[9]

The U.S. income tax effect of the Hong Kong Policy Act is that Hong Kong continues to be treated as a separate sovereign under the Code and, thus, is treated as separate from the PRC. This point was made explicit by Treasury and the IRS in Notice 97-40.^[10] Section II of Notice 97-40 expressly notes that the Shipping Agreement that was entered into in 1987 will continue to apply after July 1, 1997, in accordance with its terms, which provide Hong Kong with a reciprocal exemption under section 883(a)(1) and treat Hong Kong and the PRC as separate countries.^[11] The separate countries aspect of the General Policy Rule effects other provisions of provisions of the Code, including the subpart F provisions, section 892, and the dual consolidated loss rules.

The Secretary of State prior to 2020 concluded in each of the Section 301 Reports that Hong Kong maintained a sufficient degree of autonomy to justify continued treatment under the General Policy Rule, although the 2019 Section 301 Report noted that the degree of Hong Kong’s autonomy had been “diminished.”^[12] No president has exercised authority under Section 202(a) of the Hong Kong Policy Act to suspend the application the General Policy Rule until July 14, 2020, when President Trump issued Executive Order 13936 suspending the General Policy Rule for certain purposes. The executive order was issued in response to Secretary of State Mike Pompeo’s 2020 Section 301 Report (issued on May 28, 2020) in which Mr. Pompeo made a section 205 certification stating that “I can no longer certify that Hong Kong continues to warrant [special] treatment.”^[13]

Section 3(j) of Executive Order 13936 states in pertinent part that:

Within 15 days of this order, the heads of agencies shall commence all appropriate actions to further the purposes of this order consistent with applicable law, including to ... give notice of

intent to terminate the agreement for the reciprocal exemption with respect to taxes on income from the international operation of ships effected by the Exchange of Notes Between the Government of the United States of America and the Government of Hong Kong (TIAS 11892)[.]^[14]

State Department announcement

Issued pursuant to Executive Order 13936, the State Department's August 19, 2020 announcement is brief and states, in pertinent part, that it has notified the Hong Kong authorities of the "suspension or termination of three bilateral agreements." The Shipping Agreement is one the agreements referenced in the State Department's announcement. The State Department announcement does not provide any additional guidance regarding effective date or implementation of the termination or suspension, leaving the U.S. Department of Treasury to provide necessary additional guidance.



Effect on other U.S. tax provisions

Neither the State Department announcement nor the July 14, 2020 executive order discusses any other U.S. tax provision. The PRC and Hong Kong appear to remain separate countries for other purposes of the Code, although the executive order does invite other agencies to "propose for my consideration any further actions deemed necessary and prudent to end special conditions and preferential treatment for Hong Kong."^[15]

KPMG observation

Tax professionals expect the Treasury Department will probably issue additional guidance regarding the Shipping Agreement. KPMG will provide additional information as it emerges.

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Endnotes

[1] See 1995-1 C.B. 228 (May 22, 1995). Any reference to the "Code" or to the "I.R.C." is a reference to the Internal Revenue Code of 1986, as amended, and a reference to "section" or "§" is a reference to a specific section of the Code.

[2] Under the treaty, Britain's sovereignty over Hong Kong was scheduled to end on June 30, 1997 and was scheduled to transfer to Qing government on July 1, 1997. The Qing government fell in 1912 and was eventually replaced with the PRC government.

[3] See 23 I.L.M. 1366 (1984); 1984 WL 196804.

[4] See P.L. 102-383, as amended. The Hong Kong Policy Act was codified at 22 U.S.C. § 5701-5732.

[5] See P.L. 102-383, § 2(1).

[6] See P.L. 102-383, § 201(a).

[7] P.L. 102-383, § 202(a).

[8] P.L. 102-383, § 202(b).

[9] See Hong Kong Human Rights and Democracy Act of 2019, P.L. 116-76, § 4 (amending Hong Kong Policy Act to include new section 205).

[10] See 1997-2 C.B. 287 (July 14, 1997).

[11] The Shipping Agreement does not apply to the PRC. See Revenue Ruling 2008-17, 2008-1 C.B. 626, n. 7. Exemptions from U.S. income taxation for residents of the PRC and corporations organized under the laws of the PRC are provided in the Agreement Between the Government of the United States of America and the Government of the People's Republic of China with Respect to Mutual Exemption From Taxation of Transportation Income of Shipping and Air Transport Enterprises.

[12] U.S. Department of State, 2019 Hong Kong Policy Act Report, state.gov/2019-hong-kong-policy-act-report/ (last visited 8.20.90). The law requiring Section 301 Reports lapsed twice before being re-enacted and extended. Accordingly, there are no Section 301 Reports for the period ending March 31, 2001, or for the periods ending March 31, 2007 through 2018.

[13] U.S. Department of State, 2020 Hong Kong Policy Act Report, state.gov/2020-hong-kong-policy-act-report/ (last visited 8.20.90).

[14] The president on the same day as Executive Order 13936 (July 14, 2020) also signed the “Hong Kong Autonomy Act,” which, *inter alia*, requires additional reporting and authorizes the president to impose new sanctions on persons who contribute to or attempt to contribute to the failure of the PRC to “meet its obligations under the Joint Declaration and the Basic Law[.]” See generally P.L. 116-149.

[15] EO 13936, § 3(l).

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