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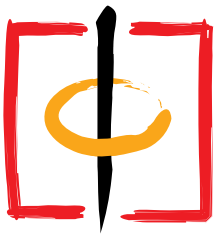

CHINA BRIEFING

From Dezan Shira & Associates

Double Taxation Avoidance in China: A Business Intelligence Primer

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CHINA BRIEFING

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Introduction

Rising operational costs in China mean that business owners must be alert to all possible means of maximizing the performance of their China-based investments. As one such measure, the benefits obtainable under double taxation avoidance (DTA) agreements are of critical importance.

Over the past decade, China has taken active measures to promote the use of DTAs, such that it is now signatory to over 100 such treaties, either in-force or pending. This compares with the United States, which has ratified only 68 DTAs (including with China) - many of which are hindered by having been written prior the rise of the Internet.

Yet the complexities of applying for and securing DTA benefits in China - entailing coordination between the requirements of multiple jurisdictions, as well as considerable foresight on the part of foreign investors - mean they are all too often lost in the bureaucratic shuffle.

In our twenty-two years' of experience in facilitating foreign investment into Asia, Dezan Shira & Associates has witnessed first-hand the development of China's double taxation avoidance mechanism and established an extensive library of resources for helping foreign investors obtain DTA benefits. In this issue of China Briefing Magazine, we are proud to present the distillation of this knowledge in the form of a business intelligence primer to DTAs in China.

Kind regards,

Sabrina Zhang
National Tax Partner
Dezan Shira & Associates
Beijing Office

For Reference

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Double Taxation Avoidance in China: A Business Intelligence Primer

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An Introduction to Double Taxation Avoidance

- By Chris Devonshire-Ellis, Zhou Qian and Matthew Zito

When a commercial transaction is undertaken between individuals or enterprises with residency in two different national tax jurisdictions (i.e. a "cross-border transaction"), differences in their respective taxation systems can give rise to redundant (or "double") taxation of the same income.

The stultifying effect this can have on attracting foreign direct investment (FDI), especially for developing countries, has led to the widespread adoption of Double Taxation Avoidance Agreements (DTAs or DTAAs) between global trading partners, including states and non-state tax jurisdictions such as Hong Kong.

DTAs are bilateral agreements by nature, and while their signatory countries are not necessarily members of the Organization for Economic Cooperation and Development (OECD), DTAs are generally based on model conventions developed by the OECD or (less commonly) the United Nations. As a result, some 75 percent of the content of a given DTA is identical with that of any other, though the applicability and specific provisions of individual treaties can vary substantially.

These agreements have been shown to be an effective means of promoting bilateral FDI (by typically between 27 and 31 percent over the long-run) between signatory countries and boosting ROI for investors, thus presenting a win-win for governments and businesses alike. In addition to their function of preventing double taxation, DTAs also work to combat tax evasion through information sharing and to promote cross-border trade efficiency.

Typically, DTAs prevent double taxation through two methods: either through providing tax credits (i.e., allowing the tax paid in one of the two countries to be offset against tax payable in the other) and/or by providing exemptions or reduced tax rates for specific income types such as interest, royalties and dividends.

From an investor's perspective, confusion regarding international taxation can arise when company operations are subject to two different and potentially conflicting tax systems. For example, Hong Kong and Singapore employ a "territorial source" principle of taxation, which means that only profits sourced locally are taxable.

Meanwhile, other countries like China and the United States are on the worldwide tax system, under which resident enterprises are required to pay tax on income sourced both in and outside of the country. DTAs not only provide certainty to investors regarding their potential tax liabilities, but also boost the tax efficiency of international investments.

China DTA Factsheet

Total tax revenue (2012)	RMB 10 trillion +
Corporate Income Tax Law effective	1 January 2008
Corporate income tax rate	25%
Number of double tax agreements	101
Dividends tax rate (paid to a non-resident company)	10%
DTA preferential rate	5 - 8%

A Background to DTAs in China

China has made significant strides in the past five years in building up its regulation in the area of double taxation avoidance, as well as implementation assurance techniques. Following the 2008 Corporate Income Tax Law, which laid the basis for anti-avoidance in China, the State Administration of Taxation (SAT) issued a flurry of related circulars stipulating reporting requirements for offshore transactions, describing qualification as a beneficial owner, and dictating protocol for claiming treaty benefits.

Before it will grant DTA relief from Withholding Tax on dividends, interest or royalties, the SAT must be satisfied that the applicant company in a DTA partner jurisdiction (for example, Hong Kong or Singapore) is indeed the "beneficial owner" of the Chinese subsidiary. The SAT bases its judgment on a principle of "substance over form" – that is, it is not enough that the applicant company is a tax resident in the DTA partner jurisdiction in question.

This can pose a significant problem, especially for companies that were established many years ago through a holding company in Hong Kong, and thus did not consider their future qualification as "beneficial owners." Therefore, conducting a preliminary assessment of a company's situation is typically the first step taken by Dezan Shira and Associates professionals to determine the likelihood of approval prior to submitting an application for DTA relief.

Based on the experience of Dezan Shira & Associates professionals, the most common difficulty that clients in Hong Kong face in securing treaty benefits under the DTA between China and Hong Kong is obtaining the tax residency certificate for their Hong Kong entity, especially when this acts solely as a holding company. In such cases, the China tax authority is likely to refuse to recognize these entities as a beneficial owner and deny the application for DTA benefits.

The development and current situation of DTAs in China can be summarized according to four legal frameworks:

Anti-avoidance foundations

China's general anti-avoidance rules were first introduced under the 2008 Corporate Income Tax (CIT) Law, which provides that, where an enterprise's taxable income is reduced due to its implementation of "arrangements that do not have a reasonable business objective," the tax authority will have the right to make adjustments to the taxes owed. The CIT Implementing Rules further clarified that such arrangements are those for which the main purpose is to reduce, avoid or defer the payment of taxes.

Where there is abuse of preferential tax policies, tax treaties, enterprise organizational structures, tax havens, or other arrangements without reasonable business purpose, the tax authorities are empowered to launch a general anti-tax avoidance investigation based on the principle of "substance over form."

Claiming treaty benefits

In August 2009, Chinese tax authorities introduced administrative requirements for non-residents to undertake in order to enjoy benefits under DTAs. Details on these requirements were given in Circular 124 and its supplementing Circular 290, which also stated that a withholding agent should complete registration procedures regardless of whether the taxpayer has provided relevant information to the tax authorities.

The procedure for claiming DTA benefits is divided into two pathways of administrative measures—either "approval" or "record-filing" with the relevant tax bureau—, depending on the type of relief being claimed. Details for both methods are provided in the chart on page 11 below.

Qualifying as beneficial owner

Circular 601 states that a recipient of dividends, royalties or interest from a Chinese resident enterprise is entitled to treaty benefits if the recipient can be named "beneficial owner" of such income.

Circular 30, released in late June 2012, built upon Circular 601 to make it simpler to obtain "beneficial owner" status. This circular presented a "safe harbor" of sorts, where listed companies are automatically considered beneficial owners of dividend income. In addition, local tax authorities were prohibited from simply rejecting DTA relief claims; but rather required to first receive approval from the provincial level tax authority and then report the case to the SAT for filing.

Reporting offshore transactions

Where an offshore investor indirectly transfers equity in a Chinese resident enterprise and the actual tax burden in the jurisdiction of the offshore holding company is lower than 12.5 percent, or the country in question exempts tax on offshore income, the Chinese authorities should be notified.

This requirement, derived from Circular 698, further states that where the transfer involves the abuse of an organizational structure, and the arrangement (i.e. the offshore holding company) has no reasonable business purpose or has the main purpose of evading the obligation to pay CIT, the tax authorities can disregard the offshore holding company following an investigation into its ownership and operations.

Apart from their nominal function of protecting against double taxation, most DTAs also include "tax sweeteners" for savvy international businesses to take advantage of, such as the following:

Dividends Tax

China charges a 10 percent dividends tax on the overseas repatriation of profits, in addition to a 25 percent corporate income tax (CIT). However, many of China's bilateral DTAs (such as that with Hong Kong) provide for a clause that reduces the dividends tax rate by 50 percent. This potential reduction, entailing considerable savings for enterprises, is not something that the taxation authorities will bring to the attention of taxpayers. In order to secure these savings, it is essential that investors plan far in advance, as applying for DTA benefits is just one step in the larger procedure of declaring and repatriating dividends (as shown).

For example, a WFOE with an accumulated profit for 2014 of RMB200,000, after placing a mandatory 10 percent (i.e. RMB20,000) into its reserve funds and paying 10 percent withholding CIT (RMB18,000) on the remainder, will only be able to repatriate **RMB162,000** for the year. But under the DTA reduced rate of 5 percent CIT, this amount increases to **RMB171,000**.

Procedure for Repatriating Dividends from China

Step 1	Tax Clearance & Annual Audit
Step 2	Derive Tax Payment & Net Profit Figures
Step 3	Board of Directors/ Executive Director of WFOE Drafts Profit Distribution Plan with Shareholder's Approval
Step 4	Apply for Preferential Tax Rate according to DTA & Payment of Withholding Tax
Step 5	Apply for Foreign Exchange Approval with State Administration of Foreign Exchange
Step 6	Dividend Remittance

Withholding Tax

Withholding Tax (WT) is charged on an array of service fees billed by a company in its home jurisdiction to a company (either a client or subsidiary) in China for services provided by the former to the latter. As CIT cannot be charged to a company that is non-resident, WT takes its place. The levied rate of WT varies considerably depending upon the service provided.

Foreign investors are advised to consult with professionals as to the applicable WT rates per type of service. However, as a rule of thumb, this is generally between 10-20 percent of the total invoice value. In many cases, the DTA mechanism can halve this amount. Service fees charged by a parent company for the use of trademarks by its subsidiaries, for example, may be remitted to the parent at a rate lower than the standard 10 percent Withholding Tax levied in China.

While foreign-invested entities (FIEs) in China are permitted to sign a variety of service agreements with foreign companies, including with their headquarters (HQ), these agreements can sometimes be looked upon with suspicion as "constructed channels" for funneling money between the HQ and its overseas subsidiaries.

It is important to bring one's intent to invoke DTA benefits to the attention of the local tax office in China, together with copies of the DTA (in Chinese), and the company's articles of association and business license. Permission is required by tax officials in China to reduce the amount of taxes due from a company and they must be able to provide an explanation to their own superiors.

Accordingly, a well presented case must be made by the applicant, for which it is advisable to contract the assistance of a professional firm such as Dezan Shira & Associates. The tax savings thus obtained typically outweigh any service fees incurred even in year-one of operations under the protection of a DTA.

Angela Ma
Associate
International Business Advisory
Beijing Office
Dezan Shira & Associates

"An American client was looking at reducing their overall profits tax bill. By utilizing the US-China DTA and discussing this with the local Chinese tax authorities, we were able to build into the client's overall tax planning structure a mechanism that would allow the American parent company to charge their China WFOE for a number of legitimate service costs and royalties. As a result, we significantly improved the client's overall profitability by substituting lower withholding tax rates in place of higher profits tax rates on several items. This resulted in an annual six-figure (US$) increase in overall tax savings for the American parent company."

Qualifying for DTA Benefits in China

– By Eunice Ku, Zhou Qian and Matthew Zito

The first step in qualifying for DTA benefits is to determine whether you are a tax resident of a country that has an effective DTA agreement with China (i.e. a non-resident with respect to China). For a list of relevant countries, see the list on page below.

Countries with Double Taxation Avoidance Agreements with China (as of October 2014)					
Albania	Croatia	India	Macedonia	Poland	Syria
Algeria	Cuba	Indonesia	Malaysia	Portugal	Tajikistan
Armenia	Cyprus	Iran	Malta	Qatar	Thailand
Australia	Czech Republic	Ireland	Mauritius	Romania	Trinidad & Tobago
Austria	Denmark	Israel	Mexico	Russia	Tunisia
Azerbaijan	Ecuador**	Italy	Moldova	Saudi Arabia	Turkey
Bahrain	Egypt	Jamaica	Mongolia	Serbia & Montenegro	Turkmenistan
Bangladesh	Estonia	Japan	Morocco	Seychelles	Ukraine
Barbados	Ethiopia	Kazakhstan	Nepal	Singapore	United Arab Emirates
Belarus	Finland	Korea (R.O.K.)	Netherlands*	Slovakia	United Kingdom*
Belgium*	France	Kuwait	New Zealand	Slovenia	United States
Bosnia-Herzegovina	Georgia	Kyrgyzstan	Nigeria	South Africa	Uzbekistan
Botswana**	Germany	Laos	Norway	Spain	Uganda**
Brazil	Greece	Latvia	Oman	Sri Lanka	Venezuela
Brunei	Hong Kong	Lithuania	Pakistan	Sudan	Vietnam
Bulgaria	Hungary	Luxembourg	Papua New Guinea	Sweden	Zambia
Canada	Iceland	Macao	Philippines	Switzerland	

** Additional protocol signed but not yet in effect.* *** Agreement signed but not in effect at time of writing.*

Following this, the qualification requirements as set out in the specific DTA should be examined. These are typically organized in terms of the following:

- Persons covered;
- Taxes covered;
- Definitions of key terms (e.g. resident, permanent establishment);
- Taxation of income;
- Taxation of capital;
- Elimination of double taxation; and
- Exchange of information.

Accordingly, the DTA applicant must be a person covered by the DTA; the benefits to be claimed must be a tax exemption or reduction stipulated by the DTA; and other relative details in the DTA must be satisfied for a positive ruling to be issued on the application of treaty benefits. Among these criteria, permanent establishment and beneficial owner status are of critical importance for understanding the workings of DTAs and are treated at length below, accordingly.

Special Purpose Vehicles

Prior to 2008, a special purpose vehicle (SPV) was the most common structure used by foreign companies to hold investments in China. An SPV is a holding company set up by a foreign investor outside of China -- usually in Hong Kong or other locations that boast notable tax advantages and favorable tax treaties with China -- for the special purpose of holding equity interest in an onshore foreign-invested enterprise (FIE).

One of the advantages of using an SPV is that it may benefit from preferential withholding tax rates on dividends and other passive income under the tax treaties between China and the jurisdiction in which the SPV is located. For example, Hong Kong's double tax agreement (DTA) with China reduces the withholding tax rate on dividends from 10 percent to five percent.

Permanent Establishment

Permanent establishment ("PE") – defined as a fixed place at which the business of an enterprise is carried out in a given country - is a key concept for the applicability of DTAs. If a non-resident enterprise (in terms of China) is a tax resident of a jurisdiction that has a DTA in place with China, it may be able to claim exemption from CIT if its establishment or venue in China does not constitute a "PE" pursuant to the "PE" article under the relevant DTA.

However, where a resident of a country which has a DTA with China carries on business in China through a PE, the profits derived by the PE will be subject to taxes in China. Simply put, foreign companies can be deemed to have a PE in China, if:

- It has an establishment or a place of business in China (Fixed place PE);
- It has a building site, a construction, assembly or installation project or related supervisory activities that last for a certain period of time (Construction PE);
- It appoints an agent in China to conclude contracts or accept orders in China (Agent PE);
- It has employees working in China for a certain period of time (Service PE).

Commonly Recognized Types of PE for Double Taxation Avoidance

Type of PE	Requisites
Fixed Place PE	• Having a fixed place of business, where the business of the foreign entity is wholly or partly carried out
Agency PE	• Having the authority to conclude contracts nearly on behalf of the foreign enterprise • Securing and delivering orders wholly or nearly so on behalf of the foreign enterprise
Service PE	• Furnishing or performing services in the foreign country • Having staff employed in the foreign country for a total of 6 months or 183 days during a 12-month period

Besides the qualification requirements contained in DTA agreements, there are also requirements stipulated by Chinese laws and regulations, clarifying whether a specific type of business can enjoy DTA benefits or not, such as "beneficial owner" status regulated by Circular 601 and Circular 30.

Beneficial Owner

Circular 601 states that a recipient of dividends, royalties and interest from a Chinese resident enterprise is entitled to treaty benefits if the recipient can be named "beneficial owner" of such income. A "beneficial owner" refers to an individual, a company or any other group having the ownership and right of control over the income or the right or property derived from the income. In determining whether the non-resident company is indeed the beneficial owner of the royalties, the tax authorities will apply a "substance over form" principle. A "beneficial owner" should be engaged in actual operating activities. An agent or a conduit company does not constitute a "beneficial owner".

In general, the following seven factors are disfavorable to an applicant's determination as beneficial owner:

- The applicant is obligated to pay or distribute all or the majority of its income (e.g., 60 percent and above) to residents of a third country (region) within a stipulated period (e.g., within 12 months from receipt of income);
- Except for holding properties or rights from which income is derived, the applicant has little or no other business activities;
- Where the applicant is a corporation, its assets, scale of operations, and staffing are relatively small (or few) and not commensurate with the amount of income;
- The applicant has little or no control or right of disposal over income or properties or rights from which income is derived, and bears little or no risk;
- The counterparty country (region) of the tax agreement does not levy tax or exempts tax on the relevant income, or the actual levy rate is very low;
- Aside from loan contracts upon which interest is derived and paid, there exist other loan or deposit contracts between the creditor and a third party which are similar in terms of amount, interest rate and date of execution, etc.;
- Aside from contracts for the transfer of copyrights, patents, proprietary technologies and other use rights based upon which royalties are derived and paid, there exist contracts between the applicant and a third party pertaining to the transfer of copyrights, patents, proprietary technologies and other usage rights or ownership.)

Fabian Knopf
Senior Associate
Co-Head of German Desk
International Business Advisory
Dezan Shira & Associates

"Many offshore companies are set up in locations that have DTAs in place with China, such as HK, but the actual investor may be in the U.S., for example. Since there is no reduced withholding tax rate under the U.S.-China DTA, setting up in HK may allow them to benefit from the reduced rate of five percent withholding rate on dividends under the HK-China DTA. To ensure that the HK presence is not merely a shell company, tax authorities need to know whether the company has actual operations and is paying taxes, since DTA benefits only apply if it is a real company."

Applying for DTA Benefits in China

– By Eunice Ku, Zhou Qian and Matthew Zito

For foreign investors doing business in China, securing DTA benefits is an important measure for reducing the tax burden as stipulated by Chinese tax law and thereby maximizing profit.

In addition to satisfying the specific requirements of the relevant DTA agreement and those mentioned above, certain administrative procedures must be followed according to Chinese laws and regulations, as outlined in Circulars 124 and 290.

The process of applying for DTA benefits can be quite onerous, requiring the applicant to submit a preferential tax treatment form as well as certain forms of documentation from the government of his/her country of tax residency.

In general, there are two pathways of administrative measures—either "approval" or "record-filing" with the relevant tax bureau—to be followed, depending on the type of relief being claimed.

	Approval Method			Record-filing Method	
Available Relief	1. Dividends; 2. Interest; 3. Royalties; and 4. Capital gains.			1. Permanent establishment and business profit; 2. Independent personal labor services; 3. Non-independent personal labor services; and 4. Any other type of income or gains stipulated in a DTA agreement.	
Authorities in Charge	Determined by the provincial-level tax authorities pursuant to prevailing conditions (and subsequently filed with the State Administration of Taxation).			N/A	
Required Materials	Application for Approval	1. Application form (for examination and approval); 2. Personal information form; 3. Proof of overseas tax residency; 4. Proof of ownership of income, or a certificate issued by an intermediary or notary public; and 5. Other relevant materials.		Record-filing	1. Application form (for record-filing); 2. Proof of overseas tax residency 3. Other relevant materials.
	Post-approval	1. Record of having received non-resident DTA benefits (submitted to relevant tax authorities).		Post-filing	N/A
Processing Time	Examination and Decision	20 working days	County or district-level tax authorities	N/A	
		30 working days	Prefectural or municipal-level tax authorities		
		40 working days	Provincial-level tax authorities		
	Extension	10 working days	Where a decision cannot be made within the original timeframe		
	Negotiation and/or Information Exchange	20 working days (per level of communications required)	Where the tax authorities are unable to determine entitlement to DTA benefits, and it is necessary to communicate with higher-level tax authorities.		
Taxpayer Deadlines	Retrospective Application for DTA Benefits	3 years	Where a non-resident has not obtained DTA benefits owing, and has paid excess taxes as a result.	3 years	Where a non-resident has not obtained DTA benefits owing, and has paid excess taxes as a result.
	Supplement or Correction	90 days	Where the applicant fails to provide relevant materials or those provided are insufficient, and is notified by the tax authorities to remedy the situation.	N/A	