

News Flash

China Tax and Business Advisory

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With over 1,200 China tax professionals and 50 China tax partners in 12 cities in Mainland China, Hong Kong, and Singapore, our PwC China Tax and Business Service Team provides a full range of tax advisory and compliance services. Leveraging on a strong international network, our tax specialists are striving to offer technically robust, industry specific, pragmatic and seamless solutions to our clients on their tax and business issues locally. The Global Tax Monitor recognises PwC as having the strongest overall reputation for tax services in China, with a lead over the competition.

Treaty Benefit for Dividends Tightened

Since the beginning of this year, the Chinese State Administration of Taxation ("SAT") has issued quite a number of circulars on the tax administration for non-tax resident enterprises ("Non-TREs"). Amongst them was Guoshuihan [2009] No. 81, ("Circular 81"), which was issued on February 22, 2009 to address the implementation of the withholding tax ("WHT") benefit in respect of dividends under Double Tax Treaties ("DTAs") concluded between China and other countries/regions.

In this Issue of News Flash, we will share with you the salient points of Circular 81 and our observations on China's tax administration on granting DTA benefits to Non-TREs.

Salient points of Circular 81 and further clarifications

Circular 81 provides for the following in relation to implementing the "Dividends" article under DTAs:

- Scope of "Dividends" – The title of Circular 81 is "SAT Notice for Implementation of the 'Dividends' Article under DTAs". Most DTAs that China has concluded with other countries/regions provide such an article whereby the WHT rate on dividend income derived from one side by the tax resident of the other side shall be restricted to a prescribed treaty rate, if the domestic WHT rate is higher. The China's Corporate Income Tax ("CIT") Law and Detailed Implementation Rules ("DIR") have unilaterally offered a reduced WHT rate of 10% on China-sourced dividends earned by Non-TREs, whether they are from DTA countries/regions or not. Out of the 93 treaties signed by China, 43 have restricted the WHT rate lower than 10% for dividends if certain shareholding criteria are met. We believe this is the treaty benefit that Circular 81 aims to manage.
- Circular 81 sets out the criteria which the Non-TRE (being the dividend recipient) must meet in order to claim the relevant treaty benefit for dividends received from China:
 - The Non-TRE must be a tax resident of the other side to the DTA (so-called "treaty resident");
 - The Non-TRE must be the beneficial owner of the dividend;
 - The dividend must be dividend or profit distribution determined in accordance with the relevant laws and regulations of China; and
 - Any other criteria set out by the SAT.
- Where the DTA stipulates that the treaty resident of the other side has to hold at least a certain percentage (usually 25% or 10%) of the share capital of the Chinese enterprise paying the dividend before it can enjoy the treaty benefit, that treaty resident of the other side has to meet the following criteria for claiming that treaty benefit:
 - It must be a company (note: This is in line with the requirement in the DTAs);

- The minimum shareholding requirement must be met in terms of both beneficial interests and voting rights;
 - The minimum shareholding requirement has to be met throughout the 12-month period preceding the obtaining of the dividend (i.e. a 12-month look-back period).
- Circular 81 emphasizes that the in-charge tax bureaus have the power to make adjustments to any transactions or arrangements to deny the treaty benefits if the main purpose of the deals or arrangements is to obtain treaty benefits for dividends. This is the application of the general anti-avoidance rules (“GAAR”) provision in the CIT Law which we will further analyze below.
- Circular 81 also lists out the following documents and declaration which are necessary for the purpose of claiming treaty benefits for dividends to treaty residents:
 - Tax resident certificate issued by the tax authority of the other side together with relevant supporting legal evidence;
 - The tax profile of the treaty resident in the other side, especially in relation to the dividends from China;
 - Whether the Non-TRE is a tax resident of a third jurisdiction;
 - Whether it is a TRE of China;
 - Documents supporting its entitlement to the dividend;
 - The shareholding of the treaty resident in the Chinese company which pays the dividend.

PwC Observations

Below are our observations arising from Circular 81:

Anti-treaty shopping and anti-tax avoidance

- Circular 81 is a circular sent by the SAT to the local-level tax bureaus on how to implement the “Dividends” Article in DTAs and how to identify abusive use of DTAs by foreign investors, e.g., by interposing a shell / nominee / intermediary company between the foreign investors (beneficial owner) and the Chinese dividend-paying enterprise, to gain treaty benefits. If such situation occurs, the local-level tax bureaus can use “beneficial ownership” or “GAAR” to challenge the transaction or arrangement and deny the granting of the treaty benefit.
- The GAAR paragraph in Circular 81 is for notifying the local-level tax bureaus that they can use the GAAR provision in Chapter 6 (Special Tax Adjustments) of the CIT Law to counter the abusive transactions or arrangements. (Note: it is clearly stated in the “Implementation Measures of Special Tax Adjustments (Trial)” released by the SAT in January 2009 that GAAR can be used to counter, among other things, the abusive use of tax treaties). However, this GAAR application may invite the following challenges:
 - Besides the DTAs with Hong Kong and Singapore, the other DTAs concluded by China so far do not have a provision allowing China to use GAAR in her domestic tax law to attack abusive use of tax treaty. There seems no legal basis for China to unilaterally adopt GAAR in this situation for all treaties. Can the affected treaty resident initiate Mutual Agreement Procedure (“MAP”) so that the competent authorities from both sides can resolve the issue? Will this potentially lead to a re-negotiation of the relevant DTA?
 - The interpretation of “main purpose” can be very subjective and controversial. Since China does not have a case law system for both the tax authorities and taxpayers to follow, the interpretation of this term may create a lot of confusions in practice.
- It appears that the 12-month look-back period criterion is introduced as a kind of anti-avoidance measures. This criterion is not in any DTAs concluded by China and is a unilateral requirement set by the SAT. To our knowledge, the 12-month look-back rule is rarely seen in any treaties. We believe that the objective of imposing such a look-back period is to counter the imposition of an intermediate holding company in jurisdictions with such treaty benefit by foreign investors right before the declaration and payment of dividends so as to enjoy the treaty benefit. Looking at the scenarios where a foreign company purchases a Chinese company or where a foreign company increases its shareholding in a Chinese company from below the threshold to above it, the Chinese company has to wait for 12 months before it declares and pays dividends to that foreign company so that the latter can enjoy this treaty benefit. The 12-month look-back period criterion seems to be harsh.

More disclosure and procedures

- As noted above, quite a lot of information and documents are required for claiming the treaty benefits on dividends. In most other jurisdictions, a tax resident certificate is the only document required for claiming such treaty benefits. This information and documents requirement may be a concern to foreign investors as it means more disclosure. It appears that the objective of the SAT is to collect as much relevant information as possible for the Chinese tax authorities to assess whether there is treaty shopping / treaty abuse or that the dividend recipient qualifies as a genuine treaty resident of the other side.
- Among the documents required is information regarding the tax profile of the treaty resident in its home jurisdiction, especially in relation to the dividends received. The taxability of the dividend in the other side is definitely not a requirement in China's DTAs for qualifying for the treaty benefit. This requirement is likely again for the purpose of assessing the possible abusive use of treaties. However, this requirement may not necessarily provide useful information to the Chinese tax authorities. For example, most EU countries adopt the tax exemption (participation exemption) method rather than the tax credit method in the relief of double taxation on foreign dividends. In that respect there will not be any tax on the dividend in the home jurisdiction of the EU recipient which qualifies for the participation exemption.
- Circular 81 is silent on the procedures for claiming DTA benefit for dividends by Non-TREs. We understand that the SAT is drafting a set of detailed administrative measures on the claiming of DTA benefits by treaty residents which will contain the necessary procedures and application forms.

Conclusion

- From now on, it is not technically correct to say that the Chinese tax authorities are not concerned about treaty shopping or tax avoidance. Rather, to the contrary, Circular 81 demonstrates that they take it very seriously in attacking treaty shopping or tax avoidance. We also understand that, whenever opportunity arises, the SAT would endeavour to add the GAAR provision to any new or re-negotiated DTAs in order to allow them to use GAAR to counter treaty shopping and treaty abuse.
- It is important for foreign investors who intend to set up intermediate holding companies to hold their China investments and those who already have the structures in place, to be aware of this tax development. Commercial purposes and business substance, supported with good documentation, are of utmost importance for the intermediate holding companies in order to secure the treaty benefit.

In the context of this News Flash, China or the PRC refers to the People's Republic of China but excludes Hong Kong Special Administrative Region, Macao Special Administrative Region and Taiwan Region.

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