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China alert

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New China-United Kingdom double tax agreement may bring tax planning opportunities

Matter discussed in this issue:

- New China-United Kingdom double tax agreement signed on 27 June 2011

Background

On 27 June 2011, China and the United Kingdom (UK) signed a new double tax agreement (new DTA) which, once in force, will replace the previous DTA of 26 July 1984 (as amended by the 1996 protocol). Ratification by the UK and Chinese governments and entry of the DTA into effect are expected by end of this year and it may be effective from as early as 1 January 2012 in China.

The DTA generally follows the OECD Model Convention, but does include a number of deviations from that Model. The DTA generally offers lower rates of withholding tax than were previously available under the old DTA, and contains changes to the definition of permanent establishment (PE) and the methodology for PE profit attribution. Also of note are that the anti-avoidance provisions of the DTA have been expanded, and the Exchange of Information (EoI) article has been updated to be consistent with the latest OECD version.

Given the existing provisions of Chinese and UK domestic tax law, the benefits under the new DTA, from a bilateral viewpoint, are particularly advantageous for UK investors investing into China. Recent improvements in the UK domestic tax regime, coupled with the DTA changes, could create opportunities for the UK to be used more generally as a holding company location for investment into China. Further, Chinese investors into the European Union might also give further consideration to using the UK as a holding company location for their investments.

Key changes at a glance:

- Lower rates of withholding tax on dividends, royalties and capital gains
- Clearer definition of PE and PE profit attribution methodology
- Extensive anti-abuse rules in the withholding tax articles, and article authorising the use of domestic anti-avoidance rules
- Inclusion of the latest version of the Exchange of Information article

Provisions of the new DTA – PE and business profits

The new DTA clarifies the PE recognition and profit attribution rules in the following respects:

- A 'services PE's' clause has been introduced in the new DTA as encompassing the provision of services for a period of more than 183 days in a 12-month period. Although this clause might be seen to extend the scope of PE, on balance, its introduction may be viewed as a positive development as it provides a certain de minimus protection for service activities undertaken in China.
- Construction and installation projects (which are now expanded to include associated supervisory services) now only constitute a PE if they continue for more than 12 months (as against six months in the old DTA).
- The previous DTA had qualified the 'independent agent' carve-out from PE recognition by stating that an agent, acting wholly or almost wholly for a foreign principal, would not be recognised as independent. The new DTA provides that the agent must additionally deal with the principal on non-arm's length terms in order not to be regarded as independent. This may facilitate the use of the independent agent PE carve-out.
- The clause in the business profits article, which states that executive and general administrative expenses incurred for the purposes of a PE's business may be allowed in calculating the taxable profits of the PE, is now no longer qualified by the previous wording, which stated that recharges from head office to the PE are not deductible. As this differs from the current customary practice of the Chinese tax authorities, the revised clause may prove to be helpful.
- It is now provided that, where it has been customary in a Contracting State for a PE to be taxed on the basis of the allocation of a proportion of the total profits of the enterprise to the PE, that practice may continue. It is also provided that PE profits shall be determined consistently from year to year using the same measure, unless there is sufficient reason to do otherwise.

Provisions of the new DTA – Withholding taxes

The rates of withholding tax applied under the DTA have generally been reduced. The reductions are of more significance for UK investors investing in China given that a Chinese investor would not, in any case, suffer withholding tax on UK sourced dividends or capital gains under current UK tax laws.

	China domestic	UK domestic	DTA rate
Dividends	10%	0%	5/10/15%
Interest	10%	20%	10%
Royalties	10%	20%	6/10%
Capital gains	10%	0%	0/10%

<u>Dividends</u>

- The withholding tax on dividends, from shareholdings of 25 percent or more of the total capital of the paying company, is reduced from 10 percent, for all dividends under the old DTA, to five percent. This change brings the treatment of dividends from substantial shareholdings in line with the preferential treatment offered under China's more recent tax treaties.

- New rates of dividend withholding tax apply to distributions from exempt real estate investment entities, such as REITs, with a 15 percent rate applying on distributions from the UK, while dividends paid to either the UK or the Chinese government (or any of its wholly owned institutions) would be exempt from withholding tax in the paying country.

  Royalties

- While the general withholding tax on royalties is unchanged at ten percent, it has been lowered from seven percent to six percent for royalties from the use of, or right to use, industrial, commercial or scientific equipment.

  Interest

- Withholding tax on interest remains at ten percent.

  Capital gains

- The capital gains tax treatment of China-sourced gains on share disposals by UK companies has been enhanced, as disposals of shareholdings less than 25 percent (subject to the "land rich" company exception outlined below) should now be exempt from Chinese withholding tax; conversely, disposals of shareholdings 25 percent and above continue to be subject to tax at 10 percent in China.

- The structure of the capital gains tax article has been brought into line with the general position for China's recent tax treaties; China reserves the right to tax gains from disposals of immovable property located in China, shares deriving more than 50 percent of their value (directly or indirectly from) Chinese immovable property, and business property of PE's.

Further, in each of the articles dealing with dividends, interest, and royalties, there is now a new specific anti-abuse provision stating that the DTA withholding tax rate reductions will not be available if it was the main purpose or one of the main purposes, of any person concerned with the creation/assignment of the shares/debts/rights under which the payments arise, to take advantage of the Article.

Provisions of the new DTA – other provisions

A number of the other changes to the DTA are worthy of note:

- It is now provided that, if greater profits are attributed to an enterprise, under the associated enterprises article, a corresponding adjustment should be made in the other Contracting State to mitigate double taxation.

- The technical fees (for more details, please refer to China alert 10) article has been removed from the DTA, and a new 'other income article' has been added, which states that other income not dealt with in the DTA should only be taxed in the state where the taxpayer is resident.

- The Shipping and Air Transport provision has now been expanded so that the profits from the rental on a bare boat basis of ships and aircraft shall be taxable only in the Contracting State of the renting enterprise.

- The threshold shareholding required, in order for a Chinese resident receiving a UK dividend to obtain a foreign tax credit under the DTA, in respect of any underlying UK tax, has been raised from 10 percent to 20 percent.

- Importantly, and in line with the trend in recent Chinese tax treaties, the new DTA includes a new 'Miscellaneous Rule' in Article 23, which provides that nothing in the DTA shall limit the application of domestic anti-avoidance rules to the DTA (such as the Chinese general anti-avoidance rule (GAAR) in Article 47 of the Corporate Income Tax (CIT) Law).

- The EoI clause has been updated to the latest OECD version. This expands the circumstances within which an EoI request may be made from cases where the information is ‘necessary’ for the enforcement of domestic tax law/provisions of the DTA and prevention of fiscal evasion to situations where the information is ‘foreseeably relevant’ to such purposes or to the application of provisions against legal avoidance.

- The new EoI article stresses that a Contracting State shall gather information at the request of the other state, even if it does not require such information for its own tax purposes and that a Contracting State will not be permitted to decline to supply information solely because held by a bank, other financial institution, nominee, or person acting in an agency or fiduciary capacity.

KPMG observations

The new China-UK DTA both facilitates the enforcement of the provisions of the tax law in the Contracting States (through the enhanced EoI, the facilitation of the application of domestic anti-avoidance rules and the inclusion of new specific anti-abuse rules in the DTA) as well as rendering investments between China and the UK more attractive from a tax perspective.

From the bilateral point of view, UK investors may have more to gain relatively speaking under the new DTA than Chinese investors. UK investors now benefit from potentially lower dividend and royalty withholding tax rates and from capital gains tax exemptions, as well as having greater clarity as to when a Chinese PE will be recognised and how much profit will be attributed to it. In addition the implications of the updated Shipping and Air Transport provision for possibly more efficient leasing activity are worthy of further consideration.

By contrast, Chinese investors already benefit from exemptions from UK withholding tax on dividends (otherwise than that from REITs) and capital gains tax under current UK domestic tax provisions, and the UK domestic rules around PE recognition and profit attribution were already reasonably developed and clear. Having said this, Chinese investors may benefit from the lower royalties withholding tax rate, the lower withholding tax on distributions on REITs (15 percent against 20 percent) and Chinese state-wholly owned investment companies are protected from any future introduction of dividend withholding tax in the UK.

UK investors into China have typically invested indirectly into China, frequently using an intermediate holding company located in jurisdictions that have more advantageous DTAs with China, for instance, in Hong Kong. Consideration may now be given to revamping and simplifying investment structures into China so that investments can be made directly from the UK. While the ultimate tax efficiency of direct investment will depend on the type of holding and investment strategy (e.g. Hong Kong continues to offer a better withholding tax rate on interest and on many types of royalty payment) the focus on substance in the Chinese interpretation of beneficial ownership (in Circular 601) and the existence of various anti-DTA shopping measures in the DTA may speak in favour of direct investment from the UK in certain cases.

From a multilateral standpoint, the UK may come to be viewed more favourably as a holding company location for investment into China, perhaps particularly for investors based in the EU. The various recent improvements to the UK’s international tax regime complement the provisions of the China-UK DTA in this regard. For instance, the UK’s current tax regime offers a wide participation exemption for dividends and capital gains where conditions are satisfied. The UK does not impose any form of withholding tax on outbound dividends, nor does it tax non-residents on capital gains. From the point of view of substance for the purposes of accessing China treaty benefits, many investors from the EU and elsewhere may be more likely to have existing presence in the UK than in the typical intermediary locations such as Luxembourg.

Chinese investors may also increasingly look to the UK as a holding location for their investment into the EU, and the UK's expansive DTA network may be viewed very favourably in this regard. In addition to the advantages of the UK's international tax regime mentioned above, a UK holding company will normally be entitled to receive dividends from EU subsidiaries free of dividend withholding tax under the terms of the EU Parent/ Subsidiary directive. An additional advantage for the Chinese investor is that the UK is on the "white list" for the purposes of China's Controlled Foreign Corporations.

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