New PRC-Taiwan double tax arrangement expected to encourage cross-straits trade and investment

Regulations discussed in this issue:

- Cross-Straits Agreement for Avoidance of Double Taxation and Strengthening Cooperation and its Appendix on the Detailed Arrangements, signed on 25 August 2015 ('PRC-Taiwan DTA and Appendix')
- China-France double tax agreement and accompanying protocol, signed on 26 November 2013
- China-Germany double tax agreement and accompanying protocol, signed on 28 March 2014
- Notice of the State Administration of Taxation on Issues Concerning the Determination of Chinese-Controlled Enterprises Registered Overseas as Resident Enterprises on the Basis of Their Bodies of Actual Management, Guo Shui Fa [2009] No. 82 (Announcement 82), effective from 20 February 2009

Background

On 25 August 2015 the People's Republic of China (PRC) and Taiwan concluded a landmark Double Tax Agreement ('the DTA') after six years of negotiations. Assuming the remaining approval procedures are completed by both parties in the remainder of 2015, the new DTA and its accompanying Appendix could take effect from as early as 1 January 2016.

The DTA provides for reduced levels of dividend, interest, royalties and capital gains withholding tax (WHT) relative to domestic rates, competitive with the best of the PRC's other DTAs. The DTA also includes some novel provisions, including specific measures addressing the treatment of third jurisdiction intermediate holding companies as tax residents of one of either the PRC or Taiwan. While the DTA incorporates anti-avoidance provisions now standard in PRC DTAs, it also includes a notably more limited Exchange of Information (EOI) article, ruling out automatic and spontaneous information exchange. There are also provisions covering mutual assistance and ongoing liaison between the tax authorities to facilitate application of the DTA and tax enforcement.

The DTA is expected to enhance cross-straits trade and investment as mutual direct investment can now avail of competitive WHT rates and benefit from the double tax mitigation features of the DTA. We expect this to lead to the use of simpler investment holding and operating structures and the door may also be opened to potential tax efficiency gains through restructuring.

Key features of the new DTA

The content and provisions of the DTA are largely drawn from the OECD Model Tax Convention (MTC) and the UN MTC, consistent with the mixed OECD/UN approach typically used in PRC DTAs. This being said, the DTA follows an unorthodox format, as the DTA itself is rather brief and most of the content appears in its Appendix.

Regulations discussed in this issue:

- Notice of the State Administration of Taxation on Issues Relating to the Implementation of Dividend Clauses in Tax Treaties, Guo Shui Han [2009] No. 81 (Circular 91), effective from 1 January 2008
- Notice of State Administration of Taxation on Issues Relating to Implementation of Royalties Clauses under Double Taxation Agreements, Guo Shui Han [2009] No. 507 (Circular 507), effective from 1 October 2009
- Announcement of the State Administration of Taxation on Issues Concerning the Clause of Property Gains in Tax Agreements, SAT Announcement 2012 No. 59 (Announcement 59), effective from 31 December 2012

DTA WHT rates

For dividends the DTA provides that, alongside a 10% general DTA WHT rate, a 5% WHT rate will apply where direct shareholdings of 25% and above are held in a company of the other jurisdiction. This is comparable with the PRC's best DTAs and reduces PRC WHT from 10% and Taiwanese WHT from 20%. Taiwanese investors should note that PRC guidance in SAT Circular 81 requires investors to have held the 25% shareholding for 12 months before they can access this relief.

The interest DTA WHT rate, at 7%, is also among China's best DTA rate alongside Hong Kong. This reduces PRC WHT from 10% and Taiwanese WHT from 20% (from 15% on certain debt securities). The DTA also provides exemption for interest payments made to a number of public institutions and publically owned financial institutions, as well as for interest guaranteed by these bodies in the course of promoting export business.

The royalties DTA WHT rate, at 7%, is also among the best of China's DTAs. This reduces PRC WHT from 10% and Taiwanese WHT from 20%. It might be noted by Taiwanese investors that PRC royalty WHT reductions are subject to the provisions of SAT Circular 507.

What is more, the DTA excludes leasing income from the royalty definition, the only PRC DTA to do so. Lease income is subject to 10% WHT under PRC domestic law and the PRC usually preserves its taxing right over lease payments through the royalty article. Given this exclusion, royalty income may be considered to fall alternatively under the business profits article. If this position were accepted by the PRC tax authorities, this could lead to the lease income being exempted from PRC tax unless it is effectively connected with a local PE. As to whether this would lead Taiwan to be preferred over other jurisdictions for leasing this initial interpretation would need further validation in practice to be confirmed.

Applicable WHT rates under DTA and comparison with Hong Kong (HK)

	PRC domestic	Taiwan domestic	PRC-TW DTA rate	PRC-HK DTA rate
Dividends	10%	20%	5[1]/10%	5[1]/10%
Interest	10%	15/20%	7%	7%
Royalties	10%	20%	0[2]/7%	5[3]/7%
Capital gains	10%	20%	0[4]/10%	0[4]/10%

[1] 5% dividend rate applies where the shareholding exceeds 25% of equity capital

[2] 0% rate for leasing dependant on precise interpretation of tax treaty

[3] 5% royalty rate for ship and aircraft leasing to be introduced with ratification of 4th Protocol

[4] 0% capital gains rate applied for non-land rich shareholdings of less than 25% of capital

The capital gains article follows a structure typical in most modern PRC DTAs, with the addition of a special feature for share disposal gains. Source jurisdiction tax rights are preserved over gains from disposals of i) PE assets. ii) immovable property, iii) equity in land rich companies, and iv) equity in non-land-rich companies in which the transferor holds at least 25% of the shares (but only where the other jurisdiction exempts such gains). In view of the latter, as Taiwan would generally tax share disposal gains, then effectively all non land rich share disposal gains would be tax exempt in the PRC. The same would also apply in the reverse for a Chinese investor investing in Taiwan. This treatment makes the PRC-Taiwan DTA one of the best for capital gains, alongside the Ireland-PRC DTA. Other gains are exclusively taxable in the residence jurisdiction, saving the disposer WHT of 10% in the PRC and 20% in Taiwan.

To the extent that a disposer asserts that the disposed shareholding should be exempt from source taxation, the DTA clarifies that the shareholding may not have exceeded 25% in the 12 month preceding the disposal. For Taiwanese disposing of PRC land-rich shares they might also note that SAT guidance in

Announcement 59 also provides for a look-back period of 36 months; gains on shares, deriving their value from PRC immovable property at any time within the 36 months before disposal, will be taxable in China.

As is standard in PRC DTAs, a beneficial ownership requirement applies to each of the dividends, interest and royalty articles. A demanding 'commercial substance' based definition of beneficial ownership has been required by the PRC tax authorities to be fulfilled in recent years in order to get tax authority pre-approval for WHT relief. Taiwanese investors should be aware that this system is set to change later in 2015 under planned new rules for the application of DTA benefits. These will scrap pre-approvals, and move to a tax authority post-payment 'follow-up procedures' system which will apply the PRC GAAR to assess the appropriateness of DTA WHT relief usage.

PE and business profits

The DTA PE definition and the PE profit attribution methodology are as per the OECD Model, though with the addition of the Service PE provision as per the UN Model. As PRC domestic law provides for a much broader taxable establishment concept, the DTA PE threshold provides protection for Taiwanese companies directly conducting business in China. Notable features include:

- Construction and installation projects, including associated supervisory services, will constitute a PE if they continue for more than 12 months
- The Service PE provision provides that a PE will exist where the provision of services is for a period of more than 183 days in a 12 month period
- The business profits article governing PE profit attribution draws on the UN Model in providing that, where it has been customary in a contracting jurisdiction for a PE to be taxed on the basis of an allocation of a proportion of the total profits of the enterprise, then that practice may continue. This is with the caveat that the profit allocation should be consistent with the profits which would be attributed under a functionally separate entity approach
- As with the UN Model and with other PRC DTAs, the DTA contains an Independent Personal Services article to govern, in an equivalent manner to the PE article for corporations, business activity conducted by individuals in a contracting jurisdiction (the OECD Models deals with both individuals and corporations under the PE article). Consistent with the UN Model and other PRC DTAs, this sets thresholds of a fixed base or 183 days presence in 12-month period

Anti-avoidance, enforcement and information exchange

As has become standard in recent PRC DTAs, the DTA includes a specific provision at Article 13(1) of the Appendix providing that where the main purpose or one of the main purposes for entering into certain transactions or arrangements was to secure the benefits of the DTA then benefits are to be denied. This facilitates the use of the GAAR by the Chinese tax authorities

The anti-avoidance provision is supported by the inclusion of the Exchange of Information (EOI) provisions (Article 6 in the DTA and Article 12 in the Appendix). In contrast to more recent PRC DTAs, and apparently as a conservative approach to information exchange in light of the special relationship between the PRC and Taiwan, the DTA does not adopt the latest (2005) version of the EOI article from the OECD Model, which exchanges all information which is 'foreseeably relevant' but rather limits information exchange, as was the case under former versions of the OECD Model, to information which is 'necessary' to administering domestic tax law.
In parallel, the DTA notes that the EOI article does not support information exchange on an automatic or spontaneous basis. This is in contrast to other PRC DTAs which make no such prohibition, and the PRC is expected to commence automatic EOI, under the OECD's Common Reporting Standard, with other DTA partners starting from 2017.

At the same time, and in the same way as the recent PRC DTAs with France and Germany, a Mutual Assistance article (Article 7 of the DTA) provides for the PRC and Taiwan to assist each other in the collection of the other's taxes. This is supported by Article 9 of the DTA which provides for exchange of tax administration staff and joint training and working sessions, Article 5 of the DTA which establishes a communications mechanism for resolving DTA application difficulties, as well as the Mutual Agreement procedure in Article 11 of the Appendix, all of which help to strengthen overall cooperation between the PRC and Taiwan.

Other notable provisions of the new DTA

- The DTA includes a specific measure (Articles 2 and 3 of the Appendix) addressing the treatment of third jurisdiction intermediate holding companies as tax residents of one of either the PRC or Taiwan. For historic reasons intermediates had been used extensively for investment by Taiwanese enterprises into China. The DTA applies a "place of effective management" (POEM) test to legal entities established under the laws of third jurisdictions to determine whether these may be treated as tax residents of the contracting jurisdictions and may have access to the benefits of the DTA. The criteria used for this test, place of business operations and decision-making, location of senior management personnel, place of corporate records, etc is in line with existing PRC guidance on tax residence in SAT Circular 82.
- Shipping and Air Transport provisions (Article 2(1) of the DTA and Article 4 of the Appendix) provide for mutual tax exemption of relevant businesses operating out of each jurisdiction
- The threshold shareholding required, in order for a PRC resident receiving a Taiwanese dividend to obtain an indirect foreign tax credit (FTC) under the DTA, in respect of any underlying Taiwan tax, is set at 10%. The PRC does provide for FTC under its own domestic law. However, as the PRC domestic law sets the required shareholding threshold at 20% the DTA's 10% will open FTC availability to more PRC companies
- The articles covering personal tax matters (Employment income, Directors, Pensions, Government service, Students) are in line with the OECD Model and should be of particular benefit to the many Taiwanese nationals working in the PRC

KPMG observations

The new DTA is a very positive development for both Taiwanese enterprises, which have a long track record of investment in the PRC, and for newly 'going out' PRC MNEs which are actively looking at business opportunities in Taiwan.

The DTA WHT rates are quite competitive by the standards of PRC DTAs and the potentially preferential treatment of leasing may be worth further exploration. The introduction of this relief through the DTA may encourage many Taiwanese companies to collapse their existing indirect investment structures into the PRC, though the DTA also provides for the alternative option of having existing offshore intermediate holding companies recognized as Taiwanese/PRC tax residents.

PRC tax law and tax practice is currently evolving rapidly in the context of the OECD's Base Erosion and Profit Shifting (BEPS) project and Taiwanese investors should be aware that the PRC anti-treaty shopping rules, including those integrated into the DTA, are likely to be increasingly applied in future, alongside the supporting DTA provisions on EOI and Mutual Assistance.

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