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PRC Tax

Authors:

Shanghai
Simon Tan
Partner
Tel: +86 21 6141 1033
Email: sitan@deloitte.com.cn

AP ICE (Hong Kong)
David Fallon
Director
Tel: +852 2852 6642
Email: dafallon@deloitte.com

For more information, please contact:

International Tax Services
National leader/Eastern China
Shanghai
Vicky Wang
Partner
Tel: +86 21 6141 1035
Email: vicwang@deloitte.com.cn

Northern China
Beijing
Jennifer Zhang
Partner
Tel: +86 10 8520 7638
Email: jenzhang@deloitte.com.cn

Southern China
Hong Kong
Sharon Lam
Partner
Tel: +852 2852 6536
Email: shalam@deloitte.com.hk

New China-UK tax treaty enters into force

The long-awaited new double tax treaty (New DTA) between China and the UK entered into force on 13 December 2013. The New DTA, originally signed in London on 27 June 2011 and amended by a protocol signed in Beijing on 27 February 2013, replaces the treaty and protocol dating from 1984 and 1996, respectively. The New DTA has effect as follows:

In China

- In respect of profits, income and capital gains arising in any tax year beginning on or after 1 January 2014.

In the UK

- In respect of income tax and capital gains tax, for any year of assessment beginning on or after 6 April 2014; and
- In respect of corporation tax, for any financial year beginning on or after 1 April 2014.

The key features of the New DTA include the following:

- A reduced 5% withholding tax (WHT) rate on certain dividends (down from 10%), 6% in respect of certain royalties (down from 7%), and measures to limit the double taxation of capital gains and "other income."

	UK domestic law	China domestic law	New DTA
Dividends	0%	10%	5/10/15%[1]
Interest	20%	10%	10%
Royalties	20%	10%	6/10%[2]
Capital gains	0%[3]	10%	0/10%[4]

- An update to the definition of a permanent establishment to include a service PE.
- A "miscellaneous rule" that specifically enables the tax authorities to apply their domestic general anti-avoidance rules, notwithstanding the provisions of the DTA.

[1] The 5% rate applies where dividends are paid to a company that holds directly at least 25% of the capital of the payer company. The 15% rate applies where the dividends are paid out of income or gains derived from immovable property by a tax-exempt investment vehicle that is required to distribute most of its income or gains annually. The rate in all other cases is 10%.
[2] The 10% rate applies to royalties paid for the use of, or the right to use, industrial, commercial or scientific equipment, but only on 60% of the gross amount; otherwise, the rate is 10%.
[3] Non-UK residents generally are not subject to UK tax on capital gains unless the underlying asset is used for purposes of a trade carried on in the UK through a permanent establishment. Note that non-UK residents may be subject to capital gains tax on high value residential property (currently where the value exceeds GBP 2 million).
[4] UK resident shareholders that hold less than a 25% interest in the capital of an enterprise may be exempt from the 10% withholding tax on capital gains provided that: (1) in the 12 months before the disposal, the shareholding did not exceed a 25% interest; and (2) the gains do not arise from the alienation of shares that derive more than 50% of their value from immovable property in China.

- Additional anti-treaty shopping clauses in the dividend, interest, royalty and other income articles that deny treaty benefits where the main purpose, or one of the main purposes, of an arrangement is to take advantage of the relevant DTA article.
- Elimination of the technical fees article.
- Several other changes to bring the new DTA more into line with the OECD model treaty.

Tax Analysis, Issue P144/2011[5] provides further commentary on many of these changes, and in this newsletter we explore some of the main holding company implications of the New DTA.

It should be noted that, with the exception of an amendment introduced in the protocol, the New DTA is unchanged from the DTA signed on 27 June 2011. The protocol amended the dividends article (article10) to ensure that the reduced WHT rates would apply only to companies that hold *directly* at least 25% of the capital of the company paying the dividends. The previous version of the DTA included the term *indirectly*. This change makes the treaty consistent with the OECD model treaty and most of China's existing tax treaties.

Deloitte comments

(i) Implications for multinational companies looking to invest into China

The introduction of a 5% withholding tax on dividends is a welcome change for multinationals considering how to hold their investments in China.

The New DTA brings the UK into line with China's treaty rates available to companies in other common holding company locations, such as Hong Kong, Luxembourg and Singapore, which provides multinationals with more options for potential holding company locations.

The treaty changes complement changes in recent years to UK domestic tax law aimed at improving the UK's competitiveness as a holding company location. These changes include:

§ One of the most competitive corporate tax rates amongst the G20 countries: currently at 23%, reducing to 21% from 1 April 2014 and a further decrease to 20% from 1 April 2015.
§ Generous exemptions from UK corporation tax for income arising on dividends and on capital gains arising on the disposal of substantial interests in shares, provided certain criteria are met.
§ Reformed controlled foreign company (CFC) legislation that exempts profits earned in controlled overseas companies from UK tax provided the profits have not been artificially diverted from the UK.
§ Tax incentives supporting innovation and R&D, with a patent box regime and tax relief for qualifying R&D expenditure.

As noted above, the New DTA includes specific anti-avoidance clauses in the dividend, interest, royalty and other income articles that limit treaty benefits where the main purpose, or one of the main purposes of the arrangement, is to take advantage of the terms of the DTA.

The specific anti-abuse rules, when considered with the need for an income recipient to demonstrate “beneficial ownership” under Chinese domestic tax law,[6] and potential further developments anticipated in the context of the OECD’s base erosion and profit shifting (BEPS) project,[7] means that intermediate holding companies with insufficient substance are unlikely to be able to claim treaty benefits.

For multinational groups that already have activities in the UK, companies may increasingly look to hold their Chinese investments directly from the UK, and for groups that need to establish substance in a new holding company, the UK may be a more viable option when compared to alternative holding company jurisdictions, particularly if the UK group is listed in the UK so that it would benefit from the Chinese beneficial ownership safe harbor rule.[8]

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[5] https://www.deloitte.com/assets/Dcom-China/Local%20Assets/Documents/Services/Tax/TaxanalysisEN2011/cn_tax_tap1442011_eng_260911.pdf
[6] See Circulars 601 and 165.
[7] The OECD BEPS study has identified treaty abuse as one of its 15 areas of specific focus.
[8] See Bulletin 30 and Circular 165.

(ii) Implications for Chinese companies investing into the UK and other jurisdictions

Except where dividends are paid by UK REITs,[9] there is no UK withholding tax on dividends paid by UK companies, so the New DTA will have limited impact in this respect. However, given the UK's extensive tax treaty network, and when taken together with the factors noted in (i) above, the UK may become an increasingly preferred holding company location for Chinese multinationals, especially those with activities outside Asia.

Furthermore, as an EU member state, the UK will be an attractive holding company location for Chinese multinationals that have other European investments. The EU parent-subsidiary and the interest and royalties directives can reduce withholding tax rates on dividends, royalties and interest payments by European companies to a UK parent company to nil.[10]

Finally, a Chinese multinational company is unlikely to impose a CFC charge on a UK company given that the UK is on China's CFC "white list," so that profits accruing in a UK company should be exempt from any CFC charge.

(iii) Implications for existing holding company arrangements

Multinationals that currently hold their Chinese investments through intermediate companies may wish to review their current structures and, where appropriate, consider whether the UK provides a better alternative.

For UK multinationals, there may be opportunities to simplify current structures by holding Chinese investments directly from the UK rather than through an intermediate holding company in a third jurisdiction. Not only could this potentially result in a stronger treaty analysis, for example, where the intermediate holding company does not have sufficient substance to meet the Chinese beneficial ownership test, it also could reduce related ongoing operating and administration costs.

Clearly, the non-UK tax implications of any proposed reorganization would need to be fully assessed, and from a Chinese perspective, it will be important to consider whether a restructuring would qualify for special reorganization relief that allows a tax neutral restructuring, or whether it would give rise to a 10% capital gains tax on the transfer of the Chinese enterprise.

Assuming the Chinese beneficial ownership test is met, the reduced withholding tax rate under the DTA technically should apply to dividends legally declared and payable to a qualifying UK resident shareholder on or after 1 January 2014, notwithstanding that the dividends are paid out of retained earnings before that date.[11] However, in practice, some local Chinese tax authorities may take a view that the reduced rate should not apply to profits earned before 1 January 2014. This issue should be resolved with the relevant local tax bureau before dividends are declared by the company's board of directors to avoid any unintended tax consequences.

Note: Contents discussed in this Tax Analysis pertain to Deloitte International Tax Services

[9] Chinese residents receiving dividends from UK Real Estate Investment Trusts (UK REITs) will suffer a 15% withholding tax.

[10] The EU parent-subsidiary directive generally eliminates withholding taxes on dividends paid to a UK company by an EU-resident company provided a minimum 10% shareholding is met. The EU interest and royalties directive generally eliminates withholding taxes on interest and royalties paid to a UK company by an EU-resident company provided a minimum 25% shareholding is met.

[11] This assumes the UK parent company has held directly at least 25% of the capital of the Chinese enterprise for the entire 12-month period before the dividends are declared.

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Beijing
Kevin Ng
Partner
Tel: +86 10 8520 7501
Fax: +86 10 8518 7501
Email: kevng@deloitte.com.cn

Hong Kong
Sarah Chin
Partner
Tel: +852 2852 6440
Fax: +852 2520 6205
Email: sachin@deloitte.com.hk

Shenzhen
Constant Tse
Partner
Tel: +86 755 3353 8777
Fax: +86 755 8246 3222
Email: contse@deloitte.com.cn

Chongqing
Claude Gong
Partner
Tel: +86 23 6310 6206
Fax: +86 23 6310 6170
Email: clgong@deloitte.com.cn

Jinan
Eunice Kuo
Partner
Tel: +86 531 8518 1058
Fax: +86 531 8518 1068
Email: eunicekuo@deloitte.com.cn

Suzhou
Frank Xu / Maria Liang
Partner
Tel: +86 512 6289 1318 / 1328
Fax: +86 512 6762 3338
Email: frakxu@deloitte.com.cn
mliang@deloitte.com.cn

Dalian
Frank Tang
Partner
Tel: +86 411 8371 2888
Fax: +86 411 8360 3297
Email: ftang@deloitte.com.cn

Macau
Quin Va
Partner
Tel: +853 8898 8833
Fax: +853 2871 3033
Email: quiva@deloitte.com.hk

Tianjin
Jason Su
Partner
Tel: +86 22 2320 6680
Fax: +86 22 2320 6699
Email: jassu@deloitte.com.cn

Guangzhou
Constant Tse
Partner
Tel: +86 20 8396 9228
Fax: +86 20 3888 0121
Email: contse@deloitte.com.cn

Nanjing
Frank Xu
Partner
Tel: +86 25 5791 5208
Fax: +86 25 8691 8776
Email: frakxu@deloitte.com.cn

Wuhan
Justin Zhu
Partner
Tel: +86 27 8526 6618
Fax: +86 27 8526 7032
Email: juszhu@deloitte.com.cn

Hangzhou
Qiang Lu
Partner
Tel: +86 571 2811 1901
Fax: +86 571 2811 1904
Email: qilu@deloitte.com.cn

Shanghai
Eunice Kuo
Partner
Tel: +86 21 6141 1308
Fax: +86 21 6335 0003
Email: eunicekuo@deloitte.com.cn

Xiamen
Lynch Jiang
Partner
Tel: +86 592 2107 298
Fax: +86 592 2107 259
Email: lijiang@deloitte.com.cn

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National Tax Technical Centre
Email: ntc@deloitte.com.cn

National Leader
Leonard Khaw
Partner
Tel: +86 21 6141 1498
Fax: +86 21 6335 0003
Email: lkhaw@deloitte.com.cn

Eastern China
Bill Ye
Partner
Tel: +86 21 6141 1261
Fax: +86 21 6335 0003
Email: bye@deloitte.com.cn

Northern China
Julie Zhang
Partner
Tel: +86 10 8520 7511
Fax: +86 10 8518 1326
Email: juliezhang@deloitte.com.cn

Southern China (Mainland/Macau)
German Cheung
Director
Tel: +86 20 2831 1369
Fax: +86 20 3888 0121
Email: gercheung@deloitte.com.cn

Southern China (Hong Kong)
Davy Yun
Partner
Tel: +852 2852 6538
Fax: +852 2520 6205
Email: dyun@deloitte.com.hk

If you prefer to receive future issues by soft copy or update us with your new correspondence details, please notify Wandy Luk by either email at wanluk@deloitte.com.hk or by fax to +852 2541 1911.