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Mainland China and Taiwan Sign Tax Agreement

Representatives of the Mainland China and Taiwan signed an income tax agreement on 25 August 2015, following a number of years of negotiations (Agreement to Avoid Double Taxation and Reinforce Tax Cooperation). Due to the unique nature of the cross-strait relations and the historical context, the agreement contains some provisions that differ from those in other tax treaties concluded by Mainland China and Taiwan, respectively, and that are based on the OECD and UN model tax treaties.

As Mainland China has been the largest investment destination for Taiwan, as well as a trade partner, and taking into account the fact that many Taiwanese work, study and live in Mainland China, the agreement should have a significant impact on current investment arrangements and the trading plans of Taiwanese individuals and corporations. The agreement also will mitigate the risk of double taxation that Mainland Chinese corporations may encounter when investing in Taiwan, so it is expected to boost cross-strait investment. The agreement will enter into force once the two partners complete their ratification procedures.

This article provides a brief overview of the main provisions of the agreement and includes some comments on the anticipated effects.

Main provisions

Scope of application

The agreement will apply to income tax, as well as business tax, value added tax (VAT) and similar categories of taxes for shipping and air transport income.

The agreement basically will be applicable to cross-strait residents, as defined under the local laws of the contracting parties. However, legal entities incorporated in a third tax jurisdiction but that have their place of effective management in the Mainland China or Taiwan also will be regarded as tax residents of respective places for treaty purposes and will be subject to the agreement. Since Taiwan's local rules do not use the "place of effective management" in determining tax residence, the provisions in the agreement are necessary to bring third-tax jurisdiction entities that are effectively managed in Taiwan and through which an investment is made into Mainland China within the scope of the agreement.

If an individual is considered a resident under the local taxation rules of both contracting parties, the tiebreaker provision in the agreement will be used to determine residence based on the individual's permanent home, center of vital interests and habitual abode (in that order).

If there is any doubt about the residence of an individual, or where a person other than an individual is a resident under the local taxation rules of both parties, the issue will be resolved through mutual agreement procedure by the competent authorities of both parties.

Main tax relief

Item	Tax relief
Business profits	Profits derived by a resident enterprise of one contracting party from carrying on business in the other party will be exempt from, or not subject to, tax in that other party, unless the enterprise has a permanent establishment (PE) in that other party. If the enterprise carries on business through a PE in that other party, the profits that may be taxed in that other party are limited to those attributable to the PE.
Shipping and air transport income	Income and profits derived by a shipping and air transport enterprise of one party from carrying on business in the other party will be exempt from, or not subject to, tax (including business tax, VAT and similar categories of taxes) in that other party.
Dividends	Dividends will be subject to a 5% or 10% withholding tax. The 5% rate will apply if the beneficial owner is a company that holds directly at least 25% of the capital of the company paying the dividends; otherwise the rate will be 10%.
Interest	The rate under the agreement is 7%.
Royalties	The rate under the agreement is 7%.
Capital gains	Gains derived by a resident of one party from transferring shares of a non-land-rich resident company of the other party generally will be taxable only in the place where the transferor is resident. However, the other party may tax the gains if both of the following conditions are satisfied: • The gains are exempt from tax in the party where the transferor is resident; and • The transferor had a direct or indirect participation of at least 25% in the capital of the company being transferred at any time during the 12-month period before the transfer.
Income from independent personal services	Income derived by a resident individual of one party from the performance of independent personal services in the other party may be taxable in that other party only if: • The individual has a fixed base in the other party for the purpose of performing the activities; or • The individual's stay in the other party is for a period or periods amounting to, or exceeding in the aggregate, 183 days within any 12-month period commencing or ending in the taxable period concerned.
Income from employment	Remuneration derived by a resident individual of one party in respect of employment exercised in the other party will be taxable only in the place where the individual is resident if all the following conditions are satisfied: • The individual is present in the other party for a period or periods that do not exceed, in the aggregate, 183 days in any 12-month period commencing or ending in the taxable period concerned; • The remuneration is paid by, or on behalf of, an employer that is not a resident of the other party; and • The remuneration is not borne by a PE or a fixed base of the employer in the other party.

Corresponding adjustments for related-party transactions

Where a contracting party makes a transfer pricing adjustment and taxes the relevant profits, and the other contracting party agrees that such adjustment is consistent with the arm's length principle, that other party will make an appropriate adjustment to the amount of tax charged on those profits. The competent authorities of the contracting parties shall consult each other during the adjustment process whenever necessary.

Dispute resolution

Where a person considers that the actions of one or both of the contracting parties result, or will result, in taxation not in accordance with the agreement, the person may present the case to the competent authority of the party of residence, irrespective of the remedies provided under the local law of the two parties. If the objection appears to be justified and the competent authority is not able to arrive at a satisfactory solution on its own, it will attempt to resolve the case by mutual agreement with the competent authority of the other party, with a view to avoiding taxation that is not in accordance with the agreement. Any agreement reached shall be implemented, regardless of time limits under the local laws of the contracting parties.

Exchange of information

To address concerns about the agreement raised by the Taiwanese public and enterprises, the agreement has restricted the application of information exchange provisions so that exchanges will not be retroactive and the information will be used only for taxation purposes, and not in criminal cases. In accordance with guidance from the Taiwan Ministry of Finance, information exchanges will occur only for specific tax evasion cases, rather than being initiated for general cases or automatically.

Observations

Anticipated benefits to Taiwan

Generally speaking, in accordance with current cross-strait business relations, the agreement should bring significant benefits to Taiwan, including the following:

- 5% withholding tax rate on dividends: Once the agreement enters into effect, qualifying distributions of profits to Taiwan parent companies may be subject to a 5% withholding tax in Mainland China, which is much lower than the 10% local rate. Although the effective income tax rate for Taiwanese corporations will remain 17%, the imputation tax system in Taiwan may allow the benefits from the concession in Mainland China to be passed on to the individual shareholders of Taiwanese corporations.

  In addition, qualifying distributions of profits to Mainland China investors may be subject to a 5% withholding tax in Taiwan, which is much lower than the 20% regular withholding tax rate.

- Corresponding adjustments and mutual agreement procedure (MAP): Investments from Taiwanese corporations in Mainland China mainly are in the manufacturing industries, where Mainland China subsidiaries take orders from a Taiwan-based group and manufacture products, which results in a significant number of related party purchase and sales transactions. In addition, the manufacturing subsidiaries generally need to pay royalties for the relevant techniques, know-how and trademarks, which ultimately are licensed from the parent companies in Taiwan. Given the intensified transfer pricing enforcement in Mainland China, particularly after the issuance of Bulletin No. 16 from the State Administration of Taxation on the scrutiny of related party payments for services, the possibility of double taxation has significantly increased. The introduction of corresponding adjustments and MAP provisions in the agreement may help to avoid double taxation arising from transfer pricing adjustments.

- More protection from taxation for business profits and employment income: Given the close business relationship across the straits, many Taiwanese individuals frequently travel to Mainland China for business purposes. Without the protection to be provided by the agreement, it could be easier for such activities to constitute a taxable presence in Mainland China under the local rules, which would result in the business profits attributable to the presence being subject to the Mainland China income tax. When there is no PE in the Mainland China, the agreement will extend the tax-exempt period for qualifying frequent Taiwanese business travelers from 90 days, under Mainland China’s local law, to 183 days, so that travelers may stay in Mainland China for a longer period without having their employment income be subject to the Mainland China income tax.

- Solution for dual residence issues: In accordance with the individual taxation rules on each side of the strait, it is possible for an individual to be considered as a resident in both Mainland China and Taiwan, so that each side would tax the income derived from the other side. Although a foreign tax credit is available, complex procedures have made the mechanism difficult to work with in practice. When the agreement enters into effect, the dual residence issue may be resolved by tiebreaker rules, or even by mutual agreement. This may be beneficial for Taiwanese who live in Mainland China for a long period (i.e. more than five consecutive years).

Considerations regarding relocating place of effective management of a third-tax jurisdiction company to Taiwan

Most Taiwanese corporations that currently invest in Mainland China do so via holding companies in Hong Kong or another tax jurisdiction in order to enjoy the 5% withholding tax rate available on dividends under the Hong-Kong-China tax arrangement (or between Mainland China and certain other tax jurisdictions), or to retain profits overseas to defer tax liabilities in Taiwan. Now that the agreement has been signed, it may be appealing to Taiwanese corporations to relocate the place of effective management of these third-tax jurisdiction companies to Taiwan to enjoy the 5% tax rate on dividends available under the agreement. However, such a relocation could bring the third-tax jurisdiction companies' income and profits (e.g. interest, dividends, capital gains and trading profits, etc.) into Taiwan's comprehensive taxation scheme, including the 17% income tax and the 10% retained earnings tax. Therefore, a relocation may not necessarily be beneficial to Taiwanese corporations, unless the additional tax burden could be offset by available benefits, such as the tax exemption for shipping/air transportation income, access to corresponding adjustments, etc.

Taiwan also is proposing the introduction of controlled foreign company rules and the "place of effective management" test to define resident companies, which could further increase the tax burden of an indirect investment to Mainland China, especially for companies with an investment structure involving more than two layers of overseas holding companies. Affected Taiwanese investors may want to consider changing such a structure to a direct investment structure.

Impact on restructuring of Taiwan-based companies

A Taiwan-based company often is subject to a high Mainland China tax burden on a direct or indirect transfer of the shares of its Mainland China subsidiaries, given the narrow scope of special tax reorganizations (i.e. tax-deferred reorganizations) for cross-border share transfers and the strict criteria for the safe harbor rule in indirect share transfers under Mainland China's local law. Since the agreement generally will grant the taxing rights on the gains from the transfer of shares of a non-land-rich company to the residence party, a transfer of the shares of a Mainland China company by a Taiwanese corporation may be protected from income tax in Mainland China. If the shares are directly held by a third-tax jurisdiction company, a Taiwan-based investor may consider whether a relocation of the place of effective management of the third-tax jurisdiction company to Taiwan is commercially viable.

Effective date of the agreement

Before the agreement enters into effect, each contracting party must complete the relevant procedures under its local law and written notice must be delivered to the other party. The relevant procedures are relatively simple in Mainland China. In Taiwan, however, it could take a relatively long period of time for the agreement to be approved by the legislative body. For example, the Cross-Strait Service and Trade Agreement signed two years ago still faces difficulties in being approved. Therefore, there is significant uncertainty regarding when the agreement will be able to enter into effect.

Comments

A key consideration for Taiwanese corporations in relation to the agreement should be whether their investment structure needs to be revised, and the draft measures on controlled foreign companies and place of effective management should be taken into consideration, especially for companies carrying out indirect investments in Mainland China via layers of foreign holding companies. Transfer pricing is another topic affected Taiwanese investors should consider if they wish to utilize the agreement to avoid double taxation.

Taiwanese individuals who frequently travel to or live in Mainland China should assess whether they have become a dual resident, and should consider whether to maintain a household registration in Taiwan to substantiate their permanent home status. Business travelers also should keep travelling records to monitor whether their physical presence in Mainland China has crossed the 183-day tax-exemption threshold.

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

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