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Tax Analysis

New China - Germany Agreement on the Avoidance of Double Taxation and the Prevention of Fiscal Evasion

Authors:

Claus Schuermann
Deloitte China (Hong Kong)
Partner
Tel: +852 2238 7884
Email: clschuermann@deloitte.com.hk

Friedman Ji
Deloitte China (Beijing)
Senior Manager
Tel: +86 10 8512 4079
Email: fenji@deloitte.com.cn

Stefan Zimmermann
Deloitte Germany (Düsseldorf)
Director
Tel: +49 211 8772 2863
Email: stzimmermann@deloitte.de

The new tax treaty between China and Germany was already signed back in March 2014. Finally, after more than two years it has been ratified and is in force since 5 April 2016. It will be applicable from 1 January 2017 in Germany and in China. While the content of the treaty has been known for two years, it is worthwhile to look at it again considering that in the meanwhile the 15 reports on Base Erosion and Profit Shifting (BEPS) have been released by the OECD.

The major changes of the treaty are the reduced withholding tax rates, the discontinuation of notional tax credits, adjustments in the permanent establishment (PE) article and in the transfer pricing article and the addition of anti-avoidance regulations.

Comparison

There were several reasons for an update of the 1985 treaty. From the German side reasons for an update include the abolition of the notional tax credits for interest and royalties and the reduction of the dividend withholding tax rate from 10% to now 5%.

For the Chinese side, all tax treaties are being updated to change the determination of permanent establishments from six months to 183 days. China is still - and despite heavily increasing outbound investment - focusing on withholding taxes, for example on capital gains, and service permanent establishments. Dividend withholding tax is reduced to 5%. While this is clearly an improvement, it would have been preferable to have the 0% rate as in the new tax treaty between Germany and Japan.

In the following we will look at the main changes in the new treaty compared to the old treaty. Thereafter, we will compare this to the BEPS Action items.

Article 4 – Resident

Whereas the old treaty refers to the "place of general management", in paragraph 1 of the new treaty the term "place of effective management" is used vs. the term "place of management" as in the German Model DTA and the 2014 OECD Model Treaty. Para. 1 refers to the place of management as determined by each of the domestic tax laws so that the relevance of the deviating wording here may be limited.

The Chinese Enterprise Income Tax (EIT) Law (Art. 2) mention the "place of effective management". Similarly, Art. 10 of the German General Tax Code (and Art. 1 of the German CIT Act) also mentions the "place of management" ("Geschaeftsleitung").

Article 5 - Permanent Establishments

In this article, a few developments to note are the extension of the construction permanent establishment (including supervisory services) from six months to 12 months and the China typical change of the service permanent establishment definition from six months to 183 days.

In particular the switch to 183 days is a positive – and for some long awaited - change as the Chinese domestic law assumes the meeting of the six months requirement under a very stringent definition so that only a day per month can create a count as one month. This change will therefore help to manage permanent establishment creation better and more in line with international interpretation.

The extension of creation of construction permanent establishments from six months to 12 months provides for a better basis of protection against taxation. However, in practice, it might still be a challenge to apply the treaty in this regard where local tax offices take the view that the PE has to be regarded as a service PE.

In accordance with OECD Model, an independent agent does not create a PE. However, an additional sentence was introduced, stating where an agent's activities are "wholly or almost wholly on behalf" of the other enterprise AND the conditions under which such is done are not at arm's length this would be regarded as a PE. This seems to be rather a clarification than an extension of the PE definition.

Article 7 - Business Profits

In Article 7, a clause on the application of the Authorised OECD Approach (AOA) is missing which is in line with China's treaty policy. The AOA has been developed by the OECD to determine the profit allocation between PE and head office on the basis of a separate entity approach. However, in the protocol, both states "express their willingness" to refer to the OECD 2008 Model treaty for the interpretation of this article, which refers to the possibility of application of the AOA. The article does not provide for an adjustment clause. As Germany generally applies the AOA, this may create risks for double taxation.

For more information, please contact:

International Tax Services
National Leader
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

Eastern China
Shanghai
Hong Ye
Partner
Tel: +86 21 6141 1171
Email: hoye@deloitte.com.cn

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

Western China
Chongqing
Tony Zhang
Partner
Tel: +86 23 8823 1216
Email: tonzhang@deloitte.com.cn

Article 8 – Shipping and Air Transport

This article has been expanded by a clarification with regard to the definition of international traffic which now includes incidental use, maintenance or rental of containers or bare-boat.

Article 9 - Associated Enterprises

Article 9 is the basis for transfer pricing corrections on the basis of the arm's length principle and guides on the taxation of associated enterprises. It has been expanded to include the OECD Model's Para. 2 on corresponding adjustments in the other state which is in line with current German treaty policy. Under the new regulation, where one state adjusts the taxable income due to a lack of arm's length in a transaction, corresponding adjustments shall be made in the other state in order to avoid double taxation. According to the OECD Model Treaty commentary the other state needs to undertake a corresponding adjustment only if and to the extent that he agrees to the adjustment. The adjustment does not require a competent authority procedure.

Considering the practical application it seems difficult to foresee situations where such a corresponding adjustment will be made by either tax authority without a competent authority procedure.

Articles 10, 11 and 12 – Dividends, interest and royalties

Under the old treaty, the dividend withholding tax rate was determined at 10% for any amount of shareholding for beneficial owners in Germany. As this was in line with the Chinese national law's withholding tax rate, the treaty was not providing additional benefits for German investors.

The new treaty applies the OECD Model in Art. 10 para. 2 lit. a) where for dividends, the application of the minimum rate of 5% requires a 25% direct shareholding in the capital of the dividend paying entity. Another newly introduced limitation is that the recipient has to be a corporation. This is in line with the OECD Model and the German Model treaty. Thus, typical German partnerships in the form of a Kommanditgesellschaft do not meet this requirement and thus not benefit from the reduced 5% rate. As under China national law the withholding tax rate is 10%, for a German partnership recipient the withholding tax remains unchanged at 10%.

Both Germany and China apply anti-avoidance regulations which require a certain degree of business activity of the dividend receiving entity in order to prove beneficial ownership and thus grant treaty relief.

With regard to interest, no withholding tax applies on payments for the financing of sales of commercial or scientific equipment. For existing financing structures for the mentioned purposes a review should be undertaken to ensure this exemption can be applied from 2017.

For royalties the general withholding tax rate remains at 10%. For royalties paid for the use of or the right to use any industrial, commercial or scientific equipment the withholding tax is being reduced from 7% under the old treaty to effectively 6%. The reduced tax rate was previously "hidden" in the protocol and has now been moved into Art. 12 para. 2 lit. b).

For both interest and royalties the current notional tax credit (refer to Art. 24(2) (c)) will be abolished under the new treaty.

Article 13 - Capital gains taxation

The article on the taxation of capital gains has been expanded by two paragraphs, i.e. (1) gains derived from the sale of shares in a company which derives more than 50% of its value from immovable property may be taxed in the source country and (2) gains derived from the sale of shares others then those under (1) may be taxed in the source country if the vendor entity owned – directly or indirectly – at least 25% of the shares during the preceding 12 month period. An exception to (2) is where shares are traded on a recognised stock exchange and where no share sales exceeding 3% of quoted shares took place during the fiscal year.

The regulation on property rich companies is in line with the OECD Model. For other share sales the right of taxation will be limited under the new treaty to shareholdings of at least 25% during the preceding 12 month period. Thus, where there are plans for restructurings including shareholdings below 25% it should be considered to postpone the restructuring and seek protection under the new treaty.

Article 14 and 15 - Independent personal services and employment income

A small change has been made related to the computation of the 183 days rule. This has been adjusted and brought in line with OECD Model and now refers to any 12 month period rather than the previous reference to the calendar year. This will require some adjustment in the controlling of business travelers to China and somewhat reduce the planning potential.

Article 23 - Methods for the avoidance of double taxation and anti-avoidance clauses

This article provides details on how each state avoids double taxation.

For Chinese investors to Germany, foreign taxes are being credited against Chinese taxes. The credit is limited to the amount of tax that would be due under Chinese income tax laws. Insofar there is no change to the old treaty. Further to the direct tax credit of 5% dividend withholding tax withheld on behalf of the Chinese recipient, a further indirect tax credit with regard to the underlying German Corporate Income Tax is available if the shareholding in the German company is at least 20%; this is a change compared to the old treaty as the shareholding requirement under the old treaty is only 10%. This is in fact the implementation of the Chinese national foreign tax credit rule into the treaty. The German corporate income tax and trade tax reaches a combined tax burden of around 30%, thus there would usually be a non-creditable surplus. For investments below 20% shareholding ratio it should therefore be considered to distribute dividends prior to 2017.

For German corporate investors to China, the tax exemption method generally applies to dividend income from shareholdings of at least 25%; under the old treaty a shareholding of 10% was sufficient for the application of the exemption. For smaller shareholdings and other types of income the tax credit method applies. However, under German tax law dividend income is already exempt for shareholdings of at least 10%, so that this change has limited relevance.

Paragraph c) of Article 23 contains the switch-over clause in case of passive income. It requires that the underlying income of the shareholding or the permanent establishment has been generated – exclusively or almost exclusively - from so-called active business as determined under Article 8 of the German Foreign Tax Act. Otherwise, a switch-over from tax exemption to the tax credit method applies. A comparable clause was previously included in the protocol.

Paragraph e) contains a new switch-over (based on the new German Model treaty) from exemption to tax credit in case of conflicts (regarding allocation or qualification) after non-successful consultation procedure resulting in non- or inadequately low taxation. In accordance with the German Model, reference is made not to 'income' but to 'items of income'. This reflects the German Finance authorities' view to look into the components of income, which has just recently been reflected in the draft law on the implementation of BEPS measures dated 31 May 2016.[1]

For interest and royalties a tax credit applies in Germany. Under the old treaty a notional credit was available at 15%, which is being discontinued under the new treaty with effect to payments after 31 December 2016.

Article 26 - Exchange of information

The new treaty is in line with OECD Model and contains the extended clause on exchange of information which enables the competent authorities to exchange both information related to the provisions of the treaty as well as information relevant to the enforcement of their domestic tax laws. This is now in line with general policies of both sides.

Not included in the new treaty is the German Model treaty's extension of paragraph 2 of Art 26 in the German Model treaty. The extension limits the use of information for other purposes.

[1] "Entwurf eines Gesetzes zur Umsetzung der Aenderungen der EU-Amtshilferichtlinie und von weiteren Massnahmen gegen Gewinnkuerzungen und –verlagerungen"

Article 27 - Assistance in the collection of taxes

This article has been newly introduced into the treaty and can be seen as a first step towards cooperation. However, the article deviates considerably from both the OECD Model and the German model. Article 27 paragraph 1 s.2 simply refers to the competent authorities to mutually agree on the application of this article and has been reduced from eight paragraphs to two. Another small deviation is that both states only agreed to "endeavour" to lend assistance rather than – as provided in the OECD Model – to actually agree to lend assistance.

Article 28 - Procedural rules for taxation at source

This article has been taken from the German Model treaty. It is neither part of the OECD Model, nor is it Chinese treaty practice. It largely clarifies withholding and refund procedures and that these follow local rules in each contracting state. Paragraph 3 further clarifies that where there is no or reduced tax to be withheld on certain income based on the treaty, each member state shall set up procedures to enable payment under the reduced rate accordingly and without the need to go through a refund procedure.

Article 29 - Miscellaneous

Finally, at the end of the treaty a main purpose test has been introduced which limits any treaty relief where the main purpose to enter into a structure or transaction was obtaining treaty benefits.

Furthermore, a clause has been introduced clarifying that the treaty is not meant to prevent either state to apply their domestic anti avoidance rules.

Comments

The new treaty clearly breathes the spirit of BEPS, which does not come as a surprise considering the two states are at the forefront of implementing anti-avoidance measures not only in their treaties but also in the domestic laws. Investors in both directions will need to review their structures to ensure they will not underlie any anti-avoidance rules even with items of income.

However, not all is bad: some obvious points of consideration would be the utilisation of the lower withholding tax rates in the new treaty. For regular dividends it might be late for planning as those distributions would generally be made earlier this year. Where possible, profit distributions should be postponed to the year 2017 to utilise the lower withholding rate. Generally, both sides technically apply the relevant withholding tax rate with reference to the payment date, not with regard to the date of profit generation. The practical implementation may not always be straightforward on the Chinese side.

For interest and royalties it might be advisable to initiate payments within the year 2016 to utilise the notional tax credit in Germany. Obviously, at the German recipient level sufficient tax credit potential should be available. As certain royalties may be taxed at the lower 6% rate under the new treaty, careful analysis is advisable.

For German corporates with shareholdings in Chinese companies which are between 10% to 25% they will need to consider possibilities to lift the shareholding to 25% to benefit from the 5% dividend withholding tax rate. Similarly, Chinese companies investing in German companies, a lift from 10% to 20% should be considered to increase the tax credit potential.

Permanent Establishments should become less due to the extended 12 months period for the highly relevant construction PE for German corporates doing business in China. The practical application might not be straightforward. Upfront discussions with the relevant tax authorities might help.

Related party transactions potentially receive better protection under the corresponding adjustment rule introduced in Article 9. However, considering China's increasing aggressive approach on Transfer Pricing and the difficulties to apply tax treaty regulations in some local tax bureaus the practical impact may be limited.

With regard to restructurings, the new treaty will not permit capital gains taxation at source for shareholdings below 25%. This change should be considered for any existing plans for group restructurings.

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Beijing
Andrew Zhu
Partner
Tel: +86 10 8520 7508
Fax: +86 10 8518 1326
Email: andzhu@deloitte.com.cn

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

Shenzhen
Victor Li
Partner
Tel: +86 755 3353 8113
Fax: +86 755 8246 3222
Email: vicli@deloitte.com.cn

Chongqing
Frank Tang
Partner
Tel: +86 23 8823 1208
Fax: +86 23 8859 9188
Email: ftang@deloitte.com.cn

Jinan
Beth Jiang
Partner
Tel: +86 531 8518 1058
Fax: +86 531 8518 1068
Email: betjiang@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
Bill Bai
Partner
Tel: +86 411 8371 2888
Fax: +86 411 8360 3297
Email: bilbai@deloitte.com.cn

Macau
Raymond Tang
Partner
Tel: +853 2871 2998
Fax: +853 2871 3033
Email: raytang@deloitte.com.hk

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

Guangzhou
Victor Li
Partner
Tel: +86 20 8396 9228
Fax: +86 20 3888 0121
Email: vicli@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
Jim Chung
Partner
Tel: +86 592 2107 298
Fax: +86 592 2107 259
Email: jichung@deloitte.com.cn

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

National Leader
Ryan Chang
Partner
Tel: +852 2852 6768
Fax: +852 2851 8005
Email: ryanchang@deloitte.com

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

Eastern China
Kevin Zhu
Director
Tel: +86 21 6141 1262
Fax: +86 21 6335 0003
Email: kzhu@deloitte.com.cn

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

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

Western China
Tony Zhang
Partner
Tel: +86 23 8823 1216
Fax: +86 23 8859 9188
Email: tonzhang@deloitte.com.cn

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.

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