

News Flash

China Tax and Business Advisory

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Our China Tax and Business
Service Team Contacts

National

Cassie Wong
Tel: +86 (10) 6533 2222
cassie.wong@cn.pwc.com

Northern China

Edward Shum
Tel: +86 (10) 6533 2866
edward.shum@cn.pwc.com

Central China

Peter Ng
Tel: +86 (21) 2323 1828
peter.ng@cn.pwc.com

Southern China

Charles Lee
Tel: +86 (755) 8261 8899
charles.lee@cn.pwc.com

With over 1,300 China tax professionals and 50 China tax partners in 13 cities in Mainland China, Hong Kong, Singapore, and Taiwan, our PwC China Tax and Business Service Team provides a full range of tax advisory and compliance services. Leveraging on a strong international network, our tax specialists are striving to offer technically robust, industry specific, pragmatic and seamless solutions to our clients on their tax and business issues locally. The Global Tax Monitor recognises PwC as having the strongest overall reputation for tax services in China, with a lead over the competition.

China and UK Entered Into A New Double Taxation Agreement

The existing Double Taxation Agreement ("DTA") between China and the United Kingdom has been in place since 1984. On 27 June 2011, China and the UK concluded a new DTA ("New DTA"). If ratified by both countries within this year, the New DTA shall enter into force within 2011, and apply in China to income derived on or after 1 January 2012.

In this Issue of News Flash, we would like to highlight the key changes reflected in the New DTA as compared with the existing one and share our observations on the impact to UK investments into China.

Salient points

The New DTA generally follows the stereotyped DTAs that China has concluded or re-negotiated in recent years. It also reflects some key features of the latest OECD Model Convention, such as the Exchange of Information Article. We tabulate below the key changes under the New DTA from the perspective of the UK investors deriving income from China.

¹ The full text of the New DTA is available at the HMRC website: "<http://www.hmrc.gov.uk/international/uk-china-dta2011.pdf>". The official version in Chinese is not yet available in any Chinese official public websites.

| Description / Income stream | | China-UK DTA | |
|---|---|--|---|
| | | Existing DTA (effective since 1 Jan 1985) | New DTA (not yet effective) |
| Permanent establishment ("PE") and Technical fees | Time threshold governing construction PE | 6 months | The period for conducting construction activities to create a PE increases from 6 months to 12 months. |
| | Service PE | No provision | A service PE provision is added by adopting a threshold of 183 days within any 12 month period. |
| | Technical fees | China, as the income sourcing State, has the taxing right over service income arising from China even though the provision of service is not regarded as creating a PE in China. | Deleted. |
| Passive income | Dividends | 10% | The withholding income tax ("WHT") rate for dividends is reduced from 10% to 5% with a minimum direct or indirect shareholding threshold of 25%. |
| | Interest | 10% | The WHT rate for interest remains unchanged. |
| | Royalties | 10% / 7% | The WHT rate on royalties is generally unchanged at 10%, but is reduced marginally from 7% to 6% on royalties from equipment rental. |
| | Limitation of Benefits" ("LOB") | No provision | An LOB paragraph is added to the three passive income Articles. |
| Capital gains | Capital gains from disposal of property-rich shares | China has the taxing right over the gain in accordance with its domestic rules. | China has the taxing right if the "50% value threshold" is exceeded. |
| | Capital gains from disposal of non-property-rich shares | | China has the taxing right if the UK investor owned directly or indirectly at least 25% of the shares in the Chinese investee company at any time during the 12 month period before the disposal. |
| Other income | | No provision | An "Other Income" article with a LOB paragraph is added and the taxing right on other income is allocated to UK, the State of resident. |
| General anti-avoidance rules ("GAAR") | | No provision | An article allowing China to invoke its GAAR provisions under its domestic tax laws is added. |

PwC observations

What is good

- Articles of Service PE and Technical Fees

The PE Article under the existing China-UK DTA does not have a separate provision for service PE. In addition, according to the Technical Fee Article under the existing China-UK DTA, even if the services provided by a UK tax resident have not created a Fixed Place PE or Construction PE, the service income derived by the UK tax resident may still be taxed in China under the Technical Fees Article. This special article has given rise to continuous disputes until the clarification from the State Administration of Taxation ("SAT") in a recent circular SAT Public Notice [2011] No.19². Now the deletion of the Technical Fees Article should be welcome by UK tax residents as they would not be subject to any China Corporate Income Tax ("CIT") on their service fee income if the provision of services in China does not create a PE in China. In

² For the details of circular SAT Public Notice [2011] No.19, please refer to our previous News Flash [2011] Issue 9.

addition, the insertion of the Service PE provision in the PE Article provides a measurable time-span threshold in allowing PE protection to the UK service providers.

- Taxing right allocation for capital gains

Provided that the “25% shareholding threshold” is not exceeded, the taxing right on capital gains derived from the disposal of the shares of a non-property-rich company is now allocated to the State of resident. It is a major breakthrough that the New DTA provides such taxing right allocation (effectively WHT exemption in China), with conditions, on capital gains derived from disposal of non-property-rich company shares. This should offer incentives for UK investors to directly invest into China.

What is uncertain

- WHT rate on dividends

A reduced WHT rate of 5% on dividends is commonly seen in China's DTAs concluded or re-negotiated in recent years, such as China/Singapore, Mainland/Hong Kong, China/Barbados, etc. However, it is interesting that this New DTA has adopted the term “holds directly or *indirectly*” in the “25% shareholding threshold” requirement. This term has only been used in another DTA concluded by China, i.e. the Trinidad and Tobago/China DTA so far. It remains to be seen how the SAT would interpret the word “indirectly”.

What is challenging

- Anti-treaty shopping and abuse

We believe it is SAT's effort to insert the Article of GAAR in the New DTA. And the SAT has been trying to include the GAAR Article in concluding /re-negotiating DTAs in recent years. Furthermore, there is also a LOB clause in each of the Articles on Dividends, Interest and Royalties, and Other Income which allows the State of source not to grant the treaty benefit provided in those Articles if the main purpose of any creation or assignment of rights to the relevant income is to take advantage of the treaty benefit offered under those articles.

The insertion of GAAR Article, coupled with the LOB clause, reflect that treaty shopping and abuse are closely scrutinized by the Chinese tax authorities. Treaty benefit applicants have to ensure the arrangement /cross-border transactions can withstand potential challenge by the Chinese tax authorities based on the anti-treaty shopping/abuse provisions in an DTA as well as the domestic anti-avoidance tax rules and measures.

Conclusion

The existing DTA between China and UK is among the “first generation” of DTAs that China concluded. The economic, political and tax environment of China and the world were so different than nowadays. There have been calls for updating that DTA for quite some time as some provisions are not able to catch up with the business and tax needs of modern international trade and investments.

Doubtlessly, this New DTA has put UK on par by large with certain treaty-friendly jurisdictions, such as Hong Kong and Singapore, in terms of making investment into China. We believe this would put the UK investors back to comparative tax position as compared to other countries' investors.

We can see the SAT's continuous efforts in recent years to create a level playing field for treaty jurisdictions by standardizing its DTAs. These attempts can effectively discourage treaty shopping / treaty abuse arrangements. We also think this New China-UK DTA illustrates where China stands in concluding /re-negotiating DTAs with other treaty partners at this stage.

It would be helpful if the SAT could further clarify the unclear issues in the assessing practice so as to provide more certainty for UK tax residents in claiming treaty benefits for the income derived from China. That said, it is advisable for UK tax residents as well as multinational corporations to revisit the current group structure, to assess the impacts brought by this New China-UK DTA, and to observe how the Chinese tax authorities would interpret and implement the relevant provisions in the New DTA.

In the context of this News Flash, China, Mainland China or the PRC refers to the People's Republic of China but excludes Hong Kong Special Administrative Region, Macao Special Administrative Region and Taiwan Region.

The information contained in this publication is for general guidance on matters of interest only and is not meant to be comprehensive. The application and impact of laws can vary widely based on the specific facts involved. Before taking any action, please ensure that you obtain advice specific to your circumstances from your usual PricewaterhouseCoopers client service team or your other tax advisers. The materials contained in this publication were assembled on 6 July 2011 and were based on the law enforceable and information available at that time.

To make enquiries about our China tax and business advisory services, please feel free to contact the following lead specialist partners:

| | | | |
|---|---------------|-------------------------|------------------------------|
| Financial Services | Matthew Wong | Tel: +86 (21) 2323 3052 | matthew.mf.wong@cn.pwc.com |
| Transfer Pricing | Spencer Chong | Tel: +86 (21) 2323 2580 | spencer.chong@cn.pwc.com |
| Indirect Tax | Alan Wu | Tel: +86 (10) 6533 2889 | alan.wu@cn.pwc.com |
| Mergers & Acquisitions | Danny Po | Tel: +852 2289 3097 | danny.po@hk.pwc.com |
| China Business & Investment Advisory | Anthea Wong | Tel: +86 (10) 6533 3352 | anthea.wong@cn.pwc.com |
| International Tax Services | Edwin Wong | Tel: +86 (10) 6533 2100 | edwin.wong@cn.pwc.com |
| Domestic Enterprises Tax Services | Elton Huang | Tel: +86 (21) 2323 3029 | elton.huang@cn.pwc.com |
| Customs & International Trade | Damon Paling | Tel: +86 (21) 2323 2877 | damon.ross.paling@cn.pwc.com |
| Registration & Corporate Compliance | Matthew Wong | Tel: +86 (21) 2323 3052 | matthew.mf.wong@cn.pwc.com |
| Tax Accounting Services | Terry Tam | Tel: +86 (21) 2323 1555 | terry.sy.tam@cn.pwc.com |
| Value Chain Transformation | Jenny Chong | Tel: +86 (21) 2323 3219 | j.chong@cn.pwc.com |
| Tax Controversy Services | Xiaoying Chen | Tel: +86 (10) 6533 3018 | xiaoying.chen@cn.pwc.com |
| International Assignment Services / Human Resources Services | | | |
| Northern Region | Edmund Yang | Tel: +86 (10) 6533 2812 | edmund.yang@cn.pwc.com |
| Central Region | Stacy Kwok | Tel: +86 (21) 2323 2772 | stacy.kwok@cn.pwc.com |
| Southern Region | Jacky Chu | Tel: +852 2289 5509 | jacky.chu@hk.pwc.com |

Our regional contacts:

| | | | |
|-----------|---------------|--------------------------|--------------------------|
| Beijing | Edward Shum | Tel: +86 (10) 6533 2866 | edward.shum@cn.pwc.com |
| Chongqing | Peter Ng | Tel: +86 (23) 6393 7888 | peter.ng@cn.pwc.com |
| Dalian | Edward Shum | Tel: +86 (411) 8379 1888 | edward.shum@cn.pwc.com |
| Guangzhou | Charles Leung | Tel: +86 (20) 3819 2128 | charles.leung@hk.pwc.com |
| Hong Kong | Charles Lee | Tel: +852 2289 8899 | charles.lee@cn.pwc.com |
| Macao | Pat Wong | Tel: +853 8799 5122 | pat.lk.wong@hk.pwc.com |
| Nanjing | Jane Wang | Tel: +86 (25) 6608 6288 | jane.y.wang@cn.pwc.com |
| Ningbo | Amy Cai | Tel: +86 (574) 8773 6888 | amy.cai@cn.pwc.com |
| Qingdao | Steven Wong | Tel: +86 (532) 8089 1888 | steven.wong@cn.pwc.com |
| Shanghai | Peter Ng | Tel: +86 (21) 2323 1828 | peter.ng@cn.pwc.com |
| Shenzhen | Charles Lee | Tel: +86 (755) 8261 8899 | charles.lee@cn.pwc.com |
| Singapore | Lennon Lee | Tel: +65 6236 3728 | lennon.kl.lee@sg.pwc.com |
| Suzhou | Linjun Shen | Tel: +86 (512) 6273 1888 | linjun.shen@cn.pwc.com |
| Taiwan | Steven Go | Tel: +886 (2) 27296666 | steven.go@tw.pwc.com |
| Tianjin | Kelvin Lee | Tel: +86 (22) 2318 3068 | kelvin.lee@cn.pwc.com |
| Xiamen | Charles Lee | Tel: +86 (592) 210 7888 | charles.lee@cn.pwc.com |
| Xian | Elton Huang | Tel: +86 (29) 8720 3336 | elton.huang@cn.pwc.com |

This China Tax and Business News Flash is issued by the **PwC TAX Knowledge Management Centre** in China and Hong Kong, which comprises of a team of experienced professionals dedicated to monitoring, studying and analysing the existing and evolving policies in taxation and other business regulations in China, Hong Kong, Singapore and Taiwan. They support the PricewaterhouseCoopers partners and staff in their provision of quality professional services to businesses and maintain thought-leadership by sharing knowledge with the relevant tax and other regulatory authorities, academics, business communities, professionals and other interested parties.

For more information, please contact:

Matthew Mui
Tel: +86 (10) 6533 3028
matthew.mui@cn.pwc.com

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