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With over 1,200 China tax professionals and 54 China tax partners in 12 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.

DIN series (II) – Clearer guidance for tax treaty treatments on dividends, interest and royalties derived from China

Our previous News Flash [2010] Issue 16 has featured the newly released Departmental Interpretation Notes (“DIN”) on the Double Tax Agreement between China and Singapore (“China/Singapore DTA”) with regard to the general implications of the DIN. In this Issue, we will cover the interpretation provided in the DIN on articles governing dividends, interest and royalties, and share our observations.

Salient points

Definition for the terms “dividends”, “interest” and “royalties”

- **Definition of “dividends”**
The notion of dividends, in brief, basically concerns distributions of profits by companies. Payments regarded as dividends may include not only distributions of profits decided by annual general meetings of shareholders, but also other benefits in money or money’s worth, such as bonus shares, bonuses, profits on a liquidation and disguised distributions of profits.

In addition, in the situation of loans, where a lender effectively shares the risks of the borrowing company, the interest derived therefrom should be deemed as “dividends”. The DIN further enumerates five factors for determining whether the lender shares the risks of the borrowing company and they are in line with the Commentary of the Organization for Economic Co-operation and Development (“OECD”) Model Convention.
- **Definition of “interest”**
The term “interest” in the China/Singapore DTA is defined as, in general, income from debt-claims of every kind. The term “debt-claims of every kind” embraces cash deposits and security in the form of money, as well as government securities, and bonds and debentures. Income associated with loan business and which is incidental to the debt-claims can be treated as “interest”, whereas income which is separable from the lender, such as a standalone guarantee fee charged by a third party, shall in principle not be considered as interest. There is more analysis in relation to guarantee fees under the Observation part of this News Flash.
- **Definition of “royalties”**
The term “royalties” in the China/Singapore DTA basically comprises of:
 - Payments for the use of, or the entitlement to use, rights or property constituting the different forms of literary and artistic property, the

elements of intellectual property specified in the text and information concerning industrial, commercial or scientific experience.

- Payments for the use of, or the right to use, industrial, commercial or scientific equipment (not including immovable property).
- Payments received as consideration for information concerning industrial, commercial or scientific experience (i.e. know-how).

The DIN also sets out guidelines for the determination of royalties as opposed to service fee. These guidelines are consistent with the relevant provisions in the tax Circular Guoshuihan [2009] No.507 (“Circular 507”)¹ and Guoshuihan [2010] No. 46 (“Circular 46”)² issued by the State Administration of Taxation (“SAT”).

Criteria for the restricted treaty rate on dividends

A resident of a Contracting State (“treaty resident”) has to meet the following criteria in order to be eligible for the restricted tax rate of 5% as per the China/Singapore DTA in respect of dividends income derived from the other Contracting State:

- The treaty resident should be a company (as opposed to individual or other bodies), and a beneficial owner (“BO”) of the dividends.
- The treaty resident has to hold directly at least 25% of the capital of the company paying the dividends. Under normal circumstances, the 25% holding percentage of the capital may be ascertained based on the percentage of the paid-in capital of the company paying the dividends.
- The treaty resident has to meet the 25% shareholding threshold at any time throughout the 12-month period preceding the entitlement to the dividends. This requirement is the same as the one stipulated in a previous SAT Circular, Guoshuihan [2009] No.81 (“Circular 81”)³.

Anti-tax avoidance elements

- With regard to the China/Singapore DTA’s articles on interest and royalties, where by reason of a special relationship between the payer and the BO, or any other person, the amount of the interest / royalties paid exceeding the arm's length rate should not be eligible for the treaty benefits available under the two articles. The relevant articles in the China/Singapore DTA further state that the excess part of the payments should remain taxable according to the laws of each Contracting State. However, the DIN does not further elaborate how this excess payment should be taxed under the Chinese transfer pricing regulations.
- There is effectively a “limitation of benefits” clause in each of the captioned articles on dividends, interest and royalties. Where the main purpose of a transaction or arrangement is to take advantage of the treaty benefits provided in the captioned articles, the in-charge tax authorities in China are empowered to make adjustments accordingly.

PwC observations

It is good to see that most of the interpretation laid down in the DIN in respect of the passive income is basically consistent with the OECD Commentary. However, it is imperative to note that there are still certain issues which are not in line with or not addressed in the OECD Commentary.

¹ Please refer to our News Flash [2009] Issue 22 for further details regarding Circular 507.

² Please refer to our News Flash [2010] Issue 3 for further details regarding Circular 46.

³ Please refer to our News Flash [2009] Issue 07 for further details regarding Circular 81.

The beneficial owner (“BO”) concept in anti-tax avoidance considerations

In addition to the above-mentioned “limitation of benefits” clause as well as the clause regarding denial of treaty benefits on interest / royalties exceeding the arm’s length rate, the BO concept is another important anti-tax avoidance means embedded in the articles on dividends, interest and royalties.

The determination of the BO status is important in the sense that the treaty residents have to be the BO of the relevant dividends, interest and royalties in order to enjoy the restricted China Withholding Income Tax (“WHT”) rates on these passive incomes. The DIN states that a previous SAT Circular Guoshuihan [2009] No.601 (“Circular 601”) should be observed in assessing the BO status. Circular 601 sets out seven unfavourable factors in the determination of the BO status by mainly assessing the commercial purposes and substance of the entity receiving the passive income. The guidance in Circular 601 is harsher than the OECD commentaries and international tax practice.⁴

The DIN merely makes reference to Circular 601 without any further elaboration. As far as we understand, currently the practical application of Circular 601 to real-life cases is very controversial at local levels. Given the complexity of the BO issue and the high demands in extensive knowledge about DTAs, we appreciate that it is not an easy task for the local-level tax bureaus to apply the principles in Circular 601 in a consistent and effective way in the course of granting treaty benefits. We believe that the SAT is contemplating to work out more concrete guidelines to facilitate the local-level tax bureaus to implement Circular 601 and to better implement the concept of BO.

“12-month look-back period”

As mentioned above, the treaty resident has to meet the 25% shareholding threshold at any time throughout the 12-month period preceding the obtaining of the dividends (“12-month look-back period”) in order to enjoy the restricted WHT rate on dividends. This condition is not stipulated in the body of the China/Singapore DTA. It is a unilateral requirement set by the SAT.

The objective of imposing such criterion is to combat the tax avoidance arrangement where a foreign investor with a shareholding of less than 25% increases its holding to more than 25% shortly before the Chinese subsidiary declares dividends primarily for the purpose of securing the benefits of the restricted WHT rate of 5%. However, this criterion may make life difficult for the treaty residents. For example, in situations where a Singaporean company acquires a Chinese company or where a Singaporean company increases its shareholding in a Chinese company from below to above the 25% threshold for genuine business purpose, the Chinese company has to wait for 12 months before it declares and pays dividends to that Singaporean company in order to meet the “12-month look-back period” criterion.

OECD does not require that the company receiving the dividends must have owned at least 25% of the capital for a relatively long time before the date of the distribution. It is open to the Contracting States, through bilateral negotiations, to include a condition in their conventions. Since the “12-month look-back period” condition is not a condition mutually agreed by both Contracting States but a unilateral condition set by the SAT, it remains to be seen whether the Singaporean competent authorities (and the other Contracting State / region) would agree with such SAT’s interpretation.

Notwithstanding the above, the DIN clarifies that if the dividends are paid out of the undistributed profits earned prior to the 12-months period preceding the receipt of the dividends, the treaty resident does not have to meet the minimum shareholding percentage at the time when such profits were earned. In other words, as long as the treaty resident satisfies the “12-month look-back period” criterion at the time of obtaining dividends, the restricted tax rate should be available to all the dividends received, including those declared out of the undistributed profits for the period in which the said treaty resident is not a shareholder or holds less than 25% shares of the company paying the dividends. It is good to see this clarification as it could help to unify the divergent practices previously adopted by the local-level tax authorities on this issue.

⁴ Please refer to our News Flash [2009] Issue 24 for further details regarding Circular 601.

Differentiation between dividends and interest

As mentioned above under the definition for dividends, interest derived from loans where the lender shares the risks of the borrowing company should be treated as dividends. This is probably the first time we have seen the SAT's interpretation on the characteristics of dividends vs. loan interest. As indicated in both the DIN and the OECD Commentary, the classification of this type of interest into the category of dividends would provide a basis to treat this type of interest as dividends on the application of the thin capitalization rule under the domestic tax law of the borrower's jurisdiction, i.e. China.

Such interpretation would also have impact on the tax planning schemes of the so-called "hybrid" instrument adopted for cross-border debt push down. The "hybrid" instrument refers to a loan arrangement whereby the repayment of interest relies on the profitability of the borrower so that, depending on the domestic rules of the lender and borrower's jurisdiction, such interest payment may be treated as interest cost in the borrower's jurisdiction but dividends in the lender's jurisdiction. With the clarification on the characteristics of dividends vs. interest provided in the DIN, interest payment under a "hybrid" instrument scheme would unlikely be treated as interest in China. It is important for treaty residents to note this new interpretation in the DIN for their future China investment planning.

Implication of the definition of interest on guarantee fee

According to the definition of "interest" provided in the DIN, a guarantee fee "which is separable from the lender" (i.e. paid to a third party) should not be considered as interest. In other words, the guarantee fee paid to a third party would not be eligible for the restricted treaty rate on interest provided in the DTA. That guarantee fee would then have to be dealt with in accordance with the domestic law, i.e., Corporate Income Tax Law and would possibly be subject to WHT at the full rate of 10% without the enjoyment of the restricted treaty rate.

Applicability of the tax-exemption clause for interest

According to paragraph 3 of Article 11 of the China/Singapore DTA, interest derived from China is exempt from tax in China if the BO of the interest is a prescribed government body or financial institution in Singapore.

The DIN does not further elaborate whether an overseas branch of a prescribed Singaporean financial institution is eligible for the tax exemption. However, an earlier tax circular Guoshuihan [2010] No.266 ("Circular 266") issued by the SAT in mid 2010 stipulated that an overseas branch of a prescribed financial institution and its headquarters are the same legal entity. Therefore, the interest income derived from China by the overseas branch of a prescribed Singaporean financial institution shall enjoy the tax exemption provided by the China/Singapore DTA, except for cases where the DTA grants the tax exemption to the headquarters only.

The interpretation in Circular 266 is specifically for the purpose of applying the tax-exemption clause under DTAs concluded by China. It is still unclear whether this principle can apply to the restricted tax rate clause on interest under DTAs.

Royalties vs. service fee for a mixed contract for technology transfer

The DIN clarifies the Chinese tax treatment for a mixed arrangement covering both transfer of technology and provision of relevant services. It basically follows the rules set out in Circular 507 and Circular 46.

Based on the interpretations provided in Circular 507 and Circular 46, where a treaty resident enters into a mixed contract for technology-transfer and relevant services with its Chinese counterparts, if no permanent establishment ("PE") is created in China, the service fee is treated as royalties; but if a PE is created, then the tax treatment will be switched from royalties to business profits in respect of the onshore service portion whereas the offshore service portion remains being treated as royalties. Thus it appears that the Chinese tax authorities are getting the upsides in both scenarios. This interpretation in the DIN following the principles set forth in Circular 507 and Circular 46 seems not in line with the principles in OECD Commentary in terms of a mixed contract.

It is worth noting that the above interpretation is based on the assumption that the service is related to the technology-transfer. If the service is not related to the technology-transfer, then it would be advisable to elaborate the service nature in details to support such disconnection and, where commercially feasible, to conclude separate contracts for such services. However, it is often difficult for foreign licensors to differentiate the service related to technology-transfer from those which are not, and to justify such distinction with the Chinese tax authorities. Thus, the foreign licensors may be facing increasing practical risks of the offshore service fee being bundled with royalties and thus subject to the WHT in China.

Suggested actions for treaty residents

During the past year 2009, the SAT actively released a series of tax circulars providing interpretation on the articles of dividends, royalties, interest and assessment of BO under DTAs. The DIN adopts the relevant provisions in these circulars to a large extent. In addition, the SAT also issued a circular Guoshuifa [2009] No.124 addressing the compliance requirements for treaty residents to claim various treaty benefits including the ones for passive income.⁵ These are all important guidelines for treaty residents to observe and appreciate the Chinese tax authorities' positions in order to secure the treaty benefits to which they are entitled in respect of dividends, interest and royalties derived from China.

On the other hand, it is also important for the treaty residents to note the interpretation in the DIN that deviates from the OECD principle and international practice. Where necessary, the treaty residents may need to come up with solutions to mitigate the negative impact potentially brought upon by such SAT's unilateral interpretation.

As usual, despite of what is laid down in the tax circulars or the DIN clearly or unclearly, it is always a practical issue as to how the local-level tax bureaus are going to implement at local levels. This is often the case particularly where some of the issues (such as BO) involved in granting relevant treaty benefits are not straight forward and demands extensive knowledge about DTAs and international tax practice. It is not impossible to see confusion or even disputes arising between the local-level tax bureaus and treaty residents in the course of assessing relevant treaty benefits. It is advisable for the treaty residents to keep regular dialogues with their in-charge tax bureaus and observe the trend in granting treaty benefits for dividends, interest and royalties at local levels.

⁵ Please refer to our News Flash [2009] Issue 20 for further details regarding circular Guoshuifa [2009] No.124.

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 PwC client service team or your other tax advisers. The materials contained in this publication were assembled on 25 October 2010 and were based on the law enforceable and information available at that time.

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