

News Flash

China Tax and Business Advisory

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With over 1,200 China tax professionals and 50 China tax partners in 12 cities in Mainland China, Hong Kong, and Singapore, 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.

Treaty Residents Having Clearer Rules for Claiming Benefits under Double Tax Treaties

Many foreign enterprises or individuals (or collectively called “non-tax residents”) with investments or operations in China are subject to China tax in respect of their China-source income. Some of them should be eligible to enjoy the favourable income tax treatments (hereinafter as “Treaty Treatments”) under Double Tax Treaties (“DTAs”) concluded by China with the countries/regions where the foreign enterprises or individuals are tax residents (or collectively called “treaty residents”).

However, there has been no clear and unified administrative rule for the treaty residents to follow to claim the Treaty Treatments. They have been relying on diverged practices adopted by different local-level tax bureaus in the locations where they derived the China-source income.

In order to address the needs of such treaty residents and Chinese local-level tax bureaus, and to counter any abusive use of Treaty Treatments, the State Administration of Taxation (“SAT”) issued a circular Guoshuifa [2009] No.124 entitled “Administrative Measures for Non-Tax Residents to Enjoy Treatments on Income under DTA (Trial)” (“the Measures”) on 24 August 2009.

It is the first time that the Chinese tax authorities introduce such comprehensive and detailed administrative rules for treaty residents to claim Treaty Treatments. The Measures will take effect from 1 October 2009.

The Measures will apply to both treaty resident enterprises and individuals. In this Issue of News Flash, we would like to highlight the salient points of the Measures and share our observations and suggestions in relation to treaty resident enterprises. There will be another News Flash coming soon addressing the Measures from the perspective of treaty resident individuals.

Compliance requirements under the Measures

The Measures set out the compliance requirements for the treaty resident enterprises to claim Treaty Treatments. The key features are captured as follows:

Chapter 1: General provisions

- “Treaty Treatments” are defined in the Measures as reduction or exemption of income tax liabilities by applying DTAs which are otherwise payable under China domestic income tax law and regulations.
- Treaty resident enterprises are not automatically granted the Treaty Treatments but are required to comply with the administrative rules under the Measures in order to enjoy the Treaty Treatments.

Chapter 2: “Approval-application” procedure and “Record-filing” procedure

- The Measures classify income derived by treaty resident enterprises into two categories of income which are subject to different procedures for claiming Treaty Treatments purpose. The Approval-application procedure is for passive income, namely dividends, interest, royalties and capital gains; while the Record-filing procedure is for active income, such as, business income of permanent establishments (“PE”), independent personal services, dependent personal services, etc.
- There are different documentation requirements for the two procedures.
- Under the Approval-application procedure, the treaty resident enterprises should lodge the applications with the Authorized-approval Tax Bureaus (“ATBs”), which are to be designated by the provincial-level tax bureaus (or equivalent), and could be different than the in-charge tax bureaus. Also, the treaty resident enterprises are not required to repeat the application if it is for the same type of income within 3 years upon the first approval, where the prescribed conditions are fulfilled.
- Under the Record-filing procedure, the treaty resident enterprises (or their withholding agents where relevant) are required to file the prescribed documents with the in-charge tax bureaus for record-filing purpose. It is silent on whether there are any examination and approval procedures by the tax bureaus.

Chapter 3: Approval and implementation

Chapter 3 provides detailed guidelines for the Approval-application procedure in respect of:

- Acceptance and rejection of the application by the tax bureaus;
- Timeframe for the ATBs to hand down their decision on the application;
- Arrangement for cases where the ATBs are not able to assess the treaty resident enterprises’ entitlement to the Treaty Treatments;
- Implementation after the approval for Treaty Treatments is obtained.

Chapter 4: Follow-up monitoring administration

- The treaty resident enterprise or its withholding agent has to re-apply / re-file for the Treaty Treatments in case of subsequent changes to the status of the treaty resident enterprise which would affect its Treaty Treatments status.
- Where a treaty resident enterprise was eligible for the Treaty Treatment but failed to apply for approval, as a result of which excessive tax was paid, it shall be allowed to re-open the application for Treaty Treatments within 3 years from the date the tax was paid and to obtain a refund.
- The tax bureaus are required to randomly check the application of Treaty Treatments by the treaty resident enterprises (for both Treaty Treatments subject to the Approval-application or Record-filing procedures).
- There are situations where the tax bureaus could revoke the Treaty Treatment approval and require the treaty resident enterprises to pay back the taxes together with relevant surcharges.

Chapter 5: Legal liabilities

Chapter 5 provides that for the various situations where there was non-compliance to the Measures or the Treaty Treatments were approved based on false information, the Chinese tax bureaus may impose penalties, surcharges and/or interest in accordance with the China Tax Collection Administration Law.

Chapter 6: Miscellaneous

- The treaty resident enterprise may engage an agent to handle the relevant issues under the Measures.
- The Measures will take effect on 1 October 2009. The treaty resident enterprises are allowed to re-open the application, after the effective date of the Measures, for the Treaty Treatments that were not claimed in respect of income derived before the Measures, as long as the 3-year time threshold is not exceeded.

PwC Observations

What is good

In general, DTAs do not provide details on the administrative procedures for claiming Treaty Treatments. In the lack of a clear guidance in the DTAs and from the SAT, the practices adopted by the Chinese local-level tax bureaus were diverged in the past for treaty resident enterprises (or their withholding agents) in claiming, and for the local-level tax bureaus in granting, the Treaty Treatments.

The Measures are aimed to unify the various practices in claiming and granting the Treaty Treatments to treaty resident enterprises adopted in different regions of China in the past and to strengthen the tax administration in this respect. It is good to see that the Measures have incorporated the following desirable features:

- The Measures are very extensive and comprehensive, covering all types of income provided in a typical DTA and almost all possible scenarios under which the treaty residents and their withholding agents may come across. The treaty resident enterprises should find the Measures more helpful in observing and undergoing full tax compliance obligations in China as compared to the diverged practices in the past.
- To some extent, the Measures try to simplify the administrative burdens, e.g. duplicate applications for the Treaty Treatments are not required for the same type of income within 3 years where the prescribed conditions are fulfilled.
- In addition, the Measures provide a set of clear timelines for the examination and approval process of tax authorities under the Approval-application procedure. This should be welcome by the treaty resident enterprises since the Measures put more time pressure to the tax bureaus to reduce bureaucracy and unnecessary delay in assessing applications.

What is uncertain

- According to the Measures, the treaty resident enterprises do not need to repeat the application if it is for the same type of passive income for the same Treaty Treatment, and with the same local-level tax bureau within 3 years after the first approval. However, where a treaty resident enterprise derives passive income from different locations in China, the Measures seem suggesting that it should lodge the Approval-applications to each of the ATBs in the locations where such income are derived. If that is the case, then it could be a heavy administrative burden to the treaty resident enterprises.
- The Measures only require Record-filing procedure for the Treaty Treatments for active income, such as PE protection, without the Approval-application procedure. In other words, the Treaty Treatments could be automatically available to the treaty resident enterprises after the Record-filing procedure is done. This sounds very liberal. However, the treaty resident enterprises should note that they, or their withholding agents, have to undergo another process to obtain the Tax Exemption Certificate which is necessary for remittance purpose of service fee payments to overseas. It remains to be seen whether the local-level tax bureaus would have to review the Record-filing package for the purpose of issuing Tax Exemption Certificate and, where in doubt, reject the PE protection claim. In any event, the Measures have provided a full set of follow-up monitoring administrative procedures, and any unwarranted tax benefits could be identified and disallowed upon such procedures.

What is challenging

- Where treaty resident enterprises derived income from China in the past, they used to follow an old tax circular (which has been superseded by the Measures) for claiming relevant Treaty Treatments. That old circular simply provided an application form and form-filling instruction. The Measures now introduce much more comprehensive and extensive procedures, documentation and disclosures for treaty resident enterprises in claiming Treaty Treatments in respect of their China-source income. This sets forth a much higher level of compliance requirements for the treaty resident enterprises as compared to the previous practice.

- The attached forms in the Measures appear to be collecting a lot of information, including the treaty resident enterprises' own particulars, their shareholders, as well as related-party transactions in third countries, etc. They are more than what are required in similar forms in many other tax jurisdictions (e.g. Canada, UK and US). We believe that the objective of collecting so much information is to facilitate the Chinese tax authorities to assess the treaty resident status, beneficial ownership, limitation of benefits, treaty shopping or treaty abuse, etc. So for some treaty resident enterprises, these procedures could mean more disclosure of sensitive information, and even more than another set of tax compliance requirements.

Interaction with other tax policies

Since early 2009, the SAT has released a series of tax circulars strengthening the tax administration for non-tax residents. Among them, there were circular Guoshuifa [2009] No. 3 for withholding obligation on passive income and SAT Order [2009] No. 19 for withholding obligation on contracted projects and labour services. Both circulars have provided the administrative compliance procedures for non-tax residents deriving the respective income from China. Both circulars have also briefly mentioned about the procedures and documentation requirements in cases where the non-tax resident enterprises are treaty residents. There was also another tax circular Guoshuihan [2009] No. 81 covering the criteria and conditions, plus some brief documentation requirements, on claiming Treaty Treatments in respect of dividends income derived from China, but not too much on the procedural matters. The SAT may be issuing similar circulars to address other types of passive income than dividends.

We believe that once the Measures come into effect, the treaty resident enterprises should follow the relevant articles in the Measures instead of the above circulars, if in conflict, because the Measures are more comprehensive in terms of administrative procedures, and serving as a supplement to the above policy-wise circulars.

What should treaty resident enterprises do

For those treaty resident enterprises which have been enjoying the Treaty Treatments in the past, we would suggest that they take immediate actions to either apply or file for record the Treaty Treatments according to the Measures in order to secure the relevant Treaty Treatments continuously, because the Measures will come into effect very soon on 1 October 2009 – the time is running short.

Alternatively, for Treaty Treatments for passive income which is subject to Approval-application procedure, the Measures allow treaty resident enterprises to re-open the claims for Treaty Treatments within 3 years from the date the excessive tax was withheld, and obtain a refund of the excessive tax paid. So if a treaty resident enterprise needs the passive income to be remitted urgently and cannot afford the time to wait for the Approval-application procedure to be completed, it may consider paying the China tax at the withholding tax rate prescribed under the Chinese domestic law first, and then re-open the claim for Treaty Treatments and get the tax refund within the prescribed time period. However, that will be involving more procedures and bureaucracy in getting back the tax refund.

Apart from the procedural matters, we believe it is also time for non-tax resident enterprises, be they treaty residents or not, to review their current and contemplated investment structures to ensure that there are reasonable commercial purposes for using intermediary vehicles and sound business substance (with good documentation) in such intermediary vehicles in order to enjoy the relevant Treaty Treatments. In light of the recent anti-tax avoidance cases as well as series of tax policies already issued or in the pipeline, it is imperative to note that treaty shopping or treaty abuse issues have come under the radar screen of the Chinese tax authorities. The Measures is another important step taken by the SAT towards this direction.

We will closely monitor the development in this aspect and share with you our further insights. In the meantime, we will be holding a webcast on the Measures. If you are interested, please follow this link to register for the webcast.

In the context of this News Flash, 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.

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