TAX NEWS CHINA

2014/03
April 2014

New Double Tax Agreement between China and Germany signed

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Key points

» Dividend withholding tax rate will be reduced to 5%

» Permanent establishment after 12 months period

» DTA not yet in effect, a quick ratification is desirable.

1) Current development

On March 28, 2014, the new Double Tax Agreement (DTA) between China and Germany has been signed. However, the new DTA is not yet in effect, since the necessary ratification is pending. If the ratification is completed in due time within this year, the DTA would be applicable for withholding taxes from January 1, 2015 respectively for all other taxes for all tax years, which start on or after January 1, 2015. Until then, the current DTA dating back to 1985 continues to be applicable. In the following, we summarise some of the major changes.

2) Major changes

» Permanent Establishments

According to the new DTA, the threshold for constituting a Permanent Establishment (PE) for a building site, or construction, assembly or installation project or supervisory activities connected therewith is now 12 months. The current DTA still mentions a 6 months period. Further, for service activities, the new PE threshold is now 183 days instead of 6 months. The 6 months threshold indicated in the current DTA has in the past often led to a problem in China. Here, based on local interpretation, part of a specific month has been considered as one full month in terms of calculating the PE threshold. As a consequence, a PE has often been constituted even if services were only provided for a few days per month. The new DTA clarifies this. We expect as a result that foreign employees working for projects in China will not be subject to Chinese Individual Income Tax (IIT) as easily as in the past.

» Business profits

In the protocol to the new DTA it has been agreed that with regard to the taxation of business profits, the OECD model convention (2008) has to be considered. If this will have consequences on the Chinese taxation of PEs in practice, remains to be seen. So far, related taxation is based mainly on deemed profit methods.

» Dividends

For distribution of certain dividends, a withholding tax (WHT) of 5% will be levied in the future, compared to currently 10%. As a precondition, the receiver of the dividends has to be the beneficial owner and must hold at least 25% of the capital of the dividend payer.

» Royalties

For license payments, a reduced WHT rate of 6% (10% WHT based on 60% of the gross amount of royalties) shall be levied, if the payments are received as a consideration for the use of, or the right to us, any industrial, commercial or scientific equipment. For payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work, any patent, trademark, design or model, plan, secret formula or process, or for information (know-how) concerning industrial, commercial or scientific experience, a tax rate of 10% shall be applied. The term “royalties” has been clarified by specifically mentioning the transfer of know how. In practice, however, we expect that this will still lead to different interpretations.

» Procedure of withholding tax payment

It has to be considered that according to the Chinese local Corporate Income Tax Law WHT is raised at 10%, which is only refunded respectively reduced upon application. China however has to implement procedures to allow payments directly applying no WHT respectively a reduced WHT rate.

» Capital gains

The new DTA also includes specific regulations regarding the transfer of shares. Gains derived thereof from a German resident can only be taxed in China, in case the shares derive more than 50% of their value from immovable property situated in China or in case the seller of the shares has owned at least 25% of the shares of the company at any time during the 12 month period preceding the alienation. For all cases not explicitly mentioned in the new DTA, the country of residence has the right of taxation.

» Independent personal services/income from employment

Regarding income from independent personal services and income from employment, the 183 days period is now applied over any 12 months period, instead of a calendar year.

» Methods article and activity clause

The exemption method is still the primary method for the avoidance of double taxation. However, the activity clause (Aktivitätsklausel) has been intensified, referring to the German Foreign Tax Act (FTA, Aussensteuergesetz). A tax exemption is only applied in case a Permanent Establishment or subsidiary is engaged in certain operative/functional activities according to the FTA. Otherwise, a switch-over to tax credit applies with regard to the taxes paid in China.

» Switch-over clause

In addition, a switch-over clause has been introduced in order to avoid cases of double non-taxation. The exemption method is then replaced by the tax credit method (e.g. qualification conflicts).

3) Conclusion

In conclusion, the new DTA is a positive development, which will for the most part result in better tax relief for taxpayers. It will have to be seen how the practical implementation will take place in China. A quick ratification is desirable.

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