China Tax News

Tax treaty developments in China and Hong Kong

Key Points

- On June 27, 2011, the Chinese Government signed a new Double Tax Agreement (DTA) with the United Kingdom.
- Beneficial Ownership will be tested by Chinese tax authorities before granting lower DTA rates.
- Some important changes regarding dividends, royalties and capital gains have been included in the amended tax treaties.
- Hong Kong has now signed 21 DTAs, most of which will come into force during 2011 or 2012. The latest have been with Portugal, Spain and the Czech Republic.

1) Latest development

In this Infoletter, we would like to provide an overview over the latest tax treaties in China and Hong Kong. We will show how China has changed their policy on tax treaties, such as the definition of permanent establishment or the reduction of withholding taxes.

The DTA between China and the United Kingdom was renewed on June 27, 2011. Assumed that the ratification of the DTA will be conducted by the end of 2011, the treaty may become effective from January 01, 2012 in China.

Before, China and Belgium signed new Agreements for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and the related protocol in 2009. The new DTA will replace the original DTA dated April 18, 1985. It is not yet determined, when the new DTA will enter into force. This depends on when the two countries complete their national implementation procedure. The new Agreement between China and Finland signed on May 25, 2010 will replace the older version from May 12, 1986. The tax treaty became applicable on January 1, 2011.

The new versions of the tax treaties bring some very positive changes for both Chinese as well as Belgian, Finnish and British residents. Especially European countries and multinational enterprises will benefit from the amended tax treaties, as Belgium, Finland and the United Kingdom as intermediary countries will become more attractive for companies investing into China.

Furthermore, since January 2010, Hong Kong has signed 16 new DTAs, i.e. Brunei, Netherlands, Indonesia, Hungary, Kuwait, Austria, United Kingdom, Ireland, Liechtenstein, France, Japan, New Zealand, Switzerland, Portugal and Spain. The latest DTA, which has been signed on 6 June 2011, is with the Czech Republic.

Through the new tax treaties, China and Hong Kong strengthen their position in international trading and financial markets by generally providing more beneficial economic conditions for foreign investors.

In the following, we will highlight the key changes in these tax treaties and show how China's and Hong Kong's policy towards concluding DTAs is developing.

2) Main changes of China tax treaties

The main changes of the renewed tax treaties compared to their respective old versions are:

- Decrease of the dividend and royalty withholding taxes;
- Different definition of construction- and services permanent establishment (PE);
- Different conditions for capital gains exemption;
- General anti-avoidance rule (GAAR).

a) Reduced withholding taxes

Belgium:

- Dividends: The old tax treaty from 1985 stipulated a withholding tax (WHT) rate of 10%. This rate has been substantially reduced to 5% according to the new treaty. The 5% rate shall however only be applicable if the receiver of the dividends is the beneficial owner and has been holding directly at least 25% of the capital of the dividend paying company for an uninterrupted period of at least 12 months prior to the payment of the dividends.

- Royalties: According to article 12 of the new tax treaty, if the beneficial owner of the royalties is a resident of a contracting state, the tax shall not exceed 7%. Compared to the 10% rate stipulated in the old tax treaty, the reduction represents a further beneficial amendment.

Finland:

- Dividends: If the parent company receiving the dividends holds directly at least 25% of the capital of the dividend paying company, the tax rate shall be 5%. In the old tax treaty this rate amounted to 10%.

United Kingdom:

- Dividends: The withholding tax has been reduced from 10% to 5% under the condition that the beneficial owner of the dividends is a company which holds at least 25% of the capital of the company paying the dividends.

- Royalties: The tax rates on royalties paid as consideration for the use of, or the right to use industrial, commercial or scientific equipment has been changed from the previous 7% to now 6%.

b) Capital gains

Belgium:

- According to article 15, gains from the alienation of shares other than shares in which there is substantial and regular trading on a recognized stock exchange provided that the total of the shares alienated by the resident (Belgian company) during the fiscal year in which the alienation takes place does not exceed 5% of the quoted shares, may be taxed in that other contracting state (China) if the other-resident has owned directly or indirectly at least 25% of the company.

- Regarding gains derived by a Belgian company from the alienation of shares of a Chinese listed company, Belgium shall have the taxing right if the Belgian company holds less than 5% of the shares of this Chinese listed company in one fiscal year.

Finland:

- The new point 5 of Article 13 states, that gains derived by a resident of a contracting state (Finnish resident) from the alienation of shares in a company which is a resident of the other contracting state (China) may be taxed in that other state if the recipient of the gain, at any time during the 12 month period preceding such alienation, had a participation, directly or indirectly, of at least 25% in the capital of the company.

United Kingdom:

- According to the updated article 13, the alienation of property shall only be taxable in the state where the alienator is resident, except in the following situations:

    - Gains derived from the alienation of immovable property in the contracting state (China) by a resident of the other contracting state (United Kingdom);

- Gains derived by a resident of a contracting state (United Kingdom) from the alienation of shares deriving more than 50 percent of their value directly or indirectly from immovable property the other contracting state (China);
- Gains derived by a resident of a contracting state (United Kingdom) from the alienation of shares in a company resident in the other contracting state (China) if, at any time during the 12-month period preceding the alienation, the U.K. resident owned at least 25 percent of the shares in the Chinese resident company.

c) Permanent Establishment (PE)

Belgium:

- Construction PE: The threshold for constituting a construction PE has changed from 6 months in the old tax treaty to 12 months according to the new version of the treaty. This new regulation constitutes a significant improvement of foreign companies doing project related business in China.

- Service PE: The threshold for the service PE has been amended from 6 months to 183 days. As the calculation of the previous 6 month period was conducted rather strictly be Chinese tax authorities, the new wording of 183 days will bring more certainty and stability in the project planning process for foreign companies.

Finland:

- A rather untypical clause which expands the definition of a PE was included in the new version of the tax treaty between China and Finland. Article 5 states that an insurance enterprise of a Contracting State (Finland) shall, except in regard to re-insurance, be deemed to have a permanent establishment in the other Contracting State (China) if it collects premiums in the territory of that other State or insures risks situated therein through a person other than an agent of an independent status.

United Kingdom:

- Construction PE: A building site, a construction, assembly or installation project or supervisory activities in connection therewith shall constitute a PE where such site, project or activities continue for a period of more than 12 month. In the current version of the DTA, the period (without supervisory activities) is only 6 month.

- Service PE: The renewed DTA also includes the concept of a service PE, which the current DTA does not. A service PE shall be constituted through the furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only if activities of that nature continue (for the same or a connected project) within a contracting state for a period or periods aggregating more than 183 days in any twelve-month period commencing or ending in the fiscal year concerned.

In this regard it is also noteworthy that in the renewed DTA, the technical fees article has been removed. Therefore, technical services provided by a UK resident to a Chinese resident shall no longer be subject to withholding tax of 7%.

d) General Anti-Avoidance Rule (GAAR)

Belgium, Finland and United Kingdom

- All three versions of tax treaties include a new article 23 that stipulates that nothing in the treaty shall prejudice the right of each Contracting State to apply its domestic laws and measures concerning the prevention of tax evasion and avoidance, whether or not described as such, insofar as they do not give rise to taxation contrary to the treaty.

4) Latest developments in Hong Kong

The reason for the sudden development of Hong Kong signing DTAs was a report by the OECD in 2009 in which Hong Kong (nearly) got grey listed as a not fully cooperating tax jurisdiction. It was then required to enter into 12 comprehensive DTAs with the 2004 OECD standard on EoI (Exchange of Information) by the end of 2010, in order to be regarded as fully compliant and avoid potential economic disadvantages.

All of Hong Kong's new DTAs are based on the 2004 OECD standard. However, two deviations can be found in all of Hong Kong's EoI clauses:

(1) exchange of information is limited to taxes which are covered by the respective DTA and

(2) the information received must not be transferred to the oversight authorities of the tax authorities or to the authorities of any third country.

Under its new DTAs, Hong Kong will exchange information only from the date the respective DTA is in force, i.e. no retroactive application has to be expected.

In the following chart we compare the dividend withholding tax rates for those countries which Hong Kong has signed a DTA with. We compare the local rates with the DTA rates for Hong Kong, Singapore and Germany. We only look at the countries in Asia-Pacific, since most European investors would generally not hold shares in other parts of the world via Hong Kong (or Singapore).

The cells highlighted orange show the best dividend withholding (wht) rate, which can be a local rate (e.g. Brunei) or one (or more) of the DTA rates. For 4 out of 7 countries Hong Kong provides for the best withholding rate, while Singapore has the same rate in the case of China. Germany is obviously a disadvantageous location (purely from the dividend withholding tax rate perspective).

Country	Local wht rate	DTA wht rate		
DIVIDENDS				
	Country	Hong Kong	Singapore	Germany
Brunei	0	0	10	-
China	10	5/10	5/10	10
Indonesia	10-20	5/10	10/15	10/15
Japan	7/20	5/10	5/15	10/15
New Zealand	30	0/5/10	5/15	15
Thailand	10	10	20	15/20
Vietnam	0	10	5/7/12.5	5/10/15

5) Conclusion

The amended versions of the tax treaties between China-Belgium, China-Finland and China-United Kingdom clearly show the effort of the involved countries to decrease the tax burden for their residents. Especially the reduction of the withholding tax regarding dividends and royalties will increase the value of Belgium, Finland and the United Kingdom as a Holding location especially in Europe for enterprises investing into China.

For Hong Kong as a regional location for functions such as holding, management and financial center, the new DTAs certainly provide for new options to structure businesses tax efficiently. The new DTAs may as well help reduce tax risks around the region, by granting access to international standards for avoidance of double taxation, such as Mutual Agreement Procedures.

With regard to Germany we want to mention that negotiations between China and Germany are presently ongoing to change the existing DTA. With regard to Hong Kong, the German Finance Ministry is presently not willing to negotiate a DTA, which creates a competitive disadvantage for Germany regarding investments coming from China via Hong Kong to Europe.

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