

**RELIEF UNDER DOUBLE TAX AGREEMENTS AND
EQUITY TRANSFERS IN PRC COMPANIES**

“Tax treaty shopping” is one of the major issues covered by the general tax avoidance provisions under the PRC Enterprise Income Tax Law and the Implementation Measures of Special Tax Adjustments (Provisional). In August 2009 the PRC State Administration of Taxation (“SAT”) issued Circular Guoshuifa [2009]124 to impose certain administrative procedures for non-resident enterprises and individuals to claim taxation relief under double tax agreements (“DTAs”). In late 2009 SAT issued another three circulars (Guoshuihan [2009]507, Guoshuihan [2009] 601 and Guoshuihan [2009]698) to counteract tax avoidance schemes and tax treaty abuses. The first two circulars clarify “royalties” and “beneficial owner” under the provisions of DTAs whilst the third one covers situations where PRC non-residents derive gains from equity transfers in PRC companies.

In this Tax Flash we summarise the major issues covered by these circulars.

1. GUOSHUIFA [2009]124 (“CIRCULAR 124”)

Our previous Tax Flash (May 2009) noted that SAT had issued a series of circulars in late 2008 and early 2009 (e.g. Guoshuifa [2009] 82, Guoshuihan [2009] 81, Guoshuifa [2009] 3 and Guoshuihan [2008]1076) to strengthen the tax administration for non-residents deriving income from the PRC and also to express SAT’s opinion on abuses of tax incentives and tax treaty shopping. On 24 August 2009 SAT issued another Circular Guoshuifa [2009]124 - “Trial Administrative Measures for Non-Residents Claiming Benefits under Double Tax Agreements” (“Circular”) to unify the various practices adopted by different PRC tax bureaus on claiming and granting taxation relief under Double Tax Agreements (“DTAs”). The Circular¹ became effective 1 October 2009 and applies to both treaty resident enterprises and individuals.

According to the Circular, qualified taxpayers are required to comply with the administrative measures as stipulated² in order to enjoy DTAs benefits and, depending on the relief they are claiming, they should either apply for approval or perform a “Record-Filing” with the respective tax bureaus:

“Approval Application”	“Record-Filing”
Relief available relating to income or gains derived by non-resident enterprises and individuals on: <ul style="list-style-type: none"> • Dividends • Interest • Royalties • Capital gains 	Relief relating to income derived by non-resident enterprises and individuals on: <ul style="list-style-type: none"> • Permanent Establishment³ • Dependent Personal Services (e.g. employment income) • Independent Personal Services (e.g. director fees, independent consultancy fee) • Others

¹ Circular 124 does not cover relief on international transportation.

² All relevant supporting documentation should be kept by the taxpayer for at least 10 years.

³ In most of the DTAs, the term Permanent Establishment includes 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) with a Contracting Party for a period or periods aggregating more than 183 days (this period may varies with different DTAs)

“APPROVAL APPLICATION”

To obtain “Approval Application” taxpayers should lodge applications⁴ with the authorised tax bureaus (designated by the provincial-level tax bureaus or equivalent) together with the following documents:

- Application form - “Non-resident's claim for relief under DTAs (for Approval Application)”
- Information sheet - “Personal Information of non-residents claiming for relief under DTAs”
- Tax resident certification issued by the tax authority of the treaty country (must be issued in or after the preceding calendar year)
- Relevant agreement and supporting documentation (e.g. payment invoice, verification issued by public notary or immediacy agency etc.)
- Other information as requested

Tax bureaus will inform taxpayers the results within 40 working days.

“RECORD-FILING”

For “Record-Filing” taxpayers should submit the following documents to the authorised in-charge tax bureau:

- Filing form - “Non-resident's claim for relief under DTAs (for Record-Filing)”
- Information sheet - “Personal Information of non-residents claiming for relief under DTAs”
- Tax resident certification issued by the tax authority of the treaty country (must be issued in or after the preceding calendar year)
- Other information as requested

Circular 124 is silent on whether any examination or review formalities will be undertaken by the respective tax bureaus when taxpayers perform “Record-Filing”. Nevertheless, taxpayers should note that “tax clearance” from the respective tax bureau is required when overseas remittances are made. It remains to be seen whether the local-level tax bureaus will need to review the “Record-Filing” package during “tax clearance” process.

BACKLOG RELIEF APPLICATION

Pursuant to the Circular if an eligible taxpayer was not aware of any DTAs relief and paid tax accordingly, a backlog “Approval Application” / “Record-Filing” can be made within 3 years of the date of tax payment and, after review tax will be refunded accordingly.

POINTS TO NOTE: “183-DAY RULE”⁵

⁴ In cases where taxpayers are claiming similar reliefs to the same tax bureau within 3 years of the first approval, they are not required to go through the application process again provided that the prescribed conditions are met.

⁵ As far as dependent personal service income (e.g. employment remuneration) earned by foreign employees is concerned, the PRC domestic IIT law and regulations exempt it from IIT if the foreign employee's physical presence in PRC does not exceed 90 days within a calendar year and none of the remuneration is paid nor borne by a PRC entity or the PE his overseas employer has in PRC. This IIT exemption threshold would extend from 90 days to 183 days for those who are residents of a treaty state if all of the following 3 conditions are satisfied:

- (a) The recipient is present in the PRC for a period or periods not exceeding in aggregate 183 days in a calendar year (“any 12-month period” instead of “calendar year” may applies in some DTAs); and
- (b) The remuneration is paid by or on behalf of an employer who is not a resident of the PRC; and
- (c) The remuneration is not borne by a permanent establishment or a fixed base which the employer has in the PRC.

In the past there were no written guidelines for foreign individuals to follow when claiming individual income tax (“IIT”) exemption on employment income under a DTA 183-day rule. Circular 124 now clearly stipulates that foreign individuals should perform “Record-Filing” with the in-charge local tax bureaus when the 90-days threshold under the PRC domestic IIT law and regulations is exceeded before they can enjoy this relief.

2. GUOSHUIHAN [2009] 507 (“CIRCULAR 507”)

Pursuant to the PRC Enterprise Income Tax Law (“EIT Law”) and its Implementation Rules non-resident enterprises deriving royalty income from PRC will be subject to PRC withholding tax at 10% (or further reduced through the operation of DTAs). On the other hand, non-resident enterprises deriving “service fee” income from PRC may or may not be subject to PRC EIT depending on whether a permanent establishment (“PE”) has been created by the non-resident enterprises’ foreign assignees working in PRC. In both cases, a charge of 5% of PRC business tax (“BT”) will be imposed regardless whether the fee is in the form of royalty or service fee, or whether a PE has been created.

In view of the different tax implications for non-residents deriving “royalty” and “service fee” income from PRC, on 14 September 2009 SAT issued Circular Guoshuihan [2009]507 - “Questions about Implementation of the Article of “Royalties” under Double Tax Agreements” to clarify the scope of “royalties” and illustrate their views on the remuneration received under different types of royalty-related service contracts.

“INCOME FOR THE USE OF INDUSTRIAL, COMMERCIAL OR SCIENTIFIC EQUIPMENT”

Pursuant to Circular 507 if the DTA explicitly stipulates that the scope of “royalties” includes income received for the use of industrial, commercial or scientific equipment (equivalent to “rental income” under the PRC EIT Law), such income should be taxed as “royalties” under the respective DTA’s provisions and the DTA’s tax rate (if lower than the domestic rate) is applied accordingly. However taxpayer should note that income from use of immovable properties is beyond the scope of “income received for the use of industrial, commercial or scientific equipment”.

“INFORMATION OF INDUSTRIAL, COMMERCIAL AND SCIENTIFIC EXPERIENCE”

Circular 507 also clarifies that “Information of industrial, commercial and scientific experience” refers to technology or industrial “know-how”, which should have the following characteristics:

- Technical information that is essential, undivulged and proprietary for the production process;
- The undivulged technical information is used by the user for his own account, and the information owner will not actively participate in the user’s application of the technical information nor guarantee the result thereof; and
- The technical information should already exist or have been developed as requested by the user with confidentiality provisions under the agreement.

“ROYALTY” OR “SERVICE FEE”

Different scenarios of technology-related service contracts have been discussed in Circular 507:

Scenarios	Royalties	Service Fee
(A) If the service provider applies technology or know-how when providing services; and		

<u>Case I</u> <ul style="list-style-type: none"> during the provision of service, the use of undivulged knowledge is not transferred / licensed to the service recipient in the PRC 		✓
<u>Case II</u> <ul style="list-style-type: none"> during the provision of services, the information / technology developed falls into the definition of “Royalties” under DTAs; and ownership of such information / technology is kept with the service provider; and service recipient only has the right to use such information / technology. 	✓	
(B) Service is rendered by the service provider’s foreign assignees (no PE is triggered) regarding support or guidance in the use of the licensed technology	✓ <i>(regardless service fee are charged separately or not)</i>	
(C) Service is rendered by the service provider’s foreign assignees (PE is triggered) regarding support or guidance in the use of the licensed technology		✓ <i>(treated as PE’s “business profit”)</i>

In addition income derived from the following activities should be classified as “service fee” and the articles of “business profits” under the DTAs should apply:

- Payments for after-sales services under merchandise trading;
- Payments for services rendered under a product-warranty period;
- Payments for services in respect of construction, management or consultancy delivered by the relevant institutions or individuals; and
- Other similar payments as stipulated by SAT.

RESIDENCY OF THE BENEFICIAL OWNER

Circular 507 also quoted the following scenarios to clarify the residency of the beneficial owner:

Scenarios	DTA
<u>Scenario I</u> “A” enterprise (tax resident of Country “A”) has a PE in Country “B” which derives royalty income from PRC	<i>DTA with Country “A” should apply</i>
<u>Scenario II</u> PRC enterprise has a PE in Country “B” which derives royalty income from PRC	<i>No DTA applicable</i>
<u>Scenario III</u> “C” enterprise (tax resident of Country “C”) has a PE in the PRC and pay royalty to “B” enterprise (tax resident of Country “B”)	<i>DTA with Country “B” should apply</i>

ADDITIONAL CLARIFICATION

On 26 January 2010 the SAT released Circular Guoshuihan [2010] 46 (“Circular 46”) “Notice regarding the Application of the Relevant Clauses under Double Taxation Agreements” as a supplement to Circular 507. The new Circular clarifies the relevant issues raised by local tax bureaus for transitional tax treatment for technology-transfer-related services.

According to Circular 46 technology-transfer-related services are considered as part of the technology transfer and thus the relevant service income derived shall fall under the scope of royalties and shall be treated in accordance with the provisions of Royalty Article under DTAs. However Circular 507 is not applicable under the following situations:-

- The foreign technology provider sends a representative to PRC to support the use of the technology being transferred; and
- The time spent by the foreign representative in PRC constituted a PE for the foreign technology provider.

Under such situations the service income attributable to the PE is treated as business profit in accordance with the Business Profits Article under DTAs. Further the income of the foreign representative shall be treated in accordance with the relevant Dependent Personal Services Article under the applicable DTAs.

POINTS TO NOTE

Circulars 507 and 46 shall apply to the technology-transfer-related services which commenced before 1 October 2009 but had not yet completed by 1 October 2009, and where no tax had been settled for the service part by 1 October 2009.

3. GUOSHUIHAN [2009] 601 (“CIRCULAR 601”)

Although most of the DTAs have stipulated that only the “beneficial owner” who is a resident of the other treaty state can enjoy treaty relief in respect of dividends, interest, royalty and capital gains, they seldom have a clear definition of the term “beneficial owner”. In order to clarify the general rules in determining whether a tax relief applicant qualifies as a “beneficial owner”, SAT released Circular Guoshuihan [2009] 601 (“Circular 601”) on 27 October 2009. According to the Circular the “beneficial owner” should be determined based on the facts and circumstances of each case and in accordance with the principle of “substance over form”. It can be an individual, corporation or other organization, and the beneficial owner should:

- own or control the income or the rights or assets that generate such income; and
- generally engage in “substantive business activities” (e.g. manufacturing, trading and management activities)

It has been explicitly stipulated in Circular 601 that agents and conduit companies (established for the purposes of tax avoidance) will not be regarded as the “beneficial owner”.

ADVERSE FACTORS

In addition Circular 601 sets forth the following factors/arrangements which would adversely affect the tax relief applicant to qualify as “beneficial owner”:

- (i) Within 12 months of receipt, the applicant is obligated to pay or distribute more than 60% of the income to a resident of a third country
- (ii) The applicant has almost no other business activities other than ownership of the assets or rights that generate the income

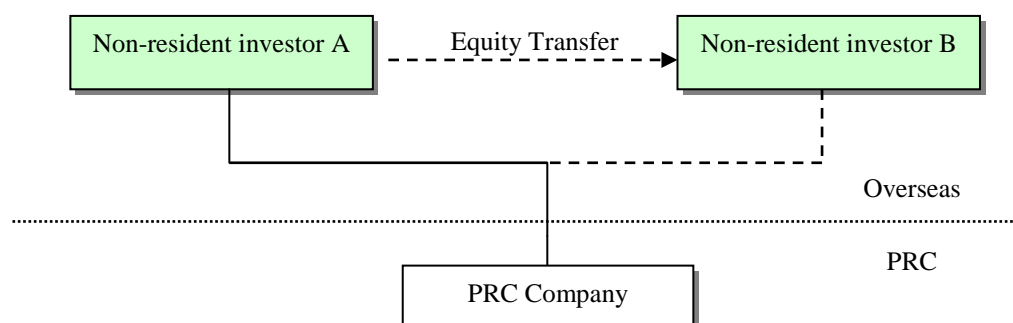
- (iii) For those applicants being a corporation, its assets, scale of operations and employees are relatively small and not commensurate with the amount of income received
- (iv) The applicant has almost no right of control or disposal over the assets or rights from which it derives the income and bears little or no risks
- (v) The income earned is either exempt from tax or taxed at a low rate in the applicant's jurisdiction
- (vi) For interest and royalty relief, the applicant has entered into another loan or IP agreement with third party lender or intellectual property provider of which the terms are similar to the one entered into between the applicant and the PRC party (i.e. "back-to-back" arrangement)

POINTS TO NOTE

Circular 601 does not provide guidelines as to what types of information the tax relief applicant should be provided to sustain their beneficial ownership. Although "investment holding" may be considered an acceptable business activity, this does not mean that an investment holding company with no substantive activities will meet the requirements to be considered the beneficial owner of income it receives from the PRC. In addition it may be very difficult for the applicants to put forward their sound commercial purposes to justify their company holding structure. Relief applicants should therefore analyse the general rules and the above adverse factors for the determination of the "beneficial owner" and obtain an understanding of their local tax authority's interpretations.

4. GUOSHUIHAN [2009]698 ("CIRCULAR 698")

According to Circular Guoshuifa [2009] 3 (please refer to our Tax Flash – May 2009), a PRC non-resident enterprise that derives gains from an offshore share transfer of a PRC enterprise should undertake the relevant tax filing, either by itself or through an agent with the in-charge tax bureau. The PRC enterprise should provide a copy of the share transfer agreement to the in-charge tax bureau to complete the tax registration amendment, and assist the tax bureau in the collection of tax from the respective non-resident enterprise.



GAIN ON EQUITY TRANSFERS

On 15 December 2009 SAT issued another Circular Guoshuihan [2009]698⁶ (effective retroactively to 1 January 2008). Pursuant to the Circular the gain on the above equity transfer will be determined based on the difference between the consideration for the transfer and the cost of equity investment:

⁶ Gains derived from buying and selling of shares of listed PRC companies in public stock exchanges are excluded from the scope of Circular 698.

Equity transfer gain = equity transfer price – cost of equity investment

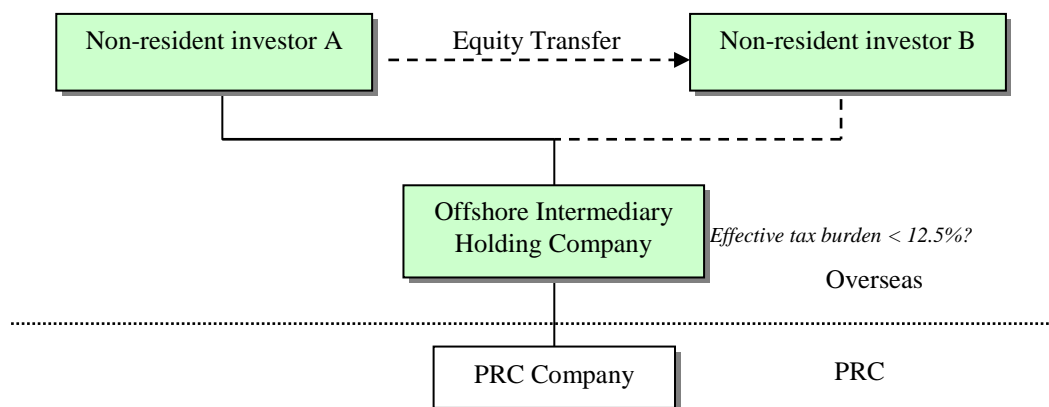
whereas:

<i>Equity transfer price</i>	<i>Sales consideration received by the transferor in the form of cash, non-cash assets, equity etc. Retained earnings and other after-tax reserve funds of the PRC investee company which is being transferred along with the equity to the transferee should not be deducted from the transfer price</i>
<i>Cost of equity investment</i>	<i>Original purchase price paid for the equity interest or the amount invested in the PRC resident company</i>
<i>Currency</i>	<i>The equity transfer price and cost of equity investment should be determined based on the currency used by the transferor in making the original equity investment in the PRC investee company or in paying for the purchase consideration on acquiring the PRC investee company⁷</i>

The non-resident investor will be required to file and remit enterprise income tax within 7 days after the date of the equity transfer as stated in the agreement if the withholding agent fails to fulfill its withholding obligations.

INDIRECT EQUITY TRANSFER

Circular [2009]698 also covered cases where a foreign investor indirectly transfers equity interests in a PRC resident enterprise by selling the shares in the offshore intermediary holding company:



In the above indirect equity transfer transaction, if the effective tax burden in the jurisdiction of the offshore intermediary holding company being transferred is less than 12.5% or where corporate income tax is not levied on the offshore income of its resident enterprise, the foreign investor will be

⁷ If the same non-resident enterprise has made more than one investment in the investee, the foreign currency in which the first capital injection is made should be used, with the cost of equity interests being calculated on a weighted average basis. Where more than one foreign currency is used in such multiple investments, the cost of equity interest for each investment shall be converted into the foreign currency in which the first investment is made using the conversion rate prevailing on the day when each investment is made.

required to submit the following document / information to the PRC tax bureaus within 30 days after the equity transfer agreement is concluded:

- Equity transfer agreement;
- The relationship between the Non-resident investor A and the offshore intermediary holding company in respect of financing, operation, sales and purchase etc.;
- The operation, personnel, finance and properties of the offshore intermediary holding company;
- The relationship between the offshore intermediary holding company and the PRC subsidiary in respect of financing, operation, sales and purchase etc.;
- The commercial purpose of the Non-resident investor A in setting up the offshore intermediary holding company; and
- Other relevant documents required by the tax authority.

If the PRC tax bureau considers the whole structure lacks business objectives and was established for the purpose of avoiding tax, the PRC tax bureau may, after obtaining the approval from SAT, take the “substance over form” approach to disregard the existence of the offshore intermediary holding company and impose tax accordingly.

POINTS TO NOTE

The Circular is not clear on how “reasonable commercial purposes” of an arrangement are to be identified and how the 12.5% “effective tax burden” of an offshore intermediate holding company is to be ascertained. Advance checking with the local tax authorities is recommended to ascertain the potential tax exposure in such a transaction.

5. IMPLICATIONS OF THESE CIRCULARS

An overview of the SAT’s recent tax circulars addressing the tax treatment on passive income derived from PRC (including Guoshuifa [2009]3, Guoshuihan [2009]81, Guoshuihan [2009]507, Guoshuifa [2009]124 and Circular 601, etc.) apparently illustrates that the SAT is gearing up its efforts to tighten the administration and granting of DTA benefits. Qualified treaty resident enterprises and individuals who want to take advantage DTA relief should take immediate action to apply for approval or file for record. Information such as taxpayer’s corporate/personal details, their shareholding structure, the relevant agreements, details of overseas related-party transactions, individual’s length and purposes of stay in the PRC and remuneration details etc. will need to be collected during the approval/record filing process. Based on this information the tax bureaus will determine if a resident enterprise is treaty shopping or treaty abuse, or if an individual taxpayer’s stay in the PRC triggers its foreign employer’s PE exposures.

Foreign investors with intermediate holding companies to hold investments in the PRC should carefully evaluate their holding and operating structures to make sure these have reasonable commercial purposes and good business substance supported by proper documentation in order to enjoy the DTA benefits. Their holding and operating structure in the PRC should be well designed with sufficient commercial substance (with supporting documentation) to withstand any challenge from the PRC tax bureaus. They may also need to clarify and discuss with the local level tax authorities on any grey or uncertain areas in relation to the interpretation and implementation of these circulars. For Circular 698 non-resident investors that disposed of PRC companies indirectly after 2007 should review their transactions to determine whether additional compliance is required.

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