Double taxation agreement (DTA) signed to benefit mutual trade and investment between mainland China and Taiwan

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In brief
On 25 August 2015, the representatives from mainland China and Taiwan signed the Agreement between the Mainland of China and Taiwan for the Avoidance of Double Taxation and Enhanced Collaboration in Tax Matters (the ‘Agreement’) after six years of negotiations between the two parties. The Agreement follows the OECD Model Tax Convention in general. However, given the special investment structure, and economic and trade relations between mainland China and Taiwan, the Agreement provides more favourable treatments compared to other DTAs signed by mainland China, for instance, the allocation of taxing right on capital gains, the applicability of the Agreement to investments in mainland China via a third jurisdiction, etc. The Agreement will enter into force after the completion of the ratification procedures by both contracting parties and apply to income derived on and after 1 January of the year following its entry into force.

In detail
Applicable scope of the Agreement
Due to historical reasons, currently indirect investments in mainland China by Taiwan investors through a company located in a third jurisdiction account for around 75% of the total mainland China investments made by Taiwan investors, according to the Taiwan Ministry of Finance (Taiwan MOF). To address the applicability of the Agreement to such indirect investments, the Agreement particularly provides that where the effective management of a third-jurisdiction incorporated company is situated in one of the contracting parties, it could be recognised as the tax resident of that party. In other words, it means that a third-jurisdiction incorporated company could be recognised as Taiwan tax resident for the purpose of the Agreement as long as it is effectively managed and controlled in Taiwan.

In addition, the Agreement also clarifies the assessment factors to determine the place of effective management, by taking into account where the decision in relation to business strategy is made, where certain documents are prepared and stored, and where major business activities are performed. The assessment standard is also highly relevant in respect of the domestic laws of the two parties. In mainland China, the ‘place of effective management’ was officially introduced as one of the tests for recognising Chinese tax resident enterprises (TREs) in the Corporate Income Tax (CIT) Law in 2008, followed by a series of circulars elaborating on the details of its assessment standard, whereas in Taiwan, the legislation on the ‘place of effective management’ is still under review. Therefore, there is currently no standard application procedure in place to apply for recognition as a Taiwan tax resident based on this principle. Upon entry into force of the Agreement, it remains to be seen whether Taiwan will release a follow-up regulation to facilitate such application, or whether the applicant could apply on a case-by-case basis in practice.

Allocation of taxing right across the strait
Currently, in the absence of a DTA, double taxation issues often arise when residents of one jurisdiction operate business or make investments in the other. Once the Agreement becomes effective, it will clearly allocate the taxing rights between mainland China and Taiwan, and thus significantly reduce the exposure to double taxation for residents of both parties.
The standard CIT rate in mainland China is generally 25%, while that in Taiwan is 17% or 20%².

Presently, if a tax resident in one jurisdiction provides services or operates business in the other, generally, it shall firstly be subject to CIT in the source jurisdiction on the business profits arising therefrom, and then claim foreign tax credit (FTC) for that portion of business profit on filing its income tax return in the resident jurisdiction.

After the Agreement takes effect, companies do not need to pay tax on the business profits derived from the source jurisdiction as long as they do not have a PE there, which effectively avoids the complicated FTC procedure and at the same time helps reduce the overall tax burden of the relevant business arrangements. In particular, the time threshold for construction and installation projects to create a PE is 12 months, while that for the provision of services is a period or periods aggregating 183 days or more within any 12-month period.

**Dividends, interests and royalties**

Usually these three types of passive income are subject to withholding income tax (WHT). According to the domestic laws of respective parties, the mainland China WHT rate for such payments made to Taiwan investors is 10%, while it is 20% or 15%³ for payments made from Taiwan to mainland China investors.

Once effective, the Agreement will provide a more preferential WHT rate for each of these three types of income:

- **Dividends**: A 5% preferential WHT rate applies in the situation where the recipient is a company which directly holds at least 25% of the capital of the company paying the dividends. Otherwise, the WHT rate is 10%.
- **Interests**: A preferential WHT rate of 7% applies. Meanwhile, interests received by certain governmental departments and institutions, as well as interests on certain recognised loans to promote exports are exempt from WHT.
- **Royalties**: A preferential WHT rate of 7% applies. It is worth noting that rental payments for the use of industrial, commercial or scientific equipment are not included in the definition of ‘royalty’ under the Agreement. As such, it remains a question open for further discussion as to whether the recipients of such rental payments would be eligible for the business profits article under the Agreement (in other words, no tax in the source jurisdiction as long as a PE is not triggered there).

Another point to note is that in line with the prevailing international convention, the recipients of the aforementioned passive income have to pass the beneficial ownership (BO) test before they can enjoy the preferential WHT rates under the Agreement.

**Capital gains**

Currently, Taiwan companies are generally subject to 10% CIT on gains arising from the transfer of properties in mainland China, whereas gains derived by mainland China companies from the transfer of Taiwan equities are subject to 20% Taiwan CIT, except for gains derived from the trading of securities which are generally exempt from Taiwan CIT.

After the Agreement takes effect, the taxing right on gains derived from equity transfer shall be allocated as follows:

- The taxing right on the transfer of the equity of a ‘property-rich company’⁵ shall lie with the source jurisdiction.
- For other situations, the taxing right shall lie with the resident jurisdiction, unless the resident jurisdiction provides tax exemption treatment on such gains and the transferor directly or indirectly holds at least 25% of the equity interests of that company at any time during the 12-month period preceding such transfer.

Since it is rare that the gains derived from equity transfer should be exempt from tax in the transferor’s resident jurisdiction under the domestic laws of mainland China and Taiwan, the Agreement effectively exempts such gains from tax at the source jurisdiction as long as no more than 50% value of the company being transferred is derived directly or indirectly from immovable properties situated in the source jurisdiction. Compared to the treaties that mainland China signed with other jurisdictions of major investors, such benefit provided in this Agreement is certainly the most favourable one.

**Shipping and air transport income**

The Agreement clarifies that business profits derived from shipping and air transport shall only be subject to tax in the resident jurisdiction. Such exemption treatment not only applies to income tax, but also to business tax, value-added tax and other similar taxes. Doubtlessly, this preferential treatment will facilitate both parties to further expand the direct flight business across the strait.

Meanwhile, the Agreement also stipulates that income from voyage charter, time charter, bareboat charter, as well as from the use, maintenance and leasing of containers will be regarded as incidental income derived from businesses associated with shipping and air transport, and thus is exempt from tax in the source jurisdiction. However, it should be noted that the SAT has clarified in its *Departmental Interpretation Notes on the China-Singapore DTA* that in order to be regarded as income from ‘incidental businesses’, such income should in general not exceed 10% of the total international transportation income of the relevant company for the year concerned⁶. Based on this interpretation, if a Taiwan shipping company merely engages in ship leasing businesses across the strait, it could not enjoy such exemption treatment.

**Personal income derived from employment and independent services**

The allocation of taxing rights on personal income provided in the Agreement is consistent with that set out in the *OECD Model Tax Convention*. In particular, qualified employment income shall only be taxed at the resident jurisdiction. For independent service income, it shall only be taxed at the resident jurisdiction as well, unless this person stays in the source jurisdiction for a period or periods aggregating 183 days or more within any 12-month period, or has a fixed place in the source jurisdiction for performing activities. Given the close ties across the strait, the clarification of the taxing rights on personal employment income will help address the double taxation issues on wages and salaries derived from cross-strait short-term business trips and secondment arrangements.
Provisions of anti-tax avoidance

Despite the favourable treatments provided under the Agreement, the Agreement also includes an anti-treaty abuse clause to counter arrangements or transactions entered into mainly for the purpose of obtaining the tax benefits under the Agreement. In addition, the Agreement allows both parties to invoke domestic rules against abusive arrangements. The inclusion of these provisions is consistent with the international practice.

Measures to avoid double taxation

One of the main purposes of the Agreement is to avoid double taxation between mainland China and Taiwan. For this purpose, the Agreement introduces the following measures:

- Ensure the availability of FTC. According to the Agreement, Taiwan residents could claim FTC for the income tax paid in mainland China, which is consistent with Taiwan’s domestic tax law. From the mainland China perspective, the Agreement reiterates the FTC rules stipulated in the mainland China’s domestic tax law. In addition, the qualified shareholding ratio for China TREs to claim FTC for the Taiwan tax indirectly borne by the China TREs for their Taiwan-sourced dividends is reduced from 20% to 10%.

- Introduce the corresponding adjustment mechanism to eliminate double taxation potentially arising from transfer pricing adjustment.

- Provide the mutual agreement procedure as a channel to eliminate double taxation, which also forms the legal basis for cross-strait advance pricing negotiations.

Exchange of information (EoI) and collaboration in tax matters

It is understood that some Taiwanese people have concerns with the EoI article in the Agreement before it was signed. The Agreement addresses their concerns by largely restricting the scope of EoI, such as no retrospective EoI for information obtained prior to the effective date of the Agreement, no automatic EoI or spontaneous EoI, and no application of information exchanged in criminal cases. Although these restrictions appear to deviate from the increasing international efforts on enhancing EoI, this relatively conservative EoI article may gain more support from the Taiwanese public in view of the special political environment across the strait.

Meanwhile, the Agreement also innovatively includes ‘collaboration in tax matters’ in its title, which indicates the other main purpose for the DTA conclusion. Specifically, the Agreement sets forth a mechanism for the tax authorities across the strait to enhance communication and collaboration, and also introduces, in principle, an article of assistance in tax collection.

Effective date

The Agreement would enter into force after completion of the ratification procedures by both contracting parties. In mainland China, the government has been authorised by the legislative authority to approve the bilateral DTA under a simplified procedure. Thus it is very likely that the ratification procedure in mainland China could be completed within 2015 if the relevant process is smooth. While in Taiwan, the Agreement has to be approved by the Legislative Yuan, the Taiwan MOF indicates that they have previously consulted the Taiwanese public many times through public hearings on signing the Agreement with mainland China and the majority of people in Taiwan support that. If both parties could complete the procedures within this year, the new Agreement would apply to income derived on and after 1 January 2016 at the earliest.

The takeaway

All in all, the allocation of taxing rights in the Agreement is more favourable to the party making outbound investments. Taiwan has made significantly more investments into mainland China than the reverse due to historical reasons. Therefore, the Agreement is likely to produce more benefits to Taiwan authorities and Taiwan companies / individuals making investment and engaging in business activities in mainland China. Meanwhile, with the accelerated pace taken by Chinese companies to ‘go abroad’, the conclusion of the Agreement will also definitely provide better protection for mainland China companies to expand their investments and economic presence in Taiwan.

The Agreement contains certain tailor-made provisions to address the specific cross-strait conditions, but the majority of the provisions remain consistent with the international tax convention. Hence, the Agreement should not be a brand new thing for taxpayers conducting cross-strait businesses. Relevant taxpayers should study the provisions in the Agreement, review their existing contracts and business arrangements, and assess its impacts on their cross-strait businesses and investments. With anti-treaty abuse in the spotlight of governments all over the world, cross-strait taxpayers should prepare for the potential challenge from the relevant tax authorities when applying for tax benefits under the Agreement, and consider whether their transactions or investment structure have any treaty abuse elements. Furthermore, taxpayers should also pay close attention to the implementation measures issued by both jurisdictions.

As mentioned above, for Taiwan investors investing in mainland China via the indirect structure (which involves multiple interposed intermediate holding companies), the Agreement allows the third-jurisdiction incorporated company to be assessed as a Taiwan tax resident based on the principle of ‘place of effective management’. This assessment not only permits such non-Taiwan incorporated companies to be eligible for the Agreement, but could also give rise to Taiwan tax consequences. Taiwan investors are suggested to do a comprehensive analysis on the impact before going for the application. In addition, with the improvement of the cross-strait direct investment, in particular with the conclusion of the Agreement, Taiwanese investors may review their current investment structure and consider the possibility of restructuring to optimise their structures.

Endnote

1. For more details, please refer to Taiwan MOF’s interpretation on the Agreement.

2. In Taiwan, companies with a fixed place or a business agent shall be subject to CIT at 17% on a net income basis. Otherwise they shall be subject to CIT at 20% on a gross income basis.

3. A 15% Taiwan WHT applies to interest income derived from short-term bills, bonds, etc. by mainland China companies.

4. For assessment factors of BO, please refer to our China Tax News Flash
5. A 'property-rich company' refers to a company deriving more than 50% of its value, directly or indirectly, from immovable properties situated in the source state.

6. GuoshuiFa [2010] No.75 (Circular 75) provides interpretations on China-Singapore DTA. Circular 75 stipulates that the interpretations therein shall also be applicable to other DTAs concluded by China if the provisions of the relevant articles in those DTAs are the same as those in the China-Singapore DTA.
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Let’s talk

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