



Tax Analysis

China

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SAT Issues New Rules for Claiming Treaty Benefits

On 27 August 2015, the State Administration of Taxation (SAT) issued new procedural guidance (Bulletin 60) on claiming tax benefits under China's double taxation agreements (DTAs) and international transportation agreements (ITAs).¹ Bulletin 60 aims to substantially simplify the process for obtaining treaty benefits and will apply as from 1 November 2015.

(1) Background

Bulletin 60 will replace Circular 124,² the predecessor guidance that governed tax treaty claims, except for international transportation income, as well as certain provisions in Bulletin 37,³ which specifically dealt with the claiming of

1 The term DTAs refers to tax agreements signed by the government of the People's Republic of China with a foreign government, as well as the arrangements between the Mainland China government with the Hong Kong and Macau Special Administrative Regions. The term ITAs refers to air, shipping and road transportation agreements, as well as to agreements and exchanges of letters for the mutual exemption of tax on international transport income, that have been concluded between the Chinese government and foreign governments.

2 "Administrative Measures on the Tax Treaty Treatment of Nonresidents," Guoshuifa [2009] No. 124.

3 Articles 11-15 of the "Interim Measures for the Tax Administration of Nonresident Enterprises Engaged in the International Transportation Business," Bulletin [2014] No. 37.

treaty benefits for international transportation income.

According to Circular 124, issued in 2009, to obtain a tax benefit under a DTA, it is necessary to obtain approval or carry out registration with the relevant PRC tax authority, depending on the type of income received:

- To obtain benefits under the dividends, interest, royalties and capital gains articles of a DTA, approval from the relevant tax authorities is required;
- To obtain benefits under all other provisions of a DTA (e.g. those relating to income derived from a permanent establishment, business profits, independent personal services, income from employment, etc.), it is necessary to register with the relevant tax authorities.

Bulletin 37, issued in 2014, contains rules for nonresident enterprises engaged in international transportation activities. Articles 11-15 of the bulletin require that nonresidents claiming benefits under a DTA or an ITA register with the relevant tax authorities with respect to their international transportation income.

The Chinese government recently has been taking proactive steps to liberalize China's regulatory regime in order to simplify processes,

improve efficiency and stimulate the economy. For instance, in May 2015, the State Council abolished the approval requirement in Circular 124 (see Guofa [2015] No. 27). Bulletin 60 is the SAT's response to the elimination of the approval requirement, by formally shifting from an approval/registration system to a self-assessment system to obtain treaty benefits.

(2) Highlights of Bulletin 60

1) Expanded scope of application

Bulletin 60 consolidates the procedural rules in Circular 124 and Bulletin 37 for claiming tax benefits and will apply to treaty benefit claims for all types of income, including international transportation income.

2) Determination by taxpayers and withholding agents at the time of filing

Bulletin 60 relaxes the procedures for nonresident enterprises and individuals to obtain benefits under DTAs and ITAs by removing the approval/registration requirements under Circular 124 and Bulletin 37. Specifically, Bulletin 60 will allow treaty benefits to be enjoyed based on assessments made by the nonresident taxpayer or the withholding agent:

- Under article 5 of Bulletin 60, a nonresident that considers itself qualified for beneficial tax treatment under a treaty (a DTA or an ITA) will be able to enjoy such treatment at the time it files its tax return; or
- Where there is a statutory or designated withholding agent, article 6 of Bulletin 60 will require a nonresident that considers itself qualified for treaty benefits to proactively inform the withholding agent and provide the agent with the forms and documents mandated in article 7 of the bulletin. The withholding agent will be allowed to apply the reduced rates or exemptions under the treaty if it determines that the information provided by the nonresident meets the relevant treaty requirements; otherwise, the withholding

agent will be required to withhold tax according to the treatment under PRC domestic law.

Notably, Bulletin 60 does not make any changes to the substantive requirements (such as beneficial ownership, purpose test, etc.) that must be met to qualify for treaty benefits. Thus, determinations made by taxpayers and withholding agents will be subject to subsequent review by the tax authorities and potentially could be challenged.

3) Required forms and documents

Article 7 of Bulletin 60 will require a nonresident or a withholding agent to submit the following forms and documents at the time the tax return for the relevant income is filed by the nonresident or the withholding agent:

- (a) Information reporting form on tax residence (with separate forms for enterprises and individuals);
- (b) Information reporting form on the treaty benefits to be enjoyed (with four separate forms for enterprises and individuals, depending on the type of income received);
- (c) Tax residence certificate, or in the case of international transportation income, copies of passports of individuals and legal person certificates of enterprises;
- (d) Documents evidencing ownership of the income received, such as contracts, board resolutions, shareholder meeting minutes or payment slips; and
- (e) Other documents specifically required by other tax regulations.⁴

This list of forms and documents is intended to

⁴ "Other documents" refers to a situation where an applicable tax rule requires a specific document; for instance, where a nonresident claims beneficial ownership based on an agency arrangement under Bulletin 30, Bulletin 30 requires the nonresident to provide documents proving the agency relationship. SAT Bulletin on "Determining Beneficial Ownership for Tax Treaties," Bulletin [2012] No. 30

be an exhaustive list. Although a nonresident will be allowed to provide additional documents to further substantiate its claim to treaty benefits, the SAT's official interpretation of Bulletin 60 explicitly states that not providing additional documents should not affect the nonresident's the right to enjoy treaty benefits at the time of the filing of the tax return. This is another significant improvement as compared with Circular 124 and Bulletin 37, both of which specifically allow the tax authorities to require more documents than what is listed in the guidance. In practice, some tax authorities have required a substantial amount of supplementary documentation, imposing a heavy compliance burden on nonresidents.

4) Increased responsibilities of withholding agents

The responsibilities of withholding agents under Bulletin 60 may substantially increase as compared with Circular 124 and Bulletin 37. The two information reporting forms include many questions and could contain a substantial amount of information on a nonresident. To determine whether a nonresident recipient of income is eligible for the treaty benefits based on the information provided will require a certain level of tax and legal knowledge and practical experience.

Given the increased burden on the withholding agent, a question arises as to whether the agent may be subject to a penalty if the Chinese tax authorities subsequently decide the withholding agent was incorrect. Bulletin 60 does not contain any specific provisions on the consequences to a withholding agent in this situation, so more generally applicable laws and regulations should be referenced. Article 69 of the PRC Tax Collection and Administration Law provides that a withholding agent could be subject to a penalty of up to three times the amount of the taxes that should have been withheld. If a withholding agent demonstrates that it has exercised reasonable care in making the relevant determination, it is unclear whether this can be

used as a defense against the imposition of a penalty. If reasonable care is a defense, the standard for what is considered "reasonable care" may create friction between the tax authorities and withholding agent. In practice, a withholding agent may adopt a conservative approach to protect itself from a potential challenge by the tax authorities, particularly when dealing with a third-party nonresident, and this could create friction between the withholding agent and the nonresident.

5) Subsequent administration by tax authorities

Subsequent administration (i.e. the tax authorities' role after treaty benefits have been obtained) is expected to play a more crucial role under Bulletin 60 than under the previous guidance, since the requirements to obtain approval and to register before enjoying treaty benefits have been eliminated.

The PRC tax authorities may subsequently conduct their own review of the submitted information and request additional information from the nonresident or the withholding agent. If the tax authorities determine that a nonresident improperly obtained benefits under a DTA/ITA, they will require the nonresident to make a supplemental payment for the taxes underpaid in a given period. If the nonresident fails to pay, the tax authorities will be allowed to claim underpaid taxes from the nonresident's other China-source income pursuant to China's Enterprise Income Tax Law, or to use other measures in accordance with the PRC Tax Collection and Administration Law.

Bulletin 60 does not affect the timing of when a tax payment obligation arises, which is governed by other generally applicable tax laws and regulations. Thus, the Chinese tax authorities should be allowed to collect interest, in addition to underpaid taxes, if they subsequently determine that a nonresident taxpayer has improperly enjoyed treaty benefits.

The extent of subsequent administration by the Chinese tax authorities is yet to be determined, but administrative challenges are likely to arise. Some nonresidents may decide to take more aggressive positions than they otherwise would in the pre-Bulletin 60 era, particularly in situations where China's administrative measures are limited. For instance, when a nonresident enterprise transfers its interest in a non-land rich company in China, the withholding agent allows the nonresident to enjoy the capital gains exemption provided in the relevant treaty by looking at the residence and ownership requirements in the treaty. If the Chinese tax authorities later determine that the capital gains exemption should not have been granted on the basis of the general anti-avoidance rule, it would be difficult for the authorities to hold the withholding agent responsible. At the same, it may be difficult to collect the taxes from the nonresident seller, which may no longer have any business operations in China and even may have dissolved. Further, Bulletin 60 may have implications not only on direct transfers of Chinese companies, but also on indirect transfers of such companies. Bulletin 7, which addresses indirect transfers of equity interests in Chinese enterprises, provides for an exception to Chinese taxation based on the capital gains provision in tax treaties.⁵

6) Withdrawal of simplified proof for Hong Kong tax residence

Bulletin 53,⁶ issued in 2013, allows Hong Kong residents to prove their Hong Kong residence without presenting a tax residence certificate; instead, a Hong Kong company can use its Hong Kong certificate of incorporation or its Hong Kong business registration certificate, and a Hong

5 "Bulletin of the State Administration of Taxation on Issues of Enterprise Income Tax on Indirect Transfers of Assets by Nonresident Enterprises," Bulletin [2015] No. 7

6 "Announcement on the Identification of Residence under the Arrangement for the Avoidance of Double Taxation between Mainland China and the Hong Kong Special Administrative Region," Bulletin [2013] No. 53

Kong individual can use his or her Hong Kong identity card, along with some other supporting documents. Bulletin 60 retracts this simplified arrangement for Hong Kong residents by abolishing Bulletin 53 entirely.

(3) Deloitte's comments

Bulletin 60 eliminates the preapproval and preregistration requirements for obtaining treaty benefits, in favor of a subsequent monitoring approach by the tax authorities. Thus, procedurally, it should be easier for nonresidents to obtain benefits under a DTA or an ITA. However, Bulletin 60 does not change the substantive standards on whether a nonresident qualifies for treaty benefits, or when a tax payment obligation arises. Thus, Bulletin 60 may present new challenges for nonresident taxpayers and withholding agents, i.e. they will need to consider the potential risk of a treaty claim subsequently being challenged by the Chinese tax authorities, as well as the potential consequences of such a challenge (e.g. interest and penalties).

Despite the simplified procedure in Bulletin 60, a payer of China-source income must take an additional step under Bulletin 40⁷ before making an outbound payment of what is considered "trade in services" for foreign exchange purposes, such as dividends, interest, royalties and transfer proceeds, if the payment exceeds USD 50,000: the payer must register the remittance with the relevant Chinese tax authorities. A registration form stamped by the tax authority must be presented to the bank before a remittance can be made. Although the registration is meant as a procedural step under Bulletin 40 without the need for the tax authorities to have a substantive review of treaty eligibility as part of the registration (a review is to be conducted post-registration), in practice, some authorities have refused to stamp the registration form when

7 "Announcement on Issues Concerning the Tax Filings for Outbound Payments under Service Trade and Other Items", Bulletin [2013] No. 40

they disagreed with the position taken by the nonresident taxpayer, while some other authorities have required a lengthy list of documents, in addition to what is required under Bulletin 40. Thus, nonresident and Chinese payers, the latter of which often are the statutory or designated withholding agents, will continue to face the potential challenges under Bulletin 40 until the registration requirement in Bulletin 40 is simplified as part of China's further liberalization of its regulatory regime.

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