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Llinks Corporate Bulletin
March 2010

Double Taxation Treaties: "New Challenge" on Tax Risk Management

By David Yu and Clare Lu

The New CIT Law and its detailed implementation rules, which came into effect on 1 January 2008, cancelled the tax exemption treatment on dividends derived by foreign investors from foreign invested enterprises. Therefore, many foreign investors are considering using double taxation treaties and arrangements ("DTTs") to reduce overall tax burden, which arrangement becomes a poplar measure widely considered and adopted by foreign investors. Meanwhile, PRC tax authorities have been paying more attention to the international tax planning arrangements that are conducted primarily through DTT treatments. In this article, we will discuss how non-PRC resident enterprises ("NREs") could enjoy DTT relief and control relevant tax risks under the regulations promulgated in 2009 and based on our practical experiences. As regards for taking advantage of DTTs to minimize double taxation for domestic companies, please refer to the article "Outbound Investment Planning: Be Cautious about Tax Evaluation!" *(October 2009)*.

Updates of PRC Laws and Regulations on NREs' Claiming DTT Benefits

Since 2009, the State Administration of Taxation ("SAT") promulgated a series of tax circulars, stipulating substantive and procedural rules regarding NREs' claiming DTT benefits:

- Circular Guoshuifa [2009]No.3 ("Circular No. 3")
- Circular Guoshuihan [2008] No.81 ("Circular No. 81");
- Circular Guoshuifa [2009] No.124 ("Circular No. 124");
- Circular Guoshuihan [2009] No. 507 ("Circular No. 507"); and
- Circular Guoshuihan [2009] No. 601 ("Circular No. 601").

The aforementioned Circular No. 3, Circular No. 124 and Circular No. 601 are generally applicable to various China sourced incomes obtained by NREs, among which Circular No. 124 and No. 601 are related to substantive issues for the application to enjoy treaty relief and thus shall be paid more attention to by NREs.

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NREs’ Claiming DTT Relief: Yes or No?

The aforementioned circulars, on one hand, provide a guidance on how NREs could enjoy treaty reliefs; on the other hand, reflect more stringent tax administration on NREs and therefore lead to higher requirement on tax risk management. In this article, we will discuss, mainly based on Circular No. 124 and Circular No. 601, some considerations before NREs’ determining “choose” or “not choose” tax treaty relief.

- Circular No. 124 provides that NREs shall go through the formalities of approval or record before enjoying DTT reliefs. NREs shall disclose more information due to such stricter application and submission requirements.

- Circular No. 601 further provides that, for the purpose of enjoying treaty benefits, the recognition of "Beneficial Owners" shall be analyzed and determined by considering the circumstances of specific cases on the purpose of DTTs and the principle of "substance over form". In practice, for tax planning purposes, conduit companies (or intermediate holding companies) are often incorporated in tax heavens, and in some cases, in the tax heavens that have concluded DTTs with Mainland China. Based on such understanding, if intermediate holding companies are lack of substantive operational activities, they might be facing challenges from tax authorities in applying for “Beneficial Owner” status.

- As of the date of this article, Mainland China has entered into DTTs with 94 countries (regions). The definition of “Beneficial Owners” remains uncertain in these DTTs. As such, the promulgation of Circular No. 601 can be regarded as the specific definition of and supplement to the term “Beneficial Owner” under PRC taxation regimes.

- The seven factors (in Circular No. 601) that will have adverse impact on NREs’ recognition of “Beneficial Owners” cover MNCs’ most tax planning business models by establishing intermediate holding companies. From our point of view, the further implementation of Circular No. 601 is to be observed.

- Withholding agents are suggested fully withholding taxes to avoid potential risks before NREs’ being approved or going through the record formalities for treaty reliefs.

With the great changes of CIT regimes in Mainland China and with the stricter administration by tax authorities in Mainland China, MNCs shall effectively adopt DTTs and take reasonable measures to restructure business models as well as manage tax risks. In addition, MNCs need to, from time to time, pay attention to the promulgation of new taxation rules under the new CIT regimes (including supplementary rules on application of DTTs), and keep close communication with third party professionals to react to the changes more proactively and control tax risks more effectively.

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This article was first published in *China Legal Review, March 2010.*