

Stay Up-to-date in China - Highlights for German Investors

ONE of the challenges in doing business in a foreign country comes from the difficulty to get and stay well informed of the changing local regulatory and taxation environment, especially so in a country like China where new business updates are coming up every day.

To navigate this complicated jurisdiction, we select for you some important recent updates in relation to the inbound German investment activities in China, specifically listed below:

- *New Sino-German Double Taxation Treaty (“DTA”); (2017)*
- *Updated Beneficial Owner Test Criteria; (2018)*
- *New version of China’s Negative List for Foreign Investment; (2018)*
- *Strengthened Reporting Requirements on Transfer Pricing and Related Party Transactions. (since 2016)*

We would like to lay out with very compact words the key considerations to which we believe attentions should be paid.

New Sino-German DTA

The new Sino-German DTA was signed in 2014 and came into effect on 1.1.2017. Some significant changes have been provided by the new DTA, which are generally considered as positive for the economic interactions between Germany and China. Among many other amendments, we would like to emphasize on the following:

➤ *5% withholding tax on dividends*

The previous 10% WHT rate on dividends is now replaced by a preferential 5%. This is the most favourable WHT rate on dividends currently available with China. Please note that such rate does not apply to dividends paid to partnership (e.g. Kommanditgesellschaft).

➤ *Raised Permanent Establishment Threshold*

The Permanent Establishment (“PE”) thresholds stipulated by the old DTA have been significantly raised, providing better double taxation protection for non-residents. Specifically:

- i) The threshold for Service PE has been revised from 6 months to 183 days, which would exclude the PE exposure in many cases where a so-called “one day one month” rule¹ is adopted;
- ii) The threshold for Construction PE has been extended from 6 months to 12 months. Please note that installation service is often subject to Construction PE articles rather than Service PE.

Our views

The new DTA is definitely a document that needs to be carefully studied by German investors. With the dual impact of the new DTA and the new global anti-BEPS trends, the holding structure of German investors’ investments into

¹ “one day one month” rule: Any natural month which contains at least one qualifying day for Service PE purpose would be counted as one month for Service PE purpose if the in-charge tax authorities adopt such rule.

China should be re-examined.

Also, please be informed that there are document requirements for enjoying the treaty benefits including application forms and other supporting documents. It is vital to understand the requirements and prepare accordingly.

Updated Beneficial Owner Test Criteria

The State Administration of Taxation (“SAT”) has released the long-awaited Public Notice 9 (SAT Public Notice [2018] No. 9) in 2018 that updates the assessment principles for the determination of Benefit Ownership (“BO”) with much clearer guidance.

Two major breakthroughs for the claiming of tax treaty benefits on dividends provided by Public Notice No.9 are: i). the safe harbor rule with respect to dividends is introduced; and, ii). qualified treaty benefit applicants may apply a “same country/same treaty benefit rule” (please refer to the Public Notice 9 for details) under multi-tier holding structures.

While providing relief under some circumstances, the Public Notice No.9 also brings challenges by making two of the 6 existing unfavourable factors for the BO test stricter.

Our views

The updated BO test reflects the convergence of the anti-treaty-abuse practice of China’s tax authorities and the international standards. We would recommend that companies with affected structures take a further look into the circular to check the test position.

New version of China’s Negative List for Foreign Investment

On 28 June, the National Development and Reform Commission and the Ministry of Commerce have jointly released the Special Administrative Measures for Access of Foreign Investment (Negative List) (Version 2018) (“the 2018 Negative List”) to lift the restrictions on foreign capital in 22 industries. The 2018 Negative List is an amendment to the Industry Category Guide for Foreign Investment (Version 2017) and shall take effect from 28 July.

The 2018 Negative List is shortened from 63 to 48 access restrictions with a range of important open-up measures. We will take a few industries as example:

➤ Automobile manufacturing:

Restrictions on foreign shareholding in manufacturing of special purpose vehicles and new energy vehicles are removed; restrictions in commercial vehicle will be lifted in 2020; restrictions in passenger vehicles and cap on number of JVs will be lifted in 2022.

➤ Finance service

Foreign shareholding restrictions on foreign invested banks are lifted. The restrictions on securities, fund management, futures, life insurance enterprise is extended to 51%. It is expected to completely lift restrictions on foreign equity proportion in finance service sector in 2021.

Our views

Even it had been expected since long that the opening-up would continue, the 2018 version still surprised many by the extent to which it lifts the foreign investment sharing restrictions.

The measures are welcomed by foreign investors and will have positive impact on the investment attraction by China.

Strengthened Reporting Requirements on Transfer Pricing and Related Party Transactions

In 2016, China's SAT issued SAT Public Notice [2016] No. 42 ("Public Notice 42"). The Public Notice 42 marks the beginning of a new era for related party transactions disclosure and contemporaneous TP documentation in China. Afterwards, new TP regulations are being continuously released to offer further guidance on related TP issues.

Public Notice 42 upgrades China's TP requirements in line with the global BEPS action plan by introducing / strengthening following principles:

- Value chain analysis;
- Location specific advantages;
- Related party service transactions.

Public Notice 42 significantly enhanced the TP documentation requirements by implementing the 3-tier contemporaneous TP documentation requirement; increasing the number of Related Party Transaction Forms required to be filed with the annual tax return from 9 forms to 22 and adding country-by-country report requirement.

Also, as part of China's efforts to react to the anti-BEPS action plan, the cross-border related-party service fee payment has been closely looked into. In practice, tax authorities often adopt a two-step method to assess the service fees:

1. Benefit test – whether the payer of service fees benefits from the service;
2. Pricing test – whether the price of the service fees are determined at arm's length.

Our views

The new TP requirements pose great challenges on the tax payers to comply with both the disclosure requirements and TP principles. Tax

payers must assess and maybe even adapt its TP policies in relation to entities in China.

Written by Tony Fu, Baker Tilly China

fuzhumin@bakertillychina.com

Reviewed by Rebecca Yan, Baker Tilly China

yanli1609@bakertillychina.com

12 July 2018