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Lehman, Lee & Xu is a top-tier Chinese commercial law firm with an associated tax and accounting practice, Lehman Tax & Accounting.

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Avoiding the DTA Blues

Most expatriates working in China act on the assumption that they are not taxable in their home country for any income earned. Any tax lawyer will tell you that tax laws are rarely that simple; many countries tax "resident taxpayers" on their world-wide income and it is only through a double taxation agreement (DTA) that such taxpayers will not be liable to taxation in their home country. This possibly erroneous assumption is important because it is common practice for expatriates to split the payment of their salary into off-shore and on-shore portions, in the common belief (which Lehman, Lee & Xu does not endorse) that the off-shore portion will not come to the attention of the Chinese tax authorities, and that Chinese tax need only be paid on the on-shore component. This is of course only beneficial if the off-shore portion is not liable to taxation elsewhere, and determining this will generally involve examining China's tax laws and the laws of the home country in conjunction with the relevant DTA.

China's DTAs provide a mechanism to determine where a dual resident taxpayer is taxable. A dual resident will, generally, be taxable in the country where services are performed. Initially, this may sound promising for expatriates in China, but there is a word of warning – such a conclusion is dependent upon the expatriate being liable to tax therein by reason of residence.

The term "resident" is not properly defined under China's tax laws. However, in practice the China tax authorities have treated taxpayers that fall within paragraph 1 of Article 1 of the Individual Income Tax Law as "residents" for the purposes of DTAs – Individuals domiciled in China are taxable and expats who have lived in China for no less than 365 days within the relevant tax year (in determining whether a taxpayer has lived in China for no less than 365 days absences of less than 31 days, or absences cumulatively less than 91 days are disregarded). The characterization by the Chinese tax authorities of these taxpayers as resident, and not others, is most likely because these taxpayers are taxable on their world-wide income and this is the usual treatment of resident is most countries.

The problem that arises, and that which expats who rely upon the income apportionment described above, is where a person is absent for more than 30 days in one absence or more than 90 days cumulatively. In such circumstances, the taxpayer would no longer be regarded as a resident taxpayer for Chinese law and the DTA would not operate to ensure that they are only taxable in China. Most DTAs provide taxpayers with a credit for tax paid in China against their taxation liability in their home country. However, the problem is that most tax administrations require proof of actual payment of tax. In the income apportionment described above, no tax has been paid on the off-shore component and as a result the taxpayer would be liable to taxation on their full income with a small credit for the tax from income portion paid on-shore. If an employee and employer intend to utilize income apportionment scheme described above then it is extremely important to pay careful attention to Chinese tax residency status.

Finally, it is important to note that the income apportionment scheme, despite its prevalence, is not a legitimate form of tax minimization.

Withholding Tax and QFIIs

The taxation treatment of dividend and interest payment from resident enterprises to qualified foreign institutional investor IIs ('QFIIs') has been clarified by *Guoshuihan* (2009) 47 (the 'Circular').

The Circular provides that QFIIs are liable to 10 percent withholding tax in such circumstances as would ordinarily be payable for any non-resident enterprise under the EIT. Non-resident enterprises that do not have an office or establishment inside China, or a non-resident enterprise whose incomes have no actual connection to its office or establishment inside China, are subject to taxation on any income derived from China on a withholding basis.

Dividends, royalties, interest and rental income are the main types of China-sourced income that most likely would not have a connection with an office or establishment, and accordingly would be subject to withholding tax. QFIIs seemingly fall within the definition of "resident enterprises" under the EIT.

Generally, resident enterprises are not subject to withholding tax on such payments, but rather are taxed on an income basis. Accordingly the Circular carves out an exception for QFIIs. The motivation for the Circular is the difficulties that the tax authorities face in monitoring tax compliance of payments made by QFIIs to the ultimate investors; in taxing the QFII on a withholding basis the authorities avoid the need to trace through to latter payments made to investors in the QFII.

The Circular also makes it clear that the "withholding agent" is the payor of the dividends and interest to the QFII. Withholding agents have a duty to ensure that the appropriate level of taxation is collected and can be penalized if the taxpayer does not fully meet its taxation obligations.

For more information on profit repatriation and how recent changes to the law may affect your business, please contact our specialized tax team.

Transfer Pricing Rules

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China's transfer pricing provisions require related party transactions to be conducted on an arm's length basis. The Implementing Regulations of the Enterprise Income Tax Law clarifies what is meant by the term "related party" which refers to enterprises, other organizations and individuals that have any of the following relations with an enterprise:

1. direct or indirect relationship with respect to capital, management, sale or purchase, et cetera;
2. directly or indirectly controlled by a common third party; or
3. any other relationship of interest.

The arm's length principle provides that related party transactions shall conform to a fair market price that would have applied if the transaction had taken place between two independent parties. Chinese tax authorities can make adjustments through "reasonable methods" in cases of non-arm's length dealing, and may impose interest and a five percent penalty on such adjustments.

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A ten year statute of limitations is imposed on the making of such adjustments. In order to avoid potential transfer pricing disputes, a resident enterprise may enter into an Advance Pricing Agreement ('APA') with tax authorities, which sets out in advance the method for determining transfer pricing for any related-party transactions.

The most substantial change in China's transfer pricing rules under the Enterprise Income Tax Law has been the inclusion of what have been termed the 'documentation requirements'. To ensure greater transparency in relation to transfer pricing, the EITL requires enterprises to provide an annual declaration in respect of related-party transactions. Further, under Article 43 of the EITL, the tax authorities can request a taxpayer to provide "relevant materials" to any transaction between affiliated enterprises.

Where the taxpayer fails to provide such documentation, the tax authorities may determine the taxable income after an investigation, and the onus then shifts to the taxpayer to establish that such a determination is not accurate.

Putting Meat on the Bones

China recently revised its transfer pricing provisions in 2008 with the introduction of the Enterprise Income Tax Law. However, a constant criticism of these rules is that they have been vague and insufficiently detailed. On 1 January 2009, the State Administration for Taxation released the *Implementation Measures of Special Taxation Adjustments (Provisional)* (*Guoshuifa* (2009) 2) (the 'Measures'), adding further detail to China transfer pricing rules. The Measures contain twelve chapters and one hundred and eighteen provisions.

Of particular note is a new broader definition of "related parties", which no longer relies on share ownership alone, but includes the broader concept of "effective control". Effective control tests are used in most jurisdictions to determine whether parties to a transaction are related, and whilst bringing more arrangements within the reach of China's transfer pricing requirements, this change is an indication of the growing sophistication of China's tax laws.

For an English translation of the Measures, please contact our taxation team or go to www.lehmanlaw.com.

Lehman, Lee & Xu's corporate and international taxation team, in association with Lehman Tax & Accounting, offers clients unrivalled and comprehensive services relating to both Chinese and international taxation matters, and provides a high standard of technical expertise with a practical and commercial approach.

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