

New **Double Taxation Agreement** signed between China and the United Kingdom

During Chinese Premier Wen Jiabao's recent visit to the UK, a new Double Taxation Agreement (DTA) between the UK and China was signed. The date when the DTA enters into force has not yet been agreed, ratification by the UK and Chinese governments and entry of the DTA into effect are expected by the end of 2011 and it may be effective from 1 January 2012 in China and 1 April 2012 in the United Kingdom.

What key changes have been made?

The main changes between the current DTA (1984) and the new DTA are as set out below:

- Lower rates of withholding tax: the rate of withholding tax on dividends paid from a Chinese company to its UK shareholders has been reduced from 10% to 5% provided the UK shareholders own at least 25% of the capital of the company either directly or indirectly.
- The Technical fees article has been removed from the DTA: technical services provided by a UK person to a Chinese entity or organisation will no longer be subject to any Chinese withholding tax. Currently technical services are subject to withholding tax of 7%. Business tax is still likely to be due at 5%.
- Clear definition of Permanent Establishment (PE): A 'services PE' clause has been introduced in the new DTA. Services (including consultancy services) provided by a UK resident person through employees or other personnel will potentially constitute a PE in China. This will be the case where the activities continue in China for a period of more than 183 days in any 12 month period commencing or ending in the fiscal year concerned. A building site or construction project will now only constitute a PE where the activities continue for a period of more than 12 months (as against six months in the old DTA).
- The Capital Gains tax article has been extended so that the sale of shares will remain subject to Capital Gains tax in China, but only if the shareholder holds at least 25% of the shares in the Chinese company.
- The Employment Income article has changed so that an individual will only be exempted from Chinese income tax where they have spent less than 183 days in China in any 12 month period commencing or ending in the fiscal year concerned. Previously the individual would be exempt when they spent less than 183 days in the fiscal year concerned.

There are various anti-avoidance provisions in each of the articles on dividends, interest, royalties and other income which states that the DTA withholding tax rate reductions will not be available if the main purpose of any creation or assignment of rights to the relevant income is to take advantage of the treaty benefit offered under those articles.

When will the new agreement come into effect?

Both China and the UK will need to notify each other that necessary procedures have been completed for the DTA to come into force. The DTA will then have effect as follows:

- In China, beginning on or after 1 January in the calendar year following that when the DTA comes into force.
- In the UK, on or after 1 April (for income tax) or 6 April (for corporation tax) in the calendar year following when the DTA comes into force.

Hong Kong intermediate holding companies

When operating in China, it has historically been seen as best practice for businesses to set up a Hong Kong intermediate holding company. One of the key advantages to this has been the reduction of withholding tax on dividends from 10% to 5% by routing them through Hong Kong. These advantages will no longer accrue in most instances after the new agreement comes into effect.

While the benefits of Hong Kong have reduced, there are still advantages (both commercial and tax) to using a Hong Kong intermediate company, so many businesses may still invest via this structure.

What action should be taken?

The new China-UK DTA has undoubtedly placed the UK as a relatively friendly jurisdiction in terms of making investment into China, particularly for investors based in Europe. By contrast, Chinese investors may also consider UK as a holding location for its outbound investment into Europe since the new DTA network is considered to be favourable.

The new DTA will not come into effect until 2012 at the earliest, therefore businesses should continue to operate under the current DTA (1984) until this time.

It is advisable for UK tax residents to revisit the current group structure and assess the impacts brought by the new China-UK DTA.

Who should I contact?

For further information about how the new DTA between China and the United Kingdom could affect your business, please contact:

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