Position

Tax Challenges for German Industry in the People's Republic of China

Federation of German Industries e.V.

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Introduction

For many German companies, China is one of the most important markets worldwide. Conversely, Germany is China's biggest trading partner in Europe. After years of collaboration, the two economies have become closely intertwined. Along with end products, Germany also imports many of its commodities, intermediates and tools from China. These imports help German industry to produce competitively.

However, China is not only an import market but also an export market for German companies. The demand for innovative and high-quality products and services from Germany remains high. Today, approximately 5,200 German companies with more than one million employees operate in China.

Consequently, German companies are subject to Chinese regulation and taxation. While the Chinese administration undertook significant efforts to improve the tax collection and administration environment in China, a development which is highly welcomed, certain taxation matters continue to pose challenges to German companies operating in China.

Therefore, the Berlin visit of the delegation of the State Taxation Administration of the People's Republic of China in June 2019 was highly appreciated. We perceived the discussion as an outstanding opportunity to exchange views on certain taxation issues. Driven by the desire to further deepen the cooperation and economic ties between China and Germany, we kindly invite you to take note of the tax challenges which faces the German industry operating in China.

1. Treatment of services rendered to China

1.1. Withholding Tax and Corporate Income Tax on Services

The provision of services by a German entity to a Chinese entity often requires corporate income tax payments in China, which might trigger a double taxation issue. The reasons for a potential double taxation are of course very different but from our experience often result from the following topics:

1. Withholding taxes ("WHT") on services through treatment as royalties (license fees),
2. determination of onshore and offshore portion of services,
3. remittance of "pay on behalf" costs (cost reimbursement).

WHT on services through treatment like license fees

The tax treatment of service fees by locally responsible tax bureaus is in some cases equal to the tax treatment of license fees according to Art. 12 of the agreement between the People's Republic of China and the Federal Republic of Germany for the avoidance of double taxation with respect to taxes on income and capital ("DTT CN-DE"), i.e. a ten percent WHT applies. The reason of this tax treatment seems to be, that locally responsible tax bureaus regard these services as connected to licenses. Due to this tax treatment, WHT is in these cases generally levied on both, the onshore and the offshore portion of the service.

Alternatively, some locally responsible tax bureaus treat only the offshore portion as license fee payments with a resulting WHT, if the onshore portion is already subject to CIT due to the creation of a service PE in China. In the same situation other local tax bureaus however do not levy WHT on the offshore portion if they consider the offshore portion not license-related.

According to international standards, however, any WHT deducted in China in a situation of pure service provision without any granting of know-how, usage of rights like licenses or royalties is regarded as a too broad interpretation of the definition of "royalties/licenses". The German tax authorities generally take the position of the internationally accepted OECD Guidelines that services are only subject to WHT if explicitly mentioned in the Double Tax Treaty ("DTT"). Therefore, the German tax authorities do not allow to accept the ten percent WHT as a foreign tax credit on such services.

Because of this different tax treatment in China and in Germany, such WHT paid for services without any grant of rights leads to a double taxation for the German entities.

Even if we would ignore the DTT CN-DE, Chinese companies that provide technical services from the territory of the PRC to companies based in Germany would not be taxed in Germany, pursuant to Sec. 8 para. 1 CITA in connection with Sec. 49 ITA.

Suggestion:

To avoid double taxation for services, we would very much appreciate if State Taxation Administration ("STA") could further give strong support that the international guidelines regarding the definition of the provision of services vis-a-vis royalties and licenses are applied by the Chinese locally responsible tax bureaus. Clarifying rules how to differentiate between pure services on the one hand and licenses on the other hand based on the Chinese tax regulations and OECD guidelines might help harmonizing the tax treatment of the different local tax bureaus.

Onshore and offshore portion of services

Regarding the determination of the onshore and offshore portion of services some locally responsible tax bureaus deem that each provision of services has to have an onshore portion, usually 50 percent as a minimum, although some services are completely provided from overseas without any link to services provided in China. Consequently, CIT has to be paid on the deemed onshore service fee in China.

As a general matter, the documents requested or accepted for proving the offshore portion of the provided services is not uniform and sometimes surprisingly extensive (e.g. passport copies in case of pure offshore services) and may not in any case be provided due to data protection rules, business secrets and other foreign privacy requirements.

As Germany in principle follows the international tax practice based on the OECD Guidelines, the German tax bureaus only provide relief from double taxation, if and to that extent where the other contracting country levies taxes in line with the relevant DTT. If China has a broader interpretation of its taxation right (as described above), then the intragroup provision of services causes double taxation and in consequence investments in China become less attractive. The same applies, if there is an extensive proof of documents required which may not be provided by the German entities due to the beforementioned reasons.

Even if we would ignore the DTT CN-DE, permanent establishments of Chinese companies in Germany are taxed only on services that are factually performed by the PE pursuant to Sec 1 para 5 FTA in connection with Sec. 4-11 Decree on the attribution of profits to PEs (BsGaV) and number 28 of the administrative principles on the attribution of profits to PEs (VWG BsGa). A deemed allocation of functions is not allowed.

Suggestions:

- As China has actively contributed to the OECD/G20 BEPS project, we hope that China could further strengthen the development of a uniform set of taxation rules, so that China's interpretation of the DTT is harmonized with the international interpretation practice according to the OECD guidelines.

- To avoid double taxation, German entities would highly appreciate if STA can provide more detailed, harmonized and standardized interpretation and implementation rules taking into consideration the international OECD guidelines for the existence of a (service) permanent establishment and the respective taxation right stated in the relevant DTT in case there is no permanent establishment created in China.

- Furthermore, we would highly appreciate any guidance of STA how to define onshore and offshore portions in case of a service permanent establishment as it would be helpful for both, the locally responsible tax bureaus and the foreign companies as taxpayers in China.

- Additionally, German entities would appreciate a not too formal process for proving the onshore and offshore portion of services. The requested documents should not contradict data protection rules or business secrets since foreign entities cannot provide them lawfully. Due to this, we would highly appreciate if some standard set of documents for this proof could be defined (e.g. a form such as certificate of residence). To improve the efficiency for both tax authority and taxpayers, tax authority might consider initiate queries to taxpayers and document submission when reasonable "doubts" occurs. Also, the tax authorities may take into consideration the tax credit rating of the affiliated Chinese entities (Grace A or B rating) of the foreign service providers in assessing whether a reduced level of documentation proof is justifiable. We kindly invite the STA to enter into a constructive dialog with the BDI to discuss such an approach in order to meet the requirements of all concerned parties.

Remittance on "pay on behalf" costs (cost reimbursement)

Overseas affiliates within one group often "pay on behalf" for Chinese legal entities on expatriate home-country social securities, centralized M&A costs to third party service vendors, and/or compensations to vendors/customers for group level promotion fees or penalties. Those centralized payments on behalf of Chinese legal entities are then recharged to the Chinese entity, however, such outbound payments are frequently disallowed.

The key issue why outbound payments are disallowed appear to be that banks in China and the State Administration of Foreign Exchange ("SAFE") inquire with the local in-charge tax bureau and request a tax exemption certificate before wiring is approved.

However, it seems that the locally responsible tax bureaus can't issue such exemption certificates based on the proof provided by the taxpayer that no profit is made with regard to the "pay on behalf"-amount and the actual wiring amount. In most cases, these are allocated amounts without back-to-back-link and evidence. In addition, information on the social securities and benefits paid to expatriates constitutes highly confidential information subject to Germany and EU data protection rules. This means it is impossible to provide such information to Chinese authorities due to legal constraints. Therefore, "pay-on-behalf" cases are rarely successfully processed, and the receivables against Chinese group entities in Germany and the liabilities against German group companies in China respectively are accumulated for years.

Suggestion:

We would highly appreciate if the STA could align with SAFE and provide a reasonable rule for processing such reasonably allocated costs for recharge purposes. We would highly appreciate if some standard set of documents for this poof could be defined (e.g. for social security contributions: an anonymised proof of payment for social security payments). We kindly invite the STA to enter into a constructive dialog with the BDI to discuss such an approach in order to meet the requirements of all concerned parties.

1.2. Tax Payments and following service fee payment to overseas

General remarks

Due to tax and foreign exchange regulations, Chinese banks will only remit money overseas after the service fee amount has been approved by the Chinese tax authorities and all taxes have been paid. For China tax purpose, each contract for outbound payment needs to be registered online regardless of the amount involved. This is separate from the remittance process. For a payment below USD 50K threshold, the bank would allow the payment to be remitted without tax clearance/payment certificates or approvals from tax authorities.

In a first step therefore, the locally responsible tax bureaus must confirm the correct tax payments to enable a final payment of the service fee to overseas. This step in some cases takes much time and administrative work at the Chinese and the German entities due to the issues described in the previous section.

Furthermore, in addition to the legally required documents, each locally responsible tax bureau might request additional documents for review purposes. As a result, the remittance process will take longer than expected and, in some cases, the approval is denied in case the entities fail to compile the additional documents.

In a second step the Chinese bank/SAFE check the entire documents again, sometimes even requesting additional documents and information. As a result, the process required to get service fees approved becomes very formalistic and high costs/resources are required to finally approve the transfer to the German entities.

In some cases, the final payment is denied even if the services have been rendered and both contractual parties agree that the service fee shall be paid. The German contractual partner therefore must write off its receivables. However, the German tax authorities generally do not allow that the expenses resulting from the write off from receivables against related parties are treated as tax-deductible expenses, resulting in taxation of income in Germany while the income was never actually received.

Suggestion:

The payment of service fees from China to overseas often takes a long time and is in some cases not possible due to the highly formalistic and complicate processes, manual checks and required hardcopy documents. It would be highly appreciated if the STA could work towards implementing guidelines, which stipulate that the documents submitted to the tax authorities within the tax payment procedure are sufficient for the determination of the correct tax payments. Please consider that such standardization would not only save resources for the businesses, but also for the Chinese administration in general.

2. Service Permanent Establishments

2.1. Improvements witnessed

In the past years, we have witnessed the efforts exerted by the STA to improve the tax collection and administration environment in China in relation to Service Permanent Establishments (“Service PEs”). Examples are seen in the areas like

- the establishment of the “12366” public hot-line to enable taxpayers to seek authoritative and free-charged tax advice, report pending issues and tax disputes with local tax authorities and supervise tax officials’ performance.
- computerize the tax filing system and make distanced online tax reporting possible.

- segregate the tax collection and audit functions into two independent teams and simplify the tax administration procedures, e.g. abolishing the approval procedure for application of enjoying non-PE treatment.
- stipulate tax rulings[1] to clarify STA's attitudes towards and interpretations of unclear or disputable DTT provisions and their implementation formalities in relation to the Service PE topic.

2.2. Present Situation and Further Improvements to be Expected

Despite of the improvements mentioned above, the Chinese tax environment for Service PEs, as same as for other tax fields, allows for further improvements in order to achieve a more taxpayer-friendly and time and cost-efficient taxation environment for foreign taxpayers. In relation to Service PEs, we would like to propose the following areas for further improvements:

Conflicting interpretation of "Service PE"

In the past, different attitudes were taken by the Chinese tax authorities at the primary level as to how to distinguish a Service PE from a Construction PE (i.e. Art. 5 para 3 lit b) vs. Art. 5 para 3 lit a) DTT CN-DE). Consequently, the tax approaches towards services of the same nature in China are inconsistent. This makes it difficult for German entities to explain their tax liabilities paid in China to the German tax authorities for purposes of a foreign tax credit claim or tax exemption.

Suggestion:

We recommend STA to stipulate clarification rules with reference to the OECD commentary in this field.

Clarification of Non-independent Labour Services

According to Art. 15 para 2 lit c of Guoshuifa [2010] No.75, the provision of "the remuneration is borne by a permanent establishment or a fixed base which the employer has in China" does not apply to individuals who are temporarily sent to China by the head office solely for the purpose of carrying

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[1] Such as STA Notice [2009] No. 19 (measures on tax collection and administration of non-residents conducting projects and services in China); Guoshuifa [2009] No. 124 (notice on how non-resident taxpayers apply for tax treaty treatments in China); Guoshuihan [2009] No. 507 (interpretation of tax treaty provision on royalties); Guoshuifa [2010] No. 75 (a comprehensive STA's interpretation of DTT provisions); Guoshuifa [2010] No. 19 and Guofa [2015] No. 11 (PE profit determination); STA Notice [2011] No. 19 (tax treatment of technical service fees under the DTT China has with commonwealth countries); STA Notice [2013] No. 19 (how to differentiate "secondment" from "service"); SAFE & STA [2013] No. 40 (Tax Filing Form for non-trading outbound remittance); STA Notice [2018] No. 11 (harmonize the interpretation of "183 days" and "6 months" when determining a Service PE under Article 5 of DTT CN-DE) and STA Notice [2019] No. 16 (New returns for non-resident taxpayers to report corporate income tax in China).

out inspection, supervision or temporary support to the permanent establishment. Unfortunately, there is no detailed guidance and explanation regarding the term “temporarily” as well as the scope of “carrying out inspection, supervision or temporary support”. Local tax authorities thus are left with no guidance to consistently provide relief to the taxpayers in practice.

Suggestion:

Further clarification from STA on the definition and scope of this clause is highly recommended.

Consolidated tax filings

For the time being, it is practically impossible to perform consolidated tax filings in China for multiple PEs of one foreign entity and also impossible to apply the actual profit rate method for corporate income tax reporting.

What even worse for German entities is that, under the deemed profit rate method, the tax authorities at the primary level are given the freedom by the prevailing Chinese tax regulations to assign a deemed profit rate within a range of 15% - 40% and, they thus take the liberty to deem the profit at the unreasonably high end (i.e. 30 %, 40 %) disregarding the service nature or the average profit level of the industry the service-PE belongs to. The 30 percent or 40 percent before-tax profit rate is in most of the cases far apart from the actual profit situation of German entities, esp. those engaged in projects for plant building or set equipment supplies.

It is our understanding that consolidated tax filing of multiple PEs is acceptable by STA’s official ruling. Also, the actual profit rate method is explicitly recognized by STA in its regulations. Nonetheless, the local tax authorities responsible for tax collection and administration have so far always rejected to consider consolidated tax filing and actual profit rate methods due to a lack of detailed implementation measures from STA. Consolidated tax filing and actual profit method are both widely implemented for Service-PEs by the DTT CN-DE contracting states of China (including Germany). German companies shall be entitled to the reciprocal treatment in China.

Suggestions:

It would be highly appreciated if the STA could stipulate detailed implementation measures to allow consolidated tax filing and actual profit method to be implementable in practice, suggesting that China tax authority promulgate a guideline to implement the actual profit method which is pragmatic and implementable by the taxpayers in practice.

Service-PE does not enjoy the same tax resident treatment of a service branch

PE registration in China is for the time being a nominal registration only. PEs in China do not have the tax-resident position of a service branch in the real meaning. One example is that PE cannot have a Chinese VAT registration number, and thus PE cannot claim VAT input for its purchases in China against the VAT output on its service income derived in China. This makes it very expensive for German entities to render services in China through Service-PEs and consequently the competitiveness of German entities is hindered by the asymmetric tax treatment on Service-PEs.

Suggestions:

We kindly request STA to leverage the experience of other countries and collaborate with other Chinese government departments to work out a Chinese characterized PE registration and taxation formalities to allow PEs in China to be treated in the same way as to service branches in China.

Secondment versus service

German entities have dispatched experienced managerial and technical personnel to their Chinese affiliated entities to assume management roles and perform technological exchange. These dispatched personnel mostly have valid employment contracts with the German parent companies and work with the Chinese affiliated companies on secondment basis.

STA issued Public Notice [2013] No. 19, which sets up the criteria on when a secondment arrangement could be treated equivalent to a Service PE.

We take the position that certain conditions are too rigid and are not in line with the Service PE provisions in DTT CN-DE nor with the BEPS request. For example, when the German parent company collects a service fee for the inevitable time spent by its HR staff in preparing payroll slips or computing the social insurance contributions in Germany for the seconded employees, the secondment arrangement could be deemed as if the home company of the seconded employees were rendering services in China through the seconded employees, and such services would give rise to a Service-PE in China to trigger Chinese corporate income tax.

Suggestions:

We kindly invite STA to organize a dialogue with BDI and with the multinational entities in China in order to have a comprehensive understanding of the secondment arrangement. Based on the research result, STA issues a clarification ruling in this regard.

3. Transfer Pricing

3.1. Transfer Pricing Documentation

As part of the BEPS project the OECD has implemented a standardized concept for the documentation of transfer prices (“TP”) based on a three-tiered

approach (Master File, Local File, Country-by-Country Reporting). The purpose of a unified approach is to balance tax administration information needs to perform a transfer pricing risk assessment and the compliance costs and burdens imposed on enterprises to provide this information.
In the last couple of years, the STA has issued bulletins considering the BEPS action item on TP documentation. However, like several other countries, China has extended the information request putting an additional information submission burden on the taxpayer. The additional information required includes local specific factor analysis, value chain analysis, special items file.

Particularly, the requirement of having a value chain analysis in Local File seems excessive and goes beyond OECD requirements. For a local subsidiary in China to disclose the multinational company’s value chain in its local documentation adds unreasonable burden for international enterprises. Additional specific financial data must be prepared by the taxpayer to cater for financial data testing on the aggregated level.

The above-mentioned topics impose additional costs and burdens on the enterprises. International enterprises cannot follow one standard documentation approach for the whole group but rather must fulfil extended requirements for some countries leading to a fragmentation of the documentation. This also implies the risk that inconsistent data is submitted by the enterprise to tax authorities in different countries.

Suggestion:

- It would be highly appreciated if the TP documentation approach for China would be more aligned with the standard OECD documentation approach. This would enable the application of one harmonized documentation approach within an international enterprise and thus reduce additional efforts and costs for the enterprises. Further information requests should only be raised in case the analysis of the standard documentation gives rise to further examination, e.g. during a tax audit. This would give relief to most companies and reduce tax authority’s burden for data analysis by limiting it to the risky cases.

- We kindly invite STA to consider issuing a national guideline which outlines the situations (specific pre-defined risk alert areas) where the local tax authorities can formally ask the taxpayers to provide additional data.

3.2. Benchmarking analysis

Regarding benchmarking the STA appear to prefer local Chinese comparables and appear to use databases not available to the foreign entity. If the Chinese tax authority uses “secret comparables” to verify the correct pricing of related party transactions and maintains/ applies a purely internal database, taxpayers do not have any transparency regarding the comparability of the results. This not only complicates the discussions between taxpayers and the

STA but also discriminates the taxpayer in his efforts to prepare a sound defence strategy.

In discussions with taxpayers on benchmarking analysis, locally responsible tax bureaus do not provide detailed comments with technical grounds on the justification of their own benchmarking results nor the reasons for rejecting a taxpayer's benchmarking results. A level playing field cannot be achieved, if the STA additionally encourages tax authorities to also collect and use potentially contradicting information from customs, banks and other authorities or entities. A high level of uncertainty for taxpayers in the determination of their transfer prices would inevitably remain.

Suggestion:

From the perspective of the enterprise it would be appreciated, if the STA would align its benchmarking practice with OECD standards to enable a fair evaluation of appropriate comparables based on industry practice to achieve arm's length results.

3.3. Transfer Pricing Methods

For specific inter-company transaction types, the STA appears to disregard methods and procedures as implemented by the OECD and follows its own local specific approach.

Regarding inter-company service charges, it is difficult for international enterprises to defend charges from and to China. The STA does not accept the low value-added services approach that was introduced to facilitate inter-company charging of services within an international group considering low risk transactions. Chinese tax authorities rather request extended information on service charges coming into China, e.g. verification on cost base, allocation keys, extended benefit test, general disregard of headquarter charges. Even for on-charges of external service fees a disproportionate amount of information is requested, including information not available to the taxpayer (see 1.2. above).

In addition to the required amount of information for a path through service, it seems not reasonable to charge at maximum more than a low handling fee on the invoiced original third-party amount. Especially pure buy-sell transactions that are economically useful and only pushed through are discriminated. This leads to distorted business decisions.

Regarding the intercompany allocation and use of IP in an international enterprise, the STA appears to have a local focus as well. Emphasis is put on the local market, requesting consideration of local specific factors when analysing IP transactions. In case of IP licensing, extended verification requirements are imposed on the taxpayer. Often detailed information on each IP component is requested and proof that each IP component is utilized by the Chinese company for justifying a license is required. Even for standardized

IP a split up and consideration of the local market is requested, which is technically not possible to provide by the international enterprise.

The above-mentioned topics impose additional costs and verification burdens on the enterprise. The disallowance of simplification approaches implemented by the OECD increases taxpayer's efforts, where they should have been reduced. Furthermore, taxpayers are limited in their options to defend their transfer pricing concepts as the information requested by the STA is not available to the enterprise and thus not possible to provide.

Suggestion:

- It would be highly appreciated, if the STA would align its transfer pricing methods practice with common OECD standards to enable a fair judgement on transfer prices charged.

- It would be highly appreciated, if the STA can accept the low value-added services approach by referring to OECD standards soon.

3.4. Processes & Procedures

Official processes and procedures in China impose a high level of uncertainty on international enterprises. General practice for tax audits is, that they are covering very long periods and with subsequent audits for the future years ("monitoring period"). With such long audit periods the taxpayer does not have certainty on the Chinese perspective and is thus limited in options on transfer pricing concepts also for the future.

When entering procedures in China it is often not transparent to the taxpayer which authorities and departments get involved, and respectively responsibilities in the process are unclear. Furthermore, some processes are structured in an inefficient way putting lots of effort on the taxpayer and slowing down the process, e.g. upfront registration of contracts, payments out of China.

The process of completing TP audit/MAP/APA in China can last for years, partly due to the very lengthy and decision-making procedures within tax authorities of all levels. More clear timelines for the procedures would be expected for reliable investment decisions.

Suggestions:

- It would be highly appreciated, if procedures and processes on transfer pricing in China would be streamlined and made more transparent to provide a higher level of certainty regarding the Chinese perspective on transfer prices to international enterprises.
- Regarding multilateral procedures (MAPs, APAs) international enterprises hope, that there will be constructive procedures and good collaboration in the future.

- It would be highly appreciated to introduce a limitation period which creates certainty for the taxpayers. Internationally, a limitation period of five years seems to be the most common one. Also carrying out other multilateral procedures (MAPs, APAs) in a more effective and efficient manner would be very helpful.

4. Preferential Withholding Tax Rates under Double Tax Treaties

Preferential withholding tax regimes under DTT grant reduced treaty withholding tax rates to qualifying participations, thereby enhancing the attractiveness of domestic investments for foreign investors. Since the issuance of the "anti-treaty shopping rule" in 2009, Chinese tax authorities have been paying close attention that the beneficial owner qualifications are met. This topic has been given new impetus by the treaty benefits provided by the new DTT CN-DE, which is in force since 2017.

Multinational companies face challenges in claiming a reduced treaty withholding tax on dividend distributions, royalties and interest from their Chinese subsidiaries in case the direct German recipient entities may not have sufficient "substance" to qualify as beneficial owners.

This problem has been addressed and partially relieved by the released STA Public Notice [2018] No. 9 (Public Notice 9). Generally, the Public Notice 9 has been well appreciated by German investors and shows the STA's efforts to engage in an investor friendly and balanced policy.

Due to this, the current situation provides greater certainty and gives the applicants as defined in Art. II of Public Notice 9 ("Applicants") improved guidance on how to avail for the reduced withholding tax rates by either passing the unfavourable factors assessment or, for dividends, satisfying the safe harbour rule.

However, practical problems remain as the reality of the global economy is often more complex than the underlying assumptions of Public Notice 9 seem to suggest. This is especially true where a separation of functions and activities such as labour (staff), manufacturing, R&D, distribution, financing and management etc. occurs. Such functions are often performed through different legal entities within the same multinational company. In this regard, further improvements on the following problematic aspects in the practical application of Public Notice 9 would be highly appreciated.

4.1. Unfavourable Factors Assessment

Art. II para 1 Public Notice 9

A very common strategy to reduce working capital costs and foreign exchange impacts for multinational companies is a cash pooling arrangement.

Here, the cash pool principal nets daily balances of the cash pool members, either in an in-house bank or in a master account with a third-party bank. Since applicants forming part of multinational company are regularly members of such cash pool arrangements, it is often assumed that a de facto payment to a resident of a third country (the cash pool principal) is made, although the applicant has not passed on ownership of the amounts received from China.

Based on such cash pool transactions, the argument (by the tax authority) may be that the parent company cannot freely dispose of the dividend proceeds from China and is considered a “pass-through” (negative factor in assessing beneficial ownership).

In this context, we would like to draw your attention to a Germany specific issue of the so-called profits and losses transfer agreement (“PLTA”). Under our corporate income tax code, German companies can join a domestic tax group with the effect that profits and losses of the member companies can be offset within the same tax year. However, to be eligible to join the tax group, member companies must conclude a PLTA with the respective parent company.

Under this agreement, profits and losses are transferred or refunded in accordance with the relevant legal provisions. Consequently, the net equity of a tax group member appears largely “frozen” during its membership in the tax group because, by definition, annual profits are transferred to the parent company while losses are refunded by the parent company. Consequently, there is an obvious conflict if this PLTA (required for purposes of the German tax group) is qualified as a “pass-through” structure since German parent can – allegedly – not freely dispose of dividend proceeds etc. from China.

Suggestion:

We would be grateful if the PLTA is not considered a harmful factor, since it is required by domestic law to form domestic tax group in Germany and does not constitute harmful tax practices.

Art. II para 2 Public Notice 9:

When assessing the “substance”, the local Chinese tax authorities rely only on the “substantive business activities” or quantifiable factors such as operating income, assets amount or employee number, and are unwilling to take commercial purpose into consideration. It is problematic, for instance, when a German resident invests into China through a joint venture with partner(s) from another country via an investment entity located in a third jurisdiction. Such structure is not set up for treaty shopping purpose but intends to serve as an investment platform (e.g., to ensure equitable interpretation of governing rules and regulations) for business negotiations among partners. However, such joint venture generally could not pass the “substance” assessment since only the above quantifiable factors are considered by the local China tax authorities.

Suggestion:

It would be highly appreciated if the “substance” consideration would also acknowledge the legitimate commercial purpose or intention of the foreign entity establishment, when it is clearly not to obtain treaty benefits.

Art. II para 3 Public Notice 9

In case of tax loss carry forward, the effective tax rate of an applicant can be extremely low. However, insofar this does not substantiate a harmful tax practice since the utilisation of tax losses in future years is a very common element of income tax codes (including the provisions in China) which intends to ensure that the taxpayer’s tax burden does not violate the ability-to-pay principle. Likewise, the effective tax rate can be very low where a (German) parent company receives multiple dividends from foreign and domestic subsidiaries which enjoy participation exemption to avoid double taxation of income already subject to corporate income tax at subsidiary levels.

Suggestions:

- It would be highly appreciated if a low effective tax rate due to the utilisation of losses is not considered harmful for the purposes of Art. II para 3 Public Notice 9.

- In the future, this could be achieved by clarifying the wording of para 3 as follows: “…tax rate is extremely low, unless this is caused by the utilisation of tax losses carried forward/backward or due to qualifying dividend income enjoying participation exemption at shareholder level.”

Art. II para 4 Public Notice 9

In order to pass the unfavourable factor assessment on back-to-back loan agreements, the applicant would need to prove the negative fact that no back-to-back arrangement exists. This is very problematic as it is extremely hard to track and prove that no back-to-back arrangement exists in practice).

Suggestion:

It would be highly appreciated if the necessity of the regulation is examined and, where appropriate, the provision is not applied.

4.2. **Look Through and Safe Harbour Rules**

Art. III and Art. IV Public Notice 9

The “substance” of German financial holding companies as shareholders is another problematic issue. Generally, German companies have faced difficulties claiming the reduced withholding tax rate for major shareholdings provided by the tax treaty (5 % instead of 10 %). The Chinese tax authorities argued that such financial holding companies (resident in Germany) have neither staff nor other resources or trading business (manufacturing, distribution etc.) of their own and thus lack “substance”. However, the required substance does in fact exist in other group companies of the same multinational company and within the same country (Germany). Broadly speaking, the STA Circulars allow to rely on the substance of higher-tier parent companies (100 % ownership) as part of a “look-through” approach. Nonetheless, they do not explicitly allow to rely on substance in sister companies (within the same country) which are controlled (100 % ownership) by the same multinational company. From a German multinational company perspective, it is hard to understand the described distinction.

In the meantime, the literal reading of Art III suggests the “look-through” require 100 percent ownership by one sole shareholder. It is problematic for shareholding structure with multiple owners, e.g. a joint venture of a German resident and partner(s) of another country and where collectively, the qualified shareholders (including via substance attribution rule suggested in the above paragraph) hold 100 percent of the treaty benefit applicant. The look-through of Art III should adopt similar ownership aggregation approach currently allowed under the safe-harbour rule of Art IV.

Also, currently, interest and royalty income are not covered by the safe harbour rule.

Suggestion:

- An explicit broadening of the “look-through” approach would be highly appreciated, i.e.:
  a) to adopt substance from (100 %) group companies (in the same country) which are not a direct or indirect parent of the group entity receiving such income (dividends etc.) from China
  b) to apply to shareholding structure with multiple owners where all shareholders qualify as beneficial owners separately with a collective 100 percent ownership.
- It would be highly appreciated if the safe harbour rule would apply to interest or royalty income as well.

Art. IV para 4 Public Notice 9

Whereas listed companies are always treated as a beneficial owner pursuant to para 2, unlisted companies require a 100 percent qualified ownership to be considered as the beneficial owner. However, such substance criteria may not be relevant in instances where proof can be produced that ultimate beneficiaries (individuals) of a multinational company are predominantly (i.e. to a degree which needs to be defined, e.g. two thirds) tax residents of the same country as the company receiving the dividends from China.

In Germany it is common for companies to be family-owned with multiple generations having a stake in the company. Currently such ownership structured are not covered for purposes of the save harbour rule. This is especially problematic when individuals with a stake in a family-owned company which is actively engaged in China move their residence to another country (i.e. for education or as part of a secondment). Such structures a generally not subject to treaty shopping since the ultimate investors are predominantly tax residents of the same country or of such countries with the same or more beneficial tax treaty benefits.

Suggestions:

In this context, it would be highly appreciated if an extension of the safe harbour rule to unlisted multinational companies would be considered.

5. Restructuring

Restructuring involving Chinese subsidiaries and their tax treatment in China has for many years caused considerable challenges in practical implementation. This applies to both direct and "indirect" transfers, i.e. restructurings in which assets located "indirectly" in China, e.g. shares in a Chinese subsidiary, are moved along with the transfer of shares in a foreign company.

5.1. Direct transfers

According to Art. 13 para 4 DTT CN-DE both states have the right to tax the profits resulting from the sale of shares. This applies to most other DTT which China has concluded with other countries, as well.

The Chinese Ministry of Finance and the STA issued corporate restructuring rules in 2009 to provide detailed guidance on the Corporate Income tax (CIT) Treatment of corporate transactions. One of the aims was to enable companies to improve operational efficiency and re-align corporate strategies. The *Circular on the Issues Concerning Treatment of Enterprise Income Tax for Enterprise Restructuring*[2] offers possibilities to execute corporate restructurings in a tax neutral manner by applying the Special Tax Treatment (STT).

STT can be applied if:

- the restructuring has “reasonable commercial purpose” and reduction, delay or exemption of tax is not the primary purpose,

[2] Caishui [2009] No. 59.

- the transferred (i.e. acquired) shares or assets are at least 50 percent of total shares/assets,
- the business regarding the transferred shares/assets will not be changed for 12 months after the restructuring,
- at least 85 percent of the consideration is in shares (100 % consideration in case of a foreign transferor),
- the shares received in consideration are kept for 12 months (3 years in case of a foreign transferor) after the restructuring.

Furthermore, with respect to direct transfers out of China it is necessary that the taxation right allocated to China regarding future transfers according to the regulations of a DTT is not limited.

The above-mentioned rules are helpful in some transactions (i.e. share for share exchanges, Spin offs, downstream mergers) but they do not cover all economically sensible reorganizations. For instance, an upstream merger of a foreign shareholder of a Chinese entity does not lead to a consideration in shares. Nevertheless, upstream mergers may be necessary and possess an economic justification, which is why it would be preferable to exclude upstream mergers from tax in China, given certain conditions are met.

Suggestions:

- Include upstream mergers in the STT.
- Caishui [2009] No. 59 only lists a limited number (three) of cross border reorganisation forms as being subject to STT in China. Many other commercially justifiable cross border restructurings are excluded from STT (e.g., mergers of China entities commonly owned by a foreign parent and upstream/downstream mergers of foreign entities along a multi-layer ownership structure of the Chinese legal entities). It is highly appreciated that the STT scope be expanded for commercially driven cross border group reorganisations.
- Shorten the 3 years period for direct equity transfer as 3 years are quite arbitrary which leads to lots of intergroup restructuring not to be in conformity with the criteria for special tax treatment.

5.2. Indirect transfers

In February 2015 the STA issued Public Notice [2015] No. 7 (Public Notice 7)[3] to provide a detailed guidance on the Chinese treatment in relation to indirect transfers of China taxable assets. According to Public Notice 7, if a non-resident enterprise indirectly transfers a China taxable asset through an arrangement without "reasonable commercial purpose" but intends to avoid Chinese CIT the transaction shall be recharacterized and treated as a direct transfer of the China taxable asset.

According to Notice 7 all arrangements related to an indirect transfer of a Chinese taxable asset shall be considered in their totality when assessing "reasonable commercial purpose". Public Notice 7 lists seven general criteria that the locally responsible tax bureau shall consider when determining whether there is "reasonable commercial purpose" for the transaction:

1. Value of share equity of overseas company primarily (directly or indirectly) comprised of China taxable assets?

2. Overseas company's assets primarily consist of (directly or indirectly) investments in China or income of overseas company is mainly derived (directly or indirectly) from China?

3. Whether the economic substance of a structure can be demonstrated by the actual function and risk profile of the overseas intermediate company or its affiliated enterprise which directly or indirectly holds a Chinese taxable asset.

4. The duration of the existence of overseas company's shareholders business model and related organizational structure.

5. Overseas income tax implications related to indirect transfer of Chinese taxable assets.

6. From a commercial point of view, whether non-resident transferor's indirect investment and indirect transfer of Chinese taxable assets could be replaced by direct investment and direct transfer.

7. Applicable DTA provisions related to indirect share transfer of taxable assets in China.

It is not clear which time interval of equity transfers according to factor 4 is necessary, particularly in case a foreign company's shareholder was established recently.

[3] Superseding the circular Guoshuihan [2009] No. 698.

The burden of proof fully lies with the taxpayer. Reporting is not compulsory. By filing a voluntary reporting, the taxpayer might be able to obtain a more certain position from the tax authorities. Furthermore, a voluntary reporting provides penalty protection for the buyers and interest reduction for sellers (acting as withholding agents), if the transaction is eventually assessed as taxable by the Chinese tax authorities while no tax was paid when the transaction was conducted. However, in general the tax authorities do not issue any written confirmation on the tax-free position. Furthermore, situations in which the same indirect transfer is treated differently depending on the in-charge tax bureau are possible.

Open Market Transaction

Public Notice 7 also provides that in case shares are transferred by way of a buy/sell transactions or the sale of listed shares at a public stock exchange, Public Notice 7 shall not apply, while based on our understanding the relevant parameters would be market determination of buyer, price and quantity.

Deemed Taxable Provision

In addition to the beforementioned criteria, Public Notice 7 provides that an indirect transfer of the China taxable assets will be deemed as not having "reasonable commercial purpose" and therefore be taxable in China if all the following criteria are met ("Red Zone"):

1. 75 percent or above of the valuable of share equity of an overseas company is comprised (directly or indirectly) of China taxable assets;

2. 90 percent or more of the total assets of the foreign company (not including cash) is directly or indirectly derived from indirectly derived from China taxable asset, or 90 percent or more of its income is directly or indirectly derived from China;

3. the foreign company and its subsidiaries which directly or indirectly hold the China taxable assets perform limited functions and undertake limited risks which are not commensurate to their economic substance; and

4. the overseas tax ought to be paid on the indirect transfer is lower than the potential tax burden applied in China through a direct transfer.

Safe Harbour Provision

Besides the deemed taxable provision, Public Notice 7 also provides a Safe Harbour regulation (i.e. no taxation of the indirect transfer) for qualifying internal group reorganizations. If all the following criteria are fulfilled, restructurings would be considered as having "reasonable commercial purposes" ("Green Zone"):

1. The shareholding relationship of the foreign transferor and the transferee is 80 percent or more (“ownership test”) (note special rules apply if significant value comes from China immovable property);

2. after the indirect transfer the China tax payable on a potential subsequent indirect transfer of the same China taxable assets is not lower than the China tax that could have been payable on a similar or an identical indirect transfer if the indirect transfer did not take place (“tax burden test”); and

3. all considerations paid by the transferee must consist of its own shares or shares of a related company with which the transferee has a controlling relationship (excluding shares of listed companies) (“consideration test”).

The Safe Harbour provision has overriding power against the deemed taxable provision according to Article 4 of Public Notice 7.

Suggestions:

- Further clarification on the definition of the time interval of equity transfers according to general criteria 4 would be highly appreciated.

- A common understanding and interpretation of the 7 general criteria in connection with the economic purpose test by all the locally responsible tax bureaus would be highly welcomed. This would ensure that the taxpayer can fulfil the preconditions and provide the required information to support the taxpayer’s and tax authorities’ common interpretation of the law.

- In case the indirect transfer does not fulfil the requirements under Public Notice 7, the taxation basis for Chinese taxable assets is not explicitly stipulated. The kind of supporting documents (for instance appraisal report or the audited financial statement) should be defined in a circular.

6. Taxation of Internationally Assigned Employees (Expats)

In the context of ever accelerating globalisation, the secondment of workers abroad is becoming increasingly important. The secondment of employees enables German companies to successfully establish operations in the foreign market, as the employees bring valuable experience from the domestic company. Hence, the tax treatment of internationally assigned employees in China represents an important field for German companies in China.

6.1. Tax-exempt Allowances

Currently certain allowances (e.g. housing allowance, school fees, etc.) granted to expats are tax-exempt in China. From January 01, 2022 onwards, these allowances will be subject to individual income tax ("IIT") with only a standard deduction limit for special items due to the Individual Income Tax Reform. As the IIT on these allowances is generally borne by the employer, this intended change in tax law would increase the total assignment cost for the employer significantly. This will likely cause a reduction of the number of internationally assigned employees working in China.

Suggestion:

It would be highly appreciated if the current favourable tax treatment of expat allowances could be maintained beyond 2022.

6.2. Application of Double Tax Treaties

Determination of treaty residency

Currently the employment income of expats working in China (e.g. monthly salary, annual bonus) is fully taxed in China in case the Chinese host entity bears the assignment cost. However, if an expat maintains his tax residence in his home country as defined by Art. 4 DTT CN-DE during his assignment to China, the employment income relating to workdays outside of China is still subject to taxation in his home country. At the moment this causes a partial double taxation of the employment income.

Example:

An employee (expat) of a German entity is seconded to a group entity in China for the period from 01.01.2019 until 31.12.2020. The total assignment costs are borne by the Chinese entity as the assignment takes place in the interest and use of the Chinese entity. During this two-year-assignment the family of the expat remains in Germany.

Application of Art. 4 DTT CN-DE

Assuming the expat will spend more than 183 days in China within the respective year, he will be considered a tax resident of China under Chinese domestic tax laws for both years. As the expat maintains his German residence during the international assignment, he will also be considered a tax resident of Germany according to domestic German tax regulations. To solve these cases of double tax residence, Art. 4 para 2 DTT CN-DE gives precedence to the contracting State with which the personal and economic relations of the individual are closer, this being understood as the centre of vital interests of the employee. According to the OECD Guidelines, the expat in our example must be considered a tax resident of Germany – for Art. 4 DTT CN-DE – as the centre of vital interests is closer to Germany because the family remains in Germany and the foreign assignment is limited to a short time period of two years.

Application of Art. 15 DTT CN-DE

Art. 15 para 1 DTT CN-DE states that the employment income is generally taxable in state of tax residence (as defined by Art. 4 DTT), unless the work is exercised in the other contracting state. In case the expat undertakes a business trip to Germany or third states during the period of the two-year-assignment to China, the portion of the employment income relating to the work performed in Germany or third states can only be taxed in Germany (i.e. the state of tax residence), even if the Chinese entity bears the total assignment cost.

Currently, the employment income is fully taxed in China and the portion of the employment income relating to workdays outside of China during international assignment is also taxed in Germany (i.e. the state of tax residence as defined by Art. 4 DTT). As a result, the employment income relating to workdays outside of China is subject to double taxation in this example. According to the DTT CN-DE, China is obliged to avoid double taxation as only Germany – being the state of tax residence as defined by Art. 4 DTT – has the right to tax the portion of the employment income relating to work days in Germany or third states.

Suggestion:

Determine the tax residence as defined by Art. 4 of the respective DTT instead of local Chinese tax regulations.

Counting method of 183 days according to Art. 15 para 2 DTT CN-DE

According to Art. 15 para 2 DTT CN-DE the taxation right remains with the state of (treaty) tax residence if:

1. the recipient is present in the other state for a period or periods not exceeding in the aggregate 183 days in any twelve-month period commencing or ending in the fiscal year concerned, and

2. the remuneration is paid by, or on behalf of, an employer who is not a resident of the other state, and

3. the remuneration is not borne by a permanent establishment or a fixed base which the employer has in the other state.

In applying the 12-month period all possible periods of twelve consecutive months must be considered. According to the OECD the days of physical presence, i.e. part of a day, day of arrival, day of departure and all other days spent inside the state of physical performance according to the DTT must be considered when calculating the 183-day period. Days during which the employee is a resident of the state of tax residence should not be considered. The first sentence of paragraph 2 refers to "salaries, wages and other similar remuneration derived by a resident of a Contracting State in respect of an employment shall be taxable only in that State unless the employment is exercised in the other Contracting State", which does not apply to a person who resides and works in the same state.

Germany applies the interpretation of the OECD. Consequently, any Chinese tax on the salary relating to activities physically performed in China due to the different counting method cannot be credited against the German income tax leading to a partial double taxation.

Example (detailed computation on the next page):

An employee of a German entity is physically present in China due to several business trips in August and September 2019 as well as in January and February 2020. As of 15 February 2020, the employee is seconded to a group entity in China for a period of 3 years; at the same time the employee transfers his treaty residency to China.

- From a German treaty perspective, the 183 days are not exceeded during the 12-month period Aug 2019 through Jul 2020.
- From a Chinese perspective the 12-month period Aug 2019 through Jul 2020 is exceeds the 183 days.

Suggestion:

Determine the 183-day period taking into consideration the days of physical presence in the state of activity.

Year	2019	2020	
Treaty residency acc. to DTT China/Germany in - Germany - China	01 Jan - 31 Dec -	01 Jan - 14 Feb 15 Feb - 31 Dec	
Counting method - Days of physical presence in China			
▪ Jan	0	14	
▪ Feb	0	15	
▪ Mar	0	31	
▪ April	0	30	
▪ May	0	31	
▪ Jun	0	30	
▪ Jul	0	31	
▪ Aug	13	31	
▪ Sep	3	30	
▪ Oct	0	31	
▪ Nov	0	30	
▪ Dec	0	31	
Total calendar year	16	335	
Total 12- month period Aug 2019 - Jul 2020 acc. to Chinese counting method			**198 > 183 days**
Total 12- month period Aug 2019 - Jul 2020 acc. to OECD's counting method			**30 < 183 days**

7. Double Taxation on Royalty Payment Related to Import Duties

In December 2013, the GAC issued the Measures on Determination of Dutiable Value for Imports and Exports (Order [2013] No. 213), which sets customs valuation adjustments on royalty payments and various non-trade payments. When customs authorities determine the dutiable value of imported goods based on transaction prices, an adjustment is made to the dutiable price by including royalty payment that meets certain criteria. This causes both import duties and VAT to arise. Consequently, for the dutiable royalty payment allocated by Customs authority to import goods, taxpayers suffer double taxation cost arises from non-trade payment related items (China customs duties and WHT).

Suggestion:

Eliminate the “double tax” effect of customs valuation adjustments for royalty payments.

8. Consolidated Corporate Income Tax Filing

Because of local policies and many other commercial reasons, German investors operate multiple legal entities across China. The ability to file corporate income tax returns on a consolidated, central basis, subject to certain preconditions (e.g., 100 per cent direct or indirect shareholding by the ultimate holding company) would significantly benefit these firms.

Suggestion:

It is highly appreciated that a consolidated corporate income tax filing regime be introduced for foreign invested entities soon.

About BDI

The Federation of German Industries (BDI) communicates German industries' interests to the political authorities concerned. She offers strong support for companies in global competition. The BDI has access to a wide-spread network both within Germany and Europe, to all the important markets and to international organizations. The BDI accompanies the capturing of international markets politically. Also, she offers information and politico-economic guidance on all issues relevant to industries. The BDI is the leading organization of German industries and related service providers. She represents 40 inter-trade organizations and more than 100.000 companies with their approximately 8 million employees. Membership is optional. 15 federal representations are advocating industries' interests on a regional level.

Imprint

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