BBD ENTERPRISES

# Amendment to the Bahrain-China double tax treaty

October 2013 Issue

## Background

Bahrain and China have recently amended their 2002 double tax treaty (DTT)[1] by a protocol signed on 16 September 2013. The protocol will enter into force on the 30th day after the exchange of ratification[2] and will apply to income derived during the taxable years beginning on or after the first day of January following its entry into force.

This technical brief provides an overview of the most important amendments to the treaty.

## 1. Article 4 – Residency

The residency article was amended as follows, whereby the underlined sentence highlights the new wording:

*"1. For the purposes of this Agreement, the term 'resident of a Contracting State' means any person who, under the laws of that Contracting State, is liable to tax therein by reason of his domicile, residence, place of incorporation, place of effective management or any other criterion of a similar nature. <u>This term, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State."</u>*

Essentially this amendment reflects the current version of Article 4(1) of the OECD Model Agreement (OECD-MA). In the case of Bahrain this amendment might be misleading, since all income is exempt from tax and Bahrain does not have a territorial tax[3] regime either where such an amendment might be reasonable and would exclude companies receiving foreign passive income only and at the same time claiming residency and benefits under a treaty. As a result, we believe that the Chinese authorities will continue to determine whether some companies seeking treaty benefits qualify as tax residents pursuant to Article 4(1) of the DTT, with a focus on abusive structures, conduit companies and treaty shopping.

## 2. New Withholding Tax Rate for Dividends

From a dividend perspective the DTT will no longer provide any tax advantages after the protocol is in force. The 10% withholding tax rate (WHT) on dividends paid by a Chinese enterprise to a non-resident company under Chinese domestic law has also been incorporated into the DTT with Bahrain. The previously stipulated 5% WHT on dividends which did not require any substantial shareholdings in the Chinese enterprise has been abolished by the protocol. Bahraini investors have now been put on equal footing with countries that do not have a DTT with China when it comes to the tax treatment of dividend distributions.

## 3. Inclusion of General Anti-Avoidance Clause

The DTT incorporates a general anti-avoidance clause, with potential broad applications. The new article reads as follows:

*"The provisions of the Agreement and this Protocol shall in no case prevent a Contracting State from the application of the provisions of its domestic laws aiming at the prevention of fiscal evasion and avoidance, provided that the taxation in that State on the income concerned is not contrary to the Agreement."*

[1] The 2002 DTT before the amendment is applicable to income derived during the taxable years beginning on or after 1 January 2003.
[2] The ratification has not been completed.
[3] With the exception of revenues from oil, gas and petroleum activities.

Because this general anti-avoidance clause provides no further details, domestic law of each contracting country will apply. This amendment is not specific to the DTT with Bahrain, but nearly all of Chinese recent tax treaties (or recent amendments to tax treaties) contain such a general anti-avoidance clause. We note that domestic anti-avoidance rules have been invoked by the Chinese tax administration and that their application resulted in a treaty override, especially in cases where DTTs did not include such an anti-avoidance clause.

Effective from 1 January 2008, China has included a so-called general anti-avoidance rule (GAAR) in its corporate income tax law whereby any Chinese tax-avoidance arrangement lacking a reasonable commercial purpose can be challenged within 10 years from the tax year in which the arrangement occurs. The GAAR essentially is similar to a substance-over-form principle targeting non-resident companies and has been commonly applied in the area of withholding tax on dividends and capital gains from indirect share transfers involving equity investments in China. The GAAR now has significant impact on foreign company's corporate structure involving Chinese equity investments. For example:

1. Many foreign companies that use a holding company located in a tax jurisdiction with a low treaty rate to hold Chinese equity investments have been denied treaty benefits on Chinese-source dividends under a Chinese domestic beneficial ownership rule (Guoshuihan [2009] 601).

2. Foreign investors who use one or more intermediate holding companies to hold Chinese equity investments so as to avoid Chinese capital gains tax from subsequent transfers of indirect ownership interests in Chinese companies were subject to the GAAR investigation and consequently were subject to Chinese income tax on capital gains from the indirect share transfers under another domestic tax rule (Guoshuihan [2009] 698).

## 4. Exchange of Information

The most recent Exchange of Information (EoI) provision as per Article 26 of the OECD-MA has been included in the DTT with a minor but very notable deviation from the OECD standard. The contracting parties have chosen one of the alternative formulations included in the Commentary to the OECD-MA whereby the revised provision does not allow authorities to argue that the information will be foreseeably relevant for carrying out the provisions of the DTT at the time the request for exchange of information is made. In other words, information must be relevant and the requested State is not obliged to answer any speculative requests or comply with fishing expeditions.

While to the best of our knowledge no EoI request was made under the previous treaty which contained the old 2002 wording of Article 26 of the OECD-MA, this amendment seems to be more prudent in the context of EoI while at the same time ensuring an effective EoI procedure within the framework of the DTT.

## 5. Conclusion

Since Bahrain is essentially a zero tax jurisdiction (except for the oil, gas and petroleum industry), the treaty has been only interesting for investments into China, particularly with a view on the very favorable 5% WHT on dividends. However, with the recent amendments to Article 10 the treaty has become much less interesting from an investment perspective.

Furthermore, the inclusion of the anti-avoidance clause adds quite some uncertainty to companies which would like to benefit from the DTT; however, this amendment is only consequent and part of the Chinese policy to renegotiate its treaties with the intention to make them more robust against fiscal evasion.

Despite this amendment, Bahrain managed to conclude a number of treaties in recent years with OECD and some other developed countries (for example, the United Kingdom, Ireland, Austria, Luxembourg, the Netherlands, Singapore, South Korea, Hungary[4], and Belgium[5]), making it a favorable place for investments in the region and elsewhere.

[4] Pending ratification.
[5] Pending ratification.

BBD ENTERPRISES

# Amendment to the Bahrain-China double tax treaty

October 2013 Issue

We update our clients and business partners on a regular basis about tax, legal, regulatory and other developments in the Middle East and Asia.

We are an independent advisory firm with the focus on helping clients to "de-offshorize" their international structures and to implement substance in various jurisdictions around the globe where we provide significant know-how when it comes to the implementation of onshore solutions.

We are proud to say that the background of our associates is very diverse, ranging from legal, tax, banking, economists and to even medical which allows us to cover various industries. Hence, we are comfortable to say that we can work with our clients in a number of different industries, ensuring that not only the tax and legal structure is put in place in compliance with the rapidly changing regulatory environment but also the various industry specific functions are carried out appropriately.

Furthermore, through our presence in the Middle East (Bahrain) and Asia (Hong Kong) we gained significant insight in the current developments in these striving markets. We also serve as an intermediary for investors from both parts of the world to establish them and also identify investment opportunities.

***Gergely Demetrovics***
Head of Tax and Compliance
gergely.demetrovics@bbd-e.com

***Thomas Hanzely***
Managing Director
thomas.hanzely@bbd-e.com

***Glen Wei***
Chinese Tax Counsel
glen.wei@bbd-e.com