L&P

# Newsletter Nr. 230 (EN)

## Offsetting Chinese Withholding Taxes from dividend payments to a German shareholder against German tax

September 2021

## I. Introduction

According to Chinese law, withholding taxes (WHT) are all taxes that foreign taxpayers must pay on China-sourced income in China. Therefore, WHT must be withhold and paid on dividend distributions by Chinese companies to foreign shareholders.

The WHT is systematically not a separate tax for non-residents. Rather, WHT is a type of levy form of China's Individual Income Tax (IIT) for individuals or Corporate Income Tax (CIT) for legal entities. The essential consequence is that the general regulations of the IIT Law or CIT Law therefore also apply in principle to non-resident taxpayers.

Under Chinese law, the **IIT for dividends paid to individuals** is 20%. It is limited by double taxation agreements (DTA). According to the DTA China - Germany to 10%. WHT must be withheld in this amount.

The **CIT**, and thus the WHT, **for dividend distributions to legal entities** that are non-residents for tax purposes is currently in general 10% under Chinese law.

The reduction to a 5% WHT rate according to the DTA China - Germany is only of significance in case of intercompany dividends, if the beneficial owner is a company (other than a partnership) which holds directly at least 25 % of the capital of the company paying the dividends.

The WHT withheld in China can generally be offset in Germany.

However, according to the German tax administration, such an offset is only possible if **no claim for reduction or refund** can be filed under the national tax law of the source state (China) or on the basis of a DTA. The WHT must be final in the source state in order to be eligible for offset in Germany.

The German tax administration currently refers **without further explanation** to the (very theoretical) fact that under Chinese law no withholding tax is levied on certain dividends. In such cases, the WHT is not final and therefore actually not eligible for offset in Germany.

**The question whether the Chinese WHT is offsetable in Germany depends on the local Chinese law** (see under II.).

Actually, the German dividend recipient faces the **risk of actual double taxation**, contrary to the general principle of avoiding any double taxation. This is due to the fact that in practice the Chinese companies or Chinese banks – regardless of very theoretical tax exemption options available under Chinese law – always withhold taxes in order to avoid their own WHT liability.

If the German tax administration refuses to offset withholding taxes with reference to existing tax exemption options under Chinese law, the WHT withheld and paid in China may become a final (double) tax burden for the dividend recipient.

## II. Tax exemption options under Chinese law

Under Chinese law, there are different tax exemption options for individuals and legal entities:

### 1. Individuals

For individuals, during the period from September 2015 to July 2019, the IIT on dividend distributions from shares of companies traded on the Shanghai Stock Exchange and Shenzhen Stock Exchange could be reduced by 50% or 100% depending on the holding period.

This rule has been revised effective July 2019. Since then, only dividend distributions of companies listed in the national SME share transfer system qualify for tax exemption at the rate of 50% or 100%, depending on the holding period.

If the holding period of the shares exceeds one year, a full exemption is granted. If the holding period is more than one month and up to and including one year, the dividend income as assessment basis is reduced by 50% when calculating the IIT and subsequently taxed at the standard tax rate. If the holding period is less than one month, dividend income is fully subject to IIT.

The regulations also apply to non-residents with respect to their China-sourced income subject to IIT.

If the above requirements are met, **German dividend recipients are** thus **generally entitled to partial or full exemption from Chinese IIT or**, in the case of incorrect withholding, **to a tax refund**. However, in practice, as a matter of fact, we have never heard about an actual case where an exemption or a refund was granted, as claims are hardly enforceable in practice.

### 2. Legal Entities

Dividend distributions to legal entities are no longer exempt from CIT since 2008.

## III. Consequences for withholding tax offsetting in Germany

The different tax exemption options under Chinese law have different consequences for the withholding tax offset in Germany.

### 1. Individuals

In cases where **objectively a full exemption or refund claim exists under Chinese law**, a double taxation is almost inevitable, since the exemption or refund claim is regularly factually or economically unenforceable or irrecoverable. At the same time, the German tax administration – but only in principal correctly – refuses to offset the incorrectly withheld Chinese WHT.

In cases where under Chinese law there is only a **partial tax exemption or refund possibility**, there should be a procedural split: Insofar as a tax exemption or refund claim against the Chinese tax authorities exists under Chinese law, an offsetting in Germany is excluded. Insofar as there is no such claim, a set-off against the German capital gains tax must be granted.

A complete refusal of the offset option results in an unintended double taxation in the amount of the WHT that had become final.

If there is **no possibility of exemption under Chinese law**, the withholding tax paid in China must be offset in Germany. Taking into account the narrow tax exemption and refund possibilities, this **<u>should be the general case.</u>**

### 2. Legal Entities

Since foreign dividends are not taxed at the level of the Company in Germany if the shareholding exceeds 10 % (§ 8b sec. 1 and 4 KStG), offsetting is not possible. The withheld withholding tax cannot be taken into account in Germany and thus basically becomes a final tax burden for legal entities.

To reduce the total tax burden, e.g. a Hong Kong, or Luxembourg, or Ireland, or Netherlands holding company can be set up between the Chinese subsidiary and the German parent company, as these countries enjoy reduced withholding rates on dividends under their respective DTA's.

Though not a tax exemption, but a periodic burden benefit can be obtained by a WHT deferral. This is possible if the entire dividend distribution amount is used directly for certain direct investments in China. The regulation aims to promote investment in China.

## IV. Conclusion

Ultimately, the problem is mostly of economic significance for natural persons.

If the German tax administration incorrectly refuses a tax offset, an appeal should be lodged against the corresponding assessment. In this context, the tax exemption options for dividend distributions under Chinese law should be comprehensively explained to the tax authorities.

In the case of legal entities, the withholding tax paid becomes a final tax in Germany. Since dividends are not taxed on a corporate level in Germany (except for § 8b sec. 4 KStG), there is no CIT to offset against.

*We believe that the information provided was helpful for you.*
*If you have any further questions, please do not hesitate to contact*

**LORENZ & PARTNERS Co., Ltd.**

27th Floor Bangkok City Tower
179 South Sathorn Road, Bangkok 10120, Thailand
Tel.: +66 (0) 2-287 1882
E-Mail: info@lorenz-partners.com
**www.lorenz-partners.com**