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China issues new rules on the interpretation and implementation of tax treaties

On 9 February 2018, the State Administration of Taxation (SAT) issued the *Bulletin on Certain Issues Relating to Implementation of Tax Treaties* ("**Bulletin 11**"),[1] which revises and supplements China's existing treaty interpretation rules under Circular 75[2] with respect to permanent establishments (PE), international shipping and air transport, artists and athletes, and partnerships. Bulletin 11 took effect on 1 April 2018.

In this article, we will discuss the key provisions of Bulletin 11 and their potential implications for multinational companies (MNCs) doing business in China.

1. Summary of Key Provisions

1.1 *Permanent establishment*

Bulletin 11 introduces two noteworthy directives for assessing a non-resident enterprise's PE exposure in China.

First, Bulletin 11 provides that a foreign entity which operates a non-legal person joint educational institution or a joint educational program with a Chinese partner in China should be treated as having a PE in China. This provision addresses a long-standing area of uncertainty that has led to tax disputes for foreign universities with operations in China. This new provision in Bulletin 11 appears to close the door for a foreign entity to argue that its joint educational institution or joint educational program in China is not a PE.

Second, Bulletin 11 provides that the "six-month" threshold for a non-resident enterprise to have a service PE should be interpreted to mean a "183-day" threshold. Most of China's tax treaties provide that a foreign enterprise will have a PE in China if its employees or other personnel stay in China for more than a certain amount of time during a 12-month period in connection with a service project or connected service projects. In some of China's treaties, the threshold is "six-months", while in other treaties, particularly more recent treaties, the threshold is "183-days". Prior to 2011, China had a rule under Notice 403[3] for applying the "six-month" service PE threshold that was often referred to as the "one day equals one month" rule. Under this rule, a non-resident enterprise was treated as having personnel in China for an entire month where at least one person was present for at least one day during a

[1] State Administration of Taxation Bulletin on Several Issues Relating to the Implementation of Tax Treaties, SAT Bulletin [2018] No. 11, dated 9 February 2018, effective from 1 April 2018.

[2] Notice of the State Administration of Taxation on the Interpretation of the Agreement Between the Government of the People's Republic of China and the Government of the Republic of Singapore for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income and the Protocols Thereof, Guo Shui Fa [2010] No. 75, dated 26 July 2010.

[3] Notice of the State Administration of Taxation on the Interpretation and Implementation of Some Clauses in the Arrangement between the Mainland of China and Hong Kong Special Administrative Region on the Avoidance of Double Taxation and Prevention of Fiscal Evasion with Respect to Taxes on Income, Guo Shui Han [2007] No. 403, issued by the SAT on 4 April 2007.

calendar month. One month could be deducted only where no personnel were present in China for 30 consecutive days. This interpretation could result in the creation of a PE where the enterprise had personnel in China for as few as seven days if the days were spread over seven months. Although this “one day equals one month” rule was removed from Notice 403 in 2011, it was uncertain whether the SAT had changed the interpretation, and some Chinese tax bureaus continued to apply the rule. With the clarification provided under Bulletin 11, a foreign enterprise from a treaty jurisdiction with the "six-month" service PE threshold can now accurately manage the presence of personnel in China to avoid crossing the threshold for creating a service PE.

1.2 *International shipping and air transport*

Bulletin 11 replaces the provisions in Circular 75 on the interpretation of the international shipping and air transport clauses in China’s tax treaties.

Bulletin 11 adopts the internationally accepted principle that income derived from the time or voyage charter of ships or the wet lease of aircraft should be characterized as income from international transportation, i.e., as income derived from the operation of ships or aircraft in international traffic. Circular 75 excluded such income from the scope of international transportation income, unless it was merely incidental to the operation of an international transportation business.

Bulletin 11 retains the Circular 75 interpretation that bare boat charters, dry leases of aircraft and leases of containers are not within the scope of international transportation business unless they are incidental to the operation of an international transportation business. However, the definition of “incidental” is more stringent under Bulletin 11 than under Circular 75.

Like Circular 75, Bulletin 11 defines “incidental” to mean (i) that the enterprise’s business registration or other relevant documents demonstrate that its core business is international transportation, and (ii) that the enterprise’s revenue from the “incidental” business does not exceed 10% of its total international transportation revenue within a fiscal year. However, Bulletin 11 further provides that an “incidental business” must be closely connected with the enterprise’s international transportation business and cannot be considered as a separate business or a separate income source. This additional condition is subjective, and it remains to be seen how the Chinese tax authorities will interpret it. Another uncertainty that is not clarified in Bulletin 11 is whether the 10% revenue test is based on the non-resident enterprise’s worldwide revenue or only its China-sourced revenue.

In other aspects, Bulletin 11 is basically consistent with Circular 75 with respect to international transportation.

1.3 *Partnership*

Bulletin 11 marks the first time the SAT has issued official rules about a partnership’s eligibility for treaty benefits. Bulletin 11 covers not only partnership but also “other entities with a similar nature” (collectively “**Partnership**”). Bulletin 11 does not define the term “entities with a similar nature”, and it is not clear whether, for example, a US limited liability company with look-through treatment under US federal tax rules may fall within this category.

Bulletin 11 provides different tax treatments for a Partnership depending on whether it is formed under Chinese or foreign laws. Under Chinese tax rules, a Chinese Partnership is a tax transparent entity and the partners are liable to pay tax in China on their respective income shares. For a Chinese Partnership, Bulletin 11 allows its foreign partner to claim treaty benefits if the partner is taxed on its respective share of the partnership income in the partner's country of residence.

In contrast, Bulletin 11 generally views a foreign Partnership as an independent non-resident taxpayer. Bulletin 11 does not allow a foreign partner of a foreign Partnership to directly claim treaty benefits in China with respect to income derived by the Partnership unless permitted under an applicable tax treaty. Instead, the foreign Partnership itself must establish its eligibility for treaty benefits. In order to do so, the foreign Partnership must, as a minimum requirement, submit a tax residency certificate supporting that the foreign Partnership is liable to pay income tax in its country of residence based on its domicile, residence, place of establishment, place of management or other criteria of a similar nature.

2. Analysis and recommendations

Although not an OECD member country, China has adopted many concepts and principles from the OECD's commentaries on the Model Tax Convention to interpret its treaties. Bulletin 11 has further incorporated OECD principles with its guidance on the service PE threshold and international transportation income.

Interpreting "six months" to have the same meaning as "183 days" will effectively raise the service PE threshold for MNCs from certain treaty partner jurisdictions such as the US, Canada, Australia, Spain, Norway, Malaysia and South Korea and therefore is good news for MNCs in these countries. MNCs may also benefit from the expanded scope of international transportation income to cover income derived from time or voyage charters of ships and wet leases of aircraft because the treaty-based tax exemption for such income is no longer subject to the incidental business requirement.

However, the provision that Sino-foreign cooperative education activities constitute PEs represents a divergence from OECD principles and may be inconsistent with China's tax treaties. As treaties should prevail over domestic tax rules in a conflict, taxpayers may consider challenging such PE assertions based on treaty PE principles and resort to mutual agreement procedure where necessary.

In terms of treaty benefits for foreign Partnerships, most of China's tax treaties do not expressly allow look-through of a Partnership for tax purposes, and thus Bulletin 11 will apply in most treaties (the China-France treaty is a notable exception).

This no look-through treatment could create issues for an MNC that invests into China where a foreign partnership or an entity of a similar nature is in the chain of ownership above China. As an example, suppose that a closed Dutch CV has two Dutch tax resident companies as its partners and *indirectly* owns 20% of a Chinese company. The Dutch CV indirectly transfers shares

of the Chinese company. Bulletin 7[4] provides a "treaty safe harbor" under which the indirect transfer of a Chinese company is not subject to tax in China where the indirect transfer would have been exempted from tax in China under an applicable tax treaty if the non-resident transferor *directly* transferred the Chinese company. In this example, if the Dutch CV does not pay income tax in The Netherlands and is unable to obtain a Dutch tax residency certificate, it would be unable to establish its eligibility for the capital gains exemption under Article 13 of the China-Netherlands income tax treaty. As a result, the Dutch CV would be prevented from claiming the treaty safe harbor. Furthermore, the two partners of the Dutch CV would also be unable to claim the treaty safe harbor, as Bulletin 11 does not allow a look-through of the Dutch CV in the absence of explicit provision in the China-Netherlands income tax treaty. As this example illustrates, MNCs with investments in China that are directly or indirectly under a foreign Partnership must carefully assess the potential impact of Bulletin 11 and plan their investments and transactions accordingly to reduce tax risk.

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[4] State Administration of Taxation Bulletin on Several Issues of Enterprise Income Tax on Income Arising from Indirect Transfers of Property by Non-resident Enterprises, SAT Bulletin [2015] No. 7, dated February 3, 2015, effective as of the same date. For a detailed discussion of Bulletin 7, please refer to the February 2015 issue of our Client Alert.

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Appendix

Unofficial Translation Prepared by Baker McKenzie

State Administration of Taxation's Bulletin on Several Issues Relating to the Implementation of Tax Treaties

(Document ref. SAT Bulletin [2018] No. 11
Dated 9 February 2018.)

In order to standardize and regulate the implementation of agreements signed by the Chinese Government for the avoidance of double taxation (hereinafter referred to as "**Tax Treaties**"), the State Administration of Taxation hereby announces in relation to the Permanent Establishment Clause, the Shipping and Air Transport Clause, and the Artists and Athletes Clause in Tax Treaties and the application of Tax Treaties to partnerships as follows:

1. A Sino-foreign cooperative education institution that does not have a legal person status, as well as the place where educational activities of a Sino-foreign cooperative education program are conducted, shall constitute a permanent establishment in China owned by the resident of the other Contracting State to the Tax Treaty.

   Under the Permanent Establishment Clause on whether a service establishes a permanent establishment, the expression "for a period or periods aggregating more than six months within any twelve-month period" shall be interpreted as meaning "for a period or periods aggregating more than 183 days within any twelve-month period".

2. If the Shipping and Air Transport Clause is consistent with Article 8 (Shipping and Air Transport) of the Agreement Between the Government of the People's Republic of China and the Government of the Republic of Singapore for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income and its Protocols (hereinafter referred to as "**China-Singapore Tax Agreement**"), it shall be implemented in accordance with the following principles:

   (a) Profits derived by an enterprise of a Contracting State from the other Contracting State through the operation of ships or aircraft in international traffic are exempted from taxation in the other Contracting State.

   The term "profits derived from international traffic" refers to the profits derived by an enterprise through passenger and freight transport by ships or aircraft and to the rental income realized through ship chartering on a voyage or time basis or aircraft wet lease (including all equipment, crew and furnishing).

   (b) The tax exemption provisions of the preceding Paragraph (a) shall also apply to profits derived from the participation in a pool, a joint business or an international operating agency. For a multi-company joint business in international traffic, each shareholder or cooperative enterprise shall be subject to tax in its country of residence on its allocated income.

(c) The term "interest derived by an enterprise of a Contracting State from its deposits of money incidental to and connected with its operations of ships or aircraft in international traffic" under Article 8.3 of the China-Singapore Tax Agreement refers to the interest derived by an enterprise of the Contracting States operating shipping or air transport in international traffic from the deposits of transportation revenue in the other Contracting State. Such interest shall not be subject to the provision under Article 11 (Interest) of the China-Singapore Tax Agreement. It shall be deemed as income incidental to and connected with international transportation and be exempted from taxation in the source country.

(d) Income derived by an enterprise through rental business including the rental of a bareboat charter, the dry lease of aircraft, the use, maintenance or rental of containers (including trailers and related equipment for the transport of containers) used for the transport of goods or merchandise is not international transportation income. However, according to Article 8.4 of the China-Singapore Tax Agreement, the above rental business income incidental to and connected with international transportation shall be subject to the same tax treatment as international transportation income.

    The term "incidental to and connected with" means being related and supportive to international transportation. It contains the feature of “supportive and ancillary”. To enjoy the tax treatment provided under the Shipping and Air Transport Clause in respect of its income derived from the above rental business that is incidental to and connected with international transportation, an enterprise must satisfy the following three criteria:

    (i) The industrial and commercial registration information and relevant certificates of the enterprise can prove that its core business is international transportation.

    (ii) The enterprise’s incidental business is comprised of activities conducted by the enterprise in international transportation, which contribute rather little to but are closely connected with the enterprise’s main business, and cannot be considered as a separate business or income source.

    (iii) In principle, within one fiscal year, income derived by the enterprise through incidental business shall not exceed 10% of its total international transportation income.

(e) The following income types closely connected with international transportation shall be viewed as part of international transportation income:

    (i) Income derived from sale of tickets for passenger transport on behalf of other international transportation enterprises.

    (ii) Income derived by transporting passengers from urban areas to airports.

(iii) Transportation income derived from transporting goods by a van from a warehouse to an airport or wharf, or from an airport or wharf to purchasers, and delivering goods directly to purchasers.

(iv) Income derived by an enterprise from hotels established to provide transit accommodations for its own passengers.

(f) Income derived by an enterprise that does not specialize in operating ships or aircraft in international traffic shall be considered as part of international transportation income.

3. If the Shipping and Aircraft Clause in a Tax Treaty does not contain a provision similar to that of Article 8.4 of the China-Singapore Tax Agreement, the tax treatment of income derived by a resident of the other Contracting State to such Tax Treaty from the rental business as listed under Article 2 Paragraph (d) of this Bulletin shall be implemented by reference to Article 2 Paragraph (d) of this Bulletin.

4. If the Artists and Athletes Clause is consistent with the provision of Article 17 (Artists and Athletes) in the China-Singapore Tax Agreement, it shall be implemented in accordance with the following principles:

(a) Entertainment activities shall include: activities in various art forms such as stage performance, film and television, music, etc.; other personal activities conducted in their capacity as artists (for instance, film promotional campaigns participated by artists, participation by artists or athletes in an activity such as advertisement shoots, corporate annual meetings, corporate ribbon-cutting ceremonies, etc.); and entertainment activities involving politics, society, religion or philanthropy.

Entertainment activities shall not include conference speeches and activities conducted in the capacity as accompanying administrative and logistics staff (such as photographers, producers, directors, choreographers, technicians and transportation staff in touring performance groups, etc.).

A speech with a performance nature given in a commercial activity shall not be considered as a conference speech.

(b) Athletic activities shall include traditional sporting events such as running, high jump, swimming, etc.; sporting events such as golf, horse racing, soccer, cricket, tennis, car racing, etc.; and contests with an entertainment nature such as billiards, chess, bridge, e-Sports, etc.

(c) Income derived by personal activities conducted in the capacity as an artist or athlete shall include income derived by performance (e.g., appearance fees) and income directly or indirectly connected with performance (e.g., advertising fees).

Income allocated to an artist or athlete from sales of audio-visual recorded performances and income derived from copyright that is connected with an artist or athlete shall be subject to the provision of Article 12 (Royalties) of the China-Singapore Tax Agreement.

(d) According to Article 17.1 of the China-Singapore Tax Agreement, if an artist or athlete directly or indirectly realizes income, the Contracting State where the performance is conducted may tax the income derived by the artist or athlete in accordance with its domestic law. The taxation shall not be subject to the restrictions under provisions of Article 14 (Independent Personal Services) and Article 15 (Dependent Personal Services) of the China-Singapore Tax Agreement.

(e) When someone other (including individuals, companies and organizations) than the artist or athlete collects part of or all of the income derived by a performance of the artist or athlete, if that income shall be deemed as income derived by the artist or athlete according to the domestic law of the Contracting State where the performance is conducted, the Contracting State may tax the artist or athlete on the income. The taxation shall not be subject to the restrictions under provisions of Article 14 (Independent Personal Services) and Article 15 (Dependent Personal Services) of the China-Singapore Tax Agreement. If the income cannot be deemed as income collected by the artist or athlete according to the domestic law of the Contracting State where the performance is conducted, the Contracting State may tax whoever collects the income according to Article 17.2 of the China-Singapore Tax Agreement. The taxation shall not be subject to the restrictions under provisions of Article 7 (Business Profits), Article 14 (Independent Personal Services) and Article 15 (Dependent Personal Services) of the China-Singapore Tax Agreement.

5. Issues concerning the application of Tax Treaties to partnerships and other similar entities (hereinafter referred to as "**Partnership**") shall be implemented in accordance with the following principles:

(a) For a Partnership established in China pursuant to Chinese laws and whose partner is a resident of the Other Contracting State to a Tax Treaty, the partner may enjoy Tax Treaty treatment in China on the part of income that generates Chinese tax liability for the partner and is considered as income of a resident by the other Contracting State.

(b) A "Partnership" established under laws of a foreign country (or region) is a non-resident enterprise taxpayer for the purpose of Chinese enterprise income tax, if it does not have a place of effective management in China but has an establishment or place in China; or if it does not have any establishment or place in China but has China-sourced income. Except as otherwise provided in a Tax Treaty, the income, for which the partnership is subject to tax in China, can only receive Tax Treaty treatment if the Partnership is a resident of the other Contracting State. The tax residency certificate issued by the tax authorities of the Other Contracting State and submitted by the Partnership in accordance with Article 7 of the *State Administration of Taxation's Bulletin on the Administrative Measures for the Non-resident Taxpayer to Claim Tax Treaty Benefits* (SAT Bulletin [2015] No. 60) must prove that the Partnership is liable to tax in the other Contracting State by reason of its domicile, residence, place of establishment, place of management or other criteria of a similar

nature in accordance with the domestic law of the other Contracting State

The term "except as otherwise provided in a Tax Treaty" means that the Tax Treaty provide that, if income derived by a Partnership shall be deemed as income derived by its partners according to the domestic laws of the Other Contracting State, the partner who is a resident of the Other Contracting State shall enjoy the Tax Treaty treatment in respect of the corresponding portion of income derived from the Partnership.

6. Any issues concerning the implementation of arrangements on the avoidance of double taxation signed by Mainland China and the Hong Kong Special Administrative Region, the Macau Special Administrative Region shall be resolved according to this Bulletin.

7. This Bulletin takes effect from 1 April 2018. Articles 8 and 17 of the *Interpretation of the Agreement Between the Government of the People's Republic of China and the Government of the Republic of Singapore for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income and the Protocols Thereof* (Guo Shui Fa [2010] No. 75) are simultaneously repealed.

It is hereby notified.

State Administration of Taxation

9 February 2018