



Osgoode Hall Law School of York University
Osgoode Digital Commons

Comparative Research in Law & Political Economy

Research Papers, Working Papers, Conference
Papers

Research Report No. 44/2012

The Great Fiscal Wall of China: Tax Treaties and Their Role in Defining and Defending China's Tax Base

Jinyan Li

Osgoode Hall Law School of York University, JLi@osgoode.yorku.ca

Follow this and additional works at: <http://digitalcommons.osgoode.yorku.ca/clpe>

Recommended Citation

Li, Jinyan, "The Great Fiscal Wall of China: Tax Treaties and Their Role in Defining and Defending China's Tax Base" (2012).
Comparative Research in Law & Political Economy. Research Paper No. 44/2012.
<http://digitalcommons.osgoode.yorku.ca/clpe/36>

This Article is brought to you for free and open access by the Research Papers, Working Papers, Conference Papers at Osgoode Digital Commons. It has been accepted for inclusion in Comparative Research in Law & Political Economy by an authorized administrator of Osgoode Digital Commons.



OSGOODE

OSGOODE HALL LAW SCHOOL
YORK UNIVERSITY

OSGOODE HALL LAW SCHOOL

Comparative Research in Law & Political Economy

RESEARCH PAPER SERIES

Research Paper No. 44/2012

The Great Fiscal Wall of China: Tax Treaties and Their Role in Defining and Defending China's Tax Base

Jinyan Li

Editors:

Peer Zumbansen (Osgoode Hall Law School, Toronto, Director Comparative Research in Law and Political Economy)

John W. Cioffi (University of California at Riverside)

Leeanne Footman (Osgoode Hall Law School, Toronto, Production Editor)



Comparative Research in
Law & Political Economy



The Great Fiscal Wall of China: Tax Treaties and Their Role in Defining and Defending China's Tax Base

By taking the Great Wall of China as an analogy for China's treaty policy, the author considers key aspects of China's treaty network and its implications, and whether or not this constitutes a "Great Fiscal Wall of China".

1. Introduction

The Great Wall is an iconic symbol of China. As a man-made structure, the Great Wall functioned historically as a practical tool of defence and territorial claims. As a symbol of China, the Great Wall may mean different things to different people, ranging from a symbol of Chinese national identity to a witness to "a history of cultural encounters that have shaped modern ideas about China within the country as well as outside".¹ At the risk of oversimplification, this article argues that the network of tax treaties functions as the Great Fiscal Wall of China, with each tax treaty forming the network as a point of encounter between the Chinese and foreign tax systems, defining the boundaries of the Chinese tax base (as well as the treaty partner's) and defending such tax base through various anti-abuse rules. Although each tax treaty is different in some respects, the network as a whole reveals some characteristics that arguably give shape to a distinct Chinese identity in treaty policy.

The analogy of the treaty network to the Great Wall has its limitations. Unlike the Great Wall, tax treaties are not a "Chinese creation". China must adopt the design and technology developed elsewhere with limited room for modification. More fundamentally, the people on the other side of the Great Wall were "outsiders" or "enemies", but the party on the other side of a tax treaty is a "partner". In addition, unlike the Great Wall, which was not intended to benefit any private citizens directly, tax treaties are designed to provide relief to taxpayers. An interesting twist is that taxpayers can also use the fiscal wall to shield their income from Chinese taxation. Metaphorically speaking, the fiscal wall has gates for cross-border fiscal travellers who can use (or abuse) a tax treaty.

In spite of the limitations in analogizing the treaty network as the Great Wall, such an approach serves a useful purpose in this article. Following this introduction, section 2. describes the development of the Great Fiscal Wall over the past three decades, China's motivation for entering into tax treaties and the influence of the OECD Model² and UN Model.³ Section 3. discusses the personal scope of tax treaties, i.e. the meaning of resident of a contracting state. Section 4. examines the substantive rules that define the scope of source-based tax jurisdiction over business profits, passive income (dividends, interest and royalties), capital gains and personal services. Section 5. discusses the use of tax treaties as a defence mechanism and examines the design and application of various anti-abuse rules. Sections 4. and 5. consider not only the provisions of tax treaties, but also the administrative policy and practice of Chinese tax authorities. On the basis of a study of selected tax treaties, section 6. identifies some major trends in China's treaty policy. The article concludes by noting some distinguishing features of the Great Fiscal Wall of China and speculates the implications for China and its treaty partners and cross-border investors. As this article focuses on the role of tax treaties in defining and defending China's tax base, it does not discuss in any detail the "special provisions", i.e. non-discrimination, mutual agreement procedure, exchange of information, assistance in the collection of taxes, etc.

-
2. The OECD first published the *OECD Model Tax Convention on Income and on Capital* (30 July 1963), Models IBFD and then the *OECD Model Tax Convention on Income and on Capital* (1 Apr. 1977), Models IBFD, which was soon adopted by OECD Member countries and non-OECD countries in bilateral treaty negotiations. The *OECD Model* is accompanied by an article-by-article *Commentary*. From 1992, the *OECD Model* and *Commentary* were published in a loose-leaf format. The most recent condensed version is *OECD Model Tax Convention on Income and on Capital* (22 July 2010), Models IBFD. For a "read only" version, see http://fiscus.fgov.be/interfzfznl/fr/downloads/ocde_en.pdf. The most relevant versions for China's treaty negotiations is the *OECD Model* (1977), although some *Commentaries* adopted in the 1990s, such as the *Commentary on Article 1* in respect of improper use of tax treaties, appear to have had a significant effect on China's tax treaties and treaty practice.
 3. The UN first published the *UN Model Tax Convention on Income and on Capital* (1 Jan. 1980), Models IBFD. The next updated version was the *UN Model Tax Convention on Income and on Capital* (1 Jan. 2001), Models IBFD, also available at <http://unpan1.un.org/intradoc/groups/public/documents/un/unpan002084.pdf> and then the *UN Model Tax Convention on Income and on Capital* (1 Jan. 2011), Models IBFD, also available at www.un.org/esa/ffd/documents/UN_Model_2011_Update.pdf.

* Professor, Osgoode Hall Law School of York University, Canada. The author can be contacted at JinyanLi@osgoode.yorku.ca.

1. C.C. Huang, *Deconstructing the Great Wall of China: The Jesuits' and British Encounters*, in *History in the Making*, vol. 1, no. 165, p. 66 (2012), available at www.historyitm.org/index.php/hitm/article/view/76. For further study of the Great Wall, see J. Lovell, *The Great Wall: China Against the World, 1000 BC - 2000 AD* (Pan Macmillan Austrl. Pty, Ltd. 2007) and A. Waldron, *The Great Wall of China: From History to Myth* (Cambridge U. Press 1990).

2. The Great Fiscal Wall: China's Treaty Network

2.1. An extensive network

China's first tax treaty was the China–Japan Income Tax Treaty (1983),⁴ concluded three years after the promulgation of the first income tax laws.⁵ By the end of 2011, China had developed one of the largest treaty networks in the world, with close to 100 tax treaties, covering OECD Member countries, transition countries and developing countries in Africa, Asia and Latin America, as well as Hong Kong and Macau, which are Special Administrative Regions of China.⁶

Table 1 in the Appendix lists the countries that have concluded a tax treaty with China in the following six groups: (1) OECD Member countries; (2) the other BRIC countries (Brazil, Russia and India); (3) transition countries; (4) treaty haven countries, i.e. countries that are known as friendly jurisdictions for tax planning purposes because of their extensive treaty network and lower withholding tax rates or narrower scope of source taxation; (5) developing countries; and (6) Hong Kong and Macau.

Between 1983 and 2011, there appear to have been three phases in the development of China's treaty network. Phase one was started with the China–Japan Income Tax Treaty (1983). Over the next five years, China had concluded tax treaties with the United States (1984), France (1984), the United Kingdom (1984, renegotiated in 2011), Belgium (1985, renegotiated in 2009), Germany (1985), Malaysia (1985), Norway (1986), Denmark (1986), Canada (1986, renegotiated in 2012),⁷ Finland (1986, renegotiated in 2010), Sweden (1986), New Zealand (1986), Thailand (1986), Italy (1986), Singapore (1986, renegotiated in 2007), the Netherlands (1987), the Czech Republic (1987, renegotiated in 2009),⁸ Poland (1988) and Australia (1988). Tax treaties with the remaining OECD Member countries were mostly concluded by 2000, with the exception of Greece (2002), Mexico (2005) and Israel (2010).

Chile seems to be the only OECD Member country that does not have a treaty with China. In negotiating tax treaties with many OECD Member countries, China took the position of a net capital-importing country and generally insisted on more source-based taxation and tax sparing in favour of China.

During the 1990s and the early 2000s, China negotiated tax treaties with the other BRICs, transition countries and many developing countries. In contrast to the OECD Member countries, these countries receive investment from China and would be expected to bargain for more source-based taxation and tax sparing credit from China.

From the mid 2000s to 2011, while new tax treaties were concluded, some earlier tax treaties were amended by way of protocols, for example, the tax treaties with Barbados, Korea (Rep.) and Mauritius, or completely renegotiated, for example, the tax treaties with Belgium, Finland, Singapore and the United Kingdom. Anti-abuse became a prominent theme in these tax treaties. The conclusion of tax information exchange agreements (TIEAs) was consistent with this theme. China entered into TIEAs with some of the well-known tax havens, such as the Bahamas, Bermuda, the British Virgin Islands, the Cayman Islands, Guernsey, the Isle of Man and Jersey.⁹ It is beyond the scope of this article to analyse TIEAs.

2.2. Motivation

The short time period between the promulgation of the first income tax laws and the conclusion of the China–Japan Income Tax Treaty (1983) and the rapid speed in expanding the treaty network indicate the importance placed by China on tax treaties. China is presumably motivated to benefit from tax treaties. The most obvious benefits are the prevention of double taxation and fiscal evasion. Double taxation impedes cross-border investment, an evil that can be most effectively removed through tax treaties. The prevention of international fiscal evasion might not be a major concern in the earlier years, but arguably became so when outbound investment and capital flight became more significant.¹⁰

During the 1980s, in addition to these tangible benefits, China may have been more motivated by the potential intangible benefits that tax treaties can generate, i.e. the “signalling effect”. Foreign investment in China was inevitably accompanied by interest in China's tax system. Foreign investors were naturally concerned as to how much Chinese tax would be imposed on the income from their Chinese investments, the stability of the Chinese tax system and the resolution of disputes with Chinese tax

4. *Agreement Between the Government of Japan and the Government of the People's Republic of China for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income* (6 Sept. 1983), Treaties IBFD.

5. CN: The Income Tax Law of the People's Republic of China Concerning Joint Ventures with Chinese and Foreign Investment adopted by National People's Congress and promulgated on 10 September 1980 (the “JVIT Law”). CN: Individual Income Tax Law of the People's Republic of China, National Legislation IBFD was enacted by the 3rd Session of the 5th National People's Congress and was also promulgated 10 September 1980.

6. For further discussion of the “one country, two tax systems” as a result of the status of Hong Kong as a Special Administrative Region, see J. Li & D. Elliot, *One Country, Two Tax Systems: International Taxation in Mainland China and Hong Kong*, 57 Bull. Intl. Fiscal Docn. 4 (2003), Journals IBFD.

7. At the time of writing this article, the text of the renegotiated tax treaty had not been officially published.

8. *The Agreement Between the Government of the People's Republic of China and the Government of the Czechoslovak Socialist Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income* (1 June 1987), Treaties IBFD continued to apply to Slovak Republic after 1 January 1993 when the Czech Republic and Slovak Republic became independent countries. A new tax treaty between China and the Czech Republic was concluded on 28 August 2009 (*Agreement Between the Government of the Czech Republic and the Government of the People's Republic of China for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income* (28 Aug. 2009), Treaties IBFD).

9. For more information, see the SAT website, www.chinatax.gov.cn.

10. For further discussion about why China was interested in entering tax treaties, see X. Jin, *Perfecting Foreign Taxation and Promoting Economic Cooperation* (1986), in *Selected Works on Taxation by Jin Xin*, vol.1, pp. 140-141 (China Taxn. Press 2008) (in Chinese) and *Guiding Principles and Policies for Our Country's Foreign Tax System in Selected Works on Taxation by Jin Xin*, vol. 2, pp. 640-650 (China Taxn. Press 2008) (in Chinese); X. Wang, *Discussion of Double Taxation Prevention Treaties* pp. 8-13 (China Fin. & Econ. Press 1987) (in Chinese); and X. Yang, *International Coordination on Income Taxation*, in *International Tax Law* 2nd ed., pp. 334-336 (Beijing U. Press 2004) (in Chinese).

authorities. After all, China was just beginning to learn how to operate a modern income tax system and how to interact with foreign investors after decades of isolation and central planning. By entering into tax treaties on the basis of the widely adopted models, China signalled to the world community that it was prepared to follow the international tax norm. China also developed its domestic tax system by transplanting concepts, principles and rules, and by ensuring that the domestic rules are consistent with the treaty rules. One example is the arm's length principle based on article 9 of the OECD Model.

Tax treaties were, of course, more than just signalling devices. They delivered substantive tax benefits to foreign investors. For instance, tax treaties reduced withholding tax rates from the domestic 20% to 15% or lower. The tax sparing clause in most tax treaties with OECD Member countries ensure the Chinese tax incentives benefit the investors as opposed to the treasury of the residence country.

From the perspective of encouraging foreign direct investment (FDI), there appears to be no disadvantage in having a tax treaty. While attracting FDI is important, using the network as a Great Fiscal Wall to define and defend China's tax base might also be motivating factors. As a large capital importing country, China can use tax treaties to clearly establish the boundaries of its tax base. This is particularly true in the case of tax treaties with OECD Member countries.

During the 1990s and early 2000s, the majority of tax treaties were concluded with developing and transition countries. Arguably, treaty negotiations were motivated by China's interest in promoting Chinese outbound investment.¹¹ Tax treaties are expected to protect China's tax base as a residence country and to prevent double taxation. These tax treaties serve slightly different functions than those with OECD Member countries, as China is more likely to be an exporter of FDI to the treaty partner countries. As such, China might take the stance that is normally taken by OECD Member countries. On the other hand, being a developing country, China might be more sympathetic to the concerns of capital importing countries and be willing to concede to more source-based taxation than a typical OECD Member country.

Recently, China has started renegotiating some of the tax treaties with capital exporting countries, while continuing expanding its treaty network to countries in Africa, Asia and Latin America. The renegotiated tax treaties with Belgium, Finland, Singapore and the United Kingdom have a strong emphasis on anti-avoidance provisions, less emphasis on source-based taxation, and the elimination of tax sparing. These features reflect the stance of a more "mature" tax system. The signalling effect, therefore, appears to be less important.

11. China's outbound investment was located in 132 countries in 2011. See Invest in China, *Summary of China's Outbound Non-financial Investment in 2011*, available at www.fdi.gov.cn/pub/FDI/wztj/jwtztj/t20120119_140581.htm.

2.3. Technical design - the OECD and UN Models

When China decided to introduce an income tax system in the early 1980s as part of the economic reform programme, it had to look to the West and to other developing countries for precedents, especially in the area of international taxation. When it came to tax treaties, the dominance of the OECD Model and UN Model was too obvious. China was eager to be seen as embracing the international tax regime. Therefore, adopting the Models appears to be the only viable option. The only room for debate was the extent of using the UN Model. It took China about two years to negotiate the first tax treaty. Once the China-Japan Income Tax Treaty (1983) had been finalized, it became the model for tax treaties with other OECD Member countries and country-specific variations were kept at a minimum.

Therefore, when it comes to building China's Great Fiscal Wall, China used the design and technology developed by other countries. The OECD Model provides the structure and the text of a tax treaty as a starting point in negotiations. The detailed OECD Commentaries worked like a guidebook. To the Chinese tax administration, this guidebook is invaluable as a learning tool and an operation manual. Recognizing the facts that the OECD Model works better when the two treaty countries have more or less equal flows of income and that China has an imbalanced flow with respect to OECD Member countries, China turned to the UN Model to deal with the imbalance. The extent of reliance on the UN Model was presumably influenced by China's interest in attracting investment from the other country and in securing source-based taxation.

China has been recently involved in developing the OECD Model and the UN Model. As an OECD non-member country, China started participating in discussions on revising the OECD Model or the Commentaries on the OECD Model in the mid 1990s.¹² Delegates from China served as a member of the UN Ad Hoc Group of Experts in the 1990s and the vice chairperson of the UN Committee of Experts on International Cooperation in Tax Matters after 2005. As mentioned in section 6.5., China's participation in these discussions appears to have served China well in becoming an early adopter of some innovative treaty rules (mostly related to anti-abuse).

2.4. Treaty interpretation and practice

The effect of tax treaties depends on how treaty provisions are interpreted and implemented in practice. In China, the State Administration of Taxation (SAT) is the competent authority and responsible for implementing tax treaties.

There is no specific law on the interpretation of tax treaties. China ratified the Vienna Convention on the Law of Treaties (the Vienna Convention) (1969)¹³ in 1997. The

12. P. 427 *OECD Model* (2010).

13. *Vienna Convention of the Law of Treaties* (23 May 1969), Treaties IBFD, also available at http://treaties.un.org/pages/ViewDetailsIII.aspx?&src=TREATY&mtdsg_no=XXIII~1&chapter=23&Temp=mtdsg3&lang=en.

interpretation principles provided in articles 31 and 32 of the Vienna Convention apply in China. The most influential circular on treaty interpretation, Guoshuifa [2010] No. 75 or the Treaty Interpretation Circular,¹⁴ cited the Vienna Convention (1969) in the preamble. Article 3(2) of the OECD Model, which governs the interpretation of undefined terms in a tax treaty, has been incorporated into China's tax treaties so that the domestic law meaning of an undefined term applies for treaty interpretation purposes as long as it is consistent with the context of the tax treaty.

Chinese tax law clearly provides that in the case of any inconsistency between domestic law and the provisions of a treaty, the treaty prevails.¹⁵ The official texts of China's tax treaties are generally in Chinese, the language of the treaty partner and English. In the event of interpretative disputes, the English text generally prevails.

The SAT has the general power to interpret tax legislation and tax treaties. The positions stated in the SAT circulars are rarely contradicted by court decisions. There appears to have been only one court decision on treaty interpretation, which contains minimal reasoning and analysis.¹⁶

The SAT has published a number of circulars on the meaning of certain treaty provisions, such as residence,¹⁷ permanent establishment (PE),¹⁸ beneficial ownership,¹⁹ arm's length principle²⁰ and procedures for claiming treaty benefits.²¹ In most cases, these administrative pronouncements are not treaty-specific. In cases where a circular²² interprets a specific tax treaty, for example, the China–Singapore Income Tax Treaty (2007),²³ the interpretative guidelines are taken to have a more generic application. OECD Commentaries, OECD Transfer Pricing Guidelines²⁴ and other reports, and foreign practices and case law, although not explicitly cited as authorities, appear to have influenced the SAT's interpretation of China's tax treaties. In practice, some SAT officials often use the OECD Commentaries as a reference when giving their

personal opinions in the interpretation of treaty provisions.²⁵ The level of expertise at local levels varies greatly, which may result in inconsistent interpretations across the country.²⁶

On the basis of the SAT interpretation circulars, it appears that the SAT's approach is consistent with article 31 of the Vienna Convention, i.e. "[a] treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in light of its object and purpose". The SAT has rejected the highly textual and/or literal approach in favour of the substance-over-form doctrine.

2.5. Assessing the trends and policy framework

Now that China's treaty network appears to be well established, it is a good time to assess the major trends in China's treaty policy. As all of the tax treaties are based on the OECD Model and incorporate some provisions of the UN Model, the trends are assessed by identifying the differences between tax treaties and trying to make some sense of the differences.²⁷

For this purpose, countries are considered in the following five groups: (1) OECD Member countries; (2) transition countries; (3) treaty heaven countries; (4) developing countries; and (5) countries with a renegotiated tax treaty with China (*see* Table 2 in the Appendix). The research does not cover each and every tax treaty due to time constraints. The selected tax treaties are representative of the types of countries and the time of conclusion of the tax treaty. Renegotiated tax treaties are analysed as a separate group in order to capture the changes in China's treaty policy from the first decade to the third decade. In addition, in order to assess the role of Hong Kong as a gateway for investment (inbound and outbound), Hong Kong's tax treaties are also examined at the end of this article (*see* section 5.8.).

This study is also limited to selected provisions that are more telling of China's major policy concerns about the taxation of business profits, investment income and capital gains, double taxation relief, and miscellaneous provisions. Table 3 in the Appendix summarizes these provisions in the UN Model. With regard to business profits, the study focuses on the incorporation of articles 5 and 7 of the UN Model in respect of the meaning of the term "permanent establishment" relating to construction sites, the provision of services, the activities of agents and limitations on the deduction of expenses in determining the amount of profits attributable to the PE. With regard to investment income, capital gains and other income, the study focuses on provisions in the UN Model that deviate from the OECD Model, such as the rate of withholding taxes, the source-country taxation of gains derived from

14. SAT, Guoshuifa [2010] No. 75, The Interpretation of Provisions of 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.

15. See CN: Enterprise Income Tax of the People's Republic of China art. 58 (promulgated at the 5th session of the 10th National People's Congress of China on 16 March 2007 and issued by Order of President No. 63 on 16 March 2007) (the "EIT Law"). CN: Implementation Regulations for the Enterprise Income Tax Law of the People's Republic of China, National Legislation IBFD was promulgated by State Council on 28 November 2007 and issued by the Order of the State Council No. 512 on 6 December 2007 (the "EIT Regulations").

16. CN: BFIPC, 2001, *PanAm SAT International Systems, Inc. v. Beijing State Tax Bureau*. For a brief discussion of this case, *see* sec. 4.4.4.

17. See sec. 3.3. and 3.4.

18. See sec. 4.3.2.

19. See sec. 5.5.

20. See sec. 5.4.

21. See sec. 3.4.

22. SAT, Guoshuifa [2010] No. 75, *supra* n. 14.

23. Agreement Between the Government of the Republic of Singapore and the Government of the People's Republic of China for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income (11 July 2007), Treaties IBFD [hereinafter: *P.R.C.–Sing. Income and Capital Tax Treaty*].

24. OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD 2010), International Organizations' Documentation IBFD.

25. F. Cao, *Corporate Income Tax Law and Practice in the People's Republic of China*, p. 268 (Oxford U. Press 2011).

26. *Id.*

27. For further discussion of China's tax treaties, *see* B. Arnold & J. Li, *China's Tax Treaty Policy*, in *China Tax Reform Options* p. 78 (T. Fulton, J. Li & D. Xu eds., World Scientific 1998) and M. Lang, J. Liu & G. Tang, *Europe–China Tax Treaties* (Kluwer L. Intl. 2010).

the alienation of shares and other income. Anti-abuse rules covered by this study include the beneficial ownership rule, the arm's length principle, the limitation on benefits (LOB) provision, the general anti-treaty abuse rule and the domestic general anti-avoidance rule (GAAR).

3. Claimants of Treaty Benefits: The Meaning of "Resident"

3.1. "Person"

China's tax treaties typically cover persons who are residents of China and/or the other treaty country. A person is defined to include "an individual, a company and any other body of persons". A "company" means "any body corporate or any entity that is treated as a body corporate for tax purposes".

According to Chinese domestic law, "individuals" are tax units under the Individual Income Tax Law and enterprises are tax units under the Enterprise Income Tax (EIT) Law (2007). The meaning of "enterprise" is much broader than that of a "company" to include for-profit and non-profit entities, but not partnerships and sole proprietorships.²⁸ Other entities include social organizations, associations, foundations, etc.²⁹

For treaty purposes, the SAT interprets the term "person" to have the meaning of "enterprise" under domestic law. Partnerships are not "persons", but associations and foundations, such as charitable organizations and pension funds, are. A trust is not taxed as a separate entity under Chinese law, but it can qualify as a "person" if the law of the treaty partner country taxes the trust as a separate entity.³⁰

3.2. Liable to tax

The meaning of the term "resident of a Contracting State" in China's tax treaties is generally based on article 4(1) of the OECD Model, i.e. any person who, under the laws of that state, is liable to tax therein on the basis of criteria such as domicile, residence, place of head office, place of incorporation or any other criterion of a similar nature.

The meaning of "residence" is, therefore, derived from domestic law. The phrase "liable to tax" is interpreted by the SAT to mean "having the legal obligation to pay tax on a comprehensive basis," but "not actual payment of tax".³¹ Charitable organizations, foundations and pension funds that are exempt from tax under domestic law are regarded as entities that are liable to tax and, therefore, qualify as "residents" for treaty purposes. Similarly, a company that pays no income tax because of tax incentives or loss carryovers is undeniably "resident" for treaty purposes.

3.3. Resident of China

Under Chinese domestic law, the basis for determining an individual's comprehensive, worldwide, tax liability is either domicile or physical presence in China for more

28. Art. 2 EIT Law.
 29. Arts. 2 and 3 EIT Regulations.
 30. Art. 3 Guoshuifa [2010] No. 75, *supra* n. 14.
 31. *Id.*, art. 4.

than one year.³² For this purpose, an individual is considered to have a domicile in China if he or she habitually resides in China due to registered permanent residence, family or economic ties.³³ The tax law concept of "domicile" is tied to citizenship or immigration status. Chinese citizens are subject to a household registration system, which records the "official" address of each citizen. Chinese citizens who are absent from China for a significant period of time for various reasons are often regarded as domiciled in China for tax purposes, even though no serious attempts have been made by the Chinese tax authorities to actually tax their foreign income.³⁴ Non-Chinese citizens living in China are domiciled in China if they receive a permanent residence status, a privilege infrequently bestowed. The full-year physical presence test means that a person stays in China for more than a year, ignoring temporary absences from China (no more than 30 days per absence or no more than 90 days of total absences during the year).

Corporations are liable to comprehensive tax liability in China if they are incorporated in China or have a place of effective management in China.³⁵ Chinese-incorporated companies typically include domestic enterprises, such as state-owned enterprises, collectively owned enterprises, privately owned enterprises, and foreign-investment enterprises, such as joint venture companies and wholly foreign-owned enterprises. Irrespective of the location of the place of management, these domestic-incorporated companies are residents in China and taxable on their worldwide income.

The place-of-effective-management test becomes relevant when a company is incorporated outside China (offshore company). Under Chinese domestic law, the term "place of effective management" refers to "the place that executes substantial and overall management and control over the production and business operations, personnel, finance, properties and other matters".³⁶ This test has become increasingly important in determining the Chinese residence of offshore companies that are controlled by Chinese investors. These offshore entities are often used as vehicles to raise capital, directly or indirectly, by holding shares of a public company whose shares are traded at a stock exchange (typically in Hong Kong or the United States).

Some offshore companies opt for the Chinese residence status to minimize their tax liability. For instance, dividends paid to Chinese investors would be tax exempt in China if the payer and the recipient of the dividends are both residents of China. A company can also rely on the Chinese tax treaties to reduce withholding taxes on invest-

32. Art. 1 EIT Law.
 33. Art. 2 EIT Regulations.
 34. W. Cui, *The Impact of the OECD and UN Model Conventions on China's Tax Treaties*, p. 2 (2011), available at http://works.bepress.com/wei_cui/8.
 35. Art. 2 EIT Law. See J. Li, *Fundamental Enterprise Income Tax Reform in China: Motivations and Major Changes*, 61 *Bull. Intl. Taxn.* 12 (2007), *Journals IBFD* and J. Li & H. Huang, *Transformation of the Enterprise Income Tax: Internationalization and Chinese Innovations*, 62 *Bull. Intl. Taxn.* (2008), *Journals IBFD*.
 36. Art. 4 EIT Regulations.

ment received from third countries. This has reportedly occurred in the case of China Unicom (HK) Ltd., which received a tax refund from Spain under the China–Spain Income and Capital Tax Treaty (1990).³⁷ China Unicom (HK) Ltd. was a listed company in Hong Kong, but had its management and control in China. It held shares in a Spanish company and received dividends. On the basis of the tax treaty, China Unicom (HK) Ltd. claimed a refund of the withholding tax that was withheld at the domestic rate (there was no tax treaty between Hong Kong and Spain).³⁸

Some other offshore companies prefer to avoid Chinese residence to minimize Chinese tax. This is presumably the case where the offshore company does not distribute much of its profits to the shareholders and is not subject to the Chinese controlled foreign corporation (CFC) rules which impute the profits to Chinese resident shareholders.³⁹

The SAT provides the following four criteria for determining if the place of effective management is in China:⁴⁰

- (1) senior management and senior management departments that are responsible for daily production, operation and management of the corporation perform their duties mainly within China;
- (2) financial decisions (such as money borrowing, lending, financing and financial risk management) and personnel decisions (such as appointment, dismissal, salary and wages) are made or need to be approved by organizations or persons located within China;
- (3) main property, accounting books, corporate seal and records of meetings of the board of directors and shareholders of the corporation are located in China; and
- (4) one half or more of the members of the board of directors or the senior management staff of the corporation habitually reside in China.

These criteria are assessed in accordance with the substance-over-form principle.⁴¹ If all of the criteria are met, the place of effective management is in China. An offshore corporation can voluntarily report its Chinese residence status. Otherwise, it may be assessed as such and required to pay Chinese tax as a resident.⁴² The SAT approach to determining corporate residence is presumably inspired

by paragraph 24 of the OECD Commentary on Article 4 of the OECD Model (2010):⁴³

The place of effective management is the place where key management and commercial decisions that are necessary for the conduct of the entity's business as a whole are in substance made. All relevant facts and circumstances must be examined to determine the place of effective management.

The issue of dual residence is resolved through tiebreakers that are based on the OECD Model. In the case of individuals, these tests are permanent home, centre of vital interests, habitual abode, nationality and competent authorities. In the case of corporations, the tiebreaker is either the place of effective management or the place of the head office. The SAT interpretation of the tiebreakers is generally consistent with the OECD Commentary on Article 4.⁴⁴

3.4. Resident of the other contracting state

In order to apply for treaty benefits, a non-resident taxpayer must provide the local tax authorities in China with a residence certificate issued by the competent authority of the other Contracting State.⁴⁵ The SAT has a standard format for proving Chinese residence.⁴⁶

As discussed further in section 5.2., possessing a tax residence certificate in a treaty partner country is not a guarantee for enjoying the benefits of the tax treaty. Treaty benefits may be denied in the case of treaty shopping or other “abuse” situations.⁴⁷

4. Defining China's Tax Base

4.1. Introductory remarks

Tax treaties allocate the jurisdiction to tax business profits, investment income and personal income between the two countries. Treaty language is neutral and applies to both countries without discrimination. Either country can be the source country or the residence country in respect of a specific item of income. In effect, however, because of the imbalance in the flows of income between China and its treaty partner, China is either a predominantly “source country” or a “residence country”.

This section examines how tax treaties define and limit the source country's tax jurisdiction over business profits, investment income, capital gains and personal services income. The emphasis is on identifying and exploring the extent to which the UN Model is incorporated into these tax treaties. To that end, the discussion of each subsequent topic generally begins with a summary of the pertinent provision in the Models, the major differences, if any, between the Models, the incorporation of the provision in Chinese tax treaties and concludes with an overview of the treaty practice in China.

37. *Agreement Between the Government of Spain and the Government of the People's Republic of China for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and on Capital* (22 Nov. 1990), Treaties IBFD.

38. *See Hundreds of Millions of Tax Refund to China from Spain Because of the Treaty Benefits*, available at www.chinaacc.com/new/253_258_201109/05wa1069423316.shtml (in Chinese).

39. Art. 45 EIT Law.

40. SAT, Guoshuifa [2009] No. 82, art. 2.

41. *Id.*, art. 3.

42. SAT Public Bulletin, 2001, No. 45, Measures on the Administration of Tax Matters Regarding Offshore Companies Controlled by Chinese Enterprises.

43. *OECD Model Tax Convention on Income and on Capital: Commentary on Article 4* (22 July 2010), Models IBFD.

44. Art. 4 Guoshuifa [2010] No. 75, *supra* n. 14.

45. SAT, Guoshuihan [2009] No. 395, Notice on Printing the Samples of Resident Certificates of Some Countries and Regions (24 July 2009).

46. SAT, Guoshuihan, [2008] No. 829, Notice on Carrying out the Work of Issuing China Tax Residence Certificate.

47. *See* secs. 5.5. and 5.6.

4.2. “China”

For the purposes of tax treaties, “China” is defined as the territory in which Chinese laws are effectively in force. This is a subtle way of indicating that, at present, China refers to “Mainland China”. China’s existing tax treaties do not apply to Hong Kong, Macau or Taiwan.

Chinese domestic tax laws regard Hong Kong, Macau and Taiwan as foreign jurisdictions and treat residents in these three regions as “non-residents” of China. In fact, China has entered into a “tax arrangement” with Macau and Hong Kong⁴⁸ that is similar to the standard tax treaties.⁴⁹

4.3. Business profits

4.3.1. Overview

China’s tax treaties generally follow the principle codified in article 7(1) of the OECD Model and UN Model, i.e. business profits of an enterprise resident in a treaty country are taxed in the other country only where the enterprise carries on business in that country through a PE and the profits are attributable to the PE. This principle is subject to two notable exceptions. First, business profits in the form of income from immovable property are taxable in the country in the source country, i.e. where the property is located (article 6 of the OECD Model and UN Model). Second, business profits of international shipping and air transportation enterprises are taxable exclusively in the residence country (article 8 of the OECD Model and UN Model). The rationale underlying these two exceptions applies to the gains realized from the disposal of shares of companies whose value is derived principally from immovable property and shares of international transportation companies (*see* section 4.4.5.).

The application of article 7 is supported by three other provisions: (1) article 5 defines the scope of a PE; (2) article 9 provides for the arm’s length principle that governs the attribution of profits to a PE; and (3) article 14 deals with a specific type of business profits, i.e. income from independent services, which has been removed from the OECD Model (2000),⁵⁰ but remains in China’s tax treaties. Table 4 in the Appendix shows the incorporation of articles 5 and 7 of the UN Model in Chinese tax treaties.

4.3.2. PEs

4.3.2.1. General definition

Article 5(1) of the two Models is identical in defining the term “permanent establishment” to mean “a fixed place of business through which the business of an enterprise

is wholly or partly carried on”. It is found in China’s tax treaties.

The SAT Treaty Interpretation Circular provides the following guidance on the interpretation of this provision: (1) the physical place of business can be owned or rented by the enterprise; and (2) it can be an office, a branch, a hotel room, or equipment, a warehouse, a site or a retail stall in a shopping mall. The place of business must be fixed and its existence has a sense of permanence. The notion of “fixed” encompasses activities conducted at several locations within a geographical proximity. For instance, when an enterprise uses several rooms in the same hotel, the hotel can be regarded as a fixed place or, when an enterprise sets up several booths in the same marketplace, the marketplace may be regarded as a fixed place of business.⁵¹ The temporal permanence of a place of business is not affected by temporary suspension of the business. In other words, a place of business qualifies as a PE when it is intended to be “permanent”, but was terminated due to failure in business after a short period of time in operation. In addition, when a place of business is created for a temporary purpose, but ends up having a longer existence, it is regarded as a PE.

The SAT broadly interprets the phrase “the business of an enterprise is wholly or partly carried on” through the fixed place of business, i.e. “any circumstances where the enterprise carries on activities at any location at its disposal”.⁵² The SAT provides the following two examples: (1) if the enterprise signs contracts with customers in China and the contracts are performed at a place of business in China, the enterprise is considered to be carrying on business through the place; and (2) if the place makes substantial contributions to the relationship between the enterprise and its Chinese clients, even if the contract is concluded directly by the enterprise and the client, the enterprise is considered to be carrying on its business through the place of business in China.

4.3.2.2. Fixed place of business

Article 5(2) of the OECD Model and UN Model provides the following non-exhaustive list of examples of fixed places of business as PEs: a place of management; a branch; an office; a factory; a workshop; and a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.

Article 5(2) is generally found in Chinese tax treaties. The SAT Treaty Interpretation Circular clarifies that “a place of management” within the meaning of article 5 is different from the “place of effective management” for the purposes of determining corporate residence. Specifically, it refers to a representative office that represents the enterprise in taking some management functions and these functions are not the same as those performed by the head office. “A mine, an oil or gas well, a quarry or other place of extraction of natural resources” is limited to situations where the enterprise has made investment and has

48. *The Joint Declaration of the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the People’s Republic of China on the Question of Hong Kong*, the “Hong Kong Agreement” signed in September 1984, following extensive negotiations between the Chinese and British governments. The Hong Kong Agreement sets out the basis on which Hong Kong will be returned to Chinese sovereignty in 1997.

49. A similar arrangement has been negotiated with Taiwan, but, at the time of the writing of this article, had not yet been published.

50. *OECD Model Tax Convention on Income and on Capital* (29 Apr. 2000), Models IBFD.

51. Art. 5 Guoshuifa [2010] No. 75, *supra* n. 14.

52. *Id.*

obtained the right to extract and operate the resources. It does not include situations where an enterprise is engaged to provide contractual engineering services to explore or develop natural resources.⁵³

4.3.2.3. *Contract engineering and services*

Article 5(3) of the UN Model differs from the OECD Model in two respects. The OECD Model contains one paragraph, stating that a “building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months”. The UN broadens the PE definition by providing that a PE also encompasses:

- (1) a building site, a construction, assembly or installation project if the activities last more than six months;
- (2) the rule in (1) also applies to supervisory activities in connection with a building site, a construction, assembly or installation project; and
- (3) the “furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only if activities of that nature continue (for the same or a connected project) within a Contracting State for a period or periods aggregating more than 183 days in any 12-month period commencing or ending in the fiscal year concerned”.

China's tax treaties generally follow the UN Model (see Table 4 in the Appendix), although the time period may vary from six months to nine months, three months or even twelve months in some tax treaties.⁵⁴ In terms of measuring the time period for the activities in connection with a building site, construction, assembly or installation project (referred to as “contractual engineering activities” in the Treaty Interpretation Circular) or related supervisory activities, the SAT takes the position that the period begins on the first date of implementation of the contract (including preparation work) and ends on the date when the project is completed and ready for use (including trial operation). Once the clock starts, it does not stop to account for the pause of work due to the lack of equipment, materials or bad weather.

If a main contractor subcontracts part of its work to a subcontractor, the time of the subcontractor is treated as part of the time for the main contractor. Supervisory activities of a general contractor generally include the work performed by a subcontractor as well as by an independent project supervision contractor.⁵⁵ If an enterprise undertakes two or more contractual projects at one work site in China and these projects are commercially and geographically connected to form a whole project, these contracts should be aggregated and the time period for the whole project should begin from the commencement of the first contract and end on the completion of the last project.

53. Id.

54. For an overview of China's tax treaties with European countries, see T. Ecker & J. Tang, *Business Profits (Articles 5, 6, 7, 8, 9 and 14 OECD Model)*, in Lang, Liu & Tang, *supra* n. 27, at pp. 33-78.

55. Guoshuifa [2010] No. 75, *supra* n. 14. A separate PE may exist for the independent supervision contractor, depending on the period of time of its activities in China.

Examples include separate contracts for different types of projects on a construction site or the highway construction project that changes the site with the progression of the work.

For the purposes of article 5(3), the services of an enterprise may be provided by an employee or other personnel engaged by the enterprise who perform services under the control and direction of the enterprise.⁵⁶ The SAT Treaty Interpretation Circular interprets services to include engineering, technical, management, design, training and consulting. In measuring the time period, for example, six months or 183 days, the clock starts on the date when the employees first arrive in China and stops when the project is completed and ready for use by the client, but include only the days when the employees are actually in China. When there are multiple employees working on the contract concurrently, the counting is based on the number of days, irrespective of the number of employees working in China. For instance, an enterprise may have 10 employees working in China for 20 days without giving rise to a PE, but an enterprise having one employee working in China for 200 days does. The period or periods for the same project or a connected project are aggregated. The SAT considers the following three factors relevant to determine if projects are connected: (1) whether they are included in a master contract; (2) if the projects are governed by different contracts, whether those contracts are signed by the same or related enterprises and whether the implementation of the first project is the prerequisite condition for the implementation of the second project; and (3) whether the nature of those projects is the same and whether those projects are performed by the same people.

4.3.2.4. *Preparatory and auxiliary activities*

Preparatory and auxiliary activities carried out by an enterprise through a fixed place of business or agents do not give rise to a PE under either the OECD Model or the UN Model. The two Models differ, however, in dealing with the use of facilities or the maintenance of stock for the purpose of delivery of goods or merchandise, i.e. such activity constitutes a PE under the UN Model, but not under the OECD Model.

China's tax treaties generally follow the OECD Model.⁵⁷ According to Guoshuifa [2010] No. 75,⁵⁸ places used to carry out preparatory and auxiliary activities generally have the following characteristics:

- There are no independent business activities performed in the place. The activities performed do not constitute an essential or key part of the enterprise's business activities as a whole.
- The activities are those listed in the tax treaty and are performed only for the enterprise and not for any other enterprises.

56. Id., art. 5(3).

57. See Ecker & Tang, *supra* n. 54, at p. 62.

58. Art. 5(4) Guoshuifa [2010] No. 75, *supra* n. 14.

- The responsibility is limited to the nature of routine activities, not activities that directly generate business profits. The key is to determine if the activity is auxiliary to the main business activity or is the business proper. For instance, purchasing activities may be auxiliary if the purchasing is for the enterprise, but, if the procurement is for the clients of the enterprise, the activities in China are of the business proper, not auxiliary within the meaning of article 5(4).

4.3.2.5. *Agents and insurance premiums*

In addition to a “fixed place of business”, both Models deem an agent to constitute a PE under certain conditions. In the case of a dependent agent, a key condition is that the agent “has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name of the enterprise”. Both Models provide that independent agents are not deemed to be a PE. The UN Model deviates from the OECD Model in three respects and deems an agent to be a PE where: (1) a person without the authority to conclude contracts in the name of the enterprise is nonetheless considered to be a dependent agent if that person “habitually maintains a stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of the enterprise” (article 5(5)(b) of the UN Model); (2) an independent agent is considered not to be independent when his/her activities are devoted wholly or almost wholly on behalf of one enterprise (article 5(7) of the UN Model); and (3) an insurance company collecting premiums in another state is deemed to have a PE in that other state under article 5(6) of the UN Model.

China’s tax treaties do not universally follow the UN Model. In fact, article 5(6) of the UN Model is rarely adopted in tax treaties with OECD Member countries, let alone those with transition and developing countries (see Table 4 in the Appendix).

The SAT interpretation of agency PE is governed by the substance-over-form principle. The “authority to conclude contracts” means not only “signing” contracts, but also “participating in contractual negotiations and discussion of contractual terms”.⁵⁹ For this purpose, “contracts” refer to those relating to the business of the enterprise, and not contracts dealing with internal affairs of the enterprise, such as employment contracts. The term “habitually exercise” does not necessarily mean the frequency of participation in negotiations or the number of contracts concluded. Its meaning in a given situation depends on the nature of the contract involved, the nature of the business of the enterprise and the frequency of the agent’s activities. Some contracts require extensive, time-consuming negotiations (such as the purchase of airplanes and shipping vessels) and the conclusion of a single contract may give rise to a PE.

In determining whether or not an agent is an independent agent whose activities do not give rise to a PE for the principal, the SAT requires the agent be legally and eco-

59. Id., art. 5(5).

nomically independent. The independence of an agent is determined by considering three questions: (1) is the agent independent in conducting business activities?, i.e. if the principal provides specific instructions and exercises overall control over the activities of the agent, the agent is not independent; (2) who bears the commercial risk?, i.e. if the risk is borne by the principal, the agent is not independent; and (3) how many principals does the agent have?, i.e. if the agent represents only one enterprise during a significant period of time, then the agent is not independent.

4.3.2.6. *Subsidiary as PE*

A subsidiary of a company does not, on its own, constitute a PE for the parent under both Models (article 5(7) of the OECD Model and article 5(8) of the UN Model).

China’s tax treaties contain this provision. In determining whether the activities of a subsidiary constitute a PE for its parent, Guoshuifa [2010] No. 75 looks at whether the personnel seconded to the subsidiary are under the direction and control of the subsidiary or whether the subsidiary acts as an agent for the parent. Seconded employees from the parent may be considered to be working for the parent, not the subsidiary, if one of the following conditions is met:⁶⁰

- the parent has control over these employees and bears the related risk and responsibilities;
- the parent decides the number and qualifications of these employees;
- the parent bears the cost of compensation; or
- the parent earns profits by sending these people to work at the subsidiary.

The Circular does not mention the period of time required for the employees to work in China to satisfy the PE test.

4.3.3. *Attribution of profits to a PE*

4.3.3.1. *Introductory remarks*

Both Models contain a basic principle for attributing business profits to a PE, i.e. business profits derived by an enterprise resident in a contracting state through a PE in another contracting state are taxable to the extent of profits attributable to the PE. The UN Model deviates from the OECD Model in several respects to broaden the tax base of the source country.

4.3.3.2. *Profits attributable to a PE*

Under article 7(1) of the UN Model, the attributable profits also include the profits that are attributable to the “sales in that other State of goods or merchandise of the same or similar kinds as those sold through the permanent establishment”, or “other business activities carried on in that other State of the same or similar kind as those effected through that permanent establishment”. In other words, the UN Model contains a limited force of attraction.

60. Id., art. 5(7). The services fees paid by the subsidiary to the parent must be reasonable to be deductible to the subsidiary.

China's tax treaties do not contain such force of attraction principle.⁶¹ The SAT interprets "profits attributable to a PE" to include not only the profits derived by the PE from Chinese sources, but also income earned from both inside or outside China that is effectively connected to the PE, such as dividends, interest, rent and royalties.⁶² The term "effectively connected" means that there is an ownership or effective management relationship in respect of the underlying equity, debt, industrial property or equipment.

Article 7(5) of the OECD Model further clarifies that no profits are attributed to a PE by reason of the mere purchase by that PE of goods or merchandise for the enterprise. This provision is missing in the UN Model as the UN Ad Hoc Expert Group saw no need in including such provision.⁶³

Since under Article 5 an office or facility maintained by an enterprise in a Contracting State in the other Contracting State for mere purchase of goods or merchandise does not constitute a permanent establishment, there would be very few cases where an enterprise having a permanent establishment dealing with other business would also have a purchasing facility for the enterprise.

China's tax treaties generally contain article 7(5) of the OECD Model. The SAT Treaty Interpretation Circular reiterates the point that this rule applies only to the purchase of goods or merchandise for the enterprise and any expenses incurred by the PE in respect of such purchasing activities are not deductible in computing the profits attributable to the PE. If the only activities of the place of business of an enterprise are the purchasing of goods or merchandise for the enterprise, there is no PE, therefore, no need to apply article 7.

4.3.3.3. *Distinct and separate entity*

Article 7(2) of the two Models is identical, providing that central principle in attributing profits to a PE, i.e. the profits attributable to a PE are the profits which the PE might be expected to make "if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment". This provision extends the arm's length principle to the attribution of profits by deeming a PE to be a distinct enterprise dealing at arm's length with the enterprise and other PEs of the enterprise.

China's tax treaties contain article 7(2). The SAT Treaty Interpretation Circular recognizes the importance of the arm's length principle in attributing profits to a PE and expects fair market prices to be used in determining the profits derived by a PE from transactions with the enterprise and other PEs of the enterprise.

4.3.3.4. *Limitations on deduction*

Article 7(3) of the Models contains rules for allowable deductions and the UN Model is more restrictive. The pre-2010 OECD Model provides that:

there shall be allowed as deductions expenses which are incurred for the purposes of the business of the permanent establishment including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere.

The UN Model continues with a prohibition of any deduction for expenses, other than reimbursement of actual expenses, paid by the PE to its head office by way of: (1) royalties, fees or other similar payments in return for the use of patents or other intangibles; (2) management fees and other fees for services; and (3) interest, except where the enterprise is a bank.⁶⁴ Intuitively, these prohibitions contradict the principle of treating each PE as an independent enterprise dealing at arm's length with its head office, but do serve the purpose of attributing more profits to a PE, thereby broadening the tax base of the source country that would otherwise be the case under the OECD Model.

China's tax treaties with OECD countries generally incorporate article 7(3) of the UN Model, but tax treaties with transition countries or developing countries generally do not.⁶⁵ The SAT Treaty Interpretation Circular reiterates the principle that all expenses incurred for the purpose of the PE, irrespective of where the expenses are incurred, are deductible in computing the profits of a PE. The deductible expenses include those that are not directly related to the PE, but are general and administrative expenses allocated to the PE by the head office. However, the expenses that are allocated to the PE must be incurred for the purpose of the PE and the amount must be reasonable. The enterprise is required to prove the reasonableness of the amounts by providing information on the scope and amount of the total expenses and the basis and methodology for allocation.

4.3.3.5. *Deemed profits or apportionment of profits*

Article 7(4) and 7(5) of the two Models are identical. Article 7(4) allows the determination of the profits attributable to a PE on the basis of an apportionment of the total profits of the enterprise to its various parts insofar as it has been customary to use the apportionment method in the contracting state and the method is used in accordance with the principles contained in article 7. Article 7(5) requires that the same method be used year by year, unless there is a good and sufficient reason to the contrary.

61. Ecker & Tang, *supra* n. 54, at p. 35.

62. Art. 7(1) Guoshuifa [2010] No. 75, *supra* n. 14.

63. *UN Model Tax Convention on Income and on Capital: Commentary on Article 7* (1 Jan. 1980), Models IBFD. The *UN Model* (2011) notes at the end of art. 7 that "The question of whether profits should be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods and merchandise for the enterprise was not resolved. It should therefore be settled in bilateral negotiations".

64. Art. 7(3) of the *UN Model* also states that "no account shall be taken, in the determination of the profits of a permanent establishment, for amounts charged (otherwise than towards reimbursement of actual expenses), by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payments in return for the use of patents or other rights, or by way of commission for specific services performed or for management, or, except in the case of a banking enterprise by way of interest on moneys lent to the head office of the enterprise or any of its other offices".

65. Ecker & Tang, *supra* n. 54, at pp. 40-43.

China's tax treaties generally include article 7(4) and (5).⁶⁶ Under Chinese domestic law, it has been customary to use the deemed profit methods in computing taxable income of non-resident enterprises carrying on business in China.⁶⁷ The deemed profit methods are used when enterprises do not maintain accurate accounting books and cannot declare and pay taxes on an actual basis.⁶⁸ There are three bases for determining the deemed profits: (1) total revenue; (2) costs and expenses; and (3) operating expenditures. The deemed profits rates are 15% to 30% for engineering projects, design and consulting services; 30% to 50% for management services; and not less than 15% for other services or other businesses.⁶⁹

The SAT Treaty Interpretation Circular recognizes the possible differences in the outcome of using the apportionment method and actual profit method (based on the accounting records of the taxpayer). The SAT also acknowledges the difficulties in applying the apportionment method, as it is not easy to determine and verify the total profit of the non-resident enterprise. It is difficult for the tax authorities of the source country to determine the profit of the head office or the taxable profit as assessed by the tax authorities in the residence country.

4.4. Investment income, capital gains and other income

4.4.1. Overview

Treaty provisions on dividends, interest, royalties, capital gains and other income are good indicators of the scope of source-country taxation. Because the residence country always has the jurisdiction to tax such income and the obligation to provide relief from double taxation, tax treaties differ in respect of the scope of source taxation. As in the case of business profits, the extent of incorporation of the UN Model in China's tax treaties reveals China's treaty policies. An overview is presented in Table 5 in the Appendix.

4.4.2. Dividends

Article 10 of the OECD Model and the UN Model are largely identical.⁷⁰ The source country is defined to be the residence country of the company that pays the dividends

66. A small number of China's tax treaties do not contain these two provisions. Examples are the original tax treaty with the United Kingdom and the tax treaty with Turkey.

67. For further discussion, see Cao, *supra* n. 25, at pp. 33-43 and P. Tao & S. Kim, *A Brief Examination of Recent Chinese Tax Rules on Nonresident Enterprises*, *The Tax Mag.* p. 35 (Dec. 2009) and *An Update on Recent Chinese Tax Rules on Nonresident Enterprises*, *The Tax Mag.* p. 33 (Nov. 2010).

68. SAT, Guoshuifa [2010] No. 19, Notice on the Administrative Measures Concerning Income Tax Collection on Non-resident Enterprises on Deemed Basis (20 Feb. 2010).

69. It is questionable as to whether or not the deemed 15% profit rate (previously, 10%) is consistent with article 7 of tax treaties. Ecker & Tang, *supra* n. 54, at pp. 40-41.

70. As the UN Model has art. 14 (independent personal services), when a PE is referred to in the OECD Model, the "fixed base" concept is included in the UN Model in respect of determining if the dividends are connected to a PE or fixed base to be taxed under art. 7, as opposed to art. 10. The UN Model also leaves the withholding tax rate blank to allow the two countries greater flexibility.

(article 10(1)). As long as the beneficial owner of dividends is a resident of the other contracting state, the treaty rates of withholding tax apply. Both Models permit split rates for direct dividends and portfolio dividends. The UN Model leaves the specific rates blank, but the OECD Model sets a 5% rate for direct dividends and 15% rate for portfolio dividends. In order to qualify for the lower rate, the OECD Model requires the shareholder to hold directly at least 25% of the capital of the company paying the dividends (article 10(2)), whereas the UN Model requires the shareholder to hold directly at least 10% of the capital of the company paying the dividends. Dividends that are effectively connected with a PE of the shareholder in the source country are taxable under article 7 (article 10(4)).

China's tax treaties closely follow the OECD Model with the exception of the split rates. The majority of these tax treaties provide for a single withholding tax rate, although more recent tax treaties use split rates (see Table 5 in the Appendix). The standard rate of withholding is 10%.⁷¹ In the case of split rates, 5% is generally used for direct dividends. In addition, some of the recent Chinese tax treaties contain a specific anti-abuse provision, which is discussed in more detail in section 5.6.

Chinese domestic law imposes a 10% withholding tax on dividends received by a non-resident, irrespective of the percentage of equity ownership.⁷² For treaty purposes, the term "dividends" is interpreted to include the amount of interest that exceeds the limits under the thin capitalization rules and is taxed as dividends under domestic law.⁷³ The distinction between debt and equity (interest and dividends) is based on the substance-over-form principle. If the form of investment is debt but the lender actually bears the risks of the borrowing company, the interest can be regarded as a dividend. The SAT Treaty Interpretation Circular sets forth the following factors in determining whether or not a lender shares the risks of the company:

- the amount of the loan significantly exceeds other forms of investment in the company and is substantially unmatched by assets with liquidity;
- the lender shares in any profits of the company;
- the repayment of the loan is subordinated to claims of other creditors or to the payment of dividends;
- the level of payment of interest depends on the profits of the company; and
- the lending contract does not specify the exact date of repayment.

The equity ownership percentage required to qualify for the lower rate for direct dividends includes both direct ownership and indirect ownership. The SAT's policy is

71. The 15% rate is used in very few tax treaties, such as those with Australia, Canada and the Philippines; and a 10% rate is used for portfolio dividends in the tax treaty with the Philippines and a 7% rate in the tax treaty with Austria.

72. Art. 91 EIT Regulations. Until 2008, the rate was zero. See CN: Income Tax Law of the People's Republic of China for Enterprises with Foreign Investment and Foreign Enterprises art. 19, National Legislation IBFD promulgated by the National People's Congress on 9 April 1991 (the "FIET Law").

73. Art. 10 Guoshuifa [2010] No. 75, *supra* n. 14.

to look at the equity ownership of a non-resident investor during a 12-month period prior to the receipt of dividends. If the required equity ownership ratio (typically 25%) is exceeded at any time during this period, the lower treaty rate applies.⁷⁴

4.4.3. Interest

Article 11 of the OECD Model is largely reproduced in the UN Model, except that the UN Model leaves the rate of withholding tax blank (as in the case of article 10(2)).⁷⁵ The source country is determined by the payer's residence or under the base-erosion rule. Under the base-erosion rule, where a Chinese non-resident has a PE in China and pays interest to a beneficial owner resident in the other contracting state, if the interest is borne by the company's PE in China, the interest is deemed to arise in China. Interest may be taxed as business profits under article 7 if it is effectively connected with a PE of the beneficial owner in the source country. Article 11(6) clarifies that the treaty reduced rate is not available to the amount of interest that exceeds the arm's length amount due to a special relationship between the payer and the beneficial owner or between both of them and some other person.

China's tax treaties follow the OECD Model. Chinese domestic law imposes a 20% withholding tax on interest received by a non-resident.⁷⁶ This rate is reduced to 10% by Chinese tax treaties.⁷⁷ A zero rate is generally provided for interest on loans received by the "government" or "policy banks" (such as the China Development Bank, the Export-Import Bank and their equivalent in the other contracting state).⁷⁸ Interest that is effectively connected with a PE in China is taxable at the standard corporate tax rate of 25% on a net basis.⁷⁹

The SAT Treaty Interpretation Circular clarifies that guarantee fees are treated as interest for the purposes of article 11, but only if the guarantee is attached to the debt that generates the interest, not provided as an independent transaction.⁸⁰ In the case of interest received by a beneficial owner who is a resident of a treaty country from an enterprise that is a resident of a third country but maintains a PE in China and the interest expense is borne by the PE, the interest is deemed to arise in China and eligible for the treaty reduced rate. However, if the debt is shifted by the third-country resident to the Chinese PE to take advantage of the tax incentives available to the PE, the reduced treaty rate does not apply.⁸¹ Some renegotiated tax treaties also contain a general anti-abuse rule in article 11 and/or article 12 (see section 5.6.).

74. SAT, Guoshuihan [2009] No. 81, Notice on the Implementation of Tax Treaty Provision on Dividends, Circular No. 75, Article 10.

75. Art. 11(4) and (5) of the *UN Model* also refers to "fixed base" to reflect the fact that art. 14 is a separate provision in the *UN Model*, but not in the *OECD Model*.

76. Art. 3 EIT Law.

77. Some tax treaties provide for a lower rate. For instance, a 7% rate is used in the tax treaties with Algeria and Hong Kong, a 7.5% rate in the tax treaties with Cuba, Jamaica and Nigeria; and a 5% rate in the tax treaties with Kuwait and Laos.

78. For instance, art. 11 of the *P.R.C. - Sing. Income and Capital Tax Treaty*.

79. *Id.*, art. 3.

80. Art. 11 Guoshuifa [2010] No. 75, *supra* n. 14.

81. *Id.*

4.4.4. Royalties

The scope of source taxation is much broader under the UN Model than under the OECD Model, which provides for exclusive jurisdiction to the residence country. The UN Model allows the source country to tax royalties at a limited rate (left blank) and expands the definition of "royalties".

The definition of "royalties" under the UN Model is the same as under earlier OECD Model (1992),⁸² including equipment rental as royalties. Both Models include in the definition of royalties payments for the use of or the right to use industrial property (copyright, patent, trademark, design or model, plan, secret formula or process and payments for information concerning industrial, commercial or scientific experience).

Article 12(4) of the UN Model provides that royalties that are effectively connected with a PE are covered by article 7. Article 12(5) defines the source of royalties to be the payer's residence country. However, if the payer has a PE in one of the treaty countries and the royalties are incurred in connection with the PE and are borne by such PE, whether or not the payer is a resident of that country, the royalties are deemed to arise in that country. In other words, the "base-erosion" test trumps the payer's residence test. Under article 12(5) of the UN Model, if by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of royalties, in excess of the arm's length amount, is not eligible for the reduced rate.

China's tax treaties follow the UN Model. Many treaties allow a lower rate (6% or 7%) of withholding tax on equipment rental (which is the lower rate shown in Table 5 in the Appendix).⁸³

The SAT Treaty Interpretation Circular offers some guidance on the meaning of "royalties".⁸⁴ Royalties in respect of industrial or intellectual property rights include payments for such rights whether such rights are registered under Chinese law or whether the payments are made under a licence or for damages for infringement. The term "information concerning industrial, commercial or scientific experience" should be understood as "proprietary technology". Proprietary technologies generally refer to the information that is not disclosed to the public and is necessary for the duplication of a product or a production process. Royalties on licensing proprietary technologies usually involve the permission to use such information by a licensee where the licensor does not normally participate in the implementation of the technology and does not guarantee the result of such implementation. The licensed technology normally already exists, but may include technologies to be developed subsequently pursuant to the needs of the licensee and the use of which is subject to the confidentiality provision of the contract.

82. *OECD Model Tax Convention on Income and on Capital* (1 Sept. 1992), Models IBFD was amended in to eliminate equipment rental from art. 12.

83. Very few tax treaties deviate from the 10% rate. For instance, the rates are 25% and 10% in the tax treaty with Brazil, 15% and 10% in the tax treaties with Malaysia and the Philippines, and 12.5% in the tax treaty with Pakistan. Presumably, these rates were insisted on by the other country.

84. Art. 12 Guoshuifa [2010] No. 75, *supra* n. 14.

In respect of the distinction between service fees that are subject to article 7 (and/or article 14 under the UN Model) and royalties covered by article 12, the SAT provides the following guidance:

- With regard to services furnished under a general contract, if proprietary knowledge and technologies are used in the process of providing services, in the absence of a licence for the use of such knowledge or technologies, the fees paid for services are not royalties. However, if certain proprietary property is developed during the process of providing services and the service provider owns the property and the client only has a right to use, the fees paid for such services fall within the scope of royalties.⁸⁵
- With regard to technical support and instructions provided by the licensor in connection with the transfer or licensing of technology, the fees paid for such technical services are in the nature of royalties, whether the fees are charged separately or as part of the licence fees. However, if the services give rise to a PE, the service fees attributable to the PE are taxable under article 7.⁸⁶
- Fees paid in respect of after-sales services, warranties, professional services of engineering, management and consultancy are not in the nature of royalties.⁸⁷

In addition, payments to a non-resident company for transmitting Chinese TV programmes by satellite to different parts of the world are characterized as equipment rentals sourced in China for the purposes of the China–United States Income Tax Treaty (1986).^{88,89} The SAT interpretation was upheld by the Beijing Intermediate Court and Beijing High Court in *PanAmSat International Systems, Inc.* (2001).⁹⁰

PanAmSat is arguably the only reported court decision on a substantive tax matter. In this case, the taxpayer was a resident of the United States. It argued that the payments at issue were for services provided and not for the right to use any equipment on the following grounds:

- (1) The equipment was at all times under its control and operation and the Chinese client, CCTV, had no right to operate such equipment, and the equipment itself could not automatically execute the contract with CCTV. In other words, CCTV had no right to use any equipment and the only person who could and

did use the equipment was PanAmSat. CCTV only had the right to use a specified bandwidth.

- (2) The characterization of income should be based on the contract between PanAmSat and CCTV. The contract clearly stated that PanAmSat was to provide transmission services and that no right to use any property was transferred to CCTV.
- (3) The payments for the services provided under the contract gave rise to business profits for the purpose of the China–United States Income Tax Treaty (1986). As PanAmSat did not carry on business in China through a PE, such income was not taxable in China.

These arguments were rejected by the First Intermediate People’s Court of Beijing. The Court held that CCTV had the right to use a specified bandwidth and such bandwidth was part of the satellite system, and the payments for such fell within the scope of “royalties” for the purposes of the tax treaty. The services provided by PanAmSat were subordinate to the use of the satellite system. Article 11 of the China–United States Income Tax Treaty (1986) also does not explicitly state that the “right to use” any industrial, commercial or scientific equipment is limited to the “actual possession and operation” of such equipment. Accordingly, the fact that CCTV did not actually possess and operate the satellite system could not support the conclusion that the payments gave rise to services fees taxable as business profits. The Intermediate Court’s decision was upheld by the Higher People’s Court of Beijing.⁹¹ This case has been controversial among Chinese commentators.⁹²

4.4.5. Capital gains

Both Models allow the source country to tax gains from the disposal of immovable property, movable property forming part of the business property of a PE (article 13(1) (2)) and allow gains from the disposal of ships and aircraft operated in international traffic and for boats engaged in inland waterways transport and movable property pertaining to the operation of such ships, aircraft and boats to be taxed in the country in which the place of effective management of the enterprise operating such ships, aircraft and boats is situated.

Under articles 13(1) and 13(2), the source of gains is determined by the location of immovable property and the PE. With regard to gains from the alienation of shares deriving more than 50% of their value directly or indirectly from immovable property, article 13(4) of the UN Model (1980)⁹³ allows the state where the immovable property is situated to tax the gains so that gains from the alienation of

85. Id.

86. Id. The Circular continues to state that the individuals who provide the services are subject to art. 15 of the tax treaty.

87. Id. and SAT, Guiguohan [2009] No. 507, Notice on the Relevant Issues of the Application of Royalty Article of Double Taxation Agreements (14 Sept. 2009).

88. *Agreement Between the Government of the United States of America and the Government of the People’s Republic of China for the Avoidance of Double Taxation and the Prevention of Tax Evasion with respect to Taxes on Income* (30 Apr. 1984), Treaties IBFD [hereinafter: *P.R.C.–U.S. Income Tax Treaty*].

89. SAT, Guoshuihan [1999] No. 566, Reply on Issues Concerning the Imposition of Tax on Rental Income Derived by PanAmSat from Leasing Satellite Communication Lines to CCTV (19 Aug. 1999).

90. CN: BFIPC, 2001, *PanAmSat International Systems, Inc. v. Beijing State Tax Bureau*, yizhonghang chuzi No. 168 Administrative Judgement.

91. The Chinese text of this decision is available at <http://shlx.chinalawinfo.com/NewLaw2002/SLC/slc.asp?db=fnl&gid=117487335>.

92. See Cui, *supra* n. 34; G. Tan, *Tax Treaties’ Interpretation and Application under the Challenges of the Digital Economy – Issues Raised by PANAMSAT v. Beijing State Tax Bureau*, 16, *Revenue L. J.* 1, p. 99 (2006); and S. Hao, *The PanAmSat Case and Distinction between Business Profits and Royalties*, in *Wuda Guojie* (reproduced by the China Academic J. Elec. Publ. H. at www.cnki.net) (in Chinese).

93. The *UN Model* (2001) extends this rule to interests in a partnership, trust or estate.

such shares and gains from the alienation of the underlying immovable property are equally taxable in the source country. A similar provision was added to the OECD Model (2003).⁹⁴ Article 13(5) of the UN Model, which has no equivalent in the OECD Model, further allows a state to tax gains from the alienation of shares (other than those covered by article 13(4)) representing a specified percentage of shares in a company which is a resident of that state. In other words, the source of such gains is determined by the residence of the company whose shares are alienated. The UN Model leaves the required equity ownership percentage to be determined through bilateral negotiations. With regard to gains from the alienation of any property other than that specifically covered by the rest of article 13, neither Model allows the source country to tax such gains.

Article 13(4) of the UN Model is found in many of China's tax treaties (see Table 5 in the Appendix). Article 13(5) is contained in all renegotiated tax treaties and 40% of the tax treaties with European countries.⁹⁵ The specified percentage of equity ownership under article 13(5) is generally 25%, which coincides with the percentage used for distinguishing between direct dividends and portfolio dividends for the purposes of article 10. Some more recent tax treaties include a clause that is now found in the UN Model (2011), i.e. the equity ownership is determined during the 12-month period preceding the alienation. In addition, some recent tax treaties exclude shares of publicly traded companies from the scope of article 13(5).⁹⁶ Some of China's tax treaties reject the catch-call provision of both Models by allowing the source country to tax gains from the alienation of "other property".⁹⁷

Chinese domestic laws provide for extensive source-based taxation of capital gains, including gains from the sale of shares in the capital stock of Chinese resident companies.⁹⁸ The taxation of gains from the alienation of shares in Chinese resident companies has been subject to much administrative interpretation.⁹⁹ The meaning of "shares of the capital stock of a company the property of which consists directly or indirectly principally of immovable property situated in China" is interpreted as follows:

- The term "immovable property" has the same meaning as under Chinese domestic law, which includes land use rights.

94. OECD Model Tax Convention on Income and on Capital (28 Jan. 2003), Models IBFD.

95. B. Folhs & W. Guo, *Capital Gains (Article 13 OECD Model)*, in Lang, Liu & Tang, *supra* n. 27, at pp. 139-162.

96. This is similar to the suggested version in *UN Model Tax Convention on Income and on Capital: Commentary on Article 13* para. 13 (1 Jan. 2011), Models IBFD.

97. Folhs & Guo, *supra* n. 95 demonstrate such deviation in China's tax treaties with Albania, Austria, Bosnia and Herzegovina, the Czech Republic, Denmark, Finland, France, Germany, Hungary, Italy, Norway, Romania, the Slovak Republic, Spain and Sweden.

98. Art. 3 EIT Law and Art. 7(3) EIT Regulations.

99. See, for example, Guoshuifa [2010] No. 75, *supra* n. 14 and SAT, Guoshuihan [2007], No. 43, *Notice on the Interpretation and Implementation of Certain Articles of the Arrangement between the Mainland of China and the Hong Kong Administration Region for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income* (4 Apr. 2007).

- The residence of the company whose shares are alienated may be in China or the other country.
- The percentage of equity ownership by the alienator is irrelevant to determining China's tax jurisdiction over the gains.
- The term "principally" means 50% or more.
- The determination of whether or not more than 50% of the value of the shares alienated is derived from immovable property situated in China can be based on a three-year period (unless another period is stipulated in the tax treaty).
- The value of property is based on the book value.
- The use of the term "indirectly" requires looking through the value of shares of lower-tier companies. For instance, a non-resident company, NRC, owns 20% of a Chinese company, ChinaCo1, which in turn owns 80% of another Chinese company, ChinaCo2. ChinaCo1's asset value is 100, including 40 in immovable properties in China. ChinaCo2's asset value is 100, including 90 in immovable properties in China. In determining whether more than 50% of the value of shares in ChinaCo1 is derived from immovable property in China, the immovable property in ChinaCo2 is taken into account. ChinaCo1's total value in immovable property is 40 (directly owned) plus 80 (indirectly owned, 80% x 90 = 72) and the total value in immovable property is 112, which is 62% of the total value of 180. In other words, 62% of the value of ChinaCo1's shares is derived, directly and indirectly, from immovable property in China.¹⁰⁰

The SAT interprets provisions based on article 13(5) of the UN Model very broadly, i.e.:

- The 25% share ownership by a non-resident alienator is determined "historically" in the sense that once the 25% threshold is met, the alienation of these shares would give rise to Chinese taxation, whether or not the shares are alienated in one transaction or several transactions. For instance, if a company resident in a treaty country acquired 40% of the shares of a Chinese company in Year 1, sells 20% of the shares in Year 2 and the remainder in Year 3, even though the share ownership is only 20% in Year 3, the transaction is still within the scope of article 13(5).¹⁰¹ If a tax treaty specifies a 12-month period for determining the ownership percentage, the "historical" approach is replaced by the 12-month period.
- "Indirect ownership" is determined by looking through equity percentage of lower-tier companies. For instance, if NR1 owns 5% of the shares of ChinaCo and 50% shares of NR2, which owns 50% of ChinaCo, NR1's direct ownership is 5% and indirect ownership is 25%, resulting in a total ownership of 30%. When

100. Art. 13 Guoshuifa [2010] No. 75, *supra* n. 14.

101. SAT Guoshuihan [2007] No. 403.

NR1 alienates its shares in ChinaCo, the gains are taxable in China.¹⁰²

- Share ownership of another person who is a member of a related group and has a significant economic relationship with the alienator may be attributed to the alienator. Such other person includes: (1) a person who has identical interest, such as a direct family member or an agent; (2) a person who directly owns 100% of the alienator; and (3) a company wholly owned by a person in (1) or (2). For instance, Parent owns 100% of each of Sub1 and Sub2, and Sub1 is a resident of a treaty country. Each of Parent, Sub1 and Sub2 owns directly 10% of ChinaCo. For the purposes of applying article 13(5), Sub1 is deemed to own 30% of shares of ChinaCo. This deeming rule applies when there is no allegation of treaty abuse.

4.5. Income from personal services

4.5.1. Initial comments

China's tax treaties have a mixture of provisions from the two Models in respect of income from independent services, dependent personal services, directors' fees, artistes and athletes, and students.

4.5.2. Independent personal services

Article 14 was deleted in the OECD Model (2000) to reflect the OECD's position that income from independent personal services should be taxed in the source country on the basis of the PE as there was no difference intended between the concept of PE and "fixed base" as used in article 14.

China's tax treaties generally have a separate provision on independent personal services, but follow the UN Model. In addition to the "fixed base" test, China's tax treaties employ the 183-day presence test found in the UN Model. China's tax treaties with some developing countries contain a third condition for source taxation, i.e. the fees are paid by a resident in that country¹⁰³ or are borne by a PE in that country.¹⁰⁴

According to the SAT Treaty Interpretation Circular,¹⁰⁵ the characterization of services as "independent services" depends on whether there is any evidence of a profession (including professional licence, registration certificate or

.....

102. Art. 13 Guoshuifa [2010] No. 75, *supra* n. 14.
 103. See, for example, *Agreement Between the Government of the People's Republic of China and the Government of Malta for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income* (23 Oct. 2010), Treaties IBFD.
 104. The *Agreement Between the Government of Malaysia and the Government of the People's Republic of China for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income* art. 14(1) (23 Nov. 1985), Treaties IBFD provides that the source country may tax professional income if the person stays in that country for more 183 days in the calendar year, or the income is paid by a resident or borne by a PE in that country and the amount exceeds USD 4,000. See also *Agreement Between the Government of the Federative Republic of Brazil and the Government of the People's Republic of China for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income* (5 Aug. 1991), Treaties IBFD.
 105. Art. 14 Guoshuifa [2010] No. 75, *supra* n. 14.

other evidence on the profession) issued by the competent tax authority of the residence country, and whether the contract governing the provision of services indicates that the nature of the relationship is not one of employer and employee. A service provider is generally not treated as an employee if: (1) he or she does not enjoy the medical insurance, social insurance, paid vacations, overseas allowances and other benefits received by employees; (2) his/her remuneration is referenced to hours, weeks or months or paid in a lump sum; (3) the scope of the services is fixed or limited by a time period; (4) the service provider is responsible for the quality of the work; and (5) the service provider bears the cost and expenses related to the performance of the contract.

4.5.3. Dependent personal services and corporate directors

With regard to income from dependent personal services, China's tax treaties generally follow the OECD Model and provide that the source country can tax the income where: (1) the employee is present in that country for more than 183 days in a calendar year (or 12-month period); (2) the employer is a resident in that country; or (3) the compensation is borne by the employer's PE or fixed base located in that country.

The meaning of the term "employer" is interpreted by the SAT to be "the person having rights with regard to the work produced and bearing the relative responsibility and risks".¹⁰⁶ In the case of international hiring-out of labour, the SAT requires a substance-over-form inquiry to determine the genuine relationship between the worker and the Chinese enterprise that receives the services. The worker may be an employee of the international hirer in form, but is, in reality, an employee of the Chinese enterprise if the Chinese enterprise that hires the services bears responsibilities and risks associated with the work performed by the worker. Whether the Chinese enterprise is the employer depends on the circumstances, such as:¹⁰⁷

- whether it has the authority to instruct the worker;
- whether the work is performed at a place that is under the control and responsibility of the Chinese enterprise;
- whether the remuneration paid to the international hirer is calculated on the basis of the time utilized by the Chinese enterprise or whether the remuneration is connected in some ways to the salary received by the worker;
- whether tools and materials are put at the employee's disposal by the Chinese enterprise; and
- whether the number and qualifications of the worker are not solely determined by the international hirer.

Directors' fees and similar payments derived by a resident of a treaty country as a member of the board of directors of a company resident in a treaty country are taxable in that country. Some of China's tax treaties also adopt article 16(2) of the UN Model, for example, those with Canada,

.....

106. *Id.*, art.15.
 107. *Id.*, art.15.

Kuwait, Norway, Pakistan, Sweden and Thailand, extending the same rule to salaries, wages and other similar remuneration derived by top-level managerial officials.¹⁰⁸

4.5.4. *Entertainers and athletes*

Article 17 is the same in the two Models and is generally found in China's tax treaties. It permits the source country (where services are performed) to tax income derived by entertainers and athletes whether the income is paid directly to the entertainers or athletes or to corporations. However, where income is derived from activities exercised in accordance with a cultural exchange programme between China and the other country, the income is exempt from tax in the source country.

4.5.5. *Pensioners, students and professors*

Article 18 deals with pensions. The OECD Model provides that pensions are taxable only in the residence state of the recipient. The UN Model provides for two alternatives. Alternative A allows exclusive residence country taxation with the exception of pensions and other payments made under a public scheme, which is taxable only in the source state. Alternative B allows the source country (where past employment was performed) and the residence country to share the taxation of pensions and similar payments, with the exception of public pensions, which are taxable only in the source country. China's tax treaties are mixed in terms of following the Models.¹⁰⁹

Article 19 of the two Models allocates exclusive source-based taxation of remuneration paid in respect of government services. Such a provision is generally contained in China's tax treaties.

Under article 20 of the two Models, payments received by visiting students and business trainees for the purpose of their maintenance, education or training are not taxable in the visiting state as long as the payments are received from sources outside that state. China's tax treaties follow the Models and extend the principle to visiting teachers and researchers.¹¹⁰

4.6. *Other income*

Income that is not specifically covered by any article of the tax treaty ("other income") is taxable only in the residence country of the taxpayer under article 22 of the OECD Model, but may be taxable in the source country under article 21(3) of the UN Model.

China's tax treaties with OECD Member countries tend to follow the UN Model, whereas tax treaties with developing countries and transition countries tend to follow the OECD Model.

108. Such income is taxable in China under the general provision with regard to employment income, as the payer of the income is a company resident in China.

109. For further discussion, see O. Gunther, W. Xing & J. Zhang, *Employment Income (Articles 15, 16, 18, 19, and 20 OECD Model)*, in Lang, Liu & Tang, *supra* n. 27, at pp. 174-178.

110. *Id.*, at pp. 182-184.

4.7. *Prevention of double taxation and tax sparing*

Following the Models, China's tax treaties require the residence country to provide relief from double taxation. Most tax treaties adopt the credit method, but some adopt the exemption method¹¹¹ or a combination of exemption and credit method.¹¹²

A tax sparing credit is included in many of China's earlier tax treaties. It deems the source country's tax that is "spared" or "waived" to be "paid" for the purposes of the foreign tax credit in the residence country. In tax treaties with developed countries, the tax sparing credit is often one-sided in favour of China. For instance, under the former China-United Kingdom Income Tax Treaty (1984),¹¹³ the United Kingdom allowed a credit for Chinese taxes which would have been payable on business profits but for an exemption or reduction of tax under Chinese domestic law, i.e. articles 5 and 6 of the Joint Venture Income Tax (JVIT) Law (1980),¹¹⁴ article 3 of the JVIT Regulations, articles 4 and 5 of the FIET Law (1991), or any other similar special incentive measures that are subsequently introduced by the Chinese government.¹¹⁵ With regard to investment income, Chinese tax is generally deemed to be paid at the treaty rate irrespective of the amount of Chinese tax actually paid.¹¹⁶ In a small number of tax treaties, a two-way or reciprocal tax sparing credit is provided, such as China's tax treaties with Cyprus, Italy, Korea (Rep.), Kuwait, Malaysia, Malta, Pakistan and Thailand. The China-United States Income Tax Treaty (1986) does not provide for tax sparing, which reflects US treaty policy,¹¹⁷ although the protocol nonetheless provides that it should be promptly amended to incorporate a tax sparing credit if the United States were to subsequently amend its laws concerning the provision of tax sparing credits or agree to grant such a relief to another country.¹¹⁸

111. For instance, business profits and most forms of personal service income, if subject to tax in China, are exempt from tax in Belgium, France, Germany, Norway and Sweden. The scope of the exemption varies from tax treaty to tax treaty. Belgium exempts all income other than dividends, interest and royalties; France and Germany add, to the non-exempt list, capital gains, directors' fees and the income of artists and athletes.

112. For instance, *Agreement Between the People's Republic of China and the Grand Duchy of Luxembourg for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and on Capital art. 24(2)* (12 Mar. 1994), Treaties IBFD provides for an exemption method for business profits and income for personal services and a credit method for investment income.

113. *Agreement Between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the People's Republic of China for the Reciprocal Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and Capital Gains* (26 July 1984), Treaties IBFD [hereinafter: *P.R.C.-U.K. Income Tax Treaty* (1984)].

114. JVIT Law, *supra* n. 5.

115. Art. 23(3) *P.R.C.-U.K. Income Tax Treaty* (1984). Similar provisions are contained in the tax treaties with Canada, Denmark, Finland, France, Germany, Japan, the Netherlands, Norway and Sweden.

116. For instance, Chinese tax on dividends is deemed to have been paid at the rate of 10% under the tax treaties with Canada (on shares representing more than 25% equity), Denmark, Finland, France, Germany, Japan, Singapore and Sweden.

117. See H.M. Liebman, *A Formula for Tax-sparing Credits in United States Tax Treaties with Developing Countries*, 72 Am. J. Intl. L., p. 296 (1978).

118. *P.R.C.-U.S. Income Tax Treaty, Exchange of Notes* (30 Apr. 1984). This compromise, giving "most favoured nation" treatment to China in this regard, goes further than the United States has hitherto been prepared to go.

More recent tax treaties often either do not contain a tax sparing clause or provide for a “sunset” requirement to phase out the credit over a specified period of time (see Table 6 in the Appendix). For example, the China–United Kingdom Income Tax Treaty (2011)¹¹⁹ no longer contains a tax sparing clause. Perhaps China sees less usefulness of tax sparing in attracting foreign investment to China due to the removal of tax incentives in domestic law.¹²⁰ The trend may also reflect the fact that China is a net capital exporter with regard to many countries and a tax sparing clause does not serve China’s interest. More importantly, it may reflect China’s agreement with the OECD in respect of the potential abuse of tax sparing clauses.¹²¹

5. Defending China’s Tax Base: Anti-Abuse Measures

5.1. Overview

It is well accepted that the original purposes of tax treaties are the prevention of double taxation and fiscal evasion. There is no universal consensus on whether the prevention of tax avoidance is a principal purpose of tax treaties. However, the most notable trend in China’s treaty policy is to enhance anti-avoidance measures (see Table 6 in the Appendix). These measures include:

- residence in a treaty country (see section 5.2.);
- LOB (see section 5.3.);
- associated enterprises (arm’s length principle) (see section 5.4.);
- beneficial ownership (see section 5.5.);
- a general anti-treaty abuse rule (see section 5.6.); and
- a domestic GAAR (see section 5.7.).

5.2. Resident in a treaty country

As noted in section 3., China’s tax treaties apply only to persons resident in China or the other treaty country. Treaty benefits are denied if the residence test is not met. In addition to the general definition of “person” and “resident” under articles 3 and 4, there are specific provisions in some of China’s tax treaties that attempt to prevent improper use of a tax treaty, such as treaty shopping or using a treaty provision to achieve tax avoidance. For instance, the China–Korea (Rep.) Income Tax Treaty

(1994),¹²² as amended by article 1 of the protocol (2006), contains a provision that denies treaty benefits to companies (trusts or other entities) that would otherwise qualify as residents of Korea (Rep.) (or China), but benefit in Korea (Rep.) (or China) from a preferential tax regime restricted to foreign-held companies. This clause is based on paragraph 21.2 of the Commentary on Article 1 of the OECD Model (2010):¹²³

In respect of Article 1 of the Agreement, it is understood that the Agreement shall not apply to any company, trust or other entity that is a resident of a Contracting State and is beneficially owned or controlled, directly or indirectly, by one or more persons who are not residents of that State, if the amount of the tax imposed on the income of the company, trust or other entity by that State (after taking into account any reduction or offset of the amount of tax in any manner, including a refund, reimbursement, contribution, credit or allowance to the company, trust, or other entity or to any other person) is substantially lower than the amount that would be imposed by that State if all of the shares of the capital stock of the company or all of the interests in the trust or other entity, as the case may be, were beneficially owned by one or more individuals who were residents of that State. However, this paragraph shall not apply if 90 per cent or more of the income on which the lower amount of tax is imposed is derived exclusively from the active conduct of a trade or business carried on by it, other than passive income from investment business.

Similarly, article 4(5) of the Australia–China Income Tax Treaty (1988)¹²⁴ denies the benefits under articles 10, 11 and 12 to a company if a company has become a resident of a contracting state for the principal purpose of enjoying benefits under the tax treaty.

The SAT has given the term “resident of a Contracting State” a purposive interpretation on the basis of substance over form. Anti-avoidance is understood by the SAT to be one of the purposes of a tax treaty. For instance, a Barbados company was denied the treaty exemption when it was discovered that the company’s directors were residents of the United States and through exchange of information, the competent authority in Barbados confirmed that the Barbados company did not meet the residency requirement under Barbados law.¹²⁵ Another example is the SAT’s requirement of the purpose test in determining the residence status under article 10 of the China–Hong

119. *Agreement Between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the People’s Republic of China for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and on Capital Gains* (27 June 2011), Treaties IBFD.

120. Until the 2008 tax reform, Chinese domestic laws provided numerous tax incentives to foreign-invested enterprises in China and foreign portfolio investors. Under the normal tax credit system, however, only taxes actually paid to the Chinese government are deductible from the investor’s tax in the home country. Consequently, the net result is that taxes “spared” in China are paid instead to the home country and the investor does not benefit from Chinese tax concessions. In order to avoid this result, a tax sparing credit would deem the taxes exempted or reduced as taxes paid for the purposes of the foreign tax credit in the resident country. See J. Li, *The Rise and Fall of Chinese Tax Incentives and Implications for International Tax Debates*, 8 Fla. Tax Rev., pp. 670-712 (2007).

121. OECD, *Tax Sparing: A Reconsideration* (1999). The recommendations were reflected in *OECD Model Tax Convention on Income and on Capital: Commentaries* (29 Apr. 2000), Models IBFD.

122. *Agreement Between the Government of the Republic of Korea and the Government of the People’s Republic of China for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income* (28 Mar. 1994) (amended through 2006), Treaties IBFD.

123. A similar provision is contained in para. 21.2 of the *UN Model: Commentary on Article 1* (2011).

124. *Agreement Between the Government of Australia and the Government of the People’s Republic of China for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income* (17 Nov. 1988), Treaties IBFD.

125. SAT, Guoshuihan [2008] No. 76, A Case of the Appropriate Handling of Tax Treaty Abuse by the Xinjiang Yugur Autonomous Region State Tax Bureau (30 Dec. 2008). For further discussion, see D. Qiu, *China’s Capital Gains Taxation of Nonresidents and the Legitimate Use of Tax Treaties*, Tax Notes Intl. p. 593 (22 Nov. 2010) and H. Yang, *New Developments in the General Anti-Abuse Rules and the Impact on International Tax Planning*, 15 Asia-Pac. Tax Bull. 3 (2009), Journals IBFD.

Kong (2006)¹²⁶ and China–Macau (2003)¹²⁷ Income Tax Agreements.¹²⁸ In general, if a transaction or arrangement was made for the principal purpose of obtaining favourable tax benefits under the tax treaty and the taxpayer inappropriately obtained treaty benefits through such a transaction or arrangement, the treaty benefits may be denied. This approach seems to be influenced by a sample provision suggested by paragraph 9.5 of the Commentary on Article 1 of the OECD Model (2010):¹²⁹

A guiding principle is that the benefits of a double taxation convention should not be available where a main purpose for entering into certain transactions or arrangements was to secure a more favourable tax position and obtaining that more favourable treatment in these circumstances would be contrary to the object and purpose of the relevant provisions.

5.3. LOB

Neither the OECD Model nor the UN Model contains an LOB article. However, the Commentary on Article 1 of the OECD Model (2010) (paragraph 20, reproduced in paragraph 56 of the Commentary on Article 1 of the UN Model (2011)) suggests language for such an article if both contracting states are interested in such provision.

The LOB article is generally absent from China's tax treaties, except for the China–United States (1986)¹³⁰ and the China–Mexico (2005)¹³¹ Income Tax Treaties. The LOB clause in these tax treaties is substantially similar. Article VI(1) and (2) of the protocol to the China–Mexico Income Tax Treaty (2005) reads as follows:¹³²

1. A person (other than an individual) which is a resident of a Contracting State shall not be entitled under this Agreement to relief from taxation in the other Contracting State unless:
 - (a) (i) more than 50% of the beneficial interest in such person (or in the case of a company more than 50% of the number of shares of each class of the company's shares) is owned, directly or indirectly, by any combination of one or more of:
 - (A) Individuals who are residents of one of the Contracting States;
 - (B) Companies as described in subparagraph 1(b); and
 - (C) One of the Contracting States, its political subdivisions or local authorities; and

- (ii) in the case of relief from taxation under Articles 10 (dividends), 11 (interest), and 12 (royalties), not more than 50% of the gross income of such person is used to make payments of dividends, interest and royalties to persons who are other than persons described in clauses (A) through (C) of subparagraph (a)(i), whether directly or indirectly; or

- (b) It is a company which is a resident of a Contracting State and in whose principal class of shares there is substantial and regular trading on a recognized stock exchange.

2. Paragraph 1 shall not apply if the establishment, acquisition and maintenance of such a person and the conduct of its operations did not have as a principal objective the purpose of obtaining benefits under the Agreement.

According to this LOB provision, a resident of Mexico does not qualify for treaty relief in China, unless it is a publicly traded company or a subsidiary of a resident individual or publicly traded company, or it is not a “stepping-stone” device, i.e. not more than 50% of the gross income is used to make payments of dividends, interest and royalties to residents of a third country, or it meets the business purpose exception.¹³³

5.4. Associated enterprises (arm's length principle)

The arm's length principle codified in article 9(1) of the OECD Model functions as an anti-avoidance rule in the sense that the tax base of the source (or residence) country cannot be eroded through transfer pricing. In determining the amount of profits attributable to a PE (or an associated enterprise), the amount paid to, or received from, a related party must reflect the arm's length price. Otherwise, the tax authorities have the power to redetermine the amount.

In addition to article 9(1), articles 11(6) and 12(5) of the UN Model build on the anti-avoidance focus by restricting the treaty rate on interest and royalties to the amount that reflects the arm's length price where the payer and payee are in a “special relationship”.

Articles 9(1), 11(6) and 12(5) of the UN Model are generally reproduced in China's tax treaties. The arm's length principle is found in Chinese domestic law.¹³⁴ The SAT regards the transfer pricing rule as one of the “special adjustment rules” or anti-avoidance rules.¹³⁵ In interpreting provisions based on articles 11(6) and 12(4) of the OECD Model, the SAT requires that reference be made to the relevant domestic anti-avoidance provisions and SAT guidelines on the application of these rules.¹³⁶

126. *Arrangement Between the Mainland of China and the Hong Kong Special Administrative Region for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income* [unofficial translation] (21 Aug. 2006), Treaties IBFD.

127. *Arrangement Between the Mainland of China and the Hong Kong Special Administrative Region for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income* [unofficial translation] (27 Dec. 2003), Treaties IBFD.

128. SAT, Guoshuihan [2009] No. 81.

129. This is reproduced in para. 23 of the *UN Model: Commentary on Article 1* (2011).

130. Protocol P.R.C.–U.S. *Income Tax Treaty*.

131. *Agreement Between the Government of the People's Republic of China and the Government of the United Mexican States for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income* (12 Sept. 2005), Treaties IBFD.

132. The remainder of the article lists the recognized stock exchanges and require the competent authorities to consult with each other before treaty relief is denied under the LOB provision.

133. In order to enforce the LOB rule, the SAT requires the tax authorities-in-charge to collect information in addition to the resident certificate when considering whether to grant treaty benefits.

134. Art. 41 EIT. For further discussion of the transfer pricing rules in China, see J. Li, *Resolving Transfer Pricing Disputes – China Chapter*, in *Resolving Transfer Pricing Disputes: A Global Analysis* (E. Baistrocchi & I. Roxan eds., Cambridge U. Press forthcoming 2012) and Cao, *supra* n. 25, at pp. 317–344.

135. SAT, Guoshuifa [2009] No. 2, Measures for the Implementation of the Special Tax Adjustment (trial) (1 Jan. 2009).

136. Arts. 11 and 12 Guoshuifa [2010] No. 75, *supra* n. 14.

5.5. Beneficial ownership

The beneficial ownership rule in articles 10, 11 and 12 of the two Models is universally included in China's tax treaties. Under this rule, the reduced treaty rate of withholding taxes on dividends, interest and royalties applies only to "beneficial owners" who are resident in the treaty country.

The concept of "beneficial ownership" is not found in Chinese domestic tax law. According to the SAT Guoshuihan [2009] No. 601¹³⁷ a "beneficial owner" is a person who has ownership of and control over an income or the rights and assets generating the income, and is generally engaged in substantial business activities. An agent or conduit company is not a beneficial owner. A conduit company is defined as one that is created for the purpose of avoiding or reducing tax, or shifting or accumulating profits. It is merely registered in a country to satisfy a legally required organization form and does not carry on any substantial business activities, such as production, trading and management.

Guoshuihan [2009] No. 601 also states that the meaning of "beneficial owner" should not be given a literal interpretation or a domestic law meaning. Instead, it should be interpreted in its context and in light of the object and purpose of the tax treaty, including the purpose of preventing treaty abuse, and should be based on the relevant facts and circumstances in accordance with the principle of substance over form. A company (or trust) is not considered a beneficial owner if:

- it is obligated to pay or distribute all or a substantial portion (60% or more) of the income within a specified period of time (for example, 12 months) of receiving the income;
- it has no or little business activity other than owning the assets or rights that generate the income;
- its assets, scale of operations or number of employees are relatively small and not commensurate with the amount of income it receives;
- it has no, or almost no, right of control or disposition over, the income or the assets or rights that generate the income and bears no or very little risk;
- its income is taxed at a zero or very low effective tax rate in the other treaty country;

137. Guoshuihan [2009] No. 601, Notice on Interpretation and Determination of "Beneficial Owner" under Tax Treaties (17 Oct. 2009). In many ways, the SAT interpretation is broader than, the principles articulated in court decisions in Canada, France, and the United Kingdom in, for example, UK: CA, 2 Mar. 2006, *Indofood International Finance Ltd v. JP Morgan Chase Bank NA* [2006] E.W.C.A. Civ. 158, S.T.L. 1195, Tax Treaty Case Law IBFD; FR:CE, 29 Dec. 2006, *Ministre de l'Economie, des Finances et de l'Industrie v. Societe Bank of Scotland*, no. 283314. See 9 ITLR 1, Tax Treaty Case Law IBFD; and CA: TC, 22 Apr. 2008, *Prévost Car Inc. v. Her Majesty the Queen*, 2008 3080 (TCC), Tax Treaty Case Law IBFD, affirmed by CA: FCA, 26 Feb. 2009, *Prévost Car Inc. v. Her Majesty the Queen*, DTC 5053, Tax Treaty Case Law IBFD. For further discussion, see J. Li, "Beneficial Ownership" in *Tax Treaties: Judicial Interpretation and the Case for Clarity in Essays in Honour of John F. Avery Jones: Tax Polymath: A Life in International Taxation* (P. Baker & C. Bobbett eds., IBFD 2010), Online Books IBFD and N. Sharkey, *China's Tax Treaties and Beneficial Ownership: Innovative Control of Treaty Shopping or Inferior Law-Making Damaging to International Law?*, 65 Bull. Intl Taxn. 12 (2011), Journals IBFD.

- its loan contract on which the interest arises is part of a "back-to-back" loan arrangement, i.e. the owner of the loan has a loan or deposit contract with third parties with similar amounts of principal, interest rate and time of conclusion of the contract; and
- the licensor to an agreement on copyright, patent and technology licensing or transfer has a contract to license or transfer the property from a third party.

5.6. General anti-treaty abuse rule

Neither Model currently contains a general anti-abuse provision. However, the Commentary on Article 1 of the OECD Model (2003)¹³⁸ and Commentary on Article 1 of the UN Model (2011) suggest sample provisions to be used in bilateral negotiations. For instance, paragraph 21.4 of the OECD Commentary suggests the following to deal with source taxation of specific types of income under articles 10, 11, 12 and 21:¹³⁹

The provisions of this Article shall not apply if it was the main purpose or one of the main purposes of any person concerned with the creation or assignment of the [Article 10: "shares or other rights"; Article 11: "debt-claim"; Articles 12 and 21: "Rights"] in respect of which the [Article 10: "dividend"; Article 11: "interest"; Articles 12 "royalties" and Article 21: "income"] is paid to take advantage of this Article by means of that creation or assignment.

Some of China's tax treaties that were concluded after 2006, such as the tax treaties with Belgium, Finland, Malta, Singapore and the United Kingdom, contain the above provision in articles 11 and 12. The SAT regards this type of provision as providing a basis for the applicable tax authority of the source country to prevent treaty abuse.¹⁴⁰ However, as discussed in section 5.7., the absence of such explicit provision does not preclude the SAT from challenging treaty shopping under other anti-abuse rules, including the domestic GAAR.

5.7. Domestic GAAR

There are no articles in the OECD Model or UN Model that explicitly allow treaty benefits to be denied by invoking a domestic GAAR. However, paragraphs 9.5 and 21.2 of the Commentary on Article 1 of the OECD Model (2010) and paragraphs 34 to 37 of the Commentary on Article 1 of the UN Model (2011) suggest the inclusion of such an explicit rule in a tax treaty. The UN Commentary (2011) advises that "the use of such a provision would probably be considered primarily by countries that have found it difficult to counter improper uses of tax treaties through other approaches".¹⁴¹

China's tax treaties concluded before 2006 do not contain any provisions that allow the use of a domestic GAAR to counter treaty abuse. The domestic GAAR in China was

138. *OECD Model Tax Convention on Income and on Capital: Commentary on Article 1* (28 Jan. 2003), Models IBFD.

139. The *OECD Commentary on Article 1* has been evolving since 1992. See also para. 22 of the *Commentary on Article 1 of the UN Model* (2001) and para. 23 of the *Commentary on Article 1 of the UN Model* (2011).

140. Art. 1 Guoshuihan [2010] No. 75, *supra* n. 14.

141. Para. 37 *UN Model: Commentary on Article 1* (2011).

enacted in 2007 and became effective on 1 January 2008.¹⁴² Some post-2006 tax treaties include such a provision (see Table 6 in the Appendix). For instance, article 26 of the China–Singapore Income Tax Treaty (2007) states:

Nothing in this Agreement shall prejudice the right of each Contracting State to apply its domestic laws and measures concerning the prevention of tax avoidance, whether or not described as such, insofar as they do not give rise to taxation contrary to the Agreement.

Article 26 clearly authorizes the competent tax authorities to apply their respective GAAR to residents of the other country, so long as the resulting taxation is not inconsistent with the tax treaty.

In practice, however, it appears to be clear that an explicit GAAR article in a tax treaty is included for the purposes of greater certainty. The absence of such a provision in a tax treaty does not mean that the GAAR is not relied on by the Chinese tax authorities. The tax authorities may instigate a GAAR investigation on any enterprise that is suspected of treaty abuse, of abuse of the corporate form, of tax avoidance using tax havens or entering into other arrangements without a reasonable business purpose.¹⁴³ The tax authorities also adopt the substance-over-form principle in determining whether or not an enterprise has a tax avoidance arrangement and consider the following factors:¹⁴⁴

- the form and substance of an arrangement;
- the creation time and implementation period of an arrangement;
- the implementation method of an arrangement;
- the relationship between each of the steps or components of an arrangement;
- the changes in each party's financial situation involved in an arrangement; and
- the tax consequences of an arrangement.

The SAT has applied the GAAR (especially the substance-over-form principle) in taxing non-resident enterprises that have alienated shares of an offshore holding company that held shares in Chinese operating companies. For example, Guoshuihan [2009] No. 698 requires an offshore company to report to the tax authorities in charge of a transaction involving a Chinese non-resident alienating shares of the company to another non-resident where the actual tax rate of alienator's residence country is less than 12.5% or if the alienator's gains from the transaction are tax-free in the residence country. On the basis of the information reported, the tax authorities in charge, after seeking the approval of the SAT, may apply the substance-over-form principle and look through the intermediate holding company in determining the Chinese source of the gains from the alienation of the shares. The substance-

over-form principle applies when all of the following three conditions are met: (1) there is an abuse of the company form; (2) there is no bona fide commercial reason for the indirect sale of the shares in a Chinese company; and (3) the transaction would otherwise result in the avoidance of Chinese tax.

A number of transactions involving indirect transfers of shares of Chinese companies were assessed and claims for treaty exemption were denied. The tax treaties that were relied on by taxpayers include treaties with Singapore,¹⁴⁵ Hong Kong,¹⁴⁶ Barbados¹⁴⁷ and other jurisdictions.¹⁴⁸ For instance, the tax authorities in Xuzhou denied treaty exemption claimed by a resident of Barbados in respect of the gains realized in 2009 from the alienation of shares of a Chinese real estate company. At the time of the transaction, the China–Barbados Income Tax Treaty (2000)¹⁴⁹ did not contain an equivalent of article 13(4) of the UN Model that allowed the source country to tax gains from the alienation of shares of companies whose value is derived principally from immovable property located in China (such a provision was added in the 2010 Protocol). Relying on article 4 of the tax treaty, the Barbadian residence of the alienator was denied on the grounds that the company failed to prove that its place of effective management was actually in Barbados.¹⁵⁰

Another example of possible reliance on domestic GAAR in denying treaty benefits is illustrated by the following case.¹⁵¹ A company resident in Luxembourg held 25% of the shares in a Chinese resident company and acquired one additional share in the same Chinese resident company immediately prior to the distribution of dividends by the Chinese company. The Luxembourg company was wholly owned by another Chinese company based in Jinan, China (in other words, the Luxembourg company was an offshore company owed by a Chinese enterprise). The withholding tax rate under the China–Luxembourg Income

142. Art. 47 EIT Law and Art. 120 EIT Regulations. For discussion on this topic, see J. Li, *Tax Transplants and Local Culture: A Comparative Study of the Chinese and Canadian GAAR* (2009) 11 Theoretical Inquiries in L. 2, pp. 75-105 (2009) and D. Buss et al., *China: Will It Challenge Tax Motivated Treaty Shopping Structuring?*, 86 Tax Mag., p. 13 (2008).

143. Art. 92 Guoshuihua [2009] No. 2, *supra* n. 135.

144. *Id.*, art. 92. In conducting a GAAR investigation, the tax authorities may request the instigators of the tax avoidance arrangement to provide relevant materials and supporting evidence.

145. For instance, in 2008, the Chongqing tax office reassessed a Singapore resident company on the gains realized from the alienation of another Singaporean company that held a 31.6% equity interest in a Chinese company located in Chongqing. The transaction took place before the introduction of the domestic GAAR and the inclusion of the GAAR article in the *P.R.C.–Sing. Income and Capital Tax Treaty*. Without explicitly relying on either the domestic GAAR or the treaty provision, the tax office appeared to rely on the general spirit behind the anti-abuse rules in denying the treaty exemption claimed by the Singapore company.

146. For instance, a Hong Kong resident company was reassessed by Yangzhou tax office on the gains realized from the sale of its shares of a Chinese public company to a US resident. See X. Yunxiang, Z. Jun & S. Yan, *The Biggest Tax Revenue on a Single Indirect Transfer of Shares Conducted by Non-Residents*, China Taxn. News (9 June 2010) (in Chinese).

147. See S. Yan, C. He & X. Yunxiang, *The First Case Xuzhou Tax Authority Refused the Abuse of Tax Treaty*, China Taxn. News (24 Feb. 2010) (in Chinese). See also the official website of the Xuzhou government on 23 February 2010 at www.xz.gov.cn/zwgk/bmxx/20100223/09194237285.html (in Chinese).

148. Some of the cases occurred even before the GAAR was enacted. For further discussion of the highly controversial practice of the tax authorities in assessing indirect transfers of shares of Chinese companies, see D. Qiu, *China's Capital Gains Taxation of Nonresidents and the Legitimate Use of Tax Treaties*, Tax Notes Intl., p.593 (22 Nov. 2010).

149. *Agreement Between the Government of Barbados and the Government of the People's Republic of China for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income* (15 May 2000), Treaties IBFD.

150. See Qiu, *supra* n. 148, at pp. 620-621.

151. The China Tax News (31 Aug. 2011) (in Chinese).

and Capital Tax Treaty (1994)¹⁵² is 5% for direct dividends and 10% for portfolio dividends. In order to qualify for direct dividends, the equity ownership must be more than 25%. The Jinan State Tax Bureau denied the treaty benefit on the grounds that the Luxembourg company had not held its interest in the dividend-paying company for 12 months before the dividend declaration. The “12-month holding period” requirement was omitted from article 10 of the tax treaty, but referred to in the SAT circular regarding the implementation of treaty dividend provisions.¹⁵³ The acquisition of the one additional share was also likely to be considered to be offensive from the perspective of the GAAR.

5.8. The role of Hong Kong

While the SAT is increasingly concerned with treaty abuse, China is, at the same time, growing its treaty network. What is also interesting to note is that Hong Kong has also begun developing its treaty network (see Table 7 in the Appendix). The combination of the China-Hong Kong Income Tax Arrangement (2006) and Hong Kong’s treaty network presents attractive tax planning opportunities for investors and potential treaty abuse situations for the tax authorities. Hong Kong’s treaty partners include not only major capital exporting countries, such as France, Japan and the United Kingdom, but also some treaty-based tax havens, such as Ireland, Luxembourg and the Netherlands.

It is beyond the scope of this article to examine and compare Hong Kong’s tax treaties with China’s tax treaties.¹⁵⁴ It is sufficient to note that Hong Kong’s tax treaties generally follow the OECD Model, and adopt a nil or very low rate of withholding tax on dividends, interest and royalties.

In terms of the source-country taxation of capital gains, gains from the alienation of shares deriving their value principally from immovable property are taxed in the source country (article 13(4) of the UN Model), but gains from the alienation of shares of other companies are generally not taxable in the source country (article 13(5) of the UN Model). As such, Hong Kong’s position as a gateway to China is strengthened by its tax treaties. This is particularly the case when an investor’s home country does not have a tax treaty with China, or has a treaty that provides for higher withholding tax rates or a broader scope of source country taxation.

The use of a Hong Kong company as a vehicle for investment in China is subject to the scrutiny of Chinese tax authorities when treaty benefits are claimed. The anti-avoidance measures, discussed in sections 5.6. and 5.7.,

all potentially apply in determining the entitlement of the China–Hong Kong Income Tax Arrangement (2006).

The use of a Hong Kong company as a financing vehicle by mainland Chinese companies gives rise to additional tax issues, such as the residence of the company for Chinese tax purposes. As discussed in section 3.3., if the place of effective management of a Hong Kong company is in Mainland China, the company is regarded as a Chinese resident. One of the implications of such a status is that the company is entitled to benefits under China’s tax treaties. On the other hand, the disposal of shares of the Hong Kong company by offshore investors may give rise to Chinese capital gains tax because the source of the gains is determined by the residence of the company.

6. Patterns and Trends in China’s Treaty Policy

6.1. General patterns

This study of the selected tax treaties shows some notable patterns and trends in China’s tax treaties and treaty practice. One notable pattern is the influence of the OECD Model and Commentaries and the UN Model and Commentaries. Such influence goes beyond the incorporation of the provisions of the Models. Some concepts, principles and approaches in the Commentaries have also been adopted into Chinese tax treaties and treaty practice. For instance, the attribution of ownership of shares of related companies or persons to the taxpayer that alienates shares in a Chinese company is probably inspired by a similar view found in paragraph 11 of the Commentary on Article 13(5) of the UN Model (2011):

It will be up to the law of the State imposing the tax to determine which transactions give rise to a gain on the alienation of shares and how to determine the level of holdings of the alienator, in particular, how to determine an interest held indirectly. An indirect holding in this context may include ownership by related persons that is imputed to the alienator. Anti-avoidance rules of the law of the State imposing the tax may also be relevant in determining the level of the alienator’s direct or indirect holdings.

Another pattern is that China’s tax treaties with OECD Member countries tend to have a broader scope of source taxation than those with non-OECD countries, especially in the case of business profits. There are no discernible differences between tax treaties with treaty haven countries and other tax treaty countries, in terms of the scope of source taxation of dividends, interest and royalties. There is also a notable pattern of adopting anti-abuse rules in more recent tax treaties with countries that have a more sophisticated tax law system and are capital exporters to China.

Finally, there are significant differences between tax treaties concluded before and after the major reform instigated by the EIT Law (2007), which reduced the standard tax rate, abolished most of the tax incentives and introduced the GAAR and specific anti-avoidance rules, such as thin capitalization and CFC rules.

In terms of treaty policy, there appears to be a general shift away from taking the stance of a net capital importer country. This is evidenced by the removal of the tax

152. *Agreement Between the People’s Republic of China and the Grand Duchy of Luxembourg for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and on Capital* (12 Mar. 1994), Treaties IBFD.

153. SAT Guishuihan [2009] No. 81.

154. For an overview, see S. Cho, *The Mainland of China and the Hong Kong SAR Double Taxation Arrangement – An Overview and Implications for Tax Planning*, 34 *Intl. Tax J.*, p. 45 (2008) and J. Vanderwolk, *Hong Kong’s New Tax Treaty Network*, 9 *Journal of Tax Research*, p. 254 (2011).

sparing clause in the majority of renegotiated tax treaties and reducing the rate of withholding tax rate on direct dividends to 5%.

6.2. Scaling down source taxation of business profits

On the basis of the data in Table 5 in the Appendix, compared to the earlier set of tax treaties with OECD Member countries, such as those with Japan (1983), the United States (1984), Denmark (1986) and Australia (1988), the scope of source country taxation of business profits is narrower in tax treaties with transition countries and developing countries, as well as in tax treaties renegotiated after 2006.

The definition of PE is narrower in tax treaties with non-OECD countries or lower-income OECD countries, such as Mexico. This is evidenced by specifying a longer period of time for supervisory services to constitute a PE (12 months as opposed to six months). The tax treaties with Georgia, Greece, Mexico and Syria do not even follow article 5(3)(b) of the UN Model. The PE definition is also narrower by not deeming an independent agent to constitute a PE under article 5(7), examples of which are tax treaties with Bulgaria, Cyprus, the Czech Republic, Georgia, Finland (2010) and Mexico.

The limitation on deductions in attributing profits to a PE under article 7(3) of the UN Model was included in the earlier tax treaties, for example, the United States (1984), Denmark (1986), Australia (1988), the Netherlands (1987) and Malaysia (1985), but missing in most other tax treaties covered by this study. The only tax treaties that contain the limitation rule were those with Mexico (2005), Kazakhstan (2002), Cyprus (1990) and Hong Kong (2006).

The trend of scaling down source taxation of business profits indicates a shift in China's interest in defining and defending its tax base. During the earlier years, China was a net capital importer and was, therefore, interested in having a broader scope for source taxation. This is particularly the case with major OECD Member countries. In more recent years, China has become a capital exporting country. Even with the major OECD Member countries, while China remains a net capital-importer, China's investment in these countries increased, presumably resulting in more two-way traffic. As such, the policy concerns over source-based taxation remain, but to a lesser extent. With regard to non-OECD countries, China is often a net capital exporter and would be expected to distance itself from the UN Model and bargain for narrower source country taxation. In practice, however, China's tax treaties with non-OECD countries still follow the UN Model, although to a lesser degree compared to the tax treaties with the OECD Member countries. This is perhaps due to China's understanding of the position of capital-importing countries and, consequently, China was more willing to accommodate their concerns than typical OECD Member countries.

6.3. Strengthening source taxation over passive income and capital gains

As indicated in Table 5 in the Appendix, China's tax treaties follow a clear pattern of withholding tax rates under articles 10, 11 and 12. The rate is generally capped at 10% and not reduced, even in tax treaties with the "treaty haven" jurisdictions. Other than the 5% rate on direct dividends, there is no systematic difference across countries or across time. Accordingly, the level of withholding tax rates indicates a reduction in the scope of source taxation rather than strengthening it. However, if the anti-abuse rules (beneficial ownership and the excessive interest and royalty provision under articles 11(6) and 12(5) of the UN Model) are taken into account, the effect is strengthening source taxation of passive income.

In the case of capital gains, there is a clear trend in strengthening source taxation by incorporating article 13(4) (shares deriving value primarily from immovable property) and article 13(5) (direct shares) of the UN Model. While the earlier tax treaties with Denmark, Japan and the United States do not include these provisions, subsequent tax treaties generally incorporate one or both. For instance, article 13(4) is contained in all of the selected tax treaties, with the exception of those with Brazil, Brunei, Cuba, the Czech Republic, Kazakhstan, Mexico, the Netherlands, Syria and Turkmenistan and article 13(5) is included in most tax treaties with tax havens (Luxembourg (1994), Mauritius (1994) and Barbados (2011)) and renegotiated tax treaties.

6.4. Aggressive stance on treaty abuse

Prior to 2006, the only general anti-abuse provision was the LOB provision contained in the tax treaties with Mexico and the United States. Since 2006, each renegotiated tax treaty contains one or both of the provisions codifying a business purpose type of a general anti-abuse rule or the use of a domestic GAAR in countering treaty abuse (see Table 6 in the Appendix). These provisions are based on the provisions suggested in the OECD Commentary and/or UN Commentary as opposed to provisions in the Models per se. In this respect, China can be considered an early adopter of such provisions or a mover of an anti-treaty abuse trend.

6.5. Some explanatory factors

It is beyond the scope of this article to fully discuss the internal and external factors that may help explain the trends and patterns noted in sections 6.1. to 6.5. A few highlights may suffice. One factor is China's rise as an economic power. The world ranking of China's GDP was ninth in 1980, fifth in 2005, and second in 2010.¹⁵⁵ Inbound FDI into China was valued at USD 916 million in 1983 and USD 11,6011 million in 2011.¹⁵⁶ Outbound

155. See International Monetary Fund, World Economic Outlook Database, available at www.imf.org/external/pubs/ft/weo/2012/01/weodata/download.aspx.

156. Source: www.fdi.gov.cn/pub/FDI/wztj/wstztj/lywzjt/t20120119_140560.htm.

FDI was valued at USD 93 million in 1983 and USD 60,070 million in 2011.¹⁵⁷

A second factor is the importance of taxation in China. The amount of tax revenue was CNY 77,560 million in 1983 and CNY 8,972,031 million in 2011. In 1983, the idea of income taxation was novel, affecting very few companies and individuals. In 2011, it was one of the reasons why the Chinese complain about “tax misery”.¹⁵⁸

A third factor is the growing sophistication of Chinese tax policy, legislation and administration. Chinese income tax policy was transformed from one that aimed at facilitating the transition from a centrally planned economy to one that aims at neutrality and equity demanded by a market-based economy. If the number of articles in the tax law is any indication of sophistication, the evidence is clear, i.e. the JVIT Law (1980) contains 18 articles and 1,302 words (excluding the Title of the legislation), whereas the EIT Law (2007) contains 60 articles and 5,345 words. The SAT interpretation bulletins and administrative measures, such as the Treaty Interpretation Circular, demonstrate an impressive degree of understanding of the technical issues and policy implications.

Some external factors presumably have also affected China’s treaty policy. These include: the updates of the OECD Model and Commentary, as well as the UN Model and Commentary in the 1990s and 2000s, the growing awareness of aggressive tax planning strategies and the revenue effect of income shifting to low-tax jurisdictions and China’s participation in the development of the Models, in joining the Joint International Tax Shelter Information Centre (JITSIC) and other organizations.

157. Source: www.fdi.gov.cn/pub/FDI/wztj/jwtztj/t20120119_140581.htm. Source: United Nations Conference on Trade and Development (UNCTAD), at http://unctadstat.unctad.org/ReportFolders/reportFolders.aspx?sCS_referer=&sCS_ChosenLang=en. The increase in outbound FDI was considered a main reason behind China’s change of treaty policy with regard to art. 7(3). See J. Khoo, *China’s Evolution as a Capital Exporter: A Shift in Tax Treaty Policy?*, 37 Hong Kong L. J., p. 891 (2007).

158. See, for example, *How Should We Look at the Tax Burden?*, Beijing Rev. 43 (27 Oct. 2011), available at www.bjreview.com.cn/forum/txt/2011-10/24/content_400222_2.htm and *Mainland’s “tax misery” highest in region: Forbes*, The China Post (27 Sept. 2011), available at www.chinapost.com.tw/business/asia-china/2011/09/27/317884/Mainlands-tax.htm.

7. Conclusions

This study of selected Chinese tax treaties and the treaty interpretation supports the claim that the treaty network plays an important role in defining and defending China’s tax base. The network consists of close to 100 tax treaties that have been concluded since 1983. It could be said that China’s treaty network functions as a Great Fiscal Wall of China. Even though China’s tax treaties are based on the OECD Model and UN Model, they have some distinguishing features that start to give shape to a Chinese identity.

In an article published in 1998,¹⁵⁹ Brian Arnold and the author predicted that “[o]wing to its increasing importance in the world economy and growing sophistication of the Chinese tax system, China will likely play an important role in shaping the international tax norms in the next century”.¹⁶⁰ Such a view is shared by other commentators.¹⁶¹ This article presents evidence that China is no longer just a norm taker, but a norm mover, especially in respect of treaty abuse issues. In this sense, elements of China’s tax treaties will most likely find their way into tax treaties concluded by other countries. Interestingly, while the iconic Great Wall cannot be duplicated by other countries, the Great Fiscal Wall of China can be.

159. Arnold & Li, *supra* n. 27.

160. *Id.*, at p. 87.

161. See, for example, Ecker & Tang, *supra* n. 54, at p. 78.

Appendix

Treaty partners	Countries (year of conclusion)
OECD Member countries	Japan (1983); the United States (1984); France (1984); the United Kingdom (1984, 2011); Belgium (1985, 2009); Germany (1985); Norway (1986); Denmark (1986); Canada (1986, 2012); Finland (1986, 2010); Sweden (1986); New Zealand (1986); Italy (1986); the Netherlands (1987); the Czech Republic (1987, 2010); the Slovak Republic (1997); ^a Poland (1988); Australia (1988); Switzerland (1990); Spain (1990); Austria (1991); Hungary (1992); Luxembourg (1994); Korea (Rep.) (1994); Slovenia (1995); Israel (1995); Turkey (1995); Iceland (1996); Portugal (1998); Estonia (1998); Ireland (2000); Greece (2002); and Mexico (2005).
Other BRICs	Brazil (1991); Russia (1994); and India (1994).
Transition countries (other than OECD Member countries)	Bulgaria (1989); Romania (1991); Croatia (1995); Belarus (1995); Vietnam (1995); Ukraine (1995); Armenia (1996); Lithuania (1996); Latvia (1996); Uzbekistan (1996); Yugoslavia (1997); Macedonia (1997); Laos (1999); Moldova (2000); Kazakhstan (2001); Kyrgyzstan (2002); Albania (2004); Azerbaijan (2005); Georgia (2005); Tajikistan (2008); and Turkmenistan (2009).
Treaty havens (non-OECD)	Cyprus (1990); Mauritius (1994); Barbados (2000, 2011); and Morocco (2002).
Developing countries	Malaysia (1985); Thailand (1986); Kuwait (1989); Pakistan (1989); Mongolia (1991); Malta (1993, 2010); United Arab Emirates (1993); Papua New Guinea (1994); Jamaica (1996); Bangladesh (1996); Sudan (1997); Egypt (1997); Seychelles (1999); the Philippines (1999); South Africa (2000); Qatar (2001); Cuba (2001); Venezuela (2001); Nepal (2001); Indonesia (2001); Oman (2002); Nigeria (2002); Tunis (2002); Iran (2002); Bahrain (2002); Sri Lanka (2003); Trinidad and Tobago (2003); Brunei (2004); Saudi Arabia (2006); Algeria (2006); Singapore (1986, 2007); Ethiopia (2009); Zambia (2010); and Syria (2010).
Special Administrative Regions	Hong Kong (1998, 2006, 2010); and Macau (2003, 2009).

Note a: The Agreement Between the Government of the People's Republic of China and the Government of the Czechoslovak Socialist Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes On Income (11 June 1987), Treaties IBFD, applied to the Slovak Republic.

Type of treaty partner	Country	Year of conclusion
OECD Member countries	Japan	1983
	United States	1984
	United Kingdom	1984
	Canada	1986
	Australia	1988
	Greece	2002
	Mexico	2005
Other BRICs	Brazil	1991
	Russia	1994
	India	1994
Transition economies	Bulgaria	1989
	Croatia	1995
	Kazakhstan	2002
	Georgia	2005
	Turkmenistan	2009
Treaty havens (OECD Member and other countries)	Netherlands	1987
	Luxembourg	1994
	Mauritius	1994
	Barbados	2000
Developing countries	Malaysia	1985
	Papua New Guinea	1994
	Sudan	1997
	Cuba	2001
	Brunei	2004
	Syria	2010
Renegotiated tax treaties	Singapore	1986, 2007
	Belgium	1985, 2009
	Finland	1986, 2010
	Malta	1993, 2010
	United Kingdom	1984, 2010

UN Model/Commentary	Subject matter
Business profits	
Article 5(2)	Deemed PE if building site and supervisory activities last more than six months
Article 5(3)(b)	Deemed services PE if activities last more than six months
Article 5(6)	Deemed PE if insurance premiums are collected or risks situated in the source country
Article 5(7)	Deemed PE if the activities of an independent agent are devoted wholly or almost wholly on behalf of the enterprise
Article 7(3)	Limitations on deduction of expenses in attributing profits to a PE
Investment income, capital gains and other income	
Article 10(2)	Lower rate for direct dividends
Article 11(2)	Withholding tax rate
Article 12(2)	Source-country taxation of royalties
Article 12(3)	"Royalties" include equipment rental
Articles 11(6) and 12(5)	Amount of interest and/or royalty in excess of the arm's length not eligible for treaty rate
Article 13(4)	Gains from the alienation of shares deriving value principally from immovable property are taxable in the source country
Article 13(5)	Gains from the alienation of "direct shares" (if alienator owns more than the specified percentage of equity in the company) are taxable in the resident country of the company
Article 21(3)	"Other income" may be taxable in the source country
Anti-Abuse	
Articles 10, 11 and 12	Beneficial owners resident in the other treaty country are entitled to reduced rates of withholding taxes
Article 9 and Articles 11(6) and 12(5)	Arm's length principle
Paragraph 56, Commentary on Article 1	Limitation on benefits
Paragraph 36, Commentary on Article 1	Denying treaty benefits where the main purpose is to obtain such benefits
Paragraph 21, Commentary on Article 1	Domestic GAAR may be applied in denying treaty benefits

Type of treaty partner	Country	Article 5(3) supervisory activity	PE services	Article 5(7) deemed dependent Agent	Article 5(6) insurance	Article 7(3) limits on deduction
OECD Member countries	Japan (1983)	Yes	Yes	Yes	No	No
	United States (1984)	Yes	Yes	Yes	No	Yes
	Denmark (1986)	Yes	Yes	Yes	No	Yes
	Australia (1988)	Yes	Yes	Yes	No	Yes
	Switzerland (1990)	Yes	Yes	Yes	No	No
	Greece (2002)	Yes (12 months)	No	Yes	No	No
	Mexico (2005)	Yes	No	No	Yes	Yes
Other BRICs	Brazil (1991)	Yes	Yes	Yes	No	No
	Russia (1994)	Yes (18 months)	Yes (18 months)	Yes	No	No
	India (1994)	Yes (183 days)	Yes (183 days)	Yes	No	No
Transition countries	Bulgaria (1989)	Yes	Yes	No	No	No
	Croatia (1995)	Yes (12 months)	Yes (12 months)	Yes	No	No
	Kazakhstan (2002)	Yes (12 months)	Yes (12 months)	Yes	No	Yes
	Georgia (2005)	Yes	No	No	No	No
	Turkmenistan (2009)	Yes (12 months)	Yes (183 days)	Yes	No	No
Treaty havens	Netherlands (1987)	Yes	Yes	Yes	No	Yes
	Cyprus (1990)	Yes (12 months)	Yes (12 months)	No	No	Yes
	Luxembourg (1994)	Yes	Yes	Yes	No	No
	Mauritius (1994)	Yes (12 months)	Yes (12 months)	Yes	No	No

Type of treaty partner	Country	Article 5(3) supervisory activity	PE services	Article 5(7) deemed dependent Agent	Article 5(6) insurance	Article 7(3) limits on deduction
Developing countries	Malaysia (1985)	Yes	Yes	Yes	No	Yes
	Sudan (1997)	Yes (18 months)	Yes (12 months)	Yes	No	No
	Cuba (2001)	Yes (12 months)	Yes (12 months)	Yes	No	No
	Brunei (2004)	Yes	Yes	Yes	Yes	No
	Syria (2010)	Yes (9 months)	No	Yes	No	No
Renegotiated tax treaties	Hong Kong (1998)	Yes	Yes	Yes	No	No
	Hong Kong (2006)	Yes	Yes (183 days)	Yes	No	Yes
	Singapore (1986)	Yes	Yes	Yes	No	Yes
	Singapore (2007)	Yes	Yes	Yes	No	No
	Belgium (1985)	Yes	Yes	Yes	No	Yes
	Belgium (2009)	Yes (12 months)	Yes (183 days)	Yes	No	No
	Finland (1986)	Yes	Yes	Yes	No	Yes
	Finland (2010)	Yes	Yes (183 days)	No	Yes	No
	Malta (1993)	Yes (8 months)	Yes (8 months)	Yes	No	No
	Malta (2010)	Yes (12 months)	Yes (183 days)	Yes	No	No
	Barbados (2000)	Yes	Yes	Yes	No	No
	Barbados (2011)	Yes	Yes	Yes	No	No
	United Kingdom (1984)	Yes	No	Yes	No	Yes
	United Kingdom (2011)	Yes (12 months)	Yes (183 days)	Yes	No	No

Table 5: Source-country taxation of dividends, interest, royalties, capital gains and other income (UN Model)

Type of treaty partner	Country	Article 10(2)	Article 11(2) and (3) (%)	Article 12(2) (%)	Article 13(4)	Article 13(5)	Article 21(3)
OECD Member countries	Japan (1983)	10	10, 0	10	No	No	Yes
	United States (1984)	10	10, 0	10, 7	No	No	No
	Denmark (1986)	10	10, 0	10, 7	No	No	Yes
	Australia (1988)	15	10	10	Yes	No	Yes
	Switzerland (1990)	10	10, 0	10, 6	Yes	No	No
	Greece (2002)	5, 10	10, 0	10	Yes	No	No
	Mexico (2005)	5	10, 0	10	No	No	No
Other BRICs	Brazil (1991)	15	15, 0	25, 15	No	No	Yes
	Russia (1994)	10	10, 0	10	Yes	Yes	No
	India (1994)	10	10, 0	10	Yes	No	Yes
Transition countries	Bulgaria (1989)	10	10, 0	10, 7	Yes	No	No
	Croatia (1995)	5	10, 0	10	Yes	Yes	No
	Kazakhstan (2002)	0, 5, 10	10, 0	5	No	No	No
	Georgia (2005)	10	10, 0	10	Yes	No	No
	Turkmenistan (2009)	5, 10	10, 0	10	No	No	No
Treaty havens	Netherlands (1987)	10	10, 0	10, 6	No	No	Yes
	Luxembourg (1994)	5, 10	10, 0	10, 6	Yes	Yes	No
	Mauritius (1994)	5	10, 0	10	Yes	Yes	No
	Barbados (2010)	5, 10	10, 0	10	Yes	Yes	No
Developing countries	Malaysia (1985)	10	10, 0	10, 15	Yes	No	No
	Sudan (1997)	5	10, 0	10	Yes	Yes	No
	Cuba (2001)	5, 10	10, 0	7.5, 0	No	No	No
	Brunei (2004)	5	10, 0	10	No	No	No
	Syria (2010)	5, 10	10, 0	10	No	No	No
Special administrative regions	Hong Kong (1998)	10	10	10	No	No	No
	Hong Kong (2006)	5, 10	7, 0	7	Yes	Yes	Yes
	Macau (2003, 2009)	5, 10	7, 0	10	Yes	Yes	Yes

Type of treaty partner	Country	Article 10(2) (%)	Article 11(2) and (3) (%)	Article 12(2) (%)	Article 13(4)	Article 13(5)	Article 21(3)
Renegotiated tax treaties	Singapore (1986)	12, 7	7, 10, 0	10	Yes	No	Yes
	Singapore (2007)	5, 10	7, 10, 0	10	Yes	Yes	Yes
	Belgium (1985)	10	5, 10	10, 6	Yes	Yes	Yes
	Belgium (2009)	5, 10	5, 10	7	Yes	Yes	Yes
	Finland (1986)	10	10, 0	10	Yes	No	Yes
	Finland (2010)	5, 10	5, 10	10	Yes	Yes	Yes
	Malta (1993)	Corporate tax rate	10, 0	10	Yes	Yes	No
	Malta (2010)	5, 10	10, 0	10, 7	Yes	Yes	No
	United Kingdom (1984)	10	10, 0	10, 6	No	No	No
	United Kingdom (2011)	5, 15, 10	10, 0	10, 6	Yes	Yes	No

Table 6: Anti-abuse rules and tax sparing in selected Chinese tax treaties

Type of treaty partner	Country	Tax sparing	Beneficial owner	Excessive amount	General anti-abuse rule	LOB	Application of domestic GAAR
OECD Member countries	Japan (1983)	Yes	Yes	Yes	No	No	No
	United States (1984)	Yes	Yes	Yes	No	Yes	No
	Denmark (1986)	Yes	Yes	Yes	No	No	No
	Switzerland (1990)	Yes	Yes	Yes	No	No	No
	Mexico (2005)	No	Yes	Yes	No	Yes	No
Other BRICs	Brazil (1991)	No	Yes	Yes	No	No	No
	Russia (1994)	No	Yes	Yes	No	No	No
	India (1994)	No	Yes	Yes	No	No	No
Transition countries	Bulgaria (1989)	No	Yes	Yes	No	No	No
	Croatia (1995)	No	Yes	Yes	No	No	No
	Kazakhstan (2002)	No	Yes	Yes	No	No	No
	Georgia (2005)	No	Yes	Yes	No	No	No
	Turkmenistan (2009)	No	Yes	Yes	No	No	No
Treaty havens	Netherlands (1987)	Yes	Yes	Yes	No	No	No
	Luxembourg (1994)	Yes	Yes	Yes	No	No	No
	Mauritius (1994)	No	Yes	Yes	No	No	No
	Barbados (2000, 2010)	No	Yes	Yes	No	No	Yes
Developing countries	Malaysia (1985)	Yes	Yes	Yes	No	No	No
	Sudan (1997)	No	Yes	Yes	No	No	No
	Cuba (2001)	Yes	Yes	Yes	No	No	No
	Brunei (2004)	Yes	Yes	Yes	No	No	No
	Syria (2010)	No	Yes	Yes	No	No	No
Renegotiated tax treaties	Hong Kong (1998)	No	No	No	No	No	No
	Hong Kong (2006)	No	Yes	Yes	No	No	Yes
	Singapore (1986)	Yes	Yes	Yes	No	No	No
	Singapore (2007)	Yes	Yes	Yes	Yes	No	Yes
	Belgium (1985)	Yes	Yes	Yes	No	No	No
	Belgium (2009)	No	Yes	Yes	Yes	No	Yes
	Finland (1986)	Yes	Yes	Yes	No	No	No
	Finland (2010)	No	Yes	Yes	Yes	No	Yes
	Malta (1993)	Yes	Yes	Yes	No	No	No
	Malta (2010)	No	Yes	Yes	Yes	No	Yes
	United Kingdom (1984)	Yes	Yes	Yes	No	No	No
	United Kingdom (2011)	No	Yes	Yes	Yes	No	Yes

Country	Year of conclusion
1. Belgium	2003
2. Thailand	2005
3. Vietnam	2008
4. Brunei	2010
5. Netherlands	2010
6. Indonesia	2010
7. Hungary	2010
8. Kuwait	2010
9. Austria	2010
10. United Kingdom	2010
11. Ireland	2010
12. Liechtenstein	2010
13. France	2010
14. Japan	2010
15. Luxembourg	2010
16. New Zealand	2010
17. Switzerland	2010
18. Malta	2011
19. Spain	2011
20. Czech Republic	2011
21. Portugal	2011
22. Malaysia	2012
23. Mexico	2012

Treaty partner	Dividends (%)	Interest (%)	Royalties (%)	UN Model Article 13(4)	UN Model Article 13(5)	UN Model Article 21(3)
Mainland China	5, 10	7, 0	7	Yes	Yes	Yes
Austria	0, 10	0	3	Yes	No	No
Netherlands	0, 10	0	3	Yes	No	Yes
Liechtenstein	0	0	3	Yes	No	Yes
Luxembourg	0, 10	0	3	Yes	No	No
United Kingdom	0, 15	0	3	Yes	No	No
Japan	5, 10	10	5	No	No	No
France	10	10, 0	10	Yes	Yes	Yes
Ireland	0	10, 0	3	Yes	No	No