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China Signs MLI to Modify Tax Treaties

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China was one of the 68 countries that participated in the signing ceremony for the OECD's Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (http://oe.cd/mli-en-text) (MLI) on 7 June 2017, with nine other countries expressing their formal intent to sign the MLI (two of these countries - Cameroon and Mauritius - already have signed the MLI). It is expected that many additional countries will sign the MLI by the end of 2017, and that the first modifications will become effective in 2018. The OECD has estimated that more than 1,100 tax treaties will be impacted by the MLI. Notably, the US, China's largest trading partner, did not attend the ceremony nor has it expressed its intent to sign the accord.

Scope of MLI

The MLI - the first multilateral agreement of its kind - aims to prevent treaty abuse and the artificial avoidance of permanent establishment status, neutralize the effects of hybrid mismatch arrangements and improve dispute resolution, which should lead to a stable and well-functioning global tax system.

The MLI will enable signatories to amend multiple treaties and implement tax treaty-related measures that are part of the BEPS project (http://oe.cd/aboutbeps) in a coordinated manner, without having to renegotiate each treaty.

The MLI requires that signatories to implement two of four BEPS minimum standards (i.e. preventing treaty abuse, and enhancing dispute resolution), although some flexibility is allowed as to how these standards will be satisfied. In addition the OECD also has recommended a number of other BEPS measures, which signatories are free to adopt or register a reservation.

The MLI requires signatory countries to identify the tax treaties (and associated instruments) that will be covered by the agreement ("Covered Tax Agreements" or CTAs). Article 1 makes it clear that: "This Convention modifies all Covered Tax Agreements…" even though each signatory has discretion as to which provisions it will accept or "reserve" (i.e. opt out of) to the extent stipulated under the MLI.

The OECD, in its role as depositary, has published on its website (http://oe.cd/mli) the provisional list of the treaties intended to be subject to the scope of the MLI, along with related reservations and notifications of each of the signatory jurisdictions. A treaty will be modified (and considered a CTA) only if both parties to the treaty agree. Unlike a protocol to amend an existing bilateral tax treaty, the MLI will not actually amend the treaty text but will change the operation of various provisions in affected treaties, meaning that to apply a CTA, it will be necessary to read both the MLI and the treaty itself. If one treaty partner reserves against a provision in the MLI, then that MLI provision will not apply or have any impact on the treaty, regardless of the views of the other treaty partner.

The OECD has launched a preliminary version of its "MLI matching database (http://oe.cd/mlimatching)," which is based on the provisional lists of reservations and notifications published by the MLI signatories, and which will help users understand how specific tax treaties are expected to be modified under the MLI mechanisms.

The Chinese provisional list of CTAs includes 102 tax treaties.[1] The CTAs with Chile, Hong Kong, India, Macau and Taiwan are omitted, even though China is on the relevant lists of Chile and India. After cross checking the lists deposited by other signatories, it appears that 47 of China's treaties will be affected by the MLI.[2]

There are more than 2,000 pages in the provisional lists deposited by the signatory jurisdictions; the Chinese list is 37 pages.

This article focuses on the main topics on China's list.

Main choices made by China

Treaty abuse

To implement the BEPS minimum standard on preventing treaty abuse, the MLI will amend the preamble of China's CTAs to indicate that the intent for tax treaties is to eliminate double taxation without creating opportunities for nontaxation (or reduced taxation) through tax evasion or avoidance. Article 6 of the MLI provides that the following language should be included in the preamble text of a treaty (bold added):

> "…Intending to eliminate double taxation with respect to the taxes covered by this agreement without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided in this agreement for the indirect benefit of residents of third jurisdictions)."

[1] Two treaties concluded with Romania are included.
[2] Mauritius, Spain and Switzerland did not include China on their lists.

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In addition to modifying the preamble of CTAs, the MLI provides for the implementation of a substantive technical rule to prevent treaty abuse in accordance with the BEPS minimum standard. This substantive rule may take several forms: a principal purpose test (PPT) or a simplified limitation on benefits (LOB) rule, supplemented by a PPT. Alternatively, the use of detailed LOB rules (supplemented by a mechanism to deal with conduit arrangements) is permitted. Like many other jurisdictions, China has opted for the PPT only option. Thus, treaty benefits will be subject to the PPT where it is reasonable to conclude, considering all of the relevant facts and circumstances, that obtaining the benefit was one of the principal purposes of an arrangement or a transaction that resulted directly or indirectly in that benefit, unless it is established that granting the benefit in the circumstances would be in accordance with the object and purpose of the relevant provisions of the MLI.

China also has opted to insert the language of article 8 of the MLI, which contains a "lookback" period of 365 days to determine the minimum shareholding period for substantial (i.e. at least 25%) shareholders to benefit from a lower withholding tax rate on dividends, and China has listed the corresponding provision in 36 treaties covered by this modification. However, China has made reservations to apply a similar 365-day lookback period with respect to the capital gains articles of its treaties; specifically, to determine real estate-rich company status (which generally implies that capital gains from the alienation of shares or interests that derived more than 50% of their value directly or indirectly from underlying immovable property also may be taxable in the state in which the property is situated). China intends to retain the current practice (i.e. 36 months before the alienation) as set forth in existing guidance (Guoshuifa [2010] 75 and SAT Bulletin [2012] 59).

Avoidance of PE (Permanent Establishment) status

The PE provision in the MLI, which aims to implement BEPS action 7 (preventing the artificial avoidance of PE status), lowers the threshold at which a PE (taxable presence) will arise by:

- **Broadening the scope of a dependent agent PE (capturing the use of commissionaire arrangements and other matters);**
- **Narrowing the exemptions for a fixed place of business PE by requiring activities to be "preparatory or auxiliary" in nature and/or by introducing an anti-fragmentation rule; and**
- **Countering avoidance where long-duration construction contracts are split into a series of shorter contracts.**

China (like 11 of the EU member states)[3] has decided not to make the proposed changes to the PE threshold, so there will be no changes in the PE provisions of China's treaties. This comes as no surprise, since the Chinese tax authorities have indicated that the current rules as set forth under Guoshuifa [2010] 75 already are sufficient, since in Guoshuifa [2010] 75, China SAT already adopted certain anti-treaty abuse-interpretation measures, e.g. it is clarified that the word "conclude contracts" should also refer to the agent's authority to negotiate the contract terms, as provided under UN and OECD Commentary.

Hybrid mismatches

Since the hybrid mismatch provisions are not BEPS minimum standards, China has opted not to apply the provision regarding transparent entities. However, it should be noted that China has adopted a new dual resident entity tiebreaker rule (to replace the place of effective management test), under which, in the absence of a mutual agreement between the relevant tax authorities, a person may not be entitled to treaty relief unless the authorities agree otherwise.

Dispute resolution mechanism

The MLI implements the BEPS minimum standard for resolving disputes under a tax treaty. China has indicated that it will not adopt the 2014 version of article 25(1) of the OECD model treaty, under which a taxpayer is permitted to present its case to the tax authorities of either of the contracting states within three years of the competent authorities' notification. Instead, China will allow a taxpayer to present its dispute only to the tax authorities of the contracting state in which it is a resident or national (in the event of a nondiscrimination case) and then the referred tax authorities will implement a bilateral notification or consultation process.

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[3] Bulgaria, Cyprus, Czech Republic, Denmark, Finland, Greece, Hungary, Latvia, Malta, Poland and Sweden.

China has not made any reservation to article 17 of the MLI, which proposes the introduction of a corresponding adjustment provision.

The mandatory binding arbitration rules will apply only if both parties to a treaty opt in. Unlike in most other areas of the MLI where reservations are standardized, parties are free to determine the scope of cases that will be eligible for arbitration (subject to acceptance by the other relevant party). China has opted not to require mandatory binding arbitration, which typically will be initiated if the competent authorities are unable to reach a resolution on a MAP case within two years (notably, 26 jurisdictions[4] have elected arbitration).

Observations and comments

Individual signatory jurisdictions now must ratify the MLI in line with their domestic rules. The MLI must be ratified by at least five jurisdictions before it first enters into force on the first day of the third full month after the date the fifth jurisdiction that ratifies the agreement deposits its instrument of ratification. A three-month period will apply for all other jurisdictions that subsequently ratify the MLI.

The date on which provisions in the MLI will enter into effect differs depending on the subject: 1) withholding tax provisions will take effect for payments made after the first day of the subsequent calendar year; and 2) all other taxes levied will have effect for taxable periods beginning on or after a period of six calendar months has elapsed.

Given that the MLI will require consensus between two contracting parties to the CTA (i.e. both jurisdictions have to embrace the lowest common position towards each relevant provision), the OECD has published a toolkit, including 31 flowcharts to illustrate the application of MLI to existing treaties by each relevant provision. As noted above, the OECD has launched a (beta version) public online matching tool based on a database containing all MLI positions to simulate the likely matching outcome.

China's tax authorities published an 83-page Chinese version of the MLI on 23 June 2017 (notably, the OECD has indicated that only English and French are the authentic languages for the MLI), but a Chinese translation of the Explanatory Statement has not been issued. It remains to be seen whether the tax authorities will produce a consolidated document of all impacted treaties and/or a list of the MLI status and reservations of each treaty partner that has signed or indicated its intent to sign the MLI (both in Chinese). Since the MLI permits a contracting party that has made a reservation to withdraw or replace it with a more limited reservation by means of a notification at any time, treaty benefit applicants should continue to monitor developments closely.

It is crucial that those that wish to apply for benefits under China's tax treaties understand how these new substantive concepts introduced in the MLI will be applied in the treaties (particularly, the PPT). It is worth noting that neither the Explanatory Statement to the MLI,[5] nor the OECD Commentary provide much detail in terms of interpreting the provisions of the MLI. Hence, since China is not an OECD member, the extent to which the Chinese tax authorities transpose the BEPS recommendations, etc. into domestic practice should be watched closely; China is subject to peer review on Action 6 since all jurisdictions that participate in the inclusive framework will be involved in the review process, which allows other countries to review China's tax systems, with a view to identifying and eliminating any aspects raising BEPS risks.

As mentioned above, the preamble to CTAs will be amended to include text to make clear that, in addition to the prevention of double taxation, the object and purpose of a treaty also should be to avoid creating situations allowing nontaxation or reduced taxation through tax evasion or avoidance activities (including through treaty-shopping arrangements). As such, it is not unrealistic to anticipate that the preamble could be interpreted as authoritative grounds to enforce a general anti-treaty shopping measure.

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[4] Andorra, Australia, Austria, Belgium, Canada, Fiji, Finland, France, Germany, Greece, Ireland, Italy, Japan, Liechtenstein, Luxembourg, Malta, Mauritius, Netherlands, New Zealand, Portugal, Singapore, Slovenia, Spain, Sweden, Switzerland and the UK.

[5] Paragraph 12 provides that: "this Explanatory Statement is intended to clarify the operation of the Convention to modify Covered Tax Agreements, it is not intended to address the interpretation of the underlying BEPS measures (except with respect to the mandatory binding arbitration provision…)."

Finally, for those that wish to claim treaty benefits, it is likely that China's administration rules (especially the documentation as required to apply for treaty benefits) will be updated to accommodate the changes brought about by the MLI, thus creating increased burdens for taxpayers, withholding agents and the tax authorities. Additional information likely will be required to substantiate a treaty benefit claim as a result of the updated restrictions introduced by the MLI, and further clarification of these requirements will be needed at both the domestic and international levels.

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