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SAT Updates Guidance on Interpretation of Tax Treaties

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On 12 February 2018, the State Administration of Taxation (SAT) issued guidance (SAT Bulletin [2018] No. 11 (Bulletin 11)) that updates and modernizes guidance issued in 2010 *(*Guoshuifa [2010] No. 75 (Circular 75)) on the interpretation of the provisions in China's tax treaties. It should be noted that, while Circular 75 was issued in the specific context of the China-Singapore treaty, it generally has been applicable to all of China's treaties/arrangements that contain similar provisions.

Bulletin 11 will take effect from 1 April 2018 and contains changes to its interpretation of the following articles in China's treaties: permanent establishment (PE), shipping and air transport; entertainers (artistes) and sportspersons; and eligibility of partnerships for treaty benefits.

This article highlights the distinctive features of Bulletin 11.

Clarifications on permanent establishment

Bulletin 11 provides two clarifications:

- The aggregate six months within any 12-month period in relation to the furnishing of services should be interpreted to mean 183 days in the aggregate within any 12-month period; and

- A place where educational and teaching activities are carried out by a China-foreign cooperative education institution without legal personality or under a China-foreign cooperative education project can give rise to a PE under a tax treaty/arrangement.

Observation

A PE can arise in China where an enterprise sends personnel to China to provide services for a specified period of time, which is typically "183 days" within any 12-month period in China's recent tax treaties, but "six months" in some older treaties (e.g. China-US treaty). The SAT issued guidance in 2007 (i.e. Guoshuihan [2007] No. 403, in the context of the Mainland China-Hong Kong tax arrangement) that adopts a stringent view on how to calculate the "six month" period, under which a presence for one day may be counted as "one month." Although the relevant provisions in the 2007 guidance have been abolished, the ambiguity on how to calculate the six-month period remains and some tax officials still may follow the 2007 guidance to determine whether a service PE exists. Bulletin 11′s acknowledgement of six months as 183 days should be welcomed by taxpayers.

Attracted by the Chinese market, more foreign universities and other educational institutions have cooperated with Chinese partners to provide educational services in China. The Chinese tax authorities apparently have taken note of these activities, and a few PE cases in China-foreign cooperative education projects have been publicly reported in the last few years. With the clarification on cooperative educational fixed PEs in Bulletin 11, affected parties (including both the foreign educational institutions and their Chinese partners) should examine their arrangements and consider the relevant PE and tax compliance risks. It also is worth noting that a foreign education institution's non-profit status in its home country will not automatically exempt its Chinese PE from Chinese income tax.

Shipping and air transport

Bulletin 11 updates Circular 75′s guidance on article 8 (the shipping and air transport article) with the following main points:

- Profits derived from the transport of passengers or cargo by leasing an aircraft (in the form of a wet lease) or ship (in the form of a voyage or time charter) will be considered profits derived by an enterprise of a contracting state from the operation of ships or aircraft in international traffic.

- Article 8(4) of the China-Singapore treaty also will apply to tax treaties that do not contain such a provision. Article 8(4) provides that profits derived from the rental on a bareboat basis (i.e. bareboat charter for ships and dry lease for aircraft), as well as profits derived from the use, maintenance or rental of containers (including trailers and related equipment used for transport of the containers) used for the transport of goods or merchandise are within the scope of article 8 if such activities are *incidental* to the operation of international traffic.

- Three factors will be considered when determining whether an activity is *incidental* (the second factor is newly added by Bulletin 11):

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1) International transportation is the main business of the company and is evidenced by business registration and other supporting documents and materials;

2) The activity, which makes a minor contribution to the main business, still is so closely related to the main business that it should not be regarded as a separate business or source of income of the enterprise; and

3) Revenue from incidental activities does not exceed 10% of the international transportation revenue of the enterprise in a fiscal year.

Observation

Bulletin 11 marks a welcome change of the SAT's interpretation of leasing a ship or aircraft on charter fully equipped, crewed and supplied (i.e. wet lease, voyage or time charter) to be aligned with the 2014 OECD and 2011 UN commentaries on the scope of the international transport articles. Currently, such profits cannot enjoy the treaty exemption under article 8 unless such leasing activities are incidental to the operation of international transportation.

Entertainers (Artistes) and Sportspersons

Bulletin 11 updates Circular 75′s guidance on article 17 (the entertainers or artistes and sportspersons article) with the following main points:

- Three new examples are added for the activities from which income covered by article 17 is derived: film promotion by entertainers, annual meetings and ribbon cutting ceremonies for companies in which entertainers and sportspersons participate.

- Visiting conference speakers (e.g. former politicians delivering speeches at academic conferences) are not covered, unless the speech is in the nature of a 〝performance〞 and made as a commercial activity, in which case article 17 will apply.[1]

- Electronic sports (i.e. competitive video gaming) activities fall within the scope of the entertainers (artistes) and sportspersons′ article.

- By invoking article 17, the source state has the right to tax the income derived by an entertainer (artiste) or sportsperson from personal activities and the income from personal activities carried out by an entertainer (artiste) or sportsperson in his/her capacity that accrues to other persons, regardless of whether the other treaty article dealing with business profits, dependent or independent personal services applies. Examples, such as an orchestra and one-person company, as well as structures set up for tax avoidance purposes, are provided under the supplementary interpretation of Bulletin 11.

Observation

The examples contained in the supplementary interpretation provide a useful reference to understand how the SAT would apply article 17 to tax relevant parties:

- In the orchestra example, it provides that the source state would have the unrestricted right to tax the orchestra members' salaries for their performance in the state, as well as the profits earned by the orchestra from the performance, *which was earned by the orchestra but not paid as remuneration to the members*. This clarification is aligned with the OECD commentary, which provides that "*the income derived in respect of the personal activities of a sportsperson or entertainer should not be taxed twice through the application of these two paragraphs (of article 17)*."[2] However, the Chinese tax authorities generally use a deemed profit method, rather than determining the actual costs, to assess the taxable profit of a foreign entity (e.g. the orchestra in this example) providing services in China. Therefore, whether the double taxation issue could be avoided may depend on the level of the deemed profit rate.

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[1] According to the positions on article 17 and its commentary, China "take(s) the view that visiting conference speakers, including especially former politicians, could be covered by article 17 if an entertainment character is present in their speeches."

[2] See paragraph 11.5 of the OECD commentary on article 17.

- In the example of a one-person company (a common feature of the entertainment industry), it follows the OECD commentary with respect the domestic law of the source state,[3] i.e. depending on its domestic law, the state may consider the income to accrue to the entertainer/sportsperson and the company, respectively, and tax them both, or "look through" the company to accrue all the income to and tax the individual. Since Bulletin 11 only provides guidance on tax treaties, it may be understandable that Chinese domestic law is not addressed in the example. It will be interesting to see whether the local tax authorities try to look through a one-person company in similar cases, due to the simplicity of this approach. However, it could be argued that the existing individual income tax law does not contain any rules to override the legal form to support the adoption of a look through approach.

- In the example of a tax avoidance structure where the remuneration was paid to persons other than the entertainer (artiste)/sportsperson, it again follows the OECD commentary,[4] i.e. depending on the domestic law of the source state, that state may either apply the domestic anti-avoidance rule (if applicable) to accrue all of the income to and tax the entertainer (artiste)/sportsperson; in the absence of an anti-avoidance rule, impose tax directly on the other persons. Technically, it appears that the Chinese tax authorities can only use the latter approach unless the individual income tax law is amended to incorporate anti-avoidance rules.

Eligibility of partnerships and other comparable entities for treaty benefits

Bulletin 11 provides guidance on partnerships and other comparable entities:

Chinese partnerships

China will treat income of a Chinese partnership as flowing through to the foreign partners so the partners (if residents of relevant contracting states) should be entitled to benefits under the relevant treaties with respect to their share of the income of the partnership, provided that such share of the income is also treated as the income of the foreign partners in the relevant contracting states.

Foreign partnerships

- A foreign partnership (that is not effectively managed in China) is considered a nonresident enterprise (i.e. "non-flow through entity") for Chinese enterprise income tax purposes.

- A foreign partnership will be entitled to treaty benefits only if it is considered a resident of the other contracting state under the relevant treaty, unless the treaty provides otherwise.

- If a foreign partnership cannot prove that it is liable to tax in the other contracting state by reason of its domicile, residence, place of establishment, place of management or any other criterion of a similar nature, it will not be considered a resident of the contracting state to access the treaty benefits, even it has submitted a residence certificate issued by the competent tax authorities of the contracting state.

Observation

Chinese partnerships

Although it has been almost eight years since a foreign party has been allowed to become a partner of a Chinese partnership, the relevant tax guidance is limited. It seems the SAT will consider the other contracting states' tax treatment in determining whether to grant treaty benefits to the foreign partners for their share of income of the Chinese partnerships. Bulletin 11 also left a few key issues unanswered, such as how to determine the classification of the income for treaty purposes, whether and how holding the interest of a Chinese partnership would give rise to a PE, and if so, how to determine that the share of income is attributable to the PE, etc.

[3] See paragraph 8 of the OECD commentary on article 17.
[4] See paragraph 11 c) of the OECD commentary on article 17.

Foreign partnerships

Bulletin 11′s confirmation of a foreign partnership's "non-flow through" treatment means that the Chinese tax authorities would accrue the relevant income to the foreign partnership and tax the partnership, rather than its partners or members. This being the case, a foreign partnership established in a country (i.e. home country) that treats such a partnership as tax transparent could be denied access to the benefits of a treaty between China and the home country, since the partnership would be unable to meet the "liable to tax" test to be considered a tax resident of its home country. One possible way to resolve this issue would be to introduce special provisions in a treaty that extend treaty benefits to partners or members that are residents of the home country regardless of the non-flow through treatment by the source country. However, the 2013 China-France treaty seems to be the only tax treaty signed by China to contain such provisions.

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