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China clarifies tax treaty clauses

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In brief

- China has enacted Announcement 11 to clarify several significant issues on tax treaties clauses:
  - Permanent establishments (PEs)
  - Partnership enterprises
  - Shipping and air transport
  - Artists and athletes
- The new rules have taken effect from 1 April 2018.

Feedback

In detail

China's State Administration for Taxation (SAT) has issued Announcement 11 to clarify the following tax issues. It is believed that ambiguity and inconsistency in some tax treaty clauses has driven the need for clarification.

1. Permanent establishments (PEs)

» For some time, two different China-day thresholds have been used in China's tax treaties for determining PE presence in China for labour services, i.e. 183 days or six months in any twelve-month period.

Announcement 11 has declared an end to the twin approaches, and adopted 183 days as the threshold for all tax treaty implementation. The distinction between these two approaches is summarised below:

	6 month approach	183 days approach
Tax rule	Guoshuihan [2007] No. 403	Guoshuifa [2010] No. 75
PE determination	6 months within any 12-month period	183 days within any 12-month period
Calculation unit	"Month"	"Day"
Calculation method	1 month is counted for any days (even 1 day) in 30 consecutive days	Exact number of days

As a matter of fact, the six-month approach has gained less popularity nowadays due to its widely criticised pitfall in PE determination - one day's presence in China within one calendar month could be counted as one month. The overall shift to the 183 days approach should be welcome by taxpayers.

» Announcement 11 also mandates that PE is considered constituted by any premises used for educational activities by a China-foreign academic programme or an insitution without a legal person status. In other words, the length of presence in China by expatriates staff is no longer relevant for PE assessment.

2. Partnership enterprises

» Announcement 11 clarifies how partnership should be treated by the following manners:

China-souced income to a Chinese partnership enterprise	China-sourced income to an overseas partnership enterprise	
	Overseas partnership enterprise	Overseas partner
A partner to a partnership enterprise can enjoy tax treaty treatment for its China-sourced income, if: • It is a resident of a tax treaty's counterparty; • Its income is taxable both in China and in its country.	Its income is taxable in China, if: • It has an establishment or premises in China; or • Its income is China-sourced. Further, it can enjoy tax treaty treatments if it is a resident in a tax treaty's counterparty and its income is taxed in China (unless provided otherwise by a tax treaty).	Its China-sourced income can enjoy tax treaty treatments, if: • The partnership enterprise is treated a transparent entity by its country's laws, i.e. its income is deemed as the income to the partner; and • The partner is a resident of a tax treaty's counterparty.

» We illustrate what the new rule means in three cases below whereby an individual (called "**A**") is a partner to a partnership enterprise (called "**B**"), and a country (called "**C**") has concluded a tax treaty with China. A and B are bound by some conditions mentioned below if intending to enjoy tax treaty treatments:

1) A, an overseas individual and a partner to a Chinese partnership enterprise, can enjoy tax treaty treatments, if A is a resident in country C, and his China-souced income is taxable in C;

2) B, an overseas partnership enterprise, can enjoy tax treaty treatments, if B is a tax resident in C;

3) A, a tax resident in C and a partner to an overseas partnership enterprise in C, can enjoy the tax treaty treatments for his China-sourced income, if:

- The tax treaty allows A to enjoy tax treaty treatments for his income from a partnership enterprise; and
- A's home country regulates that the income of a partnership enterprise is deemed as income to A.

3. Shipping and air transport

» Announcement 11 clarifies the scope of international transportation business (ITB) which can enjoy tax exemption per the tax treay. ITB refers to the use of planes or vessels to operate cross-border cargo / passenger transportation, with the following inclusions and exclusions elaborated by Announcemnt 11.

ITB includes:

Income from voyage / time chartered vessels, wet leased planes, interest earnings from ITB income deposits, and income from auxiliary activities closely related to ITB (e.g. sales of tickets for other ITB enterprises, sending passengers to airports, sending goods between buyers (or warehouses) and airports / ports, and delivery of goods to buyers directly.)

Auxilliary activities have to meet all these criteria in order to qualify as ITB:

a) The applicant's core business is ITB, and can be proven by an official business license;
b) Auxilliary activites are closely related to ITB, and can hardly be run separately; and
c) Income from auxilliary activites is less than 10% of the gross ITB income.

ITB excludes:

Income from dry leased vessels / planes and leased containers (or containers related facilities) – unless they constitute the auxiliary activities to ITB.

» The clarification has removed doubts on whether voyage / time chartered vessels, wet leased planes and auxilliary activities is ITB or not for tax exemption, and ended the recurrent dispute with tax authority.

4. Artists and athletes

» Income to artists and athletes is usually exceptionally treated in tax treaties, and taxed by the country where activites are conducted (as opposed to individual services clauses which are not taxed unless a PE is constituted). It is thus crucial to assess what artist and athlete activities do cover.

» Announcement 11 adds further clarification to usually brief tax treaty clauses regarding artists and athletes, and endorses the principles of existing explanatory notes provided by a SAT (ref. Guoshuifa [2010] No. 75).

1) Scope of activities by artists and athletes

It adds also activities not yet mentioned in Circular 75, like corporate promotional activities, e.g. annual dinners, ribbon-cutting ceremony, speaking in commercial events (except speaking in meetings), and electronic games.

2) Taxation right on income to artists and athletes

Announcement 11 reiterates that the taxation right is vested in the nation where the artists or athletes perform their activities, and emphasizes that their income, even collected indirectly via an agent, will still be taxed but under two different manners:

- Taxed as income to artists or athletes – if it is deemed as their income by domestic laws; or
- Taxed as income to the agents – if it is silent in domestic laws about the income ownership.

WTS observation

Announcement 11 provides important SAT interpretations applicable to all tax treaties of China. It aims at eliminating ambiguity and disputes in treaty implementation. However, there remains some room for different interpretation on tax treaty treatments for partnership enterprises. It may call for the need for further elaboration.

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