The PRC SAT issued Public Note 11 to update interpretations of tax treaty articles

China Tax News – April 2018

ABOUT MAZARS

Mazars is an international, integrated and independent organisation, specialising in audit, accountancy, tax and advisory services. We rely on the skills of more than 20,000 professionals in the 86 countries and territories which make up our integrated partnership.

Including the Hong Kong office, we operate 28 offices in China with around 3,500 staff. They are fully committed to serving the growing and diversified needs of both Chinese companies and international firms.

INTRODUCTION

On 9 February 2018, the PRC State Administration of Taxation ("SAT") issued Public Notice [2018] No. 11 ("PN No.11"). The circular updates the SAT's interpretation of a few selected articles under Double Tax Agreements ("DTAs") that are concluded by China[1] and clarifies the tax treatments of partnerships.

[1] China's current interpretation regarding the implementation of Double Tax Agreements is mainly reflected in the "Notice Issued by the SAT Releasing the (Interpretation of the Articles in the DTA between China and Singapore and the Relevant Protocols)" (Guoshuifa [2010] No.75) ("Circular 75"). The interpretation in Circular 75 is also applicable to other DTAs concluded by China, which are similar to those in the China-Singapore DTA.

MAZARS

Salient points are set out as follows:

- Clarification of permanent establishment ("PE") for Sino-foreign co-operative education institutions and the 6-month period threshold for service PEs;
- Amending the scope of international shipping and air transportation income under DTAs;
- Comprehensive interpretations of the DTA article involving Artists and Sportsmen; and
- New interpretations for DTA treatment of partnerships, both domestic and foreign, and their partners.

Details

Permanent Establishment ("PE")

PN No. 11 clarifies that if the foreign partner of a Sino-foreign co-operative education institution which may not have a legal person status, is conducting the education activities in a location in China, that location would be considered as a PE in China for the foreign partner. In other words, these foreign parties would be subject to PRC corporate income tax ("PRC CIT") for their China sourced income even though their staff or personnel may be present in China for a very short period of time. If a PE exists, their staff sent to China would likely be subject to the PRC individual income tax ("PRC IIT") as well. As such, these foreign parties should immediately review their PRC tax positions to avoid challenges by the PRC tax authorities.

Besides, PN No. 11 also formally clarifies that the 6-month period threshold should be interpreted as 183 days. In some relatively old DTAs signed by China, e.g., China-Canada DTA, "the 6-month period" expression is used instead of 183 days. The "6-month period" would sometimes trigger disputes with local tax authorities as different local tax bureaus may have different interpretations. The argument relates to what constitutes a month. It is conceivable that if a foreign person being present in China for say 20 days in a particular month could be considered as being present in China for a month. This formal clarification would be welcome news to taxpayers. It is hoped that it would be the end of future disputes with local tax bureaus in this regard.

Shipping and air transport income

It has long been an international practice that international transport income would include income from voyage charter, time charter and wet lease of ships and aircraft but excluding income from bare-boat and dry lease. In addition, ancillary activities to the international transportation can be considered as part of an international transportation as long as the extent of income from these ancillary activities is less than a certain percentage of the shipping enterprise's gross income. Generally that percentage is 10%. However, the PRC tax authorities in the past under Circular 75 took the view that those above mentioned income was excluded from international transport income and was considered as ancillary income. Therefore they would only be eligible for treaty benefits if their amount, along with other ancillary income is less than 10% of the gross income of the enterprise.

As a result, many ship owning entities would not be eligible for the DTA benefits. Ship owning entities generally obtain their income from wet leases.

PN No. 11 reclassifies these incomes as international transport income. This practice is in line with international practice. However, income from bare-boat lease and dry lease of aircraft and lease of containers are still not considered as international transport income but may be eligible for treaty benefit only if their

total amount, together with income from other ancillary activities, is not exceeding the 10% threshold.

Artists and Sportsmen

PN No. 11 clarifies the scope of activities of foreign artists and sportsmen performed in China that would be subject to PRC income tax.

The general principle is that China has the taxing right on the income from the activities taken place in China regardless of whether such income is received by the relevant artists or sportsmen.

First of all, PN No. 11 defines what the activities of artists / sportsmen are. For example, activities of an artist include his activities in performing and its related promotion activities, but excluding any public speaking activities not forming part of promotion activities.

Secondly, artists or sportsmen receiving compensation directly or indirectly would be subject to PRC tax without having considered the provisions under Articles 7 (Business Profits), 14 (Income from Independent Services) and 15 (Income from Employment).

The second point is illustrated in examples noted, in the explanatory notes to PN 11 as follows:

Example 1:

In a symphony orchestra case, artists employed by the orchestra would be subject to PRC IIT, without any protection under Articles 15, on the part of salary income corresponding to the performances in China while the orchestra itself would be subject to PRC CIT on the relevant performance income regardless of whether the orchestra is considered having a PE in China or not.

Example 2:

The relevant artists / sportsmen are employed by a one-person company. The tax treatment is the same as the above orchestra case. That is: both the relevant artists / sportsmen would be subject to PRC IIT even if he / she is in China for less than 183 days in any twelve month period. The company would be subject to the relevant PRC tax on its net profits sourced from China, even though it has not established a PE in China.

Example 3:

The employer would not pay any salaries to the individual artists / sportsmen. Even the income is not received by the concerned artists / sportsmen or their employers, the PRC tax authorities would still be entitled to charge tax on the recipients of the relevant income. Anti-avoidance provision may apply as the case may be.

DTA treatments for partnerships and their partners

Partnerships established in China

It is unclear as to the DTA application to a partnership and its partners who are non-residents of China. Under China's tax laws, a partnership established in China is not a taxable entity. Instead, each partner is the taxpayer in relation to the income allocated from the partnership. After the partner is taxed on the income, future distributions from the partnership would not be subject to PRC tax again. PN 11 clarifies that, for a partnership established in China, if its partner is a tax resident of another contracting jurisdiction, the portion of the income derived by the partner from sources in China may be eligible for the DTA benefits in China.

For example, if the partnership receives dividends, such dividends may be eligible for the DTA benefits.

Partnerships established outside China

Under China's tax laws, a partnership established outside China ("foreign partnership") is regarded as a non-resident enterprise. PN 11 clarifies the DTA treatment for a foreign partnership under the following two scenarios:

Scenario 1:

If the foreign partnership is treated as a tax resident of the other contracting jurisdiction and is liable to tax in that jurisdiction (i.e. the partnership is being treated as a taxable entity), then the partnership may enjoy the DTA benefits in China as a tax resident of that other contracting jurisdiction.

For example, under Hong Kong's tax laws, a Hong Kong partnership would be the taxable entity. In that case, the Hong Kong partnership may enjoy the DTA benefit under the Hong Kong-China Tax Agreement, as long as the partnership obtains a Tax Resident Certificate issued by the Hong Kong tax authority.

Scenario 2:

Where income derived by a foreign partnership is treated as income earned by its partner (i.e. the partnership is being treated as a tax transparent entity) under the domestic law of the other contracting jurisdiction, the PRC tax authorities will grant the DTA benefits to the partners of the partnership. However, this treatment is applicable only if the DTA between China and the other contracting jurisdiction clearly stipulates that under the abovementioned circumstances, the partners who are tax residents of the other contracting jurisdiction may enjoy the relevant DTA benefits. Under PN 11, it seems that under Scenario 2, only partners who are tax residents of the same jurisdiction as the partnership can enjoy the DTA benefits in China. In other words, partners who are tax residents of a third tax jurisdiction would not be eligible for the DTA benefits in China.

This interpretation is too restrictive. Out of the more than 100 DTAs entered into by China, only the DTA with France explicitly states the above treatment. It seems therefore only French partners of a French partnership would be able to enjoy the treaty benefits. If the DTA does not specify the treatment, even if the partnership is a tax transparent entity under the domestic tax laws of the other country, the partners may not be able to enjoy any DTA benefits in China.

Mazars observations

In general, it is welcome news that the SAT has clarified certain issues in its interpretation of DTA terms since the issue of Guoshifa [2000] No. 75. However it seems to be too harsh for partnerships in Scenario 2 above. It is a general international practice that when a partnership is tax transparent, its partners should be entitled to treaty benefits. The current practice is somewhat deviating from that international practice.

The content of this newsletter is only for general guidance on matters of interest and is not meant to be comprehensive. The application and impact of laws can vary widely based on the specific facts involved. Readers are advised to consult their tax advisors before making any business decisions.

About Mazars
Mazars is an international, integrated and independent organisation, specialising in audit, accountancy, tax and advisory services. We rely on the skills of more than 20,000 professionals in the 86 countries and territories which make up our integrated partnership. Including the Hong Kong office, we operate 28 offices in China with around 3,500 staff. They are fully committed to serving the growing and diversified needs of both Chinese and international companies.

CONTACTS

Mazars – Tax Department

HONG KONG
42nd Floor, Central Plaza
18 Harbour Road
Wanchai, Hong Kong
Tel.: (+852) 2909 5555

Michael To
Managing Partner
Tel: (+852) 2909 5680
Email: michael.to@mazars.hk

Anthony Tam
Tax Partner
Tel: (+852) 2909 5604
Email: anthony.tam@mazars.hk

BEIJING
Floor 25 (front desk & meeting rooms area) & 26 (staff working area), Tower A
Pacific Century Place 2A
Gong Ti Bei Lu - Chao Yang District
100027 Beijing
Tel: (+86 10) 8429 8078

Joey Zhou
Partner
Tel: (+86 10) 8429 8078 (ext. 228)
E-mail: joey.zhou@mazars.cn

SHANGHAI
8th Floor, One Lujiazui
No. 68 Yin Cheng Middle Road
200120 Shanghai
Tel: (+86 21) 6168 1088

Peter Law
Partner
Tel: (+86 21) 6168 1088 (ext. 278)
Email: peter.law@mazars.cn

GUANGZHOU
1308, Grand Tower
No. 228 Tianhe Road - Tianhe District
510620 Guangzhou
Tel: (+86 20) 3833 0235

Benoît Stos
Partner
Tel: (+86 20) 3833 0235 (ext. 201)
E-mail: benoit.stos@mazars.cn

For more information, please visit:
www.mazars.hk