

# China Tax Alert

Issue 19, June 2017



## China signs Multilateral Instrument to implement BEPS reforms

### Regulations discussed in this issue:

- Organisation for Economic Co-operation and Development ("OECD") document "Multilateral Convention to implement tax treaty related measures to prevent Base Erosion and Profit Shifting (BEPS)", released on 24 November 2016 ("Multilateral Instrument", or "MLI")
- OECD document "Explanatory Statement to the Multilateral Convention to implement tax treaty related measures to prevent Base Erosion and Profit Shifting", released on 24 November 2016 ("MLI Explanatory Statement")
- "Status of List of Reservations and Notifications at the Time of Signature" document submitted by 67 MLI signatories to OECD on 7 June 2016
- OECD document "Action Plan on Base Erosion and Profit Shifting", issued on 19 July 2013 ("BEPS Action Plan")
- OECD report "BEPS Action 15: Developing a Multilateral Instrument to Modify Bilateral Tax Treaties", issued on 5 October 2015 ("BEPS Action 15 Report")

### Background

On 7 June 2017 the OECD hosted a signing ceremony in Paris at which representatives of 68 jurisdictions, including Wang Jun, Commissioner of the Chinese State Administration of Taxation (SAT), signed the G20/OECD BEPS Project's Multilateral Instrument (MLI). The MLI was envisaged by the 2013 BEPS Action Plan (Action 15) as a mechanism for simultaneously updating thousands of bilateral double tax agreements (DTAs) with the October 2015-finalized BEPS minimum standards and recommendations, and so deliver a more robust global tax framework. It had been released by the OECD on 24 November 2016, following its adoption by the 100 plus jurisdictions of the MLI development group.

The conclusion of the MLI by the 68 signatory jurisdictions is anticipated to lead to updates of in excess of 1100 DTAs, out of a global network of more than 3000. A further 8 countries have formally expressed their intent to sign the MLI, and an additional 25 plus countries are anticipated to join the MLI by the end of 2017, for which further signing ceremonies may be arranged. Updates will be made, inter alia, to treaty abuse rules, permanent establishment (PE) rules, and MAP rules. In view of the requirements for MLI ratification by jurisdictions, the treaty updates are anticipated to generally start to take effect in 2019 and 2020.

### Tax treaty changes selected by China under the MLI

The first round of updates will update 46 of China's DTAs, which may rise to 52 in the near future. This includes the DTAs with most of China's major trading and investment partners, but not the US, which has not signed the MLI. The most significant updates will be the insertion of treaty anti-abuse principal purposes test (PPT) rules into each of the updated DTAs, alongside a new 'preamble' reinforcing anti-treaty abuse rules. There will also be a replacement of the corporate tax residence tie breaker test in some of the updated DTAs, and a modernization of the MAP and TP articles in certain older treaties. However, the most highly anticipated MLI update, in respect of the new BEPS PE rules, will not be made to Chinese DTAs.

#### Regulations discussed in this issue:

- OECD report " BEPS Action 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances" issued on 5 October 2015 ("BEPS Action 6 Report")
- OECD report " BEPS Action 7: Preventing the Artificial Avoidance of Permanent Establishment Status" issued on 5 October 2015 ("BEPS Action 7 Report")
- OECD report "BEPS Action 14: Making Dispute Resolution Mechanisms More Effective" issued on 5 October 2015 ("BEPS Action 14 Report")
- OECD report " BEPS Action 2: Neutralising the Effects of Hybrid Mismatch Arrangements" issued on 5 October 2015 ("BEPS Action 2 Report")

A host of other rules adopted by other MLI signatories, in relation to arbitration, transparent entities, and PE triangular abuses, will also not be adopted by China. Enterprises operating cross-border with China should monitor the entry into effect of the new DTA rules and new SAT guidance, and plan accordingly.

#### *BEPS rule changes and how the MLI updates for them*

The October 2015 BEPS Deliverables set out a large number of international tax rule changes, both domestic law and DTA related, to upgrade and reinforce the global tax system. Some of these are minimum standards, which can be satisfied in a number of different ways, and some of these are recommended (non-mandatory) best practices. For further detail see [China Tax Alert Issue 28 \(October 2015\)](#).

The MLI provides a sophisticated mechanism through which the treaty-related measures, both minimum standards and recommendations, can be updated to DTAs in a highly customized manner attuned to the needs and existing rules of a given jurisdiction. The various options set out for jurisdictions to choose from, and the mechanisms through which MLI updates take effect, are set out in [China Tax Alert Issue 35 \(November 2016\)](#). This alert will not recap fully on all of these options and mechanics, but will focus instead on the selections made by China and their effect on China's tax treaties.

Very briefly, the MLI contains complex 'matching' rules. Signatory countries need to nominate DTAs ('covered tax arrangements'), within their treaty network, for update, and must choose from a broad range of update options. Where two signatory countries both nominate the DTA they have with each other, then MLI updates may take effect. However, this additionally requires that the countries selected the same, or compatible, update options. Whether specific MLI update selections by two countries 'match', and are effective in updating the bilateral DTA in question, is a function of the complex mechanics of the MLI.

To allow these mechanics to operate, signatory jurisdictions deposited 'position' documents with the OECD (the 'Depositary') on 7 June, detailing their selection of DTAs for update and provisional update preferences. It is recognized that these preferences may subsequently be adjusted in the course of national ratification procedures. The position documents contain, in respect of each possible MLI update, the signatories' choice of update options and alternatives, and their reservations not to update DTAs, for a particular provision, in certain instances (e.g. where equivalently effective provisions exist, or where they simply do not desire the update). The position documents must also include a detailed identification ('notifications') of the provisions in existing DTAs which the signatories have designated for substitution (this is guided by the MLI's 'Compatibility Clauses'). China's position document is 37 pages in length, similar to those of other countries.

The OECD has produced a decision flow chart to facilitate determination of whether two signatory countries selections 'match' and result in effective updates. It is understood that a software tool is being developed by the OECD to facilitate the 'matching' analysis but, for the moment, a purely manual exercise needs to be conducted to come to an evaluation of effective 'matches' and updates. KPMG China have conducted initial analysis on this basis.

### Regulations discussed in this issue:

- OECD Report " BEPS Action 5: Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance" issued on 5 October 2015 ("BEPS Action 5 Report")
- OECD Model Tax Convention on Income and Capital, issued in 2014
- Notice on Implementation of Dividend Clause in Treaties, Guo Shui Han [2009] No. 81, issued by the SAT on 20 February 2009 ("SAT Circular 81 [2009]")
- Circular on How to Understand and Recognise the "Beneficial Owner" in DTAs, Guo Shui Han [2009] No. 601, issued by the SAT on 27 October 2009 ("SAT Circular 601 [2009]")
- Announcement on Property Gains Clause in Treaties, SAT Announcement [2012] No. 59, issued by the SAT on 31 December 2012 ("SAT Circular 59 [2012]")

### MLI updates to the global treaty network

A central purpose of the MLI is to update DTAs for the BEPS minimum standards, which include:

- BEPS Action 5: Patent box regimes and exchange of rulings;
- BEPS Action 6: Anti-treaty abuse rules;
- BEPS Action 13: Transfer Pricing (TP) documentation;
- BEPS Action 14: Mutual Agreement Procedure (MAP) measures.

Of these, Action 6 and 14 both provide for certain minimum standard DTA updates, though they also set out certain optional updates. The 98 members of the Inclusive Framework on BEPS have all committed to meet the BEPS minimum standards and are subject to rolling Peer Reviews on their timely adherence. In light of this, many Inclusive Framework jurisdictions have clearly concluded that the MLI provides a useful mechanism to facilitate the speedy update of their DTAs to meet the treaty abuse and MAP minimum standards. Most of the 68 signatories of the MLI are Inclusive Framework members.

Signatory countries have all selected to update their nominated treaties for the Action 6 PPT minimum standard, and a small number (12 countries, mainly in South America) have additionally selected the limitation on benefits (LOB) clause. Countries have also largely used the MLI to update their DTA MAP articles in line with the BEPS Action 14 minimum standard requirements. This being said, as the mandatory binding arbitration rule, which forms part of MAP, was optional this has only been adopted by 26 jurisdictions. Indeed, most of the optional elements of the Action 6 and Action 14 rules have seen only partial uptake amongst signatories.

Partial uptake is also evident for the purely optional Action 2 (hybrid mismatches) and Action 7 (PE) update options available through the MLI. With regards to the highly anticipated BEPS PE changes, it appears, on a preliminary analysis that more than 60 of the signatories selected to make at least some of the BEPS PE updates through the MLI. However, just over 30 signatories (mainly in South America and Europe) opted for the more controversial dependent agent PE updates.

Crucial for the success of the MLI is that signatories nominate a large number of their DTAs for update. This seems to have been generally the case for most signatories, and the OECD reports 85% of the DTAs of the signatories were nominated into the MLI. A small number of countries (e.g. Switzerland) have limited the number of nominated DTAs, at least initially. It is understood that this is to leave further time for advance discussions with DTA counterparties before nomination into the MLI. Certain countries that are already in bilateral negotiations on BEPS-updates to DTAs also decided to exclude these DTAs from the MLI.

### *MLI updates to China's treaty network*

China has nominated 101 of its 103 DTAs with sovereign states into the MLI. This excludes the tax arrangements between Mainland China and Hong Kong, Macao, and Taiwan, and the treaties with Chile (recently updated) and India. As not all of the MLI signatories have DTAs with China, a total of 49 China DTA nominations are matched by a relevant signatory. Excluding Switzerland and Spain which have not nominated their China DTAs into the MLI, and Norway, which is yet to supply its position paper, 46 China DTAs are clear for update.

There are a further 5 DTAs, nominated by China, the counterparty for which have formally notified the OECD of their intent to sign. As such, assuming that Norway and the new signatories do not exclude their China DTAs from the MLI, the 52 relevant China DTAs for update are:

Armenia, Australia, Austria, Belgium, Bulgaria, Canada, Croatia, Cyprus, Czech Republic, Denmark, Egypt, Estonia\*, Finland, France, Georgia, Germany, Greece, Hungary, Iceland, Indonesia, Ireland, Israel, Italy, Jamaica\*, Japan, Korea, Kuwait, Latvia, Lithuania, Luxembourg, Malta, Mauritius\*, Mexico, Netherlands, New Zealand, Nigeria\*, Norway\*\*, Pakistan, Poland, Portugal, Romania, Russia, Serbia, Seychelles, Singapore, Slovakia, Slovenia, South Africa, Sweden, Tunisia\*, Turkey, UK.

\* It is assumed that these countries, which have indicated a formal intent to sign the MLI, will nominate their China DTAs into the MLI

\*\* It is assumed that Norway, which has signed the MLI, will nominate its China DTA into the MLI

The MLI updates will therefore cover the DTAs with China's major OECD trading partners (with the exception of the US) and partly cover DTAs with China's BRICS trading partners (excluding Brazil and India). As China has, in total, 106 tax treaties and arrangements, the update of 52 through the MLI means that 54 treaties and arrangements will see no MLI update.

The precise updates that will be made to the China DTAs are a function, as noted above, of the 'matching' of the selections made by China and by the DTA counterpart in their position documents. The following sections outline in more detail the notable China's MLI update selections.

### *Treaty anti-abuse updates to China's DTAs*

BEPS Action 6 on treaty anti-abuse rules contains both minimum standards and recommended (non-obligatory) DTA changes.

China has opted for the PPT minimum standard, rejecting updates based on the LOB. The PPT uses a purpose test which asks whether "one of the principal purposes" of a business or investment arrangement designed and used by a taxpayer is to gain access to benefits under a DTA (so-called 'treaty shopping'). DTA benefits may be denied where the tax authorities determine this to be the case. The PPT will be inserted into 45 of the 46 initially matching DTAs. The Germany DTA, which was recently updated with a PPT, will not be further updated.

China's position document identifies, for 12 of the matched DTAs, existing provisions in the dividends, interest, royalty and other income articles (and in some cases standalone articles) which deny DTA relief to arrangements which have DTA benefits as "the main purpose or one of the main purposes". These will be replaced by the PPT. The relevant DTAs in this regard are those with Australia, Belgium, Czech Republic, Denmark, Finland, France, Malta, Netherlands, New Zealand, Russia, Singapore, and the UK.

It might further be noted that the other 33 of the DTAs nominated for PPT update are, due to the workings of the MLI matching mechanism, to be updated "to the extent of incompatibility", i.e. where existing provisions are not adequate to meet the PPT standard. This may involve further analysis and discussion between China and the relevant DTA partners.

China has also selected to replace, in line with the minimum standard, the preamble language of all its DTAs with the following wording to clarify DTA object and purpose:

*"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)".*

*And (as an optional addition):*

*"Desiring to further develop their economic relationship and to enhance their co-operation in tax matters".*

It would appear that more than half the MLI nominated treaties will be updated with the additional 'economic relationship' sentence.

China has opted to insert, into its DTAs which provide for a lower WHT rate on dividends arising from substantial shareholdings, a time requirement qualification criterion. The ownership/control holding in the payer must exceed 25% of the total capital throughout a 365 day time period that includes the date of payment of the dividends. Given limited matching it appears that just 7 China DTAs would be updated for this provision, including those with Armenia, Belgium, France, Germany, Ireland, Netherlands, and Russia.

China has opted to update the provisions, included in the capital gains articles of most of its DTAs, which apply WHT to disposals of equity in land-rich entities. China will expand the scope of this provision to cover disposals of interests in partnerships and trusts with immovable property holdings, alongside the disposals of corporate equity currently covered. It appears that 14 DTAs are to be updated for this, including the DTAs with Australia, Belgium, Egypt, France, Germany, Greece, Indonesia, Ireland, Mexico, Netherlands, Portugal, Russia, Serbia, and Slovakia,. China has, however, chosen not to insert into DTAs an MLI provision which would provide a 365 day "look back" period for determining whether an entity was land-rich at any point in that time frame. SAT Circular 59 [2012] already provides a three year look back period for the land-rich test.

China has chosen to include the MLI provision in DTAs which clarifies that DTAs do not restrict a jurisdiction's right to tax its own residents, which appears to update 12 DTAs. However, China has chosen not to make the MLI update which would include an integrity provision for WHT relief on payments to third country PEs in so-called "triangular cases". This is the only treaty abuse MLI provision not adopted, even in part, by China.



### *PE updates to China's DTAs*

China has decided not to make any of the proposed BEPS updates to PE rules. These proposed expansion of the dependent agent PE (DAPE) rule accompanied by a narrowing the independent agent PE rule, the subsection of the PE exclusions for 'specific activities' (e.g. warehousing, purchasing, information collection etc.) to an overriding 'preparatory and auxiliary' (P&A) test or an anti-fragmentation safeguard on the specific exclusions, and an anti-contract splitting rule directed at planning around the construction PE time test.

### *Action 2 hybrid mismatches related updates to China's DTAs*

All of the Action 2 related MLI updates are optional.

China has chosen not to make the update to clarify the application of DTAs to transparent entities. This provision is of particular relevance to partnership and trust arrangements, providing that a source country for a payment, considering how to apply WHT in line with a DTA, will be guided by the tax treatment in a residence state. If the underlying partner's residence state taxes him on income earned through the partnership, then the source state should look to apply WHT rates as per the DTA with the partner's residence state.

China has, however decided to adopt the provision on dual resident entities. This substitutes a 'mutual agreement' approach to the resolution of such cases, in place of the traditional 'place of effective management' (POEM) rule used under the OECD and UN MTCs, and in most of China's DTAs. 18 DTAs appear to be updated for this, including those with Armenia, Australia, Egypt, Indonesia, Ireland, Israel, Japan, Mexico, Netherlands, New Zealand, Poland, Romania, Russia, Slovakia, Slovenia, Serbia, South Africa, and the UK. This means that for the remaining 88 Chinese DTAs the "POEM" test continues to apply.

### *MAP updates to China's DTAs*

BEPS Action 14 on MAP sets out 17 specific minimum standard measures and 11 best practices. Most of these are identified improvements to tax authority internal administrative procedures, but a small number of the minimum standards require updates to DTA provisions. The default option provided under the MLI is for signatories to update their DTA MAP articles to the version included in the 2014 version of the OECD MTC. China has chosen, in line with the alternatives offered in the MLI, to have its updates deviate from the 2014 version in certain respects. In particular:

- China provides that it will not update its DTAs with the first sentence of the 2014 version MTC MAP article, which permits a local resident to reach out to the competent authority of the other contracting state, as well as that in his own. China will instead seek to ensure, through bilateral negotiations, for its DTAs to permit a local resident to present his MAP case solely to the competent authority of the jurisdiction in which he is resident, and not to the competent authority of the other contracting state. Should the local competent authority not consider the taxpayer's objection to be justified then they will implement a bilateral notification or consultation process with the other competent authority.

- China will, however, update several older DTAs, with Italy, Romania and Turkey, where the permitted period for initiating the MAP is less than three years since the taxing action, as per the 2014 version MTC MAP article. Amendments may also be made to the DTAs with Canada and the UK, to the extent of incompatibility with such update.
- China will update the Mexico DTA to include a commitment for both sides to endeavor, through mutual agreement between the competent authorities, to resolve issues for which one side alone cannot arrive at a satisfactory solution.
- China will update the agreements with Indonesia, Italy, and Turkey, to provide that any MAP adjustment agreement reached between the competent authorities will be implemented, notwithstanding the time limits in the domestic law of the contracting states.
- China will update the DTAs with Belgium, Italy, Australia and Mexico, to provide that the competent authorities will consult together for the elimination of double taxation in cases not provided for in the DTA. This provision was lacking relative to the 2014 version MTC MAP article, and other China DTAs.

China has chosen to allow the replacement of its Article 9 corresponding adjustment rules, across 25 DTAs in its network, through the MLI. Many of these will only be updated 'to the extent of incompatibility' for which further review by China and the other DTA partner will be necessary.

China has not opted to make any of the binding arbitration MLI updates. It might be noted that the Peer Review of China's MAP arrangements is set to commence in late 2018.

### **KPMG Observations**

China has, with 106 DTAs, the world's third most expansive DTA network after the UK and France. The network has been under construction for 34 years, since 1983 when the first China DTA was signed with Japan. While China has been continuously refreshing its DTAs and upgrading their provisions, with 52 China DTAs set for update through the MLI, this is a very significant overhaul. The effective date of the changes will depend on the China and DTA counterparty timeframes for national ratification of the MLI, and further legislative procedures in certain cases. The changes would generally be expected to start to come into effect in the course of 2019 and 2020, with some DTA updates taking longer to take effect. China has yet to clarify whether it would produce consolidated versions of Chinese DTAs updated through the MLI.

High-level observations on the significance of the changes in a China context are set out below.

*Treaty abuse rules:* As was widely anticipated, China has opted for the PPT updates to its DTAs through the MLI. There is some concern amongst taxpayers with the broad wording of this rule; it can be activated where “one of the principal purposes” of an arrangement is to obtain DTA benefits. The “one of the principal purposes” PPT rule appears broader than the domestic China general anti-avoidance rule (GAAR), which targets arrangements with a “sole or main purpose” of avoiding tax. There is concern that it could be used to deny DTA benefits for many arrangements which, while primarily commercially motivated, were also structured in order to gain access to optimal treaty relief, e.g., essentially commercially motivated holding company structures for which DTA dividend withholding tax (WHT) relief was an important consideration, amongst others.

It must be said that, at the present time, the ultimate impact of the PPT updates to China’s DTA network remains unclear. In treaty abuse enforcement cases by Chinese local tax authorities observed in practice it is not always clear which rule the tax authorities are applying to deny DTA relief.

A broad ‘beneficial ownership’ test, encompassing anti-treaty abuse features, has been at the disposal of the authorities for many years under SAT Circular 601 [2009]. The GAAR may be applied, and many Chinese DTAs include specific articles reserving China’s ability to apply the GAAR. As noted above, many treaties include provisions in the passive income articles which deny DTA relief to arrangements which have DTA benefits as “the main purpose or one of the main purposes” (i.e. essentially the same language as the PPT). In addition, a small number of DTAs contain LOB clauses (e.g. US, Mexico, Russia, Chile), and one even already includes a BEPS-influenced PPT (Chile). How PPT fits into this framework and how it would materially affect taxpayer access to DTA benefits, is yet to be confirmed and subject to further SAT guidance.

The other MLI treaty abuse updates are of lesser significance. One matter though is whether, in light of the inclusion of the 365 day time test in 7 China DTAs, China will alter its existing, unilateral provision, in SAT Circular 81 [2009], which requires equity interests to be held for 12 months prior to declaration of dividend, for WHT relief to be applied.

*PE:* China was earlier thought likely to adopt the BEP PE changes, and China was, in one sense, an early adopter of the BEPS PE changes, with the May 2015-signed China-Chile DTA even adopting the BEPS PE rules pre-finalization by the OECD. However, China has ultimately decided not to adopt the BEPS PE rules through the MLI.

The BEPS expanded agency PE concept had created much concern about the subjectivity of the new standards and uncertainty as to whether sales hub structures would need to be reorganized. With the decision not to include these changes in China’s MLI updates, this relieves somewhat the earlier concerns. The SAT have signaled plans to release new PE recognition and profit attribution guidance by the end of 2017, so this will be highly anticipated.



*MAP:* The SAT has recently been bulking up its resources to resolve MAP cases. The MLI updates to the MAP wording in some of China's older DTAs further facilitates MAP, though these are not changes of the highest significance.

*Action 2 updates:* The decision not to adopt the transparency provision means that, as before, ambiguity remains as to when relief can be accessed under China DTAs when tax transparent entities are in point. It might be noted that the Chinese domestic entity characterization rules, including partnership tax rules, are still being developed, and so even with greater clarity on transparency issues in the DTA context this would have remained a challenging area.

The updates to the dual residence rules would likely mean greater reliance on competent authority procedures for the 18 relevant DTAs, though this is an issue that rarely arises in practice in China.

#### *MLI updates are an ongoing process*

The MLI update process has only just begun, and a great range of complex issues call for resolution in the coming months and years:

- The details mechanics of the MLI are tailored to guide signatories towards the appropriate updates for each of their bilateral DTAs. However, MLI DTA updates may still run into difficulty. MAP procedures and even a conference of the MLI participants may be called upon to resolve disputes in relation to updates of China's or other countries' DTAs.
- Existing MLI signatories are likely to nominate further DTAs into the MLI. Signatories may, in addition, withdraw their initial reservations on particular MLI updates, resulting in further DTA updates. Taking such expansive action is rendered simple by the MLI (by contrast withdrawing nominated DTAs and MLI selections is difficult). Indeed, China may at some future point decide to withdraw its initial reservations on certain MLI rules, leading to further changes to the China DTA network.
- The effective dates of the MLI updates for specific bilateral DTAs will depend on the date of final ratification of the MLI in both of the relevant countries. Changes will likely start to enter into effect from 2019 and 2020 for many countries. In order to plan for the effective dates of updates to China's DTAs through the MLI, taxpayers will need to carefully monitor national ratification processes.
- As noted above, the BEPS minimum standard compliance Peer Review processes for treaty abuse rules and MAP rules are getting underway, and there will be continual updates on whether countries have, via the MLI, met their obligations. China will be amongst the countries reviewed in this regard.

Further jurisdictions are set to join the MLI and nominate their DTAs into it. As China has nominated 101 DTAs but only matches on 46 (52 soon) this means that many China DTAs will be subject to additional update, without any action by China and simply by other countries entering the MLI. As such, taxpayers around the world can expect a steady stream of MLI related news in future, which require monitoring.

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