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CHINA TAX ALERT

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New China-France double tax agreement signed

Regulations discussed in this issue:

- China-France double tax agreement and accompanying protocol, signed on 26 November 2013 ('PRC-France DTA and Protocol')

Background

A new People's Republic of China (PRC) – France Double Tax Agreement (DTA), due to replace the 1984 PRC-France DTA and its associated Protocol of the same year, was signed on 26 November 2013 alongside a new Protocol. Assuming the remaining approval procedures are completed in the course of 2014, the new DTA could take effect from as early as 1 January 2015.

The DTA provides for lower levels of dividend withholding tax (WHT) than under the 1984 DTA. It clarifies the application of the DTA to partnerships to deal with conflicts of classification, and tightens up the DTA permanent establishment (PE) provisions, allowing for greater certainty in their application. Reflecting the changes in China's economic status and global role since the conclusion of the last DTA, it provides for special WHT treatment of Sovereign Wealth Funds (SWF), while abolishing the previous tax sparing relief. Further, in line with the thrust of tax policy in both of France and China in recent years, the new DTA introduces new anti-abuse provisions, facilitates the application of domestic anti-avoidance measures, and provides for greater administrative cooperation.

Key features of the new DTA

DTA WHT rates

The old DTA provided for a dividend WHT rate of 10%. Because Chinese sourced dividends paid to non-resident corporations are subject to a 10% withholding tax under domestic law, the old DTA provides no incremental benefit for a French company deriving such dividends. The new DTA now goes further providing that, above and beyond the 10% general DTA rate, a 5% rate will apply where direct shareholdings of 25% and above are held in a company of the other state.

The general DTA WHT rates for interest (10%) and royalties (10% generally; 6% for use of or right to use industrial, commercial or scientific equipment) remain the same under the new DTA as under the old DTA. This being said, a more detailed and comprehensive list of the public, and publically owned, institutions benefitting from the 0% interest WHT rate is set out in the interest article.

The capital gains article is clarified, to reserve exclusive taxing rights to the residence country, over gains not specifically dealt with elsewhere in the article. Further, for the purposes of determining whether the source country possesses taxing rights over disposals of equity in land rich companies, and in non-land-rich companies in which the transferor holds at least 25% of the shares, the new DTA establishes look-back periods of 36 months and 12 months, respectively.

Further, the Protocol provides that 0% WHT will apply to dividends, interest and capital gains, other than those in relation to immovable properties, derived by qualified, listed sovereign wealth funds (SWF).

Application of DTA to partnerships

Complexity in determining entitlements to DTA benefits can arise where partnerships are used for cross-border business and investment activity. This is due to both inter-jurisdictional conflicts of classification as well as contrasting approaches to entity taxation, which may result in one country treating the partnership entity as the taxable person while the other country regards the partners as taxable. Unwarranted denial of DTA benefits resulting in double taxation, or opportunities to exploit the DTA to obtain double non-taxation, may result.

The OECD has set out an interpretative approach to applying DTAs to deal with such issues under which partners are entitled to DTA benefits to the extent they are liable to tax on their share of the partnership profits in a given DTA country. Consequently, focus is on the classification of a partnership by the residence state of its members. However, greater complexity arises in the case of France due to the 'quasi-transparent' French tax law treatment of partnerships. Partnerships may be considered to realise taxable income while the partners are viewed as simply settling the tax liability. A similar issue exists with respect to Chinese partnerships. This complicates the determination of which person may be considered 'subject to tax' and the 'resident' entitled to invoke DTA benefits.

In line with the OECD recommendation to modify DTAs to reflect the advised approach where an interpretative approach cannot achieve this aim, the China-France DTA includes detailed rules on partnership DTA entitlements in the residence article, as is the case in France's DTAs with Japan, the UK, and the US. These rules operate by reference to; (i) the source of profits; (ii) the state in which the partnership is organised; (iii) whether income is treated as being that of the partnership or the partners.

Under the rules, where China sourced income arises to a French partnership, then DTA benefits may be granted to the French partnership, if it is a taxable person under the French tax law, or granted to the French partners, if they are instead treated as the taxable persons under the French tax law. In other words, the characterization of the French partnership by France controls in this case. In contrast, where China sourced income arises to a Chinese partnership with French partners, DTA benefits may be denied if either France or China views the Chinese partnership as non-transparent.

Issues arising where the partnership is in a third country are also addressed. In the case where income is sourced from China via a third country partnership with partners who are tax residents of France, if both France and the third country view the partnership as transparent, the China sourced income will be

eligible to treaty benefits under the new China-France DTA, as long as the partnership country has Exchange of Information provisions in place with both France and China. However, if France views the third-country partnership as opaque, China will not grant DTA benefits to such income.

PE and business profits

Clearer definitions of PE and the PE profit attribution methodology are included in the new DTA, and should be of particular benefit to French investors into the PRC.

- Construction and installation projects, which are now expanded to include associated supervisory services, now only constitute a PE if they continue for more than 12 months, as against 6 months in the old DTA

- The Service PE provision has been altered such that a PE will now exist where the provision of services is for a period of more than 183 days in a 12 month period; this replaces the previous reference to 6 months in a 12 month period

- The 'independent agent' carve-out from PE recognition has been clarified so as to limit the circumstances in which the carve-out will be rendered unavailable due to the agent acting almost wholly for a foreign principal. The new DTA provides that the agent must additionally deal with the principal on non-arm's length terms in order not to be regarded as independent. Similar language can be found in the recently ratified China-UK DTA.

- The clause in the business profits article, which states that executive and general administrative expenses incurred for the purposes of a PE's business may be allowed in calculating the taxable profits of the PE, is now no longer qualified by the previous wording, which stated that recharges from head office to the PE are not deductible

- Additional clarifications on the calculation of PE profits are provided in the Protocol, which look to pre-empt potential arbitrary PE profit attributions. In particular they clarify that (a) a PE is not to be taxed on its total trade receipts but on the remuneration for its actual activity and (b) in the case of installation, construction and public works projects, the PE is to be taxed only on the part of the contract accomplished by the PE

Anti-avoidance and enforcement

Specific anti-avoidance limitation on benefits (LOB) clauses, which exclude the application of DTA benefits where the main purpose or one of the main purposes of an arrangement is to take advantage of the terms of the DTA, have been included in each of the dividend, interest, royalties and other income articles. This sits alongside the new provision in Article 24, providing that DTA should not be available if the main purpose for entering into certain transactions or arrangements was to secure a more favourable tax position, and granting the DTA benefits would be contrary to the object and purpose of the DTA. This means that the Chinese general anti-avoidance rule (GAAR) may be applied where appropriate.

These anti-avoidance measures are further supported by the inclusion of the latest version of the Exchange of Information (EOI) article from the OECD Model, which expands the information which can be requested from the DTA counterparty, from solely what is 'necessary' to administering domestic tax law, to what is 'foreseeably relevant'.

A new article has been included on assistance in the collection of taxes. In parallel with the signing of the new DTA, the PRC's State Administration of Taxation (SAT) and France's Public Finance Administration entered into a

Memorandum of Understanding on Bilateral Cooperation. This is intended to be a multi-channel bilateral mechanism for tax cooperation which will seek to leverage the possibilities provided by the new tax collection assistance article.

Provisions have been included in the immovable property, capital gains and other income articles to enable France to apply anti-avoidance provisions directed at tax planning which aims to avoid tax on income and gains associated with investments in French immovable property.

Other notable provisions of the new DTA

- It is now provided that, if greater profits are attributed to an enterprise, under the associated enterprises article, a corresponding adjustment should be made in the other Contracting State to mitigate double taxation

- The "other income" article in the previous DTA permitted both states to tax income which arises in one of the Contracting states and is not dealt with in other DTA articles. Under the new DTA taxing rights over such income are reserved to the residence state

- A Shipping and Air Transport Article, absent from the previous DTA, has been inserted into the new DTA and provides for mutual tax exemption. The relevant matters were previously covered by separate agreements between France and China; these continue to be in force

- The threshold shareholding required, in order for a Chinese resident receiving a French dividend to obtain an indirect foreign tax credit (FTC) under the DTA, in respect of any underlying French tax, has been raised from 10% to 20%

- The New DTA additionally covers a new French social tax,"les contributions sur l'impôt sur les sociétés", introduced since the old DTA was signed. This inclusion may facilitate obtaining FTC in respect of such taxes, where relevant, by Chinese corporate investors.

- The old DTA tax sparing clause, which gave a French FTC in respect of China sourced passive income regardless of actual Chinese tax paid, has been abolished, though limited period grandfathering applies

- A number of other articles in the DTA have been modernised. The residence article now includes the standard tie breaker test for individuals, and place of effective management is clarified as determinative for corporations. The timeframe within which it is determined whether independent service and employment income is subject to tax is also tweaked to take account of periods of activity straddling calendar years

KPMG observations

The new DTA, which generally follows the OECD Model Convention but with a number of deviations, is largely consistent with the approach taken in the new and recently renegotiated DTAs with a number of European countries, including Belgium, Finland, Denmark, the Netherlands, Switzerland and the UK.

The detailed provisions concerning the application of the DTA in situations involving partnerships is, however, new to Chinese DTA practice. Chinese tax practice with respect to partnerships is still evolving, with the long-awaited SAT circular on partnership taxation still to be released. While the particular partnership provisions of the PRC-France DTA are limited in direct application, they may prove helpful in establishing the basis on which Chinese international tax practice will deal with partnerships, in cross-border situations, going forward.

The change to the capital gains article, clarifying that taxing rights on gains not dealt with elsewhere in the article are reserved to the residence country, helps to settle a long-running ambiguity as to whether gains on disposals of Chinese shareholdings of less than 25% would be exempt from Chinese WHT under the PRC-France DTA.

The shift from the 6 month test to the 183 day test for the Services PE is positive. In some cases local PRC tax authorities have applied the latter by counting one day's presence in a month as a whole month, although the SAT is preparing to issue a new circular to clarify this aspect.

The introduction of special WHT treatment of SWFs, while in parallel abolishing the previous tax sparing relief, neatly encapsulates the shift in China's economic status, and in its global economic role. In the place of an incentive for French companies to invest in China, the new DTA facilitates and orients the flow of China's ever-growing outbound investment towards France.

The new DTA anti-abuse provisions, the updated EoI, and the administrative cooperation provision reflect the increased focus globally, shared by China and France, on cooperation to combat aggressive tax planning, and are in line with other initiatives being undertaken by the countries both unilaterally and multilaterally.

CONTACTS

Khoonming Ho
Partner in Charge, Tax
China and Hong Kong SAR
Tel. +86 (10) 8508 7082
khoonming.ho@kpmg.com

Beijing/Shenyang
David Ling
Partner in Charge, Tax
Northern China
Tel. +86 (10) 8508 7083
david.ling@kpmg.com

Qingdao
Vincent Pang
Tel. +86 (532) 8907 1728
vincent.pang@kpmg.com

Shanghai/Nanjing
Lewis Lu
Partner in Charge, Tax
Central China
Tel. +86 (21) 2212 3421
lewis.lu@kpmg.com

Hangzhou
Martin Ng
Tel. +86 (571) 2803 8081
martin.ng@kpmg.com

Chengdu
Anthony Chau
Tel. +86 (28) 8673 3916
anthony.chau@kpmg.com

Guangzhou
Lilly Li
Tel. +86 (20) 3813 8999
lilly.li@kpmg.com

Fuzhou/Xiamen
Maria Mei
Tel. +86 (592) 2150 807
maria.mei@kpmg.com

Shenzhen
Eileen Sun
Partner in Charge, Tax
Southern China
Tel. +86 (755) 2547 1188
eileen.gh.sun@kpmg.com

Hong Kong
Karmen Yeung
Tel. +852 2143 8753
karmen.yeung@kpmg.com

Northern China
David Ling
Partner in Charge, Tax
Northern China
Tel. +86 (10) 8508 7083
david.ling@kpmg.com

Vaughn Barber
Tel. +86 (10) 8508 7071
vaughn.barber@kpmg.com

Roger Di
Tel. +86 (10) 8508 7512
roger.di@kpmg.com

John Gu
Tel. +86 (10) 8508 7095
john.gu@kpmg.com

Kevin Lee
Tel. +86 (10) 8508 7536
kevin.lee@kpmg.com

Paul Ma
Tel. +86 (10) 8508 7076
paul.ma@kpmg.com

Vincent Pang
Tel. +86 (10) 8508 7516
+86 (532) 8907 1728
vincent.pang@kpmg.com

Michael Wong
Tel. +86 (10) 8508 7085
michael.wong@kpmg.com

Jessica Xie
Tel. +86 (10) 8508 7540
jessica.xie@kpmg.com

Irene Yan
Tel. +86 (10) 8508 7508
irene.yan@kpmg.com

Leonard Zhang
Tel. +86 (10) 8508 7511
leonard.zhang@kpmg.com

Tracy Zhang
Tel. +86 (10) 8508 7509
tracy.h.zhang@kpmg.com

Abe Zhao
Tel. +86 (10) 8508 7096
abe.zhao@kpmg.com

Catherine Zhao
Tel. +86 (10) 8508 7515
catherine.zhao@kpmg.com

Eric Zhou
Tel. +86 (10) 8508 7610
ec.zhou@kpmg.com

David Chamberlain
Tel. +86 (10) 8508 7056
david.chamberlain@kpmg.com

Tony Feng
Tel. +86 (10) 8508 7531
tony.feng@kpmg.com

Tiansheng Zhang
Tel. +86 (10) 8508 7526
tiansheng.zhang@kpmg.com

Central China
Lewis Lu
Partner in Charge, Tax
Central China
Tel. +86 (21) 2212 3421
lewis.lu@kpmg.com

Anthony Chau
Tel. +86 (21) 2212 3206
+86 (28) 8673 3916
anthony.chau@kpmg.com

Cheng Chi
Tel. +86 (21) 2212 3433
cheng.chi@kpmg.com

Chris Ho
Tel. +86 (21) 2212 3406
chris.ho@kpmg.com

Lily Kang
Tel. +86 (21) 2212 3359
lily.kang@kpmg.com

Sunny Leung
Tel. +86 (21) 2212 3488
sunny.leung@kpmg.com

Christopher Mak
Tel. +86 (21) 2212 3409
christopher.mak@kpmg.com

Martin Ng
Tel. +86 (21) 2212 2881
+86 (571) 2803 8081
martin.ng@kpmg.com

Yasuhiko Otani
Tel. +86 (21) 2212 3360
yasuhiko.otani@kpmg.com

John Wang
Tel. +86 (21) 2212 3438
john.wang@kpmg.com

Jennifer Weng
Tel. +86 (21) 2212 3431
jennifer.weng@kpmg.com

Lachlan Wolfers
Tel. +86 (21) 2212 3515
lachlan.wolfers@kpmg.com

Grace Xie
Tel. +86 (21) 2212 3422
grace.xie@kpmg.com

Bruce Xu
Tel. +86 (21) 2212 3396
bruce.xu@kpmg.com

Zichong Xu
Tel. +86 (21) 2212 3404
zichong.xu@kpmg.com

William Zhang
Tel. +86 (21) 2212 3415
william.zhang@kpmg.com

Michelle Zhou
Tel. +86 (21) 2212 3458
michelle.b.zhou@kpmg.com

Cheng Dong
Tel. +86 (21) 2212 3410
cheng.dong@kpmg.com

David Huang
Tel. +86 (21) 2212 3605
david.huang@kpmg.com

Dylan Jeng
Tel. +86 (21) 2212 3080
dylan.jeng@kpmg.com

Ho Yin Leung
Tel. +86 (21) 2212 3358
hoyin.leung@kpmg.com

Henry Ngai
Tel. +86 (21) 2212 3411
henry.ngai@kpmg.com

Amy Rao
Tel. +86 (21) 2212 3208
amy.rao@kpmg.com

Southern China
Eileen Sun
Partner in Charge, Tax
Southern China
Tel. +86 (755) 2547 1188
eileen.gh.sun@kpmg.com

Sam Fan
Tel. +86 (755) 2547 1071
sam.kh.fan@kpmg.com

Angie Ho
Tel. +86 (755) 2547 1276
angie.ho@kpmg.com

Jean Jin Li
Tel. +86 (755) 2547 1128
Tel. +86 (592) 2150 888
jean.j.li@kpmg.com

Jean Ngan Li
Tel. +86 (755) 2547 1198
jean.li@kpmg.com

Lilly Li
Tel. +86 (20) 3813 8999
lilly.li@kpmg.com

Kelly Liao
Tel. +86 (20) 3813 8668
kelly.liao@kpmg.com

Maria Mei
Tel. +86 (592) 2150 807
maria.mei@kpmg.com

Michelle Sun
Tel. +86 (20) 3813 8615
michelle.sun@kpmg.com

Bin Yang
Tel. +86 (20) 3813 8605
bin.yang@kpmg.com

Hong Kong
Ayesha M. Lau
Partner in Charge, Tax
Hong Kong SAR
Tel. +852 2826 7165
ayesha.lau@kpmg.com

Chris Abbiss
Tel. +852 2826 7226
chris.abbiss@kpmg.com

Darren Bowdern
Tel. +852 2826 7166
darren.bowdern@kpmg.com

Barbara Forrest
Tel. +852 2978 8941
barbara.forrest@kpmg.com

Daniel Hui
Tel. +852 2685 7815
daniel.hui@kpmg.com

Charles Kinsley
Tel. +852 2826 8070
charles.kinsley@kpmg.com

John Kondos
Tel. +852 2685 7457
john.kondos@kpmg.com

Alice Leung
Tel. +852 2143 8711
alice.leung@kpmg.com

Curtis Ng
Tel. +852 2143 8709
curtis.ng@kpmg.com

Kari Pahlman
Tel. +852 2143 8777
kari.pahlman@kpmg.com

John Timpany
Tel. +852 2143 8790
john.timpany@kpmg.com

Wade Wagatsuma
Tel. +852 2685 7806
wade.wagatsuma@kpmg.com

Jennifer Wong
Tel. +852 2978 8288
jennifer.wong@kpmg.com

Christopher Xing
Tel. +852 2978 8965
christopher.xing@kpmg.com

Karmen Yeung
Tel. +852 2143 8753
karmen.yeung@kpmg.com

Rebecca Chin
Tel. +852 2978 8987
rebecca.chin@kpmg.com

Kate Lai
Tel. +852 2978 8942
kate.lai@kpmg.com

Alex Lau
Tel. +852 2143 8597
alex.lau@kpmg.com

Benjamin Pong
Tel. +852 2143 8525
benjamin.pong@kpmg.com

kpmg.com/cn