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CHINA TAX ALERT

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Extensive clarifications to China's international tax rules in context of new China-France tax treaty

Regulations discussed in this issue:

- *Announcement concerning putting into effective implementation the People's Republic of China (PRC)-France double tax agreement and accompanying protocol*, ('PRC-France DTA interpretative guidance') issued on 4 March 2015
- *China-France double tax agreement and accompanying protocol*, signed on 26 November 2013 ('PRC-France DTA and Protocol')
- *Interpretations on Clauses of the Agreement between the Government of the People's Republic of China and the Government of the Republic of Singapore for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and of the Protocol thereto*, Guo Shui Fa [2010] No. 75 (Circular 75)

Background

On 4 March 2015 the Chinese State Administration of Taxation (SAT) issued interpretative guidance for the PRC-France double tax agreement (DTA) and accompanying protocols, which entered into effect from 1 January 2015. The PRC-France DTA interpretative guidance is a significant document which sheds light on the interpretation and application of China's extensive network of comprehensive income and capital DTAs, and follows on from Circular 75 issued by the SAT five years ago and which was applicable to the interpretation of the PRC-Singapore DTA.

The interpretative guidance gives an insight on how China is putting the work of the G20/OECD Base Erosion and Profit Shifting (BEPS) project into effect. Furthermore, guidance is provided on somewhat novel China tax concepts such as the China DTA treatment of transparent entities such as partnerships and collective investment vehicles (CIVs), the use of China's domestic law and treaty-based anti-avoidance rules to combat treaty shopping, and the interaction of the new indirect offshore disposal rules with DTAs.

PRC-France DTA interpretative guidance clarifications

A detailed description of the content of the PRC-France DTA is set out in *China Tax Alert Issue 3 (February 2014)* and can be referred to for a full overview of the DTA's provisions, while the following concentrates on interpretative guidance clarifications of a potentially wider relevance to China's DTA network.

Application of DTA to partnerships and similar entities

The PRC-France DTA interpretative guidance reiterates the rules, in Article 4 of the DTA, which describe how to determine the tax resident who is entitled to claim relief under DTA, where partnerships or similar entities are in use. The rules are designed to deal with the particular complexity that arises because of the novel 'quasi-transparent' French tax law treatment of partnerships under which partnerships may be considered to realise taxable income while the partners are viewed as simply settling the tax liability.

Regulations discussed in this issue:

- *Administrative Measures for the General Anti-tax Avoidance Rules: Trial Implementation* ('GAAR Measures'), SAT Order No. 32, issued by the SAT on 2 December 2014 and effective 1 February 2015
- OECD Report, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances*, issued on 16 September 2014
- *Announcement on Issues Concerning the Clauses on Capital Gains in Tax Agreements,* SAT Announcement [2012] No. 59 (Announcement 59)
- *Announcement of the State Administration of Taxation on Several Issues Relating to Corporate Income Tax on Gains from Indirect Transfer of Assets by Non-resident Enterprises*, Gong Gao [2015] No. 7 (Announcement 7), issued by the SAT on 3 February 2015
- *Circular on how to understand and recognise the "Beneficial Owner" in DTAs*, Guoshuihan [2009] No.601 (Circular 601), issued by the SAT on 27 October 2009
- OECD Report, *The Granting of Treaty Benefits with respect to the Income of Collective Investment Vehicles*, issued in 2010
- OECD discussion draft, *Preventing the artificial avoidance of PE status*, issued on 31 October 2014

As China does not have comprehensive entity classification and income attribution rules, the elucidation by the PRC-France DTA of specific rules explaining when to treat an entity as transparent potentially also advances the development of entity classification and income attribution rules in China. While the PRC-France DTA had set out the mechanism for dealing with partnerships simply as rules, the PRC-France DTA interpretative guidance states them in terms of 'principles' which are to be 'abided by'. This principle requires the source state to adopt a treaty application approach, which has regard to the attribution rules of the residence state, when making its own income attribution for determining whether DTA benefits apply.

Treatment by the residence state of a partnership as transparent or non-transparent is consequently followed by the source state to treat, respectively, the partners/members, or the partnership itself, as residents capable of claiming DTA relief. The situations where the partnership is in the residence state, the source state or a third state are all dealt with and such rules help to accommodate the quasi-transparent French partnership taxation approach, as well as the Chinese partnership taxation approach (which in principle treats partnerships as transparent), avoiding unwarranted denial of DTA relief and consequent double taxation, or undesired double non-taxation outcomes.

Collective investment vehicles

The DTA protocol provides that tax exempt CIVs may request for the withholding tax reductions provided in the dividend and interest articles to be granted to the extent that the income arises to residents of the CIV's state of establishment who are invested in the CIV, and to the extent that the income is taxed in the hands of those resident investors as beneficial owners of this income. It is clarified that it is the CIV itself which could apply for such tax relief, and this is confirmed in the PRC-France DTA interpretative guidance.

Anti-avoidance rules

Article 24 of the PRC-France DTA provides that DTA benefits shall not be available if the main purpose for entering into certain transactions or arrangements was to secure a more favorable tax position, and granting the DTA benefits would be contrary to the object and purpose of the DTA.

This is notably the first time that a China DTA has incorporated a full-fledged DTA-based GAAR. China in recent years had generally tended to incorporate provisions in its DTAs allowing for the application of the domestic law GAAR and inclusion of anti-avoidance rules in the passive income articles for dividend, interest, royalties and other income.

The PRC-France DTA interpretative guidance notes Article 24 to be an "independent" anti-avoidance provision, which is a purpose-based test looking at arrangements which have as their "main purpose or one of their main purposes" the securing of DTA benefits. The kind of tax avoidance arrangements targeted are clarified as including those looking to take advantage of the PE article, the residence definition, and income characterisation rules.

Both the Article 24 DTA GAAR rule and passive income article anti-avoidance rules are noted in the PRC-France DTA interpretative guidance to be required to be administered by the Chinese tax authorities in accordance with the recently released GAAR measures; see China Tax Alert Issue 1, January 2015.

Also of relevance to anti-avoidance are the comments in the PRC-France DTA interpretative guidance on Article 13 on capital gains. The guidance draws particular attention to the rule providing that gains on shares, deriving their value from PRC immovable property at any time within the 36 months before disposal, will be taxable in China. This puts formally into the DTA a rule which was already introduced unilaterally by SAT Circular 59 [2012] (see *China Tax Alert Issue 1, January 2013*) and it is very much in line with the recommendation in the OECD BEPS Treaties report.

The PRC-France DTA interpretative guidance draws attention to the fact that China's taxing rights under this provision extend beyond share transfers to transfers of holdings in trusts and similar entities and that the rules apply to holdings through several layers of intermediaries. As such, through this interpretation of the DTA provision, the SAT is supporting the application of the newly expanded indirect offshore disposal rules in Announcement 7. This cover transfers of PRC immovable property through a broad range of offshore transactions, beyond the mere transfer of foreign holding company shares; see *China Tax Alert Issue 3, February 2015*.

Permanent establishment

The DTA protocol provides, and the interpretative guidance clarifies, guidance to pre-empt potential arbitrary PE profit attributions. It insists that a PE must be taxed solely on remuneration for its actual activity and not on its total trade receipts/ the total value of the contract to which its efforts relate.

KPMG observations

The PRC-France DTA interpretative guidance is a document of comparable breadth and significance to the SAT Circular 75 [2010] guidance on the interpretation of the PRC-Singapore DTA and touches on a large number of matters which may assist with the interpretation and application of China's current 105 comprehensive income and capital DTAs. It also provides an insight into how China may look to (re)negotiate future DTAs, a process which could be significantly accelerated should the BEPS proposal for a multilateral instrument to update all DTAs simultaneously gain traction.

Application of DTAs to partnerships and similar entities

The PRC CIT Law treatment of partnerships and other non-corporate entities remains highly ambiguous. Foreign entities (including foreign partnerships) which source income from China are prima facie treated as taxable persons, regardless of their organisational form, as the CIT Law applies PRC tax to all "foreign enterprises and other organisations". Due to ambiguities in the implementing provisions for taxing Chinese partnerships, foreign partners in Chinese partnerships may not benefit from transparent income flow-through treatment, despite the goal of the law being to treat Chinese partnerships as tax transparent. Chinese trust arrangements and joint ventures can also potentially be subject to default non-transparent tax treatment, in the absence of specific 'look-through' provisions for the circumstances in point.

Given the potential for confusion this can create when these domestic rules interact with DTAs, the clear look-through rules provided in PRC-France DTA, now clarified in the PRC-France DTA interpretative guidance as more broadly applicable 'principles', are helpful.

Collective investment vehicles

The ability for a tax-exempt CIV to apply for DTA relief reflecting the qualification of local CIV investors for such relief is a direct application of the OECD's recommendations in their 2010 Report on "The Granting of Treaty Benefits with respect to the Income of Collective Investment Vehicles".

This provides for a far more commercial and workable tax treaty relief access arrangement than having to make, on a 'look-through' basis, individual applications for DTA relief for each and every of the underlying foreign CIV investors. The generalised expansion of such an approach to other DTAs would be very welcome. The incorporation of this provision in the PRC-France DTA at least allows this treatment to be argued for persuasively in relation to other DTAs.

Anti-avoidance rules

In the past year the SAT have been steadily working towards a greater alignment of their key PRC anti-avoidance rules directed at cross-border transactions and structures, namely the indirect offshore disposal rule, the GAAR and the various DTA anti-avoidance measures.

The strong inter-linkage of the GAAR and the indirect offshore disposal rule was recently confirmed with the issuance of Announcement 7 [2015], and it is clear from the comments in the PRC-France DTA interpretative guidance on the capital gains article that the SAT also is crafting its DTAs to accommodate the latest manifestation of the indirect disposal rule.

The emphasis in the PRC-France DTA interpretative guidance that the administration of the anti-avoidance rules in the DTA must be in line with the GAAR measures further strengthens the alignment of the GAAR and anti-treaty shopping rules. It remains to be seen whether this will result in future changes to tax authority practice in applying the Circular 601 [2009] 'commercial substance' test when determining whether to grant DTA relief for dividends, interest and royalties, and in determining whether to grant DTA relief for capital gains.

It is further notable that the wording of the Article 24 DTA-based GAAR rule, when considered together with the clarifications in the interpretative guidance, bears a likeness to the "Principal Purposes Test" recommended by the OECD in the BEPS 2014 Deliverables Report on Treaty Abuse.

Permanent establishment

The emphasis on the activities actually conducted in China is helpful leverage for taxpayers dealing with local tax authorities' potential over-zealous attribution of profits to their PRC PEs. This is particularly so in the context of the expansions to the PE concept envisioned under the discussion draft issued by the OECD on BEPS Action Plan Point 7, for Agency PE and Construction PE contract splitting. This being said, the explicit focus on PE in the guidance notes on the new DTA based GAAR shows how the PRC tax authorities are gearing up for more rigorous enforcement against PE, going forward.

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