Analysis: Australia – China Income Tax Agreement

See treaty text
Type of treaty: Income Tax
Based on the UN Model Treaty
Signed: November 17, 1988
Entry into force: December 28, 1990
Effective date: Australia: For WHT on income derived by a non-resident: income that is derived on or after July 1, 1991, For other Australian income tax: income of any year beginning on or after July 1, 1991; China: Income derived during any taxable year beginning on or after January 1, 1991
This Analysis was written in May 2010 by **Bob Deutsch** of KPMG Australia and updated in March 2011 by **Professor Michael Dirkis** of Sydney Law School.

Article 1 Personal Scope

See treaty text
Persons who are resident of one or both States.

Article 2 Taxes Covered

See treaty text
In Australia
- Federal income tax;
- Resource rent tax.

In China
- Individual income tax;

As well as application to the taxes existing at the time the Treaty was signed (listed above) there is a provision applying the Treaty to any identical or substantially similar taxes which are imposed after the date of signing of this Treaty.

Article 3 General Definitions

See treaty text
"Australia": The territory of Australia including:
- The Territory of Norfolk Island;
- The Territory of Christmas Island;
- The Territory of Cocos (Keeling) Islands;
- The Territory of Ashmore and Cartier Islands;
- The Territory of Heard and McDonald Islands; and
- The Coral Sea Islands Territory,

including any territory beyond the territorial seas which, under Australian law and in accordance with international law, has, or may be designated as an area within which Australia may exercise rights with respect to the seabed and subsoil and their natural resources.
"China": The People's Republic of China. It includes its territorial sea in which Chinese tax laws apply and areas beyond the territorial sea over which China may, in accordance with domestic and international law, exercise sovereign rights for the purpose of the exploration and exploitation of the natural resources of the seabed and subsoil and the waters above these.
"Person": Includes an individual, company or any other body of persons.
"Company": Any body corporate or any entity which is treated as a body corporate for tax purposes.
All terms not specifically defined take their meaning from the domestic tax law of the country seeking to apply the Treaty.

Article 4 Residence

See treaty text
Under this Article, "Resident" refers to a person who is fully liable to tax in one of the Contracting States by reason of being resident of that State under that tax laws of that State.
In the case of individuals resident in both Contracting States, a tie-breaker rule applies, such that:
- A person will be deemed to be a resident of the State in which he has a permanent home.

• If that person has a permanent home in both States, he will be deemed to be resident in the State with which his economic and personal (or neither) relations are closer (for a discussion of these concepts in Australia, see, e.g. ATO ID 2006/107, ATO ID 2006/108, and ATO ID 2006/184).

Domestic law
Australia
Generally, you are an Australian resident for tax purposes if you can be said to be "residing in Australia". It covers persons who ordinarily live in Australia and those persons who have retained foreign nationality, citizenship or domicile but whose usual place of residence is Australia;
You may be deemed to be a resident if
• your domicile is Australia (regardless of any physical presence in Australia) unless you can prove that you have established a permanent place of abode elsewhere; or ;

• you are present, continuously or intermittently, in Australia for a total of more than one-half of the year of income, unless you establish both that you have a usual place of abode outside Australia and do not intend to take up residence. A person will be deemed to be a resident of the State in which he has a permanent home.

Residence: Companies
If a company is resident in both States, (e.g. because one determines residence according to the place of legal incorporation and the other according to place of management) then it will be deemed resident in the State where its place of effective management or head office is situated. However, if such a company has its place of effective management in the State and head office in the other State, the company will be deemed to be resident solely where the head office is situated.
Domestic law
Australia
A company is resident in Australia if the following is satisfied:
• It is incorporated in Australia (irrespective of where central management and control is exercised). Once a company has been incorporated in Australia it can never lose its Australian residence for tax purposes.

• Central management and control is exercised in Australia (irrespective of which country the company was incorporated in) and the company carries on business in Australia.

• The company is neither incorporated in Australia nor is its central management and control exercised there but carries on business in Australia and its voting control is in the hands of resident Australian shareholders.

China
Companies incorporated in China are considered tax resident. Additionally, under the Corporate Income Tax Law which became effective as of January 1, 2008, China now determines company residence according to the place of effective management. This is interpreted as the exercise of the overall management and control of production, business, employees, finance and assets of a company (Articles 2 and 3 of the CITL). Thus day-to-day control as well as strategic management must be considered and the definition is very broad.
Partnerships and fiscally transparent enterprises
There are no definitions given in the Treaty as to which bodies may be treated as transparent. Article 3 merely states that the term "company" designates any body corporate or any entity which is treated as a body corporate for tax purposes. Australia treats partnerships as transparent consistent with OECD principles.

Article 5 Permanent Establishment

See treaty text
This Article defines the term "permanent establishment". The profits of an enterprise of one of the Contracting States can only be taxed on an arising basis in the other Contracting State to the extent that they are attributable to a permanent establishment in that other State.
This Treaty broadly uses the OECD and UN definitions: Three types of permanent establishment are envisaged: A fixed place of business, a service permanent establishment and an agency permanent establishment.
Fixed placed of business

In this context a "permanent establishment" means a fixed place of business through which the business of the enterprise is wholly or partly carried on. Types of establishment particularly included follow the UN Model and involves:

- A place of management;
- A branch;
- An office;
- A factory;
- A workshop;
- A mine, an oil or gas well, a quarry or any other place of extraction of natural resources; and
- A farm or forest.

The term "permanent establishment" encompasses:

- A building site, construction or assembly or installation project which lasts for more than six months. Supervisory activities in connection with such activities are also included. Note the departure here from the more usual period of 12 months, reflecting the use of the UN Model Convention;
- The furnishing of services, including consultancy services, in a Contracting State by an enterprise of the other Contracting State through employees or other personnel engaged by the enterprise for such purpose, but only where those activities continue (for the same or a connected project) within the first-mentioned Contracting State for a period or periods aggregating more than six months within any twelve-month period; and
- A structure, installation, drilling rig, ship or other equipment used for the exploration for or exploitation of natural resources, or in activities connected with that exploration or exploitation.

According to the OECD Commentary, a "fixed place of business" means to be established at a distinct place with a certain degree of permanence, however, it could be a pitch in a market place, or even part of the premises of another enterprise. There is no requirement that the premises be owned. The Commentary offers the example of an employee of Company A who is allowed to use an office at the premises of Company B. This could create a permanent establishment for Company A in the country of Company B if the arrangement persists for long enough and if the employee is carrying out activities which are more than merely "preparatory or auxiliary" (see below).

The OECD considers that to be fixed, a place of business must be at a specific geographic point. However, if the PE consists of mechanical equipment only, then there is no requirement for mechanical equipment to be fixed to the soil.

As to what constitutes a reasonable period of time to give the necessary degree of permanence, most countries will not consider a presence of less than six months to give rise to a fixed place.

The usual exclusions from the definition of permanent establishment are given so that the following will not constitute a permanent establishment:

(a) The use of facilities solely for the purposes of storage, display or delivery of goods or merchandise belonging to the enterprise;

(b) The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;

(c) The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;

(d) The maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, or of collecting information, for the enterprise;

(e) The maintenance of a fixed place of business solely for the purpose of carrying on any other activity of a preparatory or auxiliary character (e.g. advertising or scientific research).

To apply this Article, it is necessary to be able to make a distinction between functions that are core to a business and those that are merely preparatory or auxiliary. What constitutes core functions will vary from one business to the next. However, any fixed place of business from which the business is partly managed will constitute a permanent establishment even if its function otherwise appears to be preparatory or auxiliary. Also, if services are rendered to other companies within the corporate group

or to third party customers then this would not be preparatory or auxiliary because activities only count as preparatory or auxiliary if they are carried on "for the enterprise" itself.

Service permanent establishment

This Treaty follows the UN Model in specifically providing that services provided by an enterprise may result in a permanent establishment, even though there is no fixed place of business.

The furnishing of consultancy and other services in a State by an enterprise of the other State, whether through an enterprise's own employees or by other personnel hired for the purpose, where the activities continue (connected project) will give rise to a permanent establishment where the activities last for more than six months within any 12-month period. There is little guidance available as to what is meant by "same or connected" but the Commentary on the OECD Model suggests that commercial connections rather than geographic connections are paramount.

Where the services are merely preparatory or auxiliary, as set out above, no permanent establishment will arise.

Agency permanent establishment

Dependent agents may constitute a permanent establishment. Where a person in one State is acting on behalf of an enterprise resident of the other State and has, and habitually exercises, that later State an authority to conclude contracts in the name of the resident, that resident is deemed to have a permanent establishment in that other State, unless the activities of the agent are limited to:

(a) the purchase of goods or merchandise for the enterprise;

(b) or manufactures or processes in that later State for the enterprise goods or merchandise belonging to the enterprise.

Independent agents acting in the ordinary course of their business are not usually PEs of an entity. This Treaty specifically provides that an agent devoted wholly or almost wholly on behalf of an enterprise will not be independent.

General

The fact that a company has a subsidiary in the other Contracting State does not mean that the subsidiary is a permanent establishment of that company, unless it binds the parent company in contract as per the rule for dependent agents. This rule applies generally to groups of companies.

Domestic law

China

The definition of an agency permanent establishment has been widened by Article 3 of the CITL to include business activities carried out for the principal other than purchases and sales. Storage or delivery of goods will also give rise to an agency permanent establishment. Regarding a fixed place of business, the Implementation Rules, effective January 1, 2008 provide that the definition of a permanent establishment (stated as being an establishment or site) will encompass:

- Any establishment from which management or business operations are conducted;
- A representative office;
- An establishment conducting management or business operations;
- A factory, farm or site for exploration of natural resources;
- A site from which services are provided;
- Construction, installation and assembly sites;
- Sites for making or repairs;
- Exploration sites;
- Other engineering projects;
- Other establishments and sites for conducting production and business operations.

The general rules is that a permanent establishment will exist if a site or project lasts for more than six months in a 12-month period.

Under Circular 403 Interpretation and implementation notice for HK's Double Tax Arrangement a permanent establishment will exist if services have been provided in China for more than six

consecutive months in any 12-month period. Counting starts from the arrival of the first employee in China and only ceases when the last employee leaves the country.

Article 6 Income from Real Property

See treaty text

The general rule is that income derived by a resident of a Contracting State from real property in the other State may be taxed in that other State. Thus, for instance, if a resident of one State owns a building in the other State and receives rent, that rent may be taxable in the other State. This treatment also applies to income from real property of an enterprise and to income from real property used for the performance of independent personal services.

Real property is defined on an inclusionary basis and otherwise as per the domestic law of the State in which the property is located.

There is no extension giving the Situs State any right to tax income from movable property of a permanent establishment.

Article 7 Business Profits

See treaty text

Although this Treaty uses elements of the UN Model as well as the OECD Model, the recent OECD work on attribution of profits to permanent establishments is relevant to this Treaty. The aspects of Article 7 of this Treaty which are based on the UN Model are those concerned with the deductibility of expenses in arriving at the taxable profits. The Commentary on the UN Model relating to the rules on deductibility of expenses makes it clear that the extra provisions are present so that all necessary definitions and clarifications on this matter are set out in the text of the treaty rather than merely in a Commentary. The central aim of Article 7 in this Treaty is identical to that in the OECD Model Convention: The profits attributable to a permanent establishment are those which would be earned by the establishment if it were a wholly independent entity dealing with its head office as if it were a distinct and separate enterprise operating under conditions and selling at prices prevailing in the regular market (per paragraph (2) of Commentary on Article 7, UN Model).

The starting point for the computation will be the branch accounts. Provided there is symmetry in the amounts recorded and in the methods of valuation applied in recording the transactions in the books of the different parts of the enterprise, the accounts will normally be an acceptable basis for attributing profit to the permanent establishment. However, any assumptions used in maintaining branch accounts, for instance, an assumption that the branch acts as principal in all cases, when in fact it only acts as intermediary would lead to a downwards adjustment in profit allocated to the branch.

The usual provision providing for the deduction of expenses from the profits of the permanent establishment in accordance with the rules laid down by domestic law is present. Deductions for executive and general administrative expenses are permitted whether incurred in the State where the permanent establishment is situated or elsewhere. There are some particular rules:

As per the UN Model Convention, no deductions are permitted for certain payments by the Head Office or any of the enterprise's other offices:

- Royalties, fees and other similar payments in return for the use of patents, unless they represent reimbursement for actual expenses;

- Commission or fees for specific services performed or for management; and

- Interest on money lent to the permanent establishment (except in the case of a banking enterprise).

On the other hand, no amounts charged by the permanent establishment to the head office, or any other office of the enterprise for these items are to be included in the taxable profits of the permanent establishment.

Only profits actually arising from a permanent establishment may be taxed by the source State. If an enterprise has both a permanent establishment in a State and also derives other income, say, dividends or interest unconnected with the permanent establishment, then the dividends or interest may only be taxed in accordance with Articles 10 and 11 of the Treaty and not this Article.

This Treaty also deals with the situation where accounting records are absent making it impossible to accurately determine the profits of the permanent establishment. The State where the permanent establishment is located may apply its domestic laws to determine the attributable profits, by reference to normal profits of similar enterprises. This seems to envisage a comparable profits approach as might be used in a transfer pricing audit.

No profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise.
The UN has declined to adopt the rewritten Article 7 of the Model Convention (adopted on 22 July 2010). However, the Australian Government has indicated that it will apply the 2010 OECD Commentary to existing treaties, unless that interpretation conflicts with the wording of the article in the agreement.
The allocation of profits
The profits that are exclusively taxable in the country of source are the business profits that are "attributable to" a PE. Under this rule of attribution, the profits that are attributable to a PE are the profits that it might be expected to make in the country in which it is located if it were a separate enterprise engaged in similar activities under similar conditions dealing independently or at arm's length with the parent enterprise of which it is a PE. Generally, amounts may be attributed whether they are from sources within or outside the country in which the PE is situated.
The significance of the application of the attribution rule is that the business profits are calculated on a net basis. That is, expenses, wherever incurred, that are reasonably connected to those profits are deductible, provided they are incurred for the purposes of the PE and pass the independent entity test. If there is no PE in the country of source there can be no taxation of business profits in that country. This is precisely what transpired in the High Court decision in *Thiel v FCT 21 ATR 531*.
Only the profits actually arising from a permanent establishment may be taxed by the source State. If an enterprise has both a permanent establishment in a State and also derives other income, say, dividends or interest unconnected with the permanent establishment, then the dividends or interest may only be taxed in accordance with Articles 10 and 11 of the Treaty and not this Article.
The profits to be attributed to the permanent establishment are the profits that would be expected if the permanent establishment was a distinct and separate enterprise. The starting point for the computation of profits will be the branch accounts, assuming they exist.
Under the 2010 version of the Commentary the approach to attributing profits to a permanent establishment requires a two step process. Firstly, a functional and factual analysis should be carried out, along the lines set out in the OECD's transfer pricing guidelines, to establish the economically significant activities and responsibilities undertaken by the permanent establishment. This will involve establishing the rights and obligations arising out of transactions between the permanent establishment and third parties, e.g. the sales revenue arising from independent customers generated by the permanent establishment as opposed to by the head office. If the permanent establishment takes the form of a factory, then it would assume the obligation to pay for the raw materials which it uses.
"Significant people functions" relevant to the attribution of economic ownership of assets need to be identified to support the attribution of economic ownership of assets of the enterprise to the permanent establishment. Economic ownership is defined in the 2008 OECD final report on the attribution of profits to permanent establishments (July 17, 2008) as the right to income from an asset or the right to depreciate it. Tangible property should be attributed to the location where it is in use. Economic ownership of intangibles rests with the location in which the risks associated with the intangibles is borne: For instance, if an enterprise owns a patent for a particular drug which is sold by distributor companies in many countries, the economic ownership would rest in that part of the enterprise responsible for commissioning the research to develop the drug and which would bear the losses if medical trials failed.
A further set of "significant people functions" are then to be identified: this time, those relevant to the assumption of risks so that an allocation of risks born by the enterprise can be made to the permanent establishment. The OECD's 2008 Report recommends looking for the place of active decision taking rather than mere "rubber stamping". Note that no such distinction between asset management and risk assumption functions are required in the case of enterprises in the financial sector, because it is considered highly likely that these functions would be carried out by the same people.
Secondly, taking into account the picture built up in the functional and factual analysis, the profits of the permanent establishment must be determined. Although this is relatively simple in the case of transactions with third parties,
transactions and dealings with other parts of the enterprise must be determined using the rules laid down in the OECD's Transfer Pricing Guidelines. This means that goods and services provided by head office must carry an arm's length mark up. Pricing policies should be properly documented, which in practice may prove troublesome as firms may not take the same care in documenting the terms of transactions within the firm as they would with third parties. In determining the profits attributable to the permanent establishment, part of the enterprise's interest costs on its borrowings should be

allocated to the permanent establishment. The amount of capital needed to support to functions carried out by the permanent establishment on the assumption that it is a separate entity must be calculated. Then, this total theoretical capital must be broken down into debt and equity (or "free capital"). The greater the risks undertaken by the permanent establishment, the higher the proportion of its notional capital that will be regarded as "free capital". Several methods of establishing the split between "free capital" and debt capital are suggested, including the use of thin capitalisation practices in the State in which the permanent establishment is located. Once the amount of notional debt capital has been determined, an allocation of the enterprise's interest liabilities can be made to the permanent establishment. Note that only actual interest liabilities can be allocated. If the enterprise as a whole has paid no interest to external lenders, then there can be no allocation of interest liability to the permanent establishment. The only exception to this rule is where the permanent establishment is involved in treasury dealings with other parts of the enterprise. Whilst this may well be the case in banking enterprises, it would be unusual in other enterprises. Generally, the interest rates used and the terms of the notional loans to the permanent establishment must be such as would be found between parties dealing at arm's length.
When deciding what transactions should be recognised between the permanent establishment and other parts of the enterprise, the 2008 OECD Report recommends that the only internal transactions which can be recognised in arriving at the permanent establishment's profits are those which relate to real and identifiable events. These would include the physical transfer of goods, the provision of services, the use of intangibles and the transfer of financial assets. Whilst the internal records (e.g. the branch accounts) are the starting point for identifying these transactions, the true test is whether there has been an internal dealing of economic significance.
The Commentary notes that there is no intention to impose "burdensome documentation requirements" and suggests that the tax administrations would give effect to documentation to the extent that:

- the documentation is consistent with the economic substance of the internal dealings?

- the arrangements are such that they are not too different from dealing which one group company might have with a fellow group company? For instance, credit periods should be similar in similar circumstances.

- the dealings presented in the documentation is consistent with the OECD principles for attributing profits to permanent establishments set out in the 2008 OECD Report.

Domestic law
China
The general rule is that permanent establishments are taxed on Chinese source income only. The rules of the Enterprise Income Tax Law are applicable to permanent establishments. The term used in domestic law is "establishments or sites". It has been the practice to limit the use of permanent establishments by foreign enterprises in favour of corporate forms and joint ventures although this appears to be changing. Note that representative offices have been widely used and there are detailed rules for determining the taxable profits of such an office.

Article 8 Shipping and Air Transport

See treaty text
This Article relates to shipping and air transport.

Article 9 Associate Enterprises

See treaty text
This contains the usual OECD provisions regarding transfer pricing. Associated enterprises must adopt the arm's length principle in their dealings with each other, and to the extent that they do not, a Contracting State may make an upwards adjustment to taxable profits.

Article 10 Dividends

See treaty text
This Article provides for the source State to levy withholding tax on dividends paid to a resident of the other Contracting State at a rate which may be lower than that charged under domestic law. The beneficial owner of the dividend must be a resident of the other State.
Withholding tax under this Treaty: 15%
Paragraph (3) defines the term "dividends" to include income from shares or other rights (which are not debt-claims) which participate in profits. Also included is income from other corporate rights which

is treated as income from shares under the law of the State in which the distributing company is tax resident.
Paragraph (4) provides that where, say, an Australian company receives a dividend from an Chinese company, and that dividend is effectively connected with a permanent establishment which the Australian company has in China, then the dividend income will be deemed to be part of the income of the permanent establishment and the provisions of Article 7 dealing with the attribution of business profits will apply.
Paragraph (5) contains the usual provision that a State does not have the right to levy any tax on a dividend unless either the dividend is paid by a resident company or received by a resident shareholder. Thus the fact that a dividend paid by, say, an Australian company may be sourced from profits earned by a permanent establishment which that Australian company has in China, does not give China any taxing rights over that dividend, unless of course, it is received by Chinese shareholders.

Domestic law

Australia

Withholding tax at a rate of 30% on unfranked dividends and 0% on franked dividends Franked dividends are essentially dividends paid out of profits that have been subjected to 30% corporate tax.

China

As per Article 4 of CITL which came into effect on January 1, 2008: 10% withholding tax. This replaces the previous exemption from withholding tax for dividends.
If a company becomes resident of Australia or China for the principal purpose of enjoying benefits under this Treaty, the company does not get the benefit of this Article (see Article 4.5).

Article 11 Interest

See treaty text

Maximum rate of withholding tax 10% providing the beneficial owner is a resident of the other State.
Interest is defined as income from debt-claims of every kind whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits. The term includes income from government securities, bonds and debentures and all other income assimilated to income from money lent from the tax law of the of the State in which the income arises.
premiums and bonuses attaching to these securities. Penalty charges for late payment are not regarded as interest.
There are the usual provisions such that interest received by a non-resident but which relates to a permanent establishment which that non-resident has in the other Contracting State is taxed under Article 7 and thus escapes withholding tax (but not necessarily other tax). Also, interest paid by an enterprise which is borne by a permanent establishment is deemed to arise in the State in which the permanent establishment is situated. Hence, if the permanent establishment and the recipient are in the same State, no withholding tax can arise.
As is usual under the Model Conventions, there is a provision limiting the treaty benefit to an arm's length amount of interest where there is a special relationship between the payer and the beneficial owner.

Domestic law

Australia

In the case of interest, the withholding tax rate is 10% in most instances.

China

Withholding tax of 10%, unless paid in connection with a permanent establishment which the recipient has in China. Interest on certain governmental loans may be exempt.
If a company becomes resident of Australia or China for the principal purpose of enjoying benefits under this Treaty, the company does not get the benefit of this Article (see Article 4.5).

Article 12 Royalties

See treaty text

Withholding tax is limited to 10% provided the beneficial owner is a resident of the other State.
Royalties are defined extensively and include especially payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work, including cinematographic films any patent, trade mark, design or model, plan, secret formula or process, or for the use of, or the right to use, industrial, commercial or scientific equipment, or for information concerning industrial, commercial or scientific experience.
There are the usual provisions such that royalties received by a non resident but which relates to a permanent establishment which that non resident has in the other Contracting State are taxed under

Article 7 and thus escapes withholding tax. Also, royalties paid by an enterprise which is borne by a permanent establishment are deemed to arise in the State in which the permanent establishment is situated. Hence, if the permanent establishment and the recipient are in the same State, no withholding tax can arise.
Where the payer and beneficial owner are connected and the amount of royalties exceeds an arm's length amount, the excess amount paid will not enjoy the treaty benefits and will be liable to tax in the payer's State at the normal domestic rate of withholding tax.

Domestic law

Australia

Withholding tax at a rate of 30%.

China

Withholding tax at a rate of 10%.

If a company becomes resident of Australia or China for the principal purpose of enjoying benefits under this Treaty, the company does not get the benefit of this Article (see Article 4.5).

Article 13 Alienation of Property

See treaty text

The usual rule that gains derived by a resident of a Contracting State from the disposal (alienation) of immovable property as defined in Article 6 and situated in the other Contracting State may be taxed by that State applies.
The term "alienation" is used in connection with events giving rise to capital gains. This will include normal disposals of assets and also events such as exchange of assets, expropriation, gifts and the passing of assets to another on death. Not all States levy tax in all these situations, but the meaning of the term "alienation" is sufficiently wide to give them the right to do so if their domestic law provides for a charge to tax in a particular situation.
Also applicable is the usual rule that gains on alienation of movable property forming part of the assets of a permanent establishment may be taxed by the Contracting State where the permanent establishment is situated, including gains from the alienation of the permanent establishment, whether or not as part of the alienation of the whole enterprise. Thus, for example, the sale of a wholly owned company resident in State A and owned by a resident of State A could give rise to a tax charge in State B if that company has a permanent establishment in State B.
Gains from the disposal (alienation) of shares in a company whose underlying assets consist mainly (whether directly or indirectly) of immovable property situated in the other State may be taxed by the State in which the property is located.

Domestic law

Australia

Alienation of property is a complex area and has been dealt with by the Australian Federal Court.
In *FCT v Lamesa Holdings BV* (1987) 36 ATR 589, the Full Federal Court held that Article 13 of the Netherlands agreement (the "Alienation of Property" Article) did not apply to profits realised by a Netherlands company on the sale of shares in an Australian subsidiary. The Netherlands company held an Australian subsidiary which was the parent of another Australian company which, in turn, held a 100% interest in an Australian mining company. The Netherlands company sold its shares in the Australian holding company. Initially, the Commissioner sought to assess the profits from the sale of shares to capital gains tax. However, assessments were subsequently issued contending that the profits were ordinary income of the Netherlands company. Article 13 permits Australia to tax income from the alienation of real property situated in Australia. The question was whether it permitted Australia to tax profits realised indirectly through a share sale, or whether the protection of the business profits article, Article 7, was available to the Netherlands company. The court held that it was not permissible to "look through" the corporate entities and that Article 13 had no application to the profits realised from the share sale. Consequently, the Netherlands had the exclusive right to tax the profits. As it happened under Netherlands domestic law such gains were exempt and even though this meant that there was effectively double non-taxation the Court held that that of itself was not a reason that justified the imposition of Australian tax.
In response, section 3A of the Agreements Act was enacted to ensure that, as from April 27, 1998, profits arising from the indirect alienation of real property situated in Australia by a non-resident are subject to tax in Australia.

China

Non-residents are taxed on gains on the disposal of Chinese property via a withholding tax.

Article 14 Independent Personal Services

See treaty text
This Treaty has separate Articles governing the taxation of income from permanent establishments (see Articles 5 and 7) and income from professional services. This Article provides that where a resident on one of the States has a "fixed base" in the other State, income in respect of professional services attributable to that fixed base may be taxed in the country in which it is situated. Thus an Australian accountant with an office in China will be taxable in China on profits attributable to the Chinese office. The attribution of profits is dealt with in the same way as for other business profits under the provisions of Article 7.
This treatment will also apply to professional services performed in the other State by individuals present in the other State for more than 183 days in aggregate in any consecutive period of 12 months.
The term "professional services" is defined to include especially independent scientific, literary, artistic, educational or teaching activities as well as the independent activities of physicians, lawyers, engineers, architects, dentists and accountants.

Article 15 Dependent Personal Services

See treaty text
Salaries, wages and other similar remuneration derived by a resident of a Contracting State in respect of employment are taxable only in that State unless the employment is exercised in the other State. If so, remuneration derived from the other State is taxable in the other State. However, the other State (the source State) will not tax provided:

- The recipient is present in the other State for no more than 183 days in aggregate in any consecutive period of 12 months;
- The remuneration is paid by, or on behalf of, an employer not resident in the other State; and
- The remuneration is not borne by a permanent establishment or a fixed base which the employer has in the other State.

The purpose of this Article is to ensure symmetry in taxation: If the employer is not taxable in a State, because it is neither resident there nor has a permanent establishment there then it will not receive any tax deduction in that State for wages and salaries paid. Wages and salaries paid by the employer in respect of short term employment postings of employees to that State are correspondingly exempted from tax in that State in the hands of the employee.
In circumstances where an expatriate worker is hired out or seconded to a "user entity" in Australia by a non-resident entity intermediary within the same corporate group, the Commissioner will adopt a substance over form approach to determine whether the Australian user entity is in fact the "economic employer", i.e. whether it exercises the main functions of an employer: Ruling TR 2003/11.

Domestic law

China

The extent of the taxation of expatriates depends on whether the stay is more than a year and whether it is more or less than five years. If the stay is for less than 90 days, then Chinese source income is taxable, except that employment income not borne by Chinese employer is not taxed. (This corresponds to the rules set out in the Treaty, where the period is 183 days.) If the stay is for more than 90 days but less than a year, then Chinese source income, but not foreign income, is taxed in China. If the stay is for less than five years, then foreign income is usually exempt from Chinese tax. Only for stays of more than five years does full Chinese taxation apply.
Employer provided accommodation, travelling expenses, removal costs, and general household costs for expatriates are tax-free.
China also permits an enhanced personal tax allowance.

Article 16 Directors' Fees

See treaty text
Such fees and similar payments derived by a director resident may be taxed in the country in which the company is resident.

Article 17 Artists and Athletes

See treaty text
The usual OECD Model rule is followed: Income derived by a resident of one State as an entertainer, such as a theatre, motion picture, radio or television artist, or a musician, or as an athlete, from their personal activities as such exercised in the other State may be taxed in the other State. This also

applies where the income accrues not to the entertainer or athlete himself, but to another person, e.g. a management company or a troupe, team or orchestra forming a legal entity or to an artist company. If the income is derived from activities performed under a cultural exchange program between the two States then the income will only be taxable in the State where the performer is resident.

Article 18 Pensions

See treaty text

Pensions are taxable only in the State where the recipient is resident.

Article 19 Government Service

See treaty text

This Article contains rules for the taxation of a remuneration paid in respect of government service.

Article 20 Professors and Teachers

See treaty text

Professors and teachers normally resident in one State can work in the other State for a period of up to two years and remain taxable only in the State of residence. The work must consist of teaching at a university, college, school or other educational institution, or research institution.

Article 21 Students and Trainees

See treaty text

Payments which a student, or trainee, who is, or was immediately before visiting a Contracting State, a resident of the other Contracting State and who is present in the visited State solely for the purpose of his education or training is not be taxed in the visited State. There is no requirement that the payments should arise outside the visited State.

Article 22 Other Income

See treaty text

Any income not dealt with in the preceding Articles is taxable only in the State of residence but if it arises in the other State then the other State may tax it according to domestic law. Thus the default position regarding the two States is that the State of source has primary taxing rights.
Income not arising in either State may be taxed by the source State. These rules follow the UN Model Treaty.

Article 23 Methods for the Elimination of Double Taxation

See treaty text

As the foregoing principles indicate, it is useful to distinguish the rules that allocate exclusive rights to tax from those that permit both countries to tax, albeit with limits in case of dividends, interest and royalties. Where the right to tax is shared between the countries, the country of residence is required to give relief in order to avoid double taxation. The two main methods are the exemption method and the foreign tax credit method. As mentioned, these are typically employed where:

- A resident of country A derives income through a permanent establishment in country B: country A taxes its resident on worldwide income and country B taxes the income attributable to the PE on an unrestricted net basis; and

- A resident of country A derives dividends, interest or royalties from a source in country B, not effectively connected to any PE in country B: country A taxes its resident on worldwide income and country B imposes a withholding tax (or withholding obligations), limited by the DTA to 10-15% of the gross amounts paid.

Under the “principle of exemption”, country A may grant a full exemption in respect of the income sourced in country B, i.e. no tax is payable to country A and the exempt foreign income is not taken into account in determining the tax imposed by country A on the remaining income of the resident. Alternatively, country A may grant “exemption with progression”, i.e. no tax is payable to country A on the foreign income, but that income is taken into account when determining the tax payable country A on the resident's other income.
Under the “principle of credit”, the tax payable to country A is first calculated on the worldwide income of the resident (including the income sourced in country B), then country A grants a deduction from the gross tax otherwise payable with respect to the tax paid to country B. Country A may allow a full credit, i.e. a deduction may be allowed for the full amount of the tax paid to country B. More commonly, the deduction permitted by country A is restricted to the amount of country A tax referable to the country B income, termed an “ordinary credit” in the OECD commentary. (If a full credit is granted where the country B tax is higher than the country A tax, the credit can have the effect of lowering the country A tax on country A income below what it would be if an exemption with the

progression were granted for the country B income). The OECD Model Convention provides only for the exemption with progression and the ordinary credit method. As Australia's foreign tax rules clearly demonstrate, the exemption and credit methods are not mutually exclusive and both may be used for different categories of income.

Article 24 Mutual Agreement Procedure

See treaty text

The usual provision founding the OECD Model is used but with different time limits. Where a person considers that the actions of one or both of the States result or will result for him in taxation not in accordance with the provisions of this Treaty, he may present his case to the competent authority of the State of which he is resident or if not resident in either Australia or China, to the competent authority of which he is a national. This is so irrespective of the remedies provided by domestic law. The time limit for bringing a claim is three years from the date of first notification of the disputed tax liability.

The two tax authorities will try to resolve the case by mutual agreement. They will also try to agree on definitions of terms not specifically defined in the Treaty and on general matters of interpretation of the Treaty.

Thus this Article removes the need for the tax authorities in each State to go through diplomatic channels: They may simply contact each other directly. The mutual agreement procedure is commonly used to decide matters concerning income and expense allocations and transfer pricing.

Article 25 Exchange of Information

See treaty text

The scope of this Article is quite wide ranging in that it provides for exchange of such information as is "necessary for carrying out the provisions of this Agreement", or of the domestic law of the Contracting States concerning taxes covered by the Agreement, insofar as the taxation thereunder is not contrary to this Agreement, in particular for the prevention of avoidance or evasion of such taxes. The exchange of information is not limited to that only concerning persons who are residents of one of the States.

The Article includes the usual provisos relieving the States from any obligation to:

- Carry out administrative measures at variance with the laws or administrative practices of either State;

- Supply information which is not obtainable under the laws or in the normal course of the administration of either State; and

- Supply information which would disclose any trade, business, industrial commercial or professional secret or trade process, or information the disclosure of which would be contrary to public policy (*ordre public*).

There is no requirement to supply any information that the requested State would not need for its own tax purposes. Neither is there any bar on declining a request solely due to secrecy concerns.

Article 26 Diplomatic Agents and Consular Offices

See treaty text

This Article confirms that any fiscal privileges to which diplomatic or consular officials are entitled under general provisions of international law or under special agreements will apply notwithstanding any provisions to the contrary in the Convention.

Article 27 Entry into Force

See treaty text

This Article contains the rules for bringing the Convention into force and giving effect to its provisions.

Article 28 Termination

See treaty text

This Convention shall remain in force so long as it is not terminated by one of the two States.