Analysis: Canada – China Income Tax Treaty

See treaty text.
Type of treaty: Income Tax
Model treaty on which based: UN
Signed: May 12, 1986
Entry into force: December 29, 1986
Entry into force (subsequent protocols): n/a
Effective date: January 1, 1987

Article 1 Personal Scope

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

Article 2 Taxes Covered

See treaty text.
Canada
• The income taxes imposed by the Government of Canada.
China
• The individual income tax;
• The income tax concerning joint ventures with Chinese and foreign investment;
• The income tax concerning enterprises; and
• The local income tax.
As well as application to the taxes existing at the time of 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 this Treaty.

Article 3 General Definitions

See treaty text.
"Canada": The territory of Canada including any area beyond the territorial seas over which Canada may exercise rights with respect to the seabed and subsoil and their natural resources.
"China": The People's Republic of China, including its territorial sea in which the laws relating to China apply. It also includes the area beyond its territorial sea, and the seabed and subsoil over which China has jurisdiction in accordance with domestic and international law.
"Person": An individual, company and any other body of persons. The Protocol states that in the case of Canada, the term includes an estate, a trust and a partnership.
"Company": Any body corporate or any entity which is treated as a body corporate for tax purposes. The French term *'société*" also means a corporation as the word is used in Canadian law.
"Nationals": All individuals possessing the nationality of Canada or China and all legal persons (which would include a company), partnerships and other bodies deriving their status as such from the laws in force in Canada or China.
Any terms not specifically defined take their meaning from the tax law of the State concerned at the time.

Article 4 Resident

See treaty text.
"Resident": Any person who is liable to tax in one of the Contracting States by reason of his domicile, residence, place of head office, place of management or any other criterion of a similar nature.
Residence: Individuals
In the case of individuals apparently resident in both Contracting States, the usual tiebreaker tests apply:
• He will be deemed to be a resident of the State in which he has a permanent home. If he has a permanent home in both States, he will be deemed to be resident in the State with which his personal and economic relations are closer (centre of vital interests).
• If unable to determine the State where the centre of vital interests lies, then resident of the State in which he has a habitual abode.
• If he has a habitual abode in both States, then resident in the State of which he is a national.
• If a national of both States or of neither of them, then the competent authorities must settle the question by mutual agreement.
Domestic law
Canada
Under Canadian law, an individual is resident in Canada if, in fact, he resides in Canada under the criteria established by the case law. Further, under the Income Tax Act, a reference to a person

resident in Canada includes a person who was "ordinarily resident." It has never been clear precisely what the word "ordinarily" adds to the word "resident." Some UK cases have interpreted "ordinarily resident" as being slightly broader than "resident," but the only substantial Canadian authority on the subject merely contrasts "ordinarily resident" with "casually resident."
The Canada Revenue Agency (CRA) has published an Interpretation Bulletin setting out its administrative practices with respect to the factors for determining whether an individual has ceased to reside in Canada or has established residence in Canada. The CRA takes the approach that residence status in any particular case must be determined on the specific facts under consideration. However, an individual will be considered to continue residence if the individual fails to sever what are considered significant ties with Canada. In the CRA's view, the significant residential ties are the location of a dwelling or dwellings, the location of a spouse, and any dependents, personal property such as a car or furniture and social ties. There is no particular length of absence from Canada that establishes non-residence. Instead, the focus is on the number and type of the individual's residential ties with Canada and the individual's intention to sever those ties. In addition to the significant ties, secondary ties with Canada include medical insurance arrangements, Canadian driving licence, Canadian bank or credit cards and immigration or work status. Interpretation Bulletins do not have the force of law, but are intended to reflect administrative practice.
Any person resident in Canada for more than 183 days in aggregate n a calendar year is deemed resident in Canada for that year.

China

An individual is tax resident in China if he habitually resides there. This is taken as presence for more than one calendar year. The precise extent of exposure to and rates of Chinese tax depends on whether the individual has been present in China for more than five years without spending more than 90 days in aggregate or 30 consecutive days per calendar year outside China.

Residence: Companies

If a company appears 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 the tax authorities of Canada and China must try to settle the question and determine how this Treaty is to be applied to the person. There is no specific tiebreaker rule.

Domestic law

Canada

Any corporation incorporated in Canada after April 26, 1965, is deemed to be resident in Canada. A corporation is resident in Canada at common law if its "central control and management" are in Canada.

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

Residence is to be determined as for companies.

Canada

A partnership is not recognised as a separate taxpayer and neither pays tax nor files an income tax return (although there are partnership information returns). Instead, each partner is subject to tax on the partner's share of partnership income.

China

The default position is that partnerships are treated as transparent unless an election is made for the partnership to be taxed as a separate entity.

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. The list of types of establishment particularly included follows the UN Model and includes:

- 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 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.

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 to 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; and

f) Any combination of the above providing that the overall activity of the fixed place of business is of a preparatory or auxiliary character.

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 appear 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.

Note that despite incorporating many features of the UN Model Convention, this Article at paragraph 4(b), unlike the UN Model, excludes “delivery of goods or merchandise” from the definition of what may be considered a permanent establishment. Thus a warehouse would not normally be considered a permanent establishment under this Treaty.

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, whether through an enterprise's own employees or by other personnel hired (for the same project or any 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 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 is acting on behalf of a resident of a Contracting State and has, and habitually exercises, in a Contracting 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 those listed at a) to f) above. Where the activities of the agent are merely preparatory or auxiliary, or where the agent is an independent agent (e.g. a general commission agent acting in the ordinary course of his business) the presence of the agent will not give rise to a permanent establishment.
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 Immovable Property

See treaty text.
The general rule is that income derived by a resident of a Contracting State from immovable 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 immovable property used by an enterprise and to income from immovable property used for the performance of independent personal services.
Immovable property is defined as per the domestic law of the State in which the property is located but it will include livestock and equipment used in agriculture, forestry, general property rights and rights for the working of natural resources.
There is no extension giving the Situs State any right to tax income from movable property of a permanent establishment.
Note that these rules also apply to profits form the disposal (alienation) of immovable property (Protocol).

Article 7 Business Profits

See treaty text.
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.
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 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 which reflect the use of the UN Model Treaty:

No deductions are permitted for certain payments by the Head Office or any of the enterprise's other offices, unless they represent reimbursement for actual expenses:

• Royalties, fees and other similar payments in return for the use of patents;
• Commission or fees for specific services performed or for management;
• Fees for technical services; 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.

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 OECD in 2008, published its final report on the attribution of profits to permanent establishments (July 17, 2008) and updated the Commentary on Article 7 of the Model Treaty. When interpreting a tax treaty, it is generally agreed that the latest version of the OECD's Commentary on the Model Treaty should be used. These notes follow the 2008 version of the Commentary. The “authorised OECD approach” to attributing profits to a permanent establishment now requires that there is 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. The OECD then recommends that “significant people functions” relevant to the attribution of economic ownership of assets are identified to support the attribution of economic ownership of assets of the enterprise to the permanent establishment. Economic ownership is defined 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 borne by the enterprise can be made to the permanent establishment. For instance, road building equipment may be economically owned by a permanent establishment in Country A but the head office, located in Country B, may have the power to determine on which road building projects the equipment is used and hence the head office bears the risk associated with profits or losses arising from the equipment. The more risks that are managed by the permanent establishment, the higher the share of the profit of the enterprise to be attributed to it. The OECD's 2008 Report looks for the place of active decision taking rather than

mere “rubber stamping”. Note that no such distinction between asset management and risk assumption functions is 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” in OECD terms). 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. This aspect of the AOA ought to be acceptable in interpreting a treaty such as this one which uses elements of the UN Model: In the introductory remarks to the Commentary on Article 7 of the UN Model, at paragraph 4 “... an allocable share of such payments, e.g. interest and royalties, paid by the enterprise to third parties should be allowed.”
When deciding what transactions should be recognised between the permanent establishment and other parts of the enterprise, the OECD 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 OECD's 2008 report suggests the following tests are used when considering whether an internal dealing should have any effect on the profits of a permanent establishment:
1) Is the documentation consistent with the economic substance of the internal dealings?
2) Are the arrangements 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.
3) Are the dealings consistent with the OECD principles for attributing profits to permanent establishments?
Allocations of head office expenses, e.g. for strategic management or centrally managed support functions such as payroll, may be set against the profits of the permanent establishment, but the arm's length principle must be observed.

The allocation of profits to dependent agent permanent establishments

A dependent agent is not part of the taxpayer enterprise and will file his tax returns independently. Normally the enterprise will make payments to the agent for his services. The question is: Should the host State merely tax the profits of the agent (the “single taxpayer approach” or should there be an additional charge on the enterprise which is using the services of the agent? The amount of the charge would depend on the excess of the enterprise's profits over the amount paid to the agent which was attributable to the activities of the agent. For instance, a dependent agent may be paid for the sales he procures on a commission bases, but the selling enterprise may make a profit on those sales even after taking into account the (arm's length) commission paid to the agent. The OECD recommends that States should always consider whether the enterprise has made a profit in respect of business

transacted via the agent which is in excess of amounts paid to the agent. Hence the host state may tax both the dependent agent and the foreign enterprise.
This Treaty permits an allocation of the profits of the enterprise to a permanent establishment based on an apportionment of the total profits of the enterprise. This is sometimes known as the unitary, or indirect method of apportionment. It is only acceptable to use this method if it has been customary to do so and in any case, the outcome must be in accordance with the result which would be obtained by using the Authorised OECD Approach (AOA) as set out above.
As is usual 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 same method of attribution is to be used year by year unless there is good and sufficient reason to the contrary.

Domestic law

Canada

Canada operates an extended definition of doing business in Canada. A non-resident is assumed to be "carrying on business in Canada" and therefore taxable on the profits made if:
(a) The non-resident solicits orders or offers anything for sale in Canada through an agent or servant, whether the contract or transaction is to be completed inside or outside Canada or partly inside and partly outside Canada; and
(b) The non-resident (or an agent acting on behalf of the non-resident) produces, grows, mines, creates, manufactures, fabricates, improves, packs, preserves or constructs, in whole or in part, anything in Canada, whether or not it is exported from Canada prior to its sale.
Where a non-resident carries on a business both inside and outside Canada, a reasonable allocation of the related income is necessary. Generally, the Canadian source income will be the portion attributable to the business operations carried on in Canada. Any deductible expenses applicable to the business should be allocated on a basis that is reasonable and consistent with the income allocation, since only the portion of such expenses applicable to the business operations carried on in Canada is deductible by the non-resident in calculating the income to be reported.
Canada charges a branch profits tax of 25% of income attributable to the permanent establishment after deduction of other Canadian taxes and certain other allowances.

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 the taxation and allocation of profits from the operation of ships or aircraft in international traffic.

Article 9 Associated 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.
There is no specific provision requiring the other State to make any corresponding downwards adjustment to taxable profits although the mutual agreement procedure provided for at Article 23 will be used to try to prevent double taxation of profits in this case.

Article 10 Dividends

See treaty text.

This Article allows the source State to levy withholding tax on dividends paid to a resident of the other Contracting State which may be below those charged under domestic law. In all cases, the recipient of the dividend must also be the beneficial owner.
• Where the beneficial owner of the dividends is a company which owns at least 10% of the voting stock of the paying company, the maximum rate of withholding tax is 10%.
• In all other cases, the maximum rate of withholding tax is 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, a Canadian company receives a dividend from a Chinese company, and that dividend is effectively connected with a permanent establishment which the Canadian 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 a Chinese company may be sourced from profits earned by a permanent establishment which that Chinese company has in Canada, does not give Canada any taxing rights over that dividend, unless of course, it is received by Canadian shareholders.
In Paragraph (6) Canada imposes a branch profits tax in order to compensate it for the fact that there is no withholding tax on the repatriation of profits by the branch. This is levied at a maximum rate of 10% on the earnings attributable to the permanent establishment after some deductions:
• Business losses attributable to the permanent establishment from the current and previous years;
• All taxes chargeable in Canada on the profits of the permanent establishment, other than this branch profits tax;
• The profits reinvested in Canada (with special rules regarding investment in property in Canada); and
• C$500,000 less the amount of any of the other permitted deductions (by the company itself or a related person from the same or similar business). Thus the minimum deduction is C$500,000. This limit is applied cumulatively from one year to the next rather than on an annual basis.

Domestic law

Canada

Withholding tax of 25%.

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.

Article 11 Interest

See treaty text.

Maximum rate of withholding tax is 10% providing the recipient is also the beneficial owner.
There are a number of exceptions to this whereby certain interest is exempt from withholding tax.
Interest paid to:
• The Government of Canada;
• The Bank of Canada;
• On a loan directly or indirectly financed or guaranteed by Export Development Canada;
• A financial establishment owned by the Government of Canada and mutually agreed upon by the tax authorities of Canada and China;
• The Government of China;
• The People's Bank of China;
• On a loan directly or indirectly financed or guaranteed by the Bank of China or the Chinese International Trust and Investment Company; and
• A financial establishment owned by the Government of China and mutually agreed upon by the tax authorities of Canada and China.
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 premiums and bonuses attaching to these securities.
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. 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

Canada
As from January 1, 2008, no withholding tax on interest paid to corporate recipients. If not paid under arm's length conditions, withholding tax is 25%.
Interest paid to individuals: Withholding tax is 25%.
China
Withholding tax is 10%, unless paid in connection with a permanent establishment which the recipient has in China. Interest on certain governmental loans may be exempt.

Article 12 Royalties

See treaty text.
This Convention provides for withholding tax rates below those which would be applied by virtue of domestic law.
This Treaty permits a withholding tax of 10% providing the recipient is the beneficial owner.
Royalties are defined as 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 cinematograph films and films or tapes for television or radio broadcasting, any patent, trademark, design or model, plan, secret formula or process, or for information (know-how) concerning industrial, commercial or scientific experience.
There are the usual provisions such that royalties received by a non resident but which relate to a permanent establishment which that non resident has in the other Contracting State are taxed under Article 7 and thus escape withholding tax. Also, royalties paid by an enterprise which are 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 recipient 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
Canada
0% on:
• Payments made in respect of copyrights of literary, dramatic, musical or other artistic works;
• Payments under cost-sharing agreements for research and development provided the payer participates in any eventual profits; and
• Certain payments where the payer can deduct the payment in computing taxable income from a business carried on outside Canada.
Otherwise 25%.
China
Withholding tax of 10%.

Article 13 Capital Gains

See treaty text.
Generally this Treaty grants the right to tax capital gains to the State in which they arise.
This reflects the UN Model Treaty which this Article follows closely and the nature of Chinese domestic law on the taxation of capital gains but is a departure from the more usual rule, that a State may tax gains of non-residents by exception only. There is an exception for gains on international transport assets.
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.
Some particular cases where the general rule applies are set out:
• There 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. This would be covered by the general rule giving the Situs State taxing rights but is set out for completeness.

• 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.
Paragraph (6) states the general rule under the UN Model Treaty, that gains derived from any property other than that dealt with specifically above may be taxed in the State where the property is situated. This does not oblige the Situs State to tax the gain but gives it the right to do so if it chooses.

Domestic law

Canada

Non-residents pay tax on disposals of a wide range of Canadian Situs assets. The principal categories are:
(a) Real property in Canada;
(b) Property used or held in, or eligible capital property in respect of, a business carried on in Canada;
(c) Designated insurance property of an insurer;
(d) Shares of a corporation resident in Canada that are not listed on a prescribed stock exchange;
(e) Shares of a non-resident corporation that are not listed on a prescribed stock exchange if, at any time during the last 60 months:
i) More than 50% of the fair market value of all the property of the non-resident corporation was made up of a taxable Canadian property, a Canadian resource property, a timber resource property, an income interest in a trust resident in Canada, or an interest or option in such properties; and
ii) More than 50% of the fair market value of the shares was derived directly or indirectly from real property situated in Canada, Canadian resource properties or timber resource properties, or any combination of such properties.
(f) Shares listed on a prescribed stock exchange that are otherwise described in (d) and (e) if, at any time during the last 60 months, 25% or more of the shares of the corporation belonged to the taxpayer and/or persons with whom the taxpayer did not deal at arm's length;
(g) An interest in a partnership if, at any time during the last 60 months, the partnership met a test comparable to the one described in (e)(i) above;
(h) A capital interest in a Canadian resident trust (other than a unit trust);
(i) A unit of a Canadian resident unit trust (other than a mutual fund trust);
(j) A unit of a mutual fund trust if, at any time during the last 60 months, 25% or more of the units of the trust belonged to the taxpayer and/or persons with whom the taxpayer did not deal at arm's length;
(k) An interest in a non-resident trust if, at any time during the last 60 months, the trust met tests comparable to the ones described in (e) above;
(l) An interest in, or an option in respect of, property described in any of items (a) to (k).
To support the system of taxing non-residents on "Canadian" capital gains, the Income Tax Act contains provisions whereby a certificate must be obtained from the Canadian tax authorities with respect to a disposition of taxable Canadian property indicating that an amount equal to 25% of any gain arising on the disposition has been paid on account of the potential tax liability of the non-resident vendor. A bank guarantee may be acceptable in lieu of actual payment, pending the filing of a Canadian tax return. In the absence of such a certificate, the purchaser (unless after reasonable inquiry the purchaser has no reason to believe the vendor is a non-resident) must withhold 25% (Canadian property other than depreciable property) or 50% (Canadian depreciable property, Canadian life insurance policies, Canadian real property, resource property or timber resource property) of the purchase price on account of the non-resident's tax and remit it to the tax authorities within 30 days after the end of the month in which the property was acquired. The purchaser is liable for this amount should he fail to withhold and remit the appropriate amount of tax and may recover from the non-resident any amount paid by him on account of the tax. Where a certificate has not been obtained and the proper withholding was not performed, the purchaser may be liable to a penalty equal to 10% of the amount that should have been withheld.

China

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

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 the calendar year concerned;
• 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.

Treatment of stock options

The treatment of employee stock options is not expressly dealt with and can be difficult as entitlement to the benefit taxable as a result of the option may have accrued partly whilst the employee was working temporarily in one of the States but there may be no taxable event, such as exercise of the option until the employee returns to the other State. A State is permitted to tax that part of the taxable benefit that can be related to the portion of the entitlement period spent working in that State.

Determining the extent to which an employee stock option benefit is derived from employment exercised in a particular State has to be done on a case by case basis, taking into account all relevant facts and circumstances. Whether a period of employment would be considered in allocating taxing rights between two States would depend on whether the entitlement to exercise the stock option was contingent upon continuing employment during that period. If an option was granted with a right to exercise, say, in three years time, regardless of continuing employment then time elapsing between grant and exercise would not count towards an apportionment of the taxing rights over the benefit in the absence of any other factors.

Periods of employment before the option was granted may be considered in the apportionment of taxing rights if the grant of the option was contingent upon a minimum period of employment or attainment of performance objectives.

Once the option is exercised, any further benefit to the employee, normally in the form of a capital gain on a disposal of the shares at a profit, will be dealt with under Article 13 and so probably only taxable in the State where he is resident.

If the shares do not vest irrevocably on exercise of the option (e.g. because they are liable to forfeiture upon certain conditions) then the increase in value of the shares until they do vest irrevocably will also be dealt with as employment income and subject to the same considerations as the benefit arising between grant and exercise.

The method of apportioning stock option benefits recommended by the OECD is by reference to the proportion of the number of days during which the employment was exercised in one State to the total number of days of employment from which the entitlement to the stock option benefits were derived. Thus if an employee was required to work for an employer for 520 days in total during a particular time period to qualify for the benefits of the stock option and was sent to work in the other State for 260 days out of that period, then half of the stock option benefits would be taxable in each State.

Domestic law

Canada

There are no tax concessions for inward expatriates other than that the tax year or arrival may be split. Non-Canadian income may be protected from Canadian tax for five years via the use of non-resident trusts.

Outward expatriates remaining tax resident in Canada

An overseas tax credit equal to the lower of foreign tax paid or Canadian tax due on employment income is available in the following circumstances:
• An individual goes to work outside Canada for a period of more than six months in a row, and the six-month period began before the end of the tax year *and* includes any part of the tax year for which the credit is claimed.
• An individual must be employed throughout that period by one of the following:
• A person residing in Canada;
• A partnership in which Canadian residents or Canadian-controlled corporations own more than 10% of the fair market value of all interests in the partnership; and
• A corporation that is a foreign affiliate of a person residing in Canada.

The individual must be working during all or most of the six-month period to secure a contract for the employer *or* in connection with a contract the employer had previously entered into.

The contract must relate to one of the following:
• Exploring for or exploiting petroleum, natural gas, minerals, or similar resources;
• Construction, installation, agricultural, or engineering activities; and
• An activity performed under contract with the United Nations.

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 a 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 Director Fees and Remuneration of Top-level Managerial Officials

See treaty text.

These fees may be taxable in the country in which the company is resident rather than/as well as that in which the director is resident.

This treatment also apples to salaries, wages and other similar remuneration derived in a capacity as an official in a top-level managerial position.

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 Government Service

See treaty text.

This provision relates to government services.

Article 19 Students

See treaty text.

Payments which a student, apprentice or business 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, receives for the purpose of his maintenance, education or training will not be taxed in the visited State.

There is no requirement that the payments should arise outside the visited State.

Article 20 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. This is normal in Canadian tax treaties and also in treaties based on the UN Model.

Article 21 Elimination of Double Taxation

See treaty text.

Canada

Canada gives relief by credit. However, where a dividend from a foreign subsidiary (a "foreign affiliate") is paid out of its "exempt surplus" (broadly, active business income, as opposed to investment income, plus 25% of all capital gains and 100% of certain capital gains) then Canada will exempt the dividend from tax. In theoretical terms, this is the equivalent of a system of exemption with activity clause. A Canadian participant in a joint venture involving Chinese and foreign investment is treated as having a foreign affiliate in respect of its interest in the joint venture so that this income too enjoys exemption.

There is no provision for credit for underlying tax on the corporation tax on profits out of which a dividend is paid.

Tax sparing
Tax sparing is granted by the Canada in respect of certain exemptions from and reductions in Chinese tax. This means that Canada will grant a double tax credit for taxes not actually paid in China. Specifically, the Chinese reductions and exemptions to which this applies are those granted under:
• Articles 5 and 6 of the Income Tax Law of China concerning Joint Venture with Chinese and Foreign Investment and Article 3 of the Detailed Rules and Regulations for the Implementation of the Income Tax Law of the People's Republic of China concerning Joint Ventures with Chinese and Foreign Investment.
• Articles 4 and 5 of the Income Tax Law of China concerning Foreign Enterprises.
• Articles I, II, II, IV and X of Part 1, Articles I, II, III and IV and Articles I, II and III of part III of the interim provisions of the State Council of China concerning reduction or exemption from enterprise income tax in special economic zones and coastal cities. This applies so long as any modifications to this legislation since the signing of this Treaty are only minor.
• Any other provision subsequently made granting an exemption from or reduction in Chinese tax agreed upon by the Chinese and Canadian authorities as being similar to those specifically set out above.
When tax sparing is in point, the rates of double tax credit which Canada will grant are:
• Dividends: 10% if the recipient is the beneficial owner of at least 10% of the voting stock of the paying company. 15% in other cases.
• Interest: 10%.
• Royalties: 5%.
China
The credit method is used, but with credit for underlying tax on Canadian dividends where the dividend is received by a Chinese company owning at least 10% of the shares of the paying company.

Article 22 Non-discrimination

See treaty text.
The usual OECD provisions, that nationals of one of the States shall not be subjected in the other State to any taxation or any requirement connected with tax, which is other or more burdensome than the taxation and connected requirements to which nationals of the other State in the same circumstances are or may be subjected.
There is an extension so that the principle of non-discrimination also applies to persons not residents of either Canada or China.

Article 23 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 Canada or China, to the competent authority of which he is a national. This is so irrespective of the remedies provided by domestic law. No time limit for bringing a claim is set.
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. As both States are Member States of the EU, the provisions of the EU Arbitration Convention will also apply (see analysis of Article 9).

Article 24 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", for the purposes of domestic law of the two States and also for the prevention of tax evasion. 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 25 Diplomatic Agents and Consular Officers

See treaty text.

The provisions of this Convention shall not affect the fiscal privileges of diplomatic agents or consular officials under the general rules of international law.

Article 26 Entry into Force

See treaty text.

This provision relates to the entry into force of this treaty.

Article 27 Termination

See treaty text.

This provision relates to the termination of this treaty.