

Analysis: China – Japan Income Tax Treaty

[See treaty text.](#)

Type of treaty: Income Tax

Based on UN Model Treaty

Signed: September 6, 1983

Entry into force: May 28, 1984

Effective date: January 1, 1985

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Article 1 Personal Scope

[See treaty text.](#)

Persons who are resident of one or both States.

Article 2 Taxes Covered

[See treaty text.](#)

China

- The individual income tax;
- The income tax concerning joint ventures using Chinese and foreign investment;
- The income tax concerning foreign enterprises; and
- The local income tax.

Japan

- The income tax;
- The corporation tax; and
- The local inhabitant taxes.

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. In particular, note that China has unified its tax laws for resident and non-resident taxpayers as of January 1, 2008 so that the tax regime facing non-residents is significantly different from that which existed at the date of signing of this Treaty.

Article 3 General Definitions

[See treaty text.](#)

“China”: The People's Republic of China, including its territorial sea in which the laws relating to China apply. It also includes any area beyond the territorial sea where it has sovereign rights of exploration and exploitation of resources of the seabed, its sub-soil in accordance with international law and in which the laws relating to Chinese tax are in force.

“Japan”: The territory of Japan including its territorial sea in which the laws relating to Japanese tax are in force. It also includes the area beyond the territorial sea including the seabed and sub-soil over which Japan has jurisdiction in accordance with Japanese law and in which the laws relating to Japan are in force.

“Person”: An individual, company and any other body of persons.

“Company”: Any body corporate or any entity which is treated as a body corporate for tax purposes.

“Nationals”:

- All individuals possessing nationality of either State;
- All legal persons (juridical persons) created or organised under the laws of either State; and
- All organisations without judicial personality treated for tax purposes as legal persons.

Any terms not defined take their meaning from the law of the State concerned at the time. Meanings specific to tax law take precedence over other meanings.

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 management or any other criterion of a similar nature

Residence: Individuals

The usual tiebreaker tests (place of abode, centre of vital interests etc.) are absent but paragraph 2 requires the tax authorities of both countries (the “competent authorities”) to reach agreement as to in which State an individual is to be considered tax resident if otherwise apparently resident in both.

Domestic law

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.

Japan

A distinction on the basis of citizenship is made for the purposes of differentiating between “permanent” and “non-permanent” residents.

A non-permanent resident is an individual who has come to Japan with the intention of having his domicile (*jusho*) in Japan for one year or more but who does not intend to reside in Japan permanently. Non-Japanese citizens who come to Japan for employment or to engage in business are generally presumed to be non-permanent residents from the moment of arrival, unless there is clear evidence (such as an employment contract) that the period of stay will be less than one year. If a non-permanent resident remains in Japan for five years out of the last 10 years, he then becomes a permanent resident of Japan for tax purposes. A non-permanent resident is subject to Japanese tax at the standard progressive rates, but only on his Japanese-domestic source income and on income from sources outside Japan only to the extent such foreign source income is paid in Japan or is remitted to Japan.

A permanent resident is an individual who intends to reside permanently in Japan. A Japanese citizen returning to Japan from abroad is presumed to intend to reside permanently in Japan and, absent special circumstances, is considered to be a permanent resident for tax purposes from the moment of his return. A non-Japanese citizen who has resided in Japan for more than five years is considered to be a permanent resident for tax purposes.

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 residence is to be decided by reference to the place where its Head Office or main office is situated. This tiebreaker rule follows Japan’s Domestic law concerning company residence rather than the usual OECD tiebreaker rule of “place of effective management”.

Domestic law

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.

Japan

A company is resident if it is incorporated in Japan or if incorporated elsewhere but with its Head Office or main office within Japan.

Partnerships and fiscally transparent enterprises

Residence is to be determined as for companies.

Domestic law

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.

Japan

Commercial partnership companies (*gomei kaisha* and *goshie kaisha*) are subject to corporate income tax. However, these forms of partnership offer little advantage over a corporation and are therefore not normally used by foreign investors. Most investment is via the joint stock corporation (*kabushki kaisha*). Other types of partnership (*kumiai*) are treated as transparent with no requirement for a separate partnership tax return.

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 UN definitions. Three types of permanent establishment are envisaged: A fixed place of business, a service permanent establishment and an agency permanent establishment.

Fixed place of business

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 definitions: 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 involve the usual ones:

- 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 this very short period which follows 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 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; and

- 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.

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

Also specifically included in the definition is the furnishing of consultancy and management services, whether through an enterprise's own employees or by other personnel hired for the purpose where a project (and any connected project) lasts for more than six months in any 12-month period. This is the normal Chinese rule, but note that in other Chinese treaties the period is extended to 18 months. The Protocol excludes consultancy services in connection with the sale or lease of machinery or equipment through employees or other personnel from this provision.

Agency permanent establishment

Dependent agents may constitute a permanent establishment even where there is no fixed place of business. 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 if:

- The agent's activities go beyond the excluded activities listed in a) to e) above (i.e. they are more than preparatory/auxiliary); or
- The agent regularly secures orders wholly or almost wholly for the foreign enterprise (or enterprises connected to it). Note that this extends the concept of a permanent establishment so that neither a fixed place of business nor the making of contracts is necessary; all that is required is that there is an agent working almost exclusively for the foreign enterprise in securing orders.

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. 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 rule 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.

Japan

Under domestic law, a Branch permanent establishment of a non-resident individual or foreign corporation is a branch (*shiten*), factory (*kojo*) or other fixed place where business is carried on. It includes a place of business (*jigyosho*), an office (*jimusho*), a sub-branch (*shutchocho*), and a warehouse (*soko*) (limited to a warehouse used by a warehouseman in his own business). It also includes a mine (*kozan*), quarry (*saisekijo*) or other place of extracting natural resources, and any other fixed place of business of a similar nature.

Under domestic law, a non-resident foreign corporation or individual acquires a permanent establishment in Japan when it carries out for a period of over one year a construction (*kensetsu*), installation (*suetsuke*), or assembly (*kumitate*) project or similar activity, or performs services in supervising or superintending (*shikikantoku*) such a project or activity in Japan. Whether such activity exceeds one year is determined by reference to each contract, but if several contracts involve the same parties and related projects, then the period is to be judged on the basis of the whole rather than the parts.

Until April 1, 2008, an agent who maintained in Japan sufficient goods to meet the normal requirements of a foreign corporation's or non-resident's customers and delivered the goods to the customers to meet such requirements constituted a permanent establishment. (However, the place where the foreign corporation or non-resident stores its assets was excluded from the permanent establishment definition.) Consequently, in the absence of a treaty, it was dangerous to send goods into Japan and to place them in the hands of another person for delivery or for passage of title because this might give rise to a permanent establishment. The sale of inventory goods located in Japan immediately prior to delivery to the customer gave rise to Japanese source income even if the sales contract was not concluded in Japan. Such sales would therefore be taxed in Japan. Japanese domestic law on agency permanent establishment is now in line with OECD norms.

As of April 2008, there are special rules used to determine whether a domestic investment manager is classed as an independent agent.

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.

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. 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).

As per the UN Model Convention, no deductions are permitted for certain payments by the permanent establishment to 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; and
- Interest on money lent to the permanent establishment except in the case of a banking enterprise.

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

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.

Japan

Until April 1 2008, an agent who maintained in Japan sufficient goods to meet the normal requirements of a foreign corporation's or non-resident's customers and delivered the goods to the customers to meet such requirements constituted a permanent establishment. (However, the place where the foreign corporation or non-resident stores its assets was excluded from the permanent establishment definition.) Consequently, in the absence of a treaty, it was dangerous to send goods into Japan and to place them in the hands of another person for delivery or for passage of title because this might give rise to a permanent establishment. The sale of inventory goods located in Japan immediately prior to delivery to the customer gave rise to Japanese source income even if the sales contract was not concluded in Japan. Such sales would therefore be taxed in Japan. Japanese domestic law on agency permanent establishment is now in line with OECD norms.

Otherwise the distinct and separate enterprise principle is used. Payments for the use of money between head office and branch are not recognised for tax purposes. Note that although not permitted by this Treaty, a non-resident with a permanent establishment consisting of a permanent fixed place of business is taxed under normal Japanese corporation tax rules as if all income whatsoever earned by the non-resident were earned by the permanent establishment. This is known as a "force of attraction" rule.

Article 8 International Transport

[See treaty text.](#)

This provision relates to international transport.

Article 9 Associated Enterprises

[See treaty text.](#)

This Article 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 for a corresponding downwards adjustment by the other State. However, any double taxation resulting from transfer pricing adjustments may be eliminated by agreement of the two States using the Mutual Agreement Article of this Treaty.

Article 10 Dividends

[See treaty text.](#)

This Convention provides for rates of withholding tax on dividends below those which would be charged in the absence of any agreement between the two countries.

Rate of withholding tax under this Treaty: 10 percent.

The recipient of the dividend must also be the beneficial owner.

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 Chinese company receives a dividend from a Japanese company, and that dividend is effectively connected with a permanent establishment which the Chinese company has in Japan, then the dividend income will be deemed to be part of the income of the permanent establishment and the provisions of Articles 7 or 14 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, a Chinese company may be sourced from profits earned by a permanent establishment which that Chinese company has in Japan, does not give Japan any taxing rights over that dividend, unless of course, it is received by Japanese shareholders.

Domestic law

China

Per Article 4 of CITL which came into effect on January 1, 2008: 10 percent withholding tax. This replaces the previous exemption from withholding tax for dividends.

Japan

Withholding tax of 20 percent.

Lower rates apply to portfolio dividends (holding of 5 percent) from listed shares paid to foreign shareholders: 7 percent until March 31, 2008 and then 15 percent.

Article 11 Interest

[See treaty text.](#)

This Convention provides for withholding tax rates below those which would be applied by virtue of Domestic law.

To qualify for the reduced rates of withholding tax under this Treaty the recipient of the interest must also be the beneficial owner.

Rates are:

0 percent for interest paid to the Chinese or Japanese Governments, their local authorities, central banks and other wholly government owned financial institutions. This treatment also extends to interest on any debts indirectly financed by either of the governments, their local authorities, central banks and other wholly government owned financial institutions.

10 percent in all other cases.

Interest is defined as debt-claims of every kind that are not classed as dividends by virtue of Article 10, whether or not secured by mortgage. The term includes income from government securities, bonds and debentures and premiums and prizes attaching to these securities as well as other bonds and debentures.

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

China

Withholding tax of 10 percent, unless paid in connection with a permanent establishment which the recipient has in China. Interest on certain governmental loans may be exempt.

Japan

Interest on business loans is to be distinguished from interest on bonds and bank deposits (*rishi shotoku*).

Interest on business loans: withholding tax 20 percent. The main exception to this general principle relates to short-term credits extended by a seller in connection with the sale of goods or services. Interest paid in such a case on an obligation of less than six months is not subject to withholding, although the seller may be subject to the income or corporation tax in the absence of an applicable tax treaty.

Withholding tax of 15 percent applies to:

- Interest on Japanese Government or local government bonds and on debt securities issued by domestic Japanese corporations;
- Interest on deposits or savings that are put on deposit at a place of business in Japan; and
- Earnings distributed by a joint operation trust or a public or private debenture investment trust located in Japan.

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 percent 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 relates 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

China

Withholding tax of 10 percent.

Japan

Withholding tax of 20 percent.

Note that a number of problems have arisen regarding the proper application of the tax on royalty income. This is to be expected because of the extensive licensing and sale of technology to Japan and the variety of patterns used by licensors.

"Initial" payments made at the time of entering into an agreement and other lump-sum payments are also included in the royalty base. Also, disclosure fees paid for the right to examine secret technology or option fees for the right to acquire technology are treated as royalties, when applied to royalties due on a contract subsequently concluded.

Article 13 Capital Gains

[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.

As with all treaty provisions, this Article does not impose a requirement upon either State to tax a capital gain; it merely allocates taxing rights so that the relevant State can tax a gain if it chooses. The usual rule is present: 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 does not include gains on ships and aircraft operated in international traffic nor to other movable property used in such a trade. Note that the wording is rather unwieldy in this Treaty, referring to gains from the alienation of "any property, other than immovable property, forming part of the business property of a permanent establishment" instead of the more usual wording "movable property forming part of the business property of a permanent establishment".

All other gains are taxable only in the State where the person making the disposal is tax resident.

Domestic law

China

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

Japan

Non-residents are subject to tax on the disposal of real estate located in Japan. The rate of tax halves to 15 percent if the property has been owned for at least five years.

Gains on sales of shares in Japanese companies if:

- The seller (together with his relatives or subordinate companies) sells 5 percent or more of the issued shares out of a holding which amounts to 25 percent or more at any time during the year of sale or during the previous three years; or
- The shares are in a Japanese company treated as a real estate corporation or a special trust fund related to real estate. A company or trust will fall into this category if more than 50 percent of its assets consist of Japanese real estate.

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 of 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 a Japanese 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 the calendar year but only to that part of the income of the person which is derived in the other State.

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 the calendar year;
- 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

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 the 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.

Japan

An inwards expatriate will probably be classified as a non-permanent tax resident (stays of more than one year but less than five years). In this case, only Japanese source income and any non-Japanese income remitted to Japan will be taxed. Note that if employment income is paid outside Japan, for example, by a parent company, and is charged back by the parent to its Japanese subsidiary, the income may be considered to be paid to the individual in Japan.

Article 16 Directors' Fees

[See treaty text.](#)

These fees and other similar payments may be taxable in the country in which the company is resident as well as that in which the director 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 activities are performed as part of a cultural exchange programme between the two States then only the State where the performer is resident may tax the income.

Article 18 Pensions

[See treaty text.](#)

These are taxable only in the State where the recipient is resident. This is the normal OECD rule.

Article 19 Government Service

[See treaty text.](#)

This provision relates to government service.

Article 20 Teachers and Researchers

[See treaty text.](#)

Teachers and researchers resident in one State can work in the other State for a period of up to three years and remain taxable only in the State of residence. There are no restrictions on the type of research involved. The work done must be at a university, college, school or other recognised educational or scientific institution. This is a fairly generous provision as the normal rule is two years only.

Article 21 Students and Trainees

[See treaty text.](#)

Payments which a student, 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 or the acquisition of special technical experience, receives for the purpose of his maintenance, education, research or training will not be taxed in the visited State. The usual provision which limits this treatment to income derived from sources outside the visited State is absent.

Article 22 Other Income

[See treaty text.](#)

This Article starts off in paragraph 1 by stating that income not dealt with in the previous Articles of this Treaty are to be taxed in the State where they arise. Paragraph 2 then contradicts this by stating the more usual rule, that such items, other than those dealt with in paragraph 1, are to be taxed only where the recipient is resident. Presumably this means that if, say, a resident of Japan receives income from a Chinese source, not covered by any of Articles 1–21, then China may tax the income. However, if China does not take the opportunity to tax the income then Japan may do so. There is an express provision that income in respect of rights or property which is connected to a permanent establishment are taxed under Article 7 as the income of that permanent establishment. Income from immovable property remains taxable under Article 6 in the State in which the property is located.

Article 23 Elimination of Double Taxation

[See treaty text.](#)

China

The credit method is used with credit for underlying tax on Japanese dividends where the dividend is received by a Chinese company owning at least 10 percent of the shares of the paying company.

Japan

The credit method is used with credit for underlying tax on Chinese dividends where the dividend is received by a Japanese company owning at least 25 percent of either the voting shares or of the total issued share capital of the paying company.

The credit for Chinese withholding tax is at certain deemed rates, irrespective of the actual rate of withholding tax suffered:

- Dividends paid by a joint venture: 10 percent.
- Other dividends: 20 percent.
- Interest: 10 percent.
- Royalties: 20 percent.

Japan also grants tax sparing: A credit against Japanese tax liability will be available for the tax that China would have levied were it not for the provisions of:

- Articles 5 & 6 of the Income Tax Law (joint ventures using Chinese foreign investment);
- Article 3 of the Income Tax Law (detailed rules and regulations for the implementation of the income tax law concerning joint ventures using Chinese and foreign investment);
- Articles 4 and 5 of the income tax law – concerning foreign enterprises; and
- Any “similar special incentive measures” designed to promote economic development in the People's Republic of China. These are defined in detail in the Exchange of Notes so that there is no general “grandfathering” provision regarding tax sparing to be granted by Japan.

Note that with the sweeping changes to the Chinese tax system which took place on January 1, 2008, many of the incentives offered to foreign direct investment by China have been abolished, following

considerable research into their effectiveness and desirability. However, it has been announced that the tax sparing credit in this Treaty will continue to be granted by Japan.

Domestic law

China

The credit method is used, with relief for foreign corporation tax underlying dividend payments received by Chinese corporate investors.

Japan

The credit method is used, although taxpayers may opt for relief by deduction from taxable income. Relief for underlying corporation tax on dividends is available to corporate taxpayers profited at least 25 percent of the voting shares in the paying company have been held for a minimum period of six months. The underlying tax credit only extends as far as second tier investments. Note that this is expected to change with effect from April 1, 2009 so that no relief for underlying tax will be available but instead, Japanese companies will only be taxed on 5 percent of foreign dividends received. The ownership requirements are as for underlying tax credit.

Article 24 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 resident of either China or Japan and to stateless persons.

Article 25 Mutual Agreement Procedure

[See treaty text.](#)

The usual provision found in 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 China or Japan, 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 26 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 Convention", 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.

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.

In July 2010, the Japanese National Tax Administration ("NTA") issued guidance on when the tax agency may exchange tax information with the nation's tax treaty partners.

According to Mr. Toshio Aritake of BNA's Daily Tax Report, when the NTA receives a request for tax information from a treaty partner, the tax agency must first consider whether the request falls into one of five categories that bar the NTA from providing the information.

The five categories are:

- The treaty partner is unable to provide Japan with comparable information;
- The treaty partner cannot maintain the confidentiality of the information provided by the NTA;
- The treaty partner may use the information for purposes other than for the work of the treaty partner's tax authorities;
- Providing the information would be harmful to Japan's national interest, including national security, diplomatic interests, public safety, or criminal investigations; or
- The treaty partner's tax authorities did not use normal means to obtain the taxpayer's information.

The NTA would also consider refusing to provide the information to the treaty partner if the request:

- Is unrelated to relevant tax issues;
- Is not covered by the information exchange provision of the relevant tax treaty;
- Infringes on the treaty partner's, or Japanese, laws, regulations, and administrative proceedings;
- Seeks information that cannot be obtained under normal administrative processes; or
- Runs counter to Japan's public interest, such as disclosing corporate management, business, industry, or confidential commercial information or transactional processes.

Article 27 Restrictions and Exemptions

[See treaty text.](#)

This Article states that nothing in the Treaty is to prevent one of the States granting tax exemptions, reductions or allowances to residents of the other State or preventing any further agreement between the two States.

Article 28 Members of Diplomatic and Permanent Missions and Consular Offices

[See treaty text.](#)

This provision relates to diplomatic agents and consular officers.

Article 29 Entry Into Force

[See treaty text.](#)

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

Article 30 Termination

[See treaty text.](#)

This provision relates to the termination of this treaty.