

## **Analysis: China – Spain Income and Capital Treaty**

[See treaty text.](#)

Type of treaty: Income and Capital

Model treaty on which based: UN

Signed: November 22, 1990

Entry into force: May 20, 1992

Entry into force (subsequent protocols): n/a

Effective date: January 1, 1993

### **Article 1 Personal Scope**

[See treaty text.](#)

Persons who are resident of one or both States.

### **Article 2 Taxes Covered**

[See treaty text.](#)

- Taxes on total income, and on capital, on elements of income and capital;
- Taxes on gains from alienation of movable or immovable property; and
- Taxes on capital appreciation.

#### **Spain**

- The income tax on individuals;
- The corporation tax;
- The capital tax; and
- Local taxes on income and capital.

#### **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 the Treaty was signed (listed above) there is a provision applying the Treaty to any identical or substantially similar taxes which are imposed after the date of signing of this Treaty.

### **Article 3 General Definitions**

[See treaty text.](#)

“China”: The entire territory of the People's Republic of China in which the Chinese tax legislation is effectively applied. It includes its territorial sea and the adjacent areas and the sea bed and sub-soil over which China may, in accordance with domestic and international law, exercise sovereign rights for the purpose of the exploration and exploitation of the natural resources of the sea bed and sub-soil and the waters above these.

“Spain”: The entire territory of the territory of the Spanish State in which the Spanish tax legislation is effectively applied. It includes its territorial sea and the adjacent areas and the sea bed and sub-soil over which Spain may, in accordance with domestic and international law, exercise sovereign rights for the purpose of the exploration and exploitation of the natural resources of the sea bed and sub-soil and the waters above these.

“Person”: Includes an individual, company or any other body of persons.

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

“Nationals”: Include individuals possessing nationality and also a legal person, partnership or association created under the laws in force in a State.

All terms not specifically defined take their meaning from domestic tax law.

### **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, place of Head Office 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**

##### **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.

##### **Spain**

Broadly, Spanish domestic law considers an individual to be tax resident if present in Spain for more than 183 days in a calendar year or if his centre of vital interests is in Spain.

#### **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 it will be deemed to be resident in the State in which its place of effective management (defined as Head Office) is located. This Treaty assumes that "Head Office" is analogous to "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.

##### **Spain**

A company is tax resident in Spain if either it is incorporated under Spanish law, its legal seat is located in Spain or its place of effective management is in Spain. Thus a company incorporated in Spain but with its place of effective management in Spain would be deemed tax resident in Spain under this Convention.

#### **Partnerships and fiscally transparent enterprises**

Residence is to be determined as for companies.

##### **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.

##### **Spain**

Partnerships are generally treated as corporations. This would include:

*Sociedades colectivas* and *sociedades comanditarias por acciones*. Note that these may be considered transparent in other jurisdictions.

Other business associations which are treated as transparent are:

- Civil corporations – non-commercial companies incorporated in accordance with the Civil Code;
- Irregular corporations – commercial corporations not registered with the Trade Registry;
- Joint proprietorships;
- Participative agreements (*cuotas en participación*); and
- Investment funds not registered with the Securities Exchange Commission (CNMV).

#### **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 involves:

- A place of management;
- A branch;

- An office;
- A factory;
- A workshop;
- A mine, an oil or gas well, a quarry or any other place of extraction of natural resources; and
- A 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 permanent establishment consists of mechanical equipment only, then there is no requirement for mechanical equipment to be fixed to the soil.

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

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

- a) The use of facilities solely for the purposes of storage, display or delivery of goods or merchandise belonging to the enterprise;
- b) The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;
- c) The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;
- d) The maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, or of collecting information, for the enterprise;
- e) The maintenance of a fixed place of business solely for the purpose of carrying on any other activity of a preparatory or auxiliary character; 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 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.

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 purpose where a project (and 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 unless the agent works wholly, or almost wholly on behalf of the foreign enterprise and transactions between the agent and the enterprise are not made under arm's length conditions.

#### **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 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.

#### **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.

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

As per the UN Model Convention, no deductions are permitted for certain payments by the 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, unless they represent reimbursement for actual expenses;
- Commission or fees for specific services performed or for management; and
- Interest on money lent to the permanent establishment except in the case of a banking enterprise).

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

The Protocol also contains some clarification as to the way in which profits are to be allocated to a permanent establishment which consists of a building site, construction, assembly or installation project. Only those profits resulting from the actual building, construction, assembly or installation may be taxed under this Article. Where machinery or equipment is supplied by the Head Office or by another permanent establishment or by third persons, the value of this supply is not to be attributed to the profits of the building site etc. Thus no force of attraction rule can apply. These provisions are relevant in the case of so-called "turnkey" projects, where part of the work on the project is done in the home state and the aim is to ensure that only that part of the project profits which are attributable to the activities of the permanent establishment are taxed by the host state. The attribution of profits in the case of a turnkey project was examined in detail in a case heard by the Supreme Court of India, *Hyundai Heavy Industries Co. Ltd v Commissioner of Income Tax* [2007] 291 ITR 482. A turnkey project is one where the finished facility (e.g. a factory or an oil platform) is handed over to the customer in a state such that the customer can begin to use it immediately.

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 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.

#### **Alternative method of attribution of profits**

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.

##### **Spain**

Spain does not permit the deduction of payments of interest, royalties, commission payments for technical assistance or rents to the Head Office in the computation of attributable profits. There is an exception for interest paid by a Spanish permanent establishment of a foreign bank in consideration for amounts received to enable it to carry on its activities.

A Spanish permanent establishment may deduct a *pro rata* share of its Head Office's general administration and management expenses, provided these amounts are clearly identified in the profit and loss account, the amounts and allocation criteria are duly reported to the tax authorities by way of a report filed together with the tax return, and the expenses have been allocated based on reasonable and consistent criteria.

Spanish permanent establishments do not benefit from the tax rate splitting arrangements available to resident companies with low turnover.

Spain levies a branch profits tax of 18% (15% before January 1, 2007) on after-tax profits of permanent establishments of non-EU companies (apart from companies resident in Luxembourg or Cyprus) paid to Head Office, meaning that the effective rate of tax on remitted profits is rather high.

#### **Article 8 Shipping Transport And Air Transport**

[See treaty text.](#)

Not analysed.

#### **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 requirement for the other State to make a downwards adjustment to taxable profits. 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 Article provides for the source State to levy withholding tax on dividends paid to a resident of the other Contracting State at a rate which may be lower than that charged under domestic law. The recipient of the dividend must also be the beneficial owner.

Withholding tax under this Treaty: 10%.

Note that the Protocol denies this reduced rate of withholding tax to certain income from certain Spanish corporations whose income is not subject to the Spanish Corporation Tax.

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. The Protocol adds that remittances out of China from profits from investment as a participant in a joint venture with Chinese and foreign investment are to be treated as dividends.

Paragraph (4) provides that where, say, a Spanish company receives a dividend from a Chinese company, and that dividend is effectively connected with a permanent establishment which the Spanish company has in China, then the dividend income will be deemed to be part of the income of the permanent establishment and the provisions of Article 7 dealing with the attribution of business profits will apply.

Paragraph (5) contains the usual provision that a State does not have the right to levy any tax on a dividend unless either the dividend is paid by a resident company or received by a resident shareholder. Thus the fact that a dividend paid by, say, a Spanish company may be sourced from profits earned by a permanent establishment which that Spanish company has in China, does not give China any taxing rights over that dividend, unless of course, it is received by Chinese shareholders.

#### **Domestic law**

##### **China**

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.

##### **Spain**

Withholding tax of 18% (15% before January 1, 2007).

#### **Article 11 Interest**

[See treaty text.](#)

Maximum rate of withholding tax of 10% providing the recipient is also the beneficial owner. Unlike the extensive provisions found in many Chinese tax treaties there is no exemption for interest paid to a government or its political subdivisions.

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. Penalty charges for late payment are not regarded as interest.

There are the usual provisions such that interest received by a non-resident but which relates to a permanent establishment which that non-resident has in the other Contracting State is taxed under Article 7 and thus escapes withholding tax. 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%, unless paid in connection with a permanent establishment which the recipient has in China. Interest on certain governmental loans may be exempt.

##### **Spain**

Withholding tax of 18% with exemptions:

Interest paid to non-resident companies: Interest is exempt from withholding tax if paid on:

- Bank deposits;
- Government bonds; and
- Certain securities issued in Spain by international organisations.

Interest paid to non-resident individuals: Interest is exempt from withholding tax if paid on:

- Bank deposits;
- Government bonds;
- Movable property; and

- Securities issued in Spain by non-residents.  
(Excluding payments to recipients in certain named tax havens, including Cyprus and certain Luxembourg companies) and certain securities issued by international organisations.

## **Article 12 Royalties**

[See treaty text.](#)

Withholding tax is limited to 10% provided the recipient is also the beneficial owner.

There is an exception for the use of or right to use industrial, commercial or scientific equipment: withholding tax on these is only to be levied (at the 10% rate) on 60% of the gross income (per the Protocol).

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 cinematographic films any patent, trade mark, design or model, plan, secret formula or process, or for the use of, or the right to use, industrial, commercial or scientific equipment, or for information concerning industrial, commercial or scientific experience.

There are the usual provisions such that royalties received by a non-resident but which 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 beneficial owner are connected and the amount of royalties exceeds an arm's length amount, the excess amount paid will not enjoy the treaty benefits and will be liable to tax in the payer's State at the normal domestic rate of withholding tax.

### **Domestic law**

#### **China**

Withholding tax of 10%.

#### **Spain**

Withholding tax of 24% (25% before January 1, 2007).

## **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.
- Gain from the disposal (alienation) of shares in any other company where the shares disposed of represent a participation in the company of at least 25% may be taxed in the State in which the company is resident.

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**

## **China**

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

## **Spain**

Residents of a country that has a tax treaty with Spain that contains an exchange of information Article (all Spain's treaties except the Spain–Switzerland treaty) are exempt from Spanish Non-residents Tax on gains derived from: (i) the transfer of shares that are quoted on a Spanish stock exchange; and (ii) the transfer or redemption of shares or participations in the capital or equity of collective investment undertakings that are quoted on a Spanish stock exchange, unless such gains derive from a tax haven territory.

Capital gains arising from the transfer of movable property located in Spain, including shares and securities issued by Spanish entities, derived by an EU resident that is not acting through a permanent establishment or by a permanent establishment of those EU residents located in another EU country, are exempt from tax provided that the EU resident or the EU permanent establishment are not located in a listed tax haven (Cyprus and Luxembourg).

The exemption does not apply when the transfer is of shares or participations in corporations or other entities the assets of which consist mainly, directly or indirectly, of real property located in Spain or when the seller has owned, directly or indirectly, at least 25% of the capital or net worth of the entity at any time during a 12-month period prior to the transfer.

Capital gains derived by non-residents that are not resident in a listed tax haven on the transfer of government securities or bonds issued in Spain are not taxable in Spain. Gains and on the sale of containers and bareboat chartered ships or aircraft used in international shipping or aircraft navigation also are exempt from Spanish tax.

## **Article 14 Independent Personal Services**

[See treaty text.](#)

This Treaty has separate Articles governing the taxation of income from permanent establishments (see Articles 5 and 7) and income from professional services. This Article provides that where a resident 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 Spanish 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 concerned. The term "professional services" is defined to include especially independent scientific, literary, artistic, educational or teaching activities as well as the independent activities of physicians, lawyers, engineers, architects, dentists and accountants.

## **Article 15 Dependent Personal Services**

[See treaty text.](#)

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

- The recipient is present in the other State for no more than 183 days in aggregate in 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**

#### **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.

#### **Spain**

The normal test of residence for individuals is presence in Spain for more than 183 days in any calendar year. Non-residents are taxed at a flat rate of 24% on employment income, although there is a special rate of 2% applied to temporary workers such as those employed in the tourist trade.

### **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. This rule does not apply if the activities of the artist or athletes whose visit to the other State is made under a cultural agreement or arrangement between the two States and is substantially supported from government funds in their home State. In this case the visited State can only tax them if the activities constitute a permanent establishment or the amounts they receive can be regarded as wages or salary.

## **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.](#)

Not analysed.

## **Article 20 Teachers And Researchers**

[See treaty text.](#)

Professors and teachers normally 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. The work must consist of teaching or engaging in research in a university, institute, school or teaching institution, or government recognised research institution. Research must be public research and not primarily for the benefit of private persons, including companies.

## **Article 21 Students, Apprentices And Trainees**

[See treaty text.](#)

Payments which a student, business apprentice or trainee, who is, or was immediately before visiting a Contracting State, a resident of the other Contracting State and who is present in the visited State solely for the purpose of his education or training will not be taxed in the visited State on:

- All remittances from abroad for the purpose of his maintenance, education, or training; and
- All scholarships, grants, allowances and awards from governmental, scientific, literary or educational organisations for the purposes of his maintenance, education or training.

If the student earns remuneration from employment in the visited State during his education or training he will be entitled to the same exemptions, reliefs or reductions in taxes as are available to residents of the visited State.

## **Article 22 Other Income**

See treaty text.

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

There is an express provision that income in respect of rights or property which is connected to a permanent establishment is 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 Capital**

[See treaty text.](#)

Wealth taxes may be imposed on:

- Immovable property according to the State where the property is located; and
- Movable property used by a permanent establishment (may be subject to wealth tax in the State where the permanent establishment is located).

Apart from these exceptions and provisions regarding international transport, all other elements of capital may only be subject to wealth taxes in the State where the owner is resident.

### **Domestic law**

#### **China**

China has no taxes on net wealth.

#### **Spain**

Non-residents (companies and individuals) are liable to the local real estate tax, charged typically at around 0.4% of the valuation.

Certain non-resident property investment companies pay a tax of 3% annually on the value of Spanish immovable property. The main exclusions from this tax are quoted companies, companies resident in countries with which Spain has an information exchange clause in the double tax treaty (which is missing in this Treaty), companies other than those which merely invest in real property in Spain.

No annual taxes on net worth is levied on non-residents.

## **Article 24 Methods For The Elimination Of Double Taxation**

[See treaty text.](#)

#### **Spain**

Spain will use the credit method for dividends, interest, royalties, directors' fees, income of artists and athletes and other income per Article 22. No relief is given for underlying corporation tax in the case of dividends.

Other income which may be taxed by China under this Treaty will be exempted by Spain.

Spain will apply the concept of exemption with progression such that any income arising in China which is exempted in Spain will still be taken into account in determining the rates of tax to be applied to domestic and other foreign income remaining taxable in Spain.

### **Tax sparing**

Whatever the actual rate of tax charged in China, Spain will give credit as follows:

- Dividends: 15%,
- Interest: 10%,
- Royalties: 15%,

of the gross amounts in each case.

These provisions are to apply for the first 10 years during which this Treaty is effective (i.e. until January 1, 2003) but may be extended by mutual agreement.

### **China**

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

### **Article 25 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 Spain or China. It applies to all taxes, not merely those listed in Article 2.

### **Article 26 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 Spain or China, to the competent authority of which he is a national. This is so irrespective of the remedies provided by domestic law. The time limit for bringing a claim is three years from the date of first notification of the disputed tax liability. The two tax authorities will try to resolve the case by mutual agreement. They will also try to agree on definitions of terms not specifically defined in the Treaty and on general matters of interpretation of the Treaty.

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

### **Article 27 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 provisions 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 28 Diplomatic Agents And Consular Officers**

[See treaty text.](#)

Not analysed.

### **Article 29 Entry Into Force**

[See treaty text.](#)

Not analysed.

### **Article 30 Termination**

[See treaty text.](#)

Not analysed.