Analysis: China – United Kingdom Income Tax and Capital Gains Treaty

See treaty text

Type of treaty: Income Tax and Capital Gains
Model treaty on which based: OECD and UN
Signed: July 26, 1984. The new DTA: June 27, 2011
Entry into force: December 23, 1984. The new DTA: n/a
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Subsequent Protocol signed: September 2, 1996. New: February 27, 2013
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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 for enterprises with foreign investment and foreign enterprises; and
• The local income tax.

UK

• Income tax;
• Corporation tax; and
• Capital gains 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. 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 the area beyond its territorial sea, and the sea bed and subsoil over which China has jurisdiction in accordance with domestic and international law.
"United Kingdom": Great Britain and Northern Ireland, including any area beyond the territorial seas over which the UK has or may in the future have rights with respect to the sea bed and subsoils and their natural resources, under international and UK law concerning the Continental Shelf.
"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.
"National":
China:
• Any individual possessing the citizenship of China and any legal person (e.g. a company), partnership or other body of persons created or organised under the laws of China.
UK:
• Any individual possessing UK nationality provided he has the right of abode in the UK; and
• Any legal person, partnership or association or other entity deriving its status as such from the law in force in the UK.
Any terms not specifically 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 Head Office, place of management, place of incorporation 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

In 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.

UK

Individuals who are present in the UK for 183 days or more in a fiscal year or, on average, at least 91 days (tested over the last four years; residence applying from the fifth) are resident in the UK. Although once considered 'resident' this applies for the entire fiscal year in which residence arises, the fiscal authority, by concession, will permit the residency to commence or cease on the day of arrival or departure, respectively, to the UK where the move to/from the UK has a degree of permanency. Note that these presence based tests are not statutory but reflect the normal practice of the UK tax authorities.

The tax law of the UK also has a concept of 'ordinary residence', arising broadly from two years' residency (ordinary residence applying from the second year); residency in the four years preceding the previous year to that being considered; or, intentions to reside or actual residence in the UK for three years. Ordinary residence is a more adhesive quality than simple residence so that a person wishing to change his residence will find this harder if he is ordinarily resident. Working abroad under a contract of employment for an entire fiscal year is one way of shedding ordinary residence.

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 resident in the State where its place of effective management is located. However, if the place of effective management is in one State, say, the UK, and the Head Office is located in the other State, say, in China then the tax authorities must use the mutual agreement procedure to determine in which State the company is to be considered tax resident. Thus the location of place of effective management will not automatically dictate the tax residence of a company.

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.

UK

The UK's domestic law states that companies incorporated in the UK are resident there. Other companies fall within a central management and control test, although this focuses on where the board meets and company policy decisions are made, not where day-to-day management is made. In the face of conflict between questions of residence arising from UK domestic law and treaty provisions, the treaty provisions prevail.

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.

UK

Unlimited partnerships are treated as transparent entities, as are Limited Liability Partnerships. The following types of entities are taxed as corporations:

Unincorporated associations, building societies, mutual insurance societies, state-owned industries, public utility companies, crown corporations, limited partners in unlimited partnerships, permanent establishments of non-resident companies. Charities are generally exempt from corporation tax, unless they are trading and the trade is not exercised in the course of carrying out the primary purpose of the charity, or is carried out mainly by its beneficiaries.

Article 5 Permanent Establishment

See treaty text

This Article adopted the UN model's approach, which a PE also includes project or activities last more than 12 months and the furnishing of services in the Other State for more than 183 days.

A service PE refers to the provision of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise of such purpose, but only if activities of that nature continue (for the same or a connected project) within a Contracting State for a prescribed period of time.

A construction PE refers to a construction, assembly or installation project or supervisory activities in connection therewith, but only where such site, project or activities continue for a prescribed period of time.

The New DTA added a new clause for the service PE, that is, provision of services for a period of more than 183 days in any 12-month period, which provides clear time frame so that the UK service providers would have clearer understanding on their exposures when accepting a service engagement for China. In addition, the New DTA also expanded the scope of "construction PE" to cover associated supervisor services and extended the period of creation of PE from 6 months to 12 months that is obviously an improved provision as compared to the existing DTA.

Agent who acts on behalf of the enterprise with conditions made or imposed differing form those between independent parties will not be considered as an independent agent under this Article.

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. Two types of permanent establishment are set out: A fixed place of business and a dependent agent.

Fixed place of business

A fixed place of business through which the business of the enterprise is wholly or partly carried on will constitute a permanent establishment.

Types of establishment particularly included involve the following:

- 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;
- An installation or structure used for the exploration of natural resources; and
- A building site, construction or installation or assembly project which lasts for more than six months. This is a departure from the norm of 12 months found in most treaties reflecting the use of the UN Model Treaty.

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.

Agency permanent establishment

Dependent agents may constitute a permanent establishment. Where a person acting on behalf of a resident of a Contracting State 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.
However, if the agent works exclusively, or nearly exclusively for the UK enterprise, then he will be not be considered a dependent agent regardless of the activities carried on by him.
Unlike many Chinese treaties, there is no provision for the recognition of a "service permanent establishment" arising through the furnishing of services in the other State.
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.

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.
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:

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;
- Fees for technical services; and
- Interest on money lent to the permanent establishment except in the case of a banking enterprise).

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

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 of profits will be the branch accounts, assuming they exist. 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.

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.

UK

The UK uses the "distinct and separate enterprise approach" in its domestic law. Both income arising directly or indirectly from a permanent establishment, including income from property used by the permanent establishment are taxable as well as chargeable gains on assets used by the permanent establishment for the purposes of its trade.

Specifically, the UK allocates the profits of the entity on the assumption that the permanent establishment has the same credit rating as the Head Office and has the capital structure that an independent enterprise in similar circumstances would be expected to have. Transactions between the permanent establishment and other parts of the enterprise are valued on the arm's length basis. An apportionment of executive and general administration expenses is permitted whether or not the permanent establishment has borne or incurred such expenses providing they would have been deductible if borne by a UK resident company.

Article 8 Shipping 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 provision requiring the other State to make a corresponding 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 beneficial owner of the dividend must be resident in the other State.

Withholding tax under this Treaty: 10% provided that the beneficial owner is a company which holds directly at least 25% of the capital of the company paying the dividends.

The New DTA added a specific anti-abuse clause. In this respect, the provisions of this article may not be able to apply if it was the main purpose or one of the main purposes of any person concerned with the creation or assignment of shares or other rights, to take advantage of this article by means of that creation or assignment

"Dividend" is defined to take the meaning which it has in the domestic law of the paying State and includes any item treated under that State's domestic law as a dividend or distribution. The Memorandum of Understanding which accompanies this Treaty includes in the definition remittances out of China of profits derived by a non-resident enterprise from its investment as a participant in a joint venture with Chinese and foreign investment.

Paragraph 5 provides that where, say, a UK company receives a dividend from a Chinese company, and that dividend is effectively connected with a permanent establishment which the UK 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 6 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 UK company may be sourced from profits

earned by a permanent establishment which that UK 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

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

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

UK

There are no withholding taxes on non-resident shareholders, although the tax (imputation) credit available to UK residents is not given on distributions to non-resident shareholders so that in practice this is treated as a withholding tax of 10%. However, the tax credit and the withholding tax cancel out so that the amount payable is not reduced.

Article 11 Interest

See treaty text

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

Rates are:

0% for interest paid to the UK or Chinese Governments, their local authorities, central banks and other Government agencies. This treatment also extends to interest on any debts guaranteed, insured or indirectly financed by either of the Governments, their local authorities, central banks and other Government agencies.

10% in all other cases providing the beneficial owner of the interest is resident in the other State.

The New DTA added a specific anti-abuse clause. In this respect, the provisions of this article may not apply if the main purpose or one of the main purposes of any person concerned with the creation or assignment of the debt claim in respect of which interest is paid, was to take advantage of this article by means of that creation or assignment.

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 prizes attaching to these securities as well as other bonds and debentures and all other income which has the same treatment as income from money lent, under domestic laws. Income dealt with in Article 10 (dividends) is 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.

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

UK

Interest paid to companies: withholding tax of 20% except on quoted Eurobonds. Certain bank interest may be paid gross on filing of a declaration.

Interest paid to individuals: withholding tax of 20%.

Article 12 Royalties

See treaty text

This Convention provides for withholding tax rates below those which would be applied by virtue of Domestic law. The beneficial owner of the royalties must be resident in the other State.

10%: on any 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, trade mark, design or model, plan, secret formula or process, or for information (know-how) concerning industrial, commercial or scientific experience.
10% but applied to only 70% of the gross amount of the royalties in the case of payments of any kind received as a consideration for the use of, or the right to use, any industrial, commercial or scientific equipment.
There are the usual provisions such that royalties received by a non-resident but which relate to a permanent establishment which that non-resident has in the other Contracting State are taxed under Article 7 and thus escape withholding tax. Also, royalties paid by an enterprise which are borne by a permanent establishment are deemed to arise in the State in which the permanent establishment is situated. Hence, if the permanent establishment and the recipient are in the same State, no withholding tax can arise.
Where the payer and recipient are connected and the amount of royalties exceeds an arm's length amount, the excess amount paid will not enjoy the treaty benefits and will be liable to tax in the payer's State at the normal domestic rate of withholding tax.

Domestic law

The New DTA added a specific anti-abuse clause. In this respect, the provisions of this article may not be able to apply if it was the main purpose or one of the main purposes of any person concerned with the creation or assignment of the right in respect of which the royalties were paid to take advantage of this article by means of that creation or assignment

China

Withholding tax of 10%.
If a company becomes resident of Luxembourg or China for the principal purpose of enjoying benefits under this Treaty, the company does not get the benefit of this Article (see Article 4.5).

UK

Withholding tax of 20%.

Article 13 Capital Gains

See treaty text

This Article generally follows OECD model.
Gains derived by a resident of a Contracting State from alienation of immovable property in the other Contracting State may be taxed in that other State.
Gains derived by a resident of a Contracting State from the alienation of shares deriving more than 50% of their value directly or indirectly from immovable property situated in the other Contracting State may be taxed in that other State.
Gains derived by a resident of a Contracting State from the alienation of shares in a company which is a resident of the other Contracting State may be taxed in that other Contracting State if the first-mentioned resident, at any time during the 12-month period preceding such alienation, owned directly or indirectly, at least 25% of the shares of that company.

Domestic law

UK

The UK does not tax chargeable gains of non-residents except assets used for the trade of a non-resident in a UK permanent establishment. This applies both to permanent establishments of a non-resident company and of a non-resident unincorporated business.

China

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

Article 14 Independent Personal Services

See treaty text

The general rule found in the UN Model Treaty is used: Capital gains arising in a State may be taxed by that State.
The rule also applies where an individual is present in the other State for more than 183 days in a 12month period.
There is an exception for gains in connection with international transport businesses.
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.

Article 15 Income from Employment

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 fiscal 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.

UK

Any income from employment carried on in the UK is taxable in the UK unless the UK duties are incidental to the duties of a non-UK employment.

Inward expatriates to the UK do not receive any special allowances, although an expatriate receiving a salary from a non-resident employer may claim a deduction for items that would receive a deduction if a corresponding item payable in the UK would have been deductible. Expatriates may also receive non-taxable travel expenses from a UK or non-resident employer for himself and his family during the first five years for journeys between home and his place of UK employment.
If an individual is present in the UK for more than 183 days in a tax year, technically he is considered tax resident, and therefore liable on his worldwide income and gains in the UK for the whole of the tax year. However, inward and outward expatriates from the UK may claim the so-called "split year' treatment, which is a concession of the UK fiscal authority and not part of domestic law. To qualify, inward expatriates must arrive with the intention of staying for at least two years. Under the concession, an outward expatriate can claim to be treated as non-resident from the day following the day of departure provided that his absence from the UK is for a complete year of assessment, for the purpose of a full time contract of employment and his visits to the UK during the period amount to less than 183 days in any tax year and average less than 91 days a tax year over a maximum period of four years.
If not leaving for the purpose of full time employment, then departure must be for three years' minimum.
Domicile, distinguished from residence has a special significance: an individual who is domiciled abroad, while being resident in the UK is taxed on the remittance basis in respect of foreign income and capital gains so that only income and gains from UK sources, or from non-UK sources but brought into the UK are taxed.

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 Artistes and Sportsmen

See treaty text

The usual OECD Model rule is followed: Income derived by a resident of one State as an entertainer, such as a theatre, motion picture, radio or television artist, or a musician, or as an athlete, from their personal activities as such exercised in the other State may be taxed in the other State. This also applies where the income accrues not to the entertainer or athlete himself, but to another person, e.g. a management company or a troupe, team or orchestra forming a legal entity or to an artist company. If the income is derived from activities performed under a cultural agreement between the two States and which are substantially funded by the State in which the performer is resident then the income will only be taxable in the State where the performer is resident.

Article 18 Pensions

See treaty text

Pensions (including government pensions and payments under a social security system) are only taxable in the country where the recipient is tax resident. This is the normal OECD treatment.

Article 20 Students

See treaty text

General rule applies with extensions to scholarships etc and income from personal services, subject to monetary limit, regardless of there these classes of income arise.

Article 21 Other Income

See treaty text

This new Article generally follows UN model. This Article broadly sets out the concept that incomes beneficially owned by a resident of a Contracting State not dealt with in the other Articles of the New DTA shall be taxable only in that State.
The New DTA added a specific anti-abuse clause. In this respect, the provisions of this article may not be able to apply if it was the main purpose or one of the main purposes of any person concerned with the creation or assignment of the rights in respect of which the income is paid to take advantage ofthis article by means of that creation or assignment

Article 22 Elimination of Double Taxation

See treaty text

China

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

UK

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

UK tax sparing

Tax sparing is granted by the UK in respect of certain exemptions from and reductions in Chinese tax. This means that the UK will grant a double tax credit for taxes not actually paid in China. Specifically, the Chinese reductions and exemptions to which this applies are those granted under:

• Articles 7, 8, 9, 10, 19(1), 19(3), 19(4) of the Income Tax Law of the People's Republic of China for Enterprises with Foreign Investment and Foreign Enterprises;

• Articles 73.75 and 81 of the Detailed Rules and Regulations for the Implementation of the Income Tax Law of the People's Republic of China for Enterprises with Foreign Investment.

The exemption from or reduction in tax must have been granted for the purposes of promoting new industrial, commercial, scientific, educational or other development in China.

The tax sparing is applicable so long as the reductions and exemptions remain substantially as they were on September 2, 1996 (the date these provisions were introduced, by Protocol).

Tax sparing will also be granted in respect of further exemptions or reductions granted by China upon agreement by the tax authorities of China and the UK that they are of a substantially similar character to Chinese tax incentives already offered.

The UK will only grant the tax sparing for a period of 10 years from March 4, 1997 (the date the Protocol introducing the tax sparing provisions entered into force).

In the case of reductions or exemptions first granted before the Protocol entered into force, the time limit is 10 years from the date the exemption or reduction was first granted. This rule is relaxed for income or profits derived from a UK taxpayer from an infrastructure project, agricultural or forestry or animal husbandry project, or from projects in remote underdeveloped areas of China. For such income or profits, the time limit is 13 years from the date the exemption or reduction was first granted.

All these time limits may be extended by agreement between the tax authorities of China and the UK.

General

Paragraph 7 confirms that profits of a permanent establishment are to be treated as profits arising in the other State and the State where the taxpayer is resident must give a tax credit for foreign tax suffered.

Article 23 Miscellaneous Rule

See treaty text

This Article specifically allows the tax authorities of the Contracting States to apply domestic GAAR when the resulting tax effect has conflict with the intention of any of the articles in the New DTA. Tax benefit may be denied in the case of tax evasion or avoidance under GAAR.

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.

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. This is so irrespective of the remedies provided by domestic law. No time limit is set.

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

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 Agreement", for the purposes of domestic law of the two States and also for the prevention of tax evasion. The exchange of information is not limited to that only concerning persons who are residents of one of the States.

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

• Carry out administrative measures at variance with the laws or administrative practices of either State;
• Supply information which is not obtainable under the laws or in the normal course of the administration of either State; and
• Supply information which would disclose any trade, business, industrial commercial or professional secret or trade process, or information the disclosure of which would be contrary to public policy (*ordre public*).

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

Article 27 Diplomatic Agents And Consular Officials

See treaty text.

Not analysed.

Article 28 Existing Agreement

See treaty text.

Not analysed.

Article 29 Entry Into Force

See treaty text.

Not analysed.

Article 30 Termination

See treaty text.

Not analysed.