Analysis: China – United States Income Tax Treaty

See treaty text.
Type of treaty: Income Tax
Based on US Model Treaty
Signed: April 30, 1984
Entry into force (main treaty and contemporaneous protocols/exchanges of notes): November 21, 1986
Effective date: January 1, 1987
Subsequent Protocol signed: May 10, 1986
Entry into force of subsequent Protocol: November 21, 1986
Effective date of subsequent Protocol: January 1, 1987
This Analysis was updated on July 5, 2010 by **James Cantillon Ross**, Tax Attorney and Member of the Bars of California, New York and Quebec.

Article 1 Persons Covered

See treaty text.
The Convention applies to residents of the United States or China except where the terms of the Convention provide otherwise. Article 1 of the Protocol states the general rule that a double tax treaty may only improve the tax position of a taxpayer, not impose any additional tax burden or charge. If a State's domestic law results in a lower tax burden then the taxpayer may rely on that. The only proviso is that for any given type of income either domestic law or the tax treaty must be relied upon, not a mixture of the two.
Article 2 of the Protocol is a simplified version of the traditional "saving clause" which is found in all US double tax treaties and enables the US to continue to tax its residents and to tax its citizens under US domestic law even if, under the terms of this Treaty, they are not tax resident in the US as if this Treaty did not exist. The object of the clause is to deny any US tax advantage under this Treaty to US residents and to US citizens who are not residents. For US residents and US citizens who are not US resident, the Treaty protects them from certain Chinese taxes but leaves their US tax liabilities unchanged. The clause is worded so that China, in theory, has the same rights, but the savings clause is essentially a US measure. So, for instance, an individual who is considered tax resident in China under this Treaty, but who is a citizen of the US could find that he is taxable in China as a tax resident there and also taxable in the US on his worldwide income by reason of his US citizenship. The Technical Explanation to the Treaty provided by the IRS states that, as an anti-avoidance measure, the US reserves the right to continue to apply this treatment to its former citizens although this is not mentioned in the Protocol. These former citizens would be taxable under the provisions of the Internal Revenue Code section 877.
There are certain Treaty benefits which the US is not permitted to deny by using the saving clause. These are:

- Reciprocal adjustments in cases where one State has made a transfer pricing adjustment (Article 8);
- The exemption from US tax of Chinese social security benefits (Article 17);
- Provisions regarding Government employees (Article 18);
- Provisions regarding teachers and students (Articles 19 and 20);
- Double tax relief under Article 22;
- The principle of non-discrimination (Article 23);
- The benefit of the mutual agreement procedure (Article 24); and
- Treaty benefits for diplomats (Article 26).

Article 2 Taxes Covered

See treaty text.
China

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

- The income tax concerning foreign enterprises; and

- The local income tax.

United States
- Federal income taxes imposed by the Code (excluding the accumulated earnings tax, the personal holding company tax, and social security taxes).

As well as application to the taxes existing at the time the Treaty was signed (listed above) there is a provision applying the Treaty to any identical or substantially similar taxes which are imposed after the date of signing of this Treaty. In particular, note that China has unified its tax laws for resident and non-resident taxpayers as of January 1, 2008 so that the tax regime facing non-residents is significantly different from that which existed at the date of signing of this Treaty.

Article 3 Definitions

See treaty text.

"China": The People's Republic of China, including its territorial sea in which the laws relating to China apply. It also includes any area beyond the territorial sea in which the laws relating to Chinese tax are in force and all the area beyond its territorial sea, including the seabed, its subsoil over which China has jurisdiction in accordance with international law and in which the laws relating to China are in force.
"The United States of America": All the territory of the United States of America, including its territorial sea, in which the laws relating to United States tax are in force, and all the area beyond its territorial sea, including the seabed and subsoil thereof, over which the United States of America has jurisdiction in accordance with international law and in which the laws relating to United States tax are in force.
"Person" includes an individual, a company, a partnership, and any other body of persons. It also includes, as provided in Article 4 of the Protocol, an estate or a trust.
"Company": Any entity treated as a corporation for tax purposes.
"Nationals": Individuals having the nationality of a Contracting State and legal entities deriving their status as such from the law in force in a State.
Any terms not defined take their meaning from the law of the State concerned at the time. Meanings specific to tax law take precedence over other meanings.

Article 4 Residence

See treaty text.

Paragraph 1: General definition of "resident"
"Resident" means 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 incorporation or any other criterion of a similar nature. Note that citizenship is not included in the criteria so that unlike the position with some other countries, a US citizen resident in China would not be considered resident in the US.
For a discussion of agency in the context of residence, see *New York Guangdong Finance Inc. v Commissioner*, 5th Cir. No. 08-60792, Nov. 20, 2009; aff'g T.C. Memo. 2008-62, No. 14809-04, March 11, 2008. The decision applies the substance-over-form doctrine in the tax treaty context, holding that a US borrower may not disregard the existence of a Hong Kong lender to which it nominally makes interest payments. The borrower sought unsuccessfully to treat the interest payments as made in substance to the pre-1997 Hong Kong lender's parent corporation, a Chinese government entity exempt from interest withholding tax under the tax treaty. The borrower also failed in its argument that the Hong Kong lender was a mere agent of the Chinese parent, and therefore that the payments should be treated as made to the parent for tax treaty purposes. The Tax Court decision does contemplate a situation in which the Hong Kong subsidiary could be disregarded for tax treaty purposes, requiring significant but not drastic changes to the facts.
Paragraph 2: Tiebreaker rules for individuals
If, under the laws of the two Contracting States, and, thus, under paragraph (1), an individual is deemed to be a resident of both Contracting States, a series of tiebreaker rules are provided in paragraph (2) to determine a single State of residence for that individual.
- The first test is based on where the individual has a permanent home.

- If that test is inconclusive because the individual has a permanent home available to him in both States, he will be considered to be a resident of the Contracting State where his personal and economic relations are closest (i.e. the location of his "centre of vital interests").

- If that test is also inconclusive, or if he does not have a permanent home available to him in either State, he will be treated as a resident of the Contracting State where he maintains an habitual abode.

- If he has an habitual abode in both States or in neither of them, he will be treated as a resident of the Contracting State of which he is a national.

- If he is a national of both States or of neither, the matter will be considered by the competent authorities, who will assign a single State of residence.

Paragraphs 3 and 4: Tiebreaker rules for 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 Head Office then residence is to be decided by mutual agreement between the two tax authorities. However, a company incorporated in the US would almost certainly be treated as US resident regardless of its treatment by China. Dual residence is possible and if this occurs, treaty benefits are not available to the company.
Paragraph (4) deals with the possibility that a company which is resident in the US would be treated, under another of China's double tax treaties, as resident in a third country. If this is the case, then that company will not be entitled to benefits under this Treaty, but would be entitled to benefits under the treaty between China and the third country.
Treatment of fiscally transparent and tax exempt bodies
A US partnership, estate or trust is a resident only to the extent that the income it derives is subject to tax either in the hands of the entity or of its partners or beneficiaries. There are no specific rules for determining the residence of entities other than companies although this term is defined to include entities treated as bodies corporate for tax purposes.
Domestic law (individuals)
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.
United States
Citizens and resident aliens of the United States are taxable on their worldwide income regardless of the length of any absence from the United States. It is therefore possible to be considered tax resident in both the United States and China.
Individual tax residents to the United States include citizens and *resident aliens*. A resident alien satisfies either the green card test or the substantial presence test for the calendar year (January 31 – December 31). If neither test is satisfied, an individual may be able to choose to be treated as a tax resident for part of the year under certain conditions.
Green card test
An individual is resident for tax purposes if he/she is a lawful permanent resident of the United States at any time during the calendar year. Lawful permanent residency is awarded to individuals given the privilege, according to the immigration laws, of residing permanently in the United States as an immigrant. This is generally recognised by the issuance of an alien registration card also known as a green card.
Substantial presence test
To meet this test of residency the individual must be physically present in the United States on at least:
- 31 days during the current year; and

- 183 days during the three-year period that includes the current year and the two years immediately before that, counting:

- All the days present in the current year; and

- 1/3 of the days present in the first year; and

- 1/6 of the days present in the second year before the current year.

Dual-status aliens

An individual can be both a United States non-resident alien and a resident alien during the same tax year. This usually occurs in the year of arrival and departure from the United States.
An individual can choose to be treated as a United States resident for part of a tax year not satisfied by the green card test or the substantial presence test if one of the tests will be satisfied the following tax year. This choice is available when:

- The individual is present in the United States for at least 31 days in a row; and

- The individual is present in the United States for at least 75 percent of the number of days beginning with the first day of the 31-day period and ending with the last day of that tax year (five days of absence is disregarded as *de minimis*).

Dual-status aliens can choose to be treated as a United States resident for the entire year if all of the following apply:

- They were non-resident aliens at the beginning of the year.

- They were resident aliens at the end of the year.

- They married a United States citizen or resident alien at the end of the year.

- Your spouse joins you in making the choice.

An election can be made to treat a non-resident spouse as a United States resident when the other spouse is a United States citizen or resident alien. This includes the situation where one spouse is non-resident at the beginning of the year and resident at the end of the year while the other spouse is non-resident at the end of the same year.

Domestic law (companies)

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.

United States

A company is treated as resident in the United States if it is created or organised under the laws of the United States or a political subdivision. Such a corporation files a charter or articles of incorporation in a state, a United States possession, or with the United States Government.

"Check-the-box" regulations

For United States Federal tax purposes, certain business entities automatically are classified as corporations. Other business entities may choose how they are classified for United States Federal tax purposes. Except for a business entity automatically classified as a corporation, a business entity with at least two members can choose to be classified as either an association taxable as a corporation or a partnership, and a business entity with a single member can choose to be classified as either an association taxable as a corporation or disregarded as an entity separate from its owner.

Domestic law (fiscally transparent enterprises)

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.

United States

Entities falling under this description in the United States include partnerships, common investment trusts under the Internal Revenue Code Section 584, grantor trusts and limited liability companies ("LLCs") that are treated as partnerships for United States tax purposes.

Article 5 Permanent Establishment

See treaty text.

Permanent establishment

This Article defines the term "permanent establishment". The profits of an enterprise of one of the Contracting States can only be taxed on an arising basis in the other Contracting State to the extent that they are attributable to a permanent establishment in that other State.

This Treaty broadly uses the UN definitions; three types of permanent establishment are envisaged: A fixed place of business, a service permanent establishment and an agency permanent establishment.

Fixed placed of business

This Treaty broadly uses the OECD definitions: a "permanent establishment means a fixed place of business through which the business of the enterprise is wholly or partly carried on". The list of types of establishment particularly included includes the usual ones:

- A place of management;
- A branch;
- An office;
- A factory;
- A workshop;
- A mine, an oil or gas well, a quarry or any other place of extraction of natural resources;
- A building site, construction or assembly or installation project which lasts for more than six months; and
- An installation, drilling rig or ship used for the exploration or exploitation of natural resources, but only if so used for a period of more than three months.

Supervisory activities in connection with such activities are also included. Note this very short period which follows the UN Model Convention. Connected projects, e.g. turnkey projects consisting of a number of linked projects would be considered as a single project for these purposes (per the U.S. Treasury Technical Explanation to this Treaty).

According to the OECD Commentary, a "fixed place of business" means 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.

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.

Service permanent establishment

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

Agency permanent establishment

Dependent agents may constitute a permanent establishment even where there is no fixed place of business. Where a person acting on behalf of a resident of a Contracting State had, has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name of the resident, that resident is deemed to have a permanent establishment in that other State if the agent's activities go beyond the excluded activities listed in a) to f) above (i.e. they are more than preparatory/auxiliary).

An enterprise is not deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through an independent agent, including a broker or general commission agent, if the agent is acting in the ordinary course of his business as an independent agent.

In June 2010, the U.S. Internal Revenue Service confirmed publicly its position that the activities of companies which send agents into the United States to do business can create a permanent establishment, even if the presence of agents does not rise to the level of incorporation or putting in place significant facilities. BNA Daily Tax reporter, June 7, 2010. The Service described scenarios in which corporations hire agents "to go out and sell in other countries," or do other business, often through branches. A US controlled foreign corporation might locate in one country and "branch through Europe." The taxpayers typically don't have big offices on the ground, but a large number of people will come in and do a "huge amount of business."

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

Domestic law

China

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

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

- Other establishments and sites for conducting production and business operations.

The general rules is that a permanent establishment will exist if a site or project lasts for more than six months in a 12 month period
Under Circular 403 Interpretation and implementation notice for HK's Double Tax Arrangement a permanent establishment will exist if services have been provided in China for more than six consecutive months in any 12 month period. Counting starts from the arrival of the first employee in China and only ceases when the last employee leaves the country.

Article 6 Income from Real Property

See treaty text.

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

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.
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;

- 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.
Paragraph 4 permits the States to use provisions of domestic law which set the profits of enterprises in a specific interest for tax purposes via a formula rather than relying on accounting profits records. This is done under Chinese domestic law in the case of foreign shipping, airlines and oil drilling operations: taxable profits are deemed to be simply 10 percent of gross income. Provided the end result is consistent with the “distinct and separate enterprise” principle, this practice is permitted.
Although this Treaty uses elements of the UN Model as well as the OECD Model, the recent OECD work on attribution of profits to permanent establishments is relevant to this treaty. The aspects of Article 7 of this Treaty which are based on the UN Model are those concerned with the deductibility of expenses in arriving at the taxable profits. The Commentary on the UN Model relating to the rules on deductibility of expenses makes it clear that the extra provisions are present so that all necessary definitions and clarifications on this matter are set out in the text of the treaty rather than merely in a Commentary. The central aim of Article 7 in this Treaty is identical to that in the OECD Model Convention: The profits attributable to a permanent establishment are those which would be earned by the establishment if it were a wholly independent entity dealing with its head office as if it were a

distinct and separate enterprise operating under conditions and selling at prices prevailing in the regular market (per Paragraph 2 of Commentary on Article 7, UN Model).

The OECD, in 2008, published its final report on the attribution of profits to permanent establishments (July 17, 2008) and updated the Commentary on Article 7 of the Model Treaty. When interpreting a tax treaty, it is generally agreed that the latest version of the OECD's Commentary on the Model Treaty should be used. These notes follow the 2008 version of the Commentary. The “authorised OECD approach” to attributing profits to a permanent establishment now requires that there is a two step process.

Firstly, a functional and factual analysis should be carried out, along the lines set out in the OECD's transfer pricing guidelines, to establish the economically significant activities and responsibilities undertaken by the permanent establishment. This will involve establishing the rights and obligations arising out of transactions between the permanent establishment and third parties, e.g. the sales revenue arising from independent customers generated by the permanent establishment as opposed to by the head office. If the permanent establishment takes the form of a factory, then it would assume the obligation to pay for the raw materials which it uses. The OECD then recommends that “significant people functions” relevant to the attribution of economic ownership of assets are identified to support the attribution of economic ownership of assets of the enterprise to the permanent establishment. Economic ownership is defined as the right to income from an asset or the right to depreciate it. Tangible property should be attributed to the location where it is in use. Economic ownership of intangibles rests with the location in which the risks associated with the intangibles is borne: For instance, if an enterprise owns a patent for a particular drug which is sold by distributor companies in many countries, the economic ownership would rest in that part of the enterprise responsible for commissioning the research to develop the drug and which would bear the losses if medical trials failed. A further set of “significant people functions” are then to be identified: This time, those relevant to the assumption of risks so that an allocation of risks borne by the enterprise can be made to the permanent establishment. For instance, road building equipment may be economically owned by a permanent establishment in Country A but the head office, located in Country B, may have the power to determine on which road building projects the equipment is used and hence the head office bears the risk associated with profits or losses arising from the equipment. The more risks that are managed by the permanent establishment, the higher the share of the profit of the enterprise to be attributed to it. The OECD's 2008 Report looks for the place of active decision taking rather than mere “rubber stamping”. Note that no such distinction between asset management and risk assumption functions is required in the case of enterprises in the financial sector, because it is considered highly likely that these functions would be carried out by the same people.

Secondly, taking into account the picture built up in the functional and factual analysis, the profits of the permanent establishment must be determined. Although this is relatively simple in the case of transactions with third parties, transactions and dealings with other parts of the enterprise must be determined using the rules laid down in the OECD's Transfer Pricing Guidelines. This means that goods and services provided by head office must carry an arm's length mark up. Pricing policies should be properly documented, which in practice may prove troublesome as firms may not take the same care in documenting the terms of transactions within the firm as they would with third parties. In determining the profits attributable to the permanent establishment, part of the enterprise's interest costs on its borrowings should be allocated to the permanent establishment. The amount of capital needed to support 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. 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.

General

As is usual no profits are to 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.

United States

Foreign Corporations are taxed at 30 percent (or lower treaty) rate on investment income from United States sources and, if engaged in a US trade or business, at regular US rates in income effectively connected with that business.

Other taxes that may apply are the accumulated earnings tax, the personal holding company tax, a branch profits tax, and a transportation tax.

Generally, the US branch of a foreign corporation or partnership is treated as a foreign person. Foreign-source income treated as "effectively connected" is limited to the items below to the extent the item is attributable to an office or other fixed place of business in the United States:

- Rents, royalties and gains on intangible personal property derived from an active licensing business;

- Dividends, interest or gain from stock or obligations derived from an active banking, financing or trading business;

- Certain inventory sales attributable to a US sales office; and

• Items economically similar to the above items.

A foreign corporation engaged in a US trade or business through a branch office in the tax year is liable for a branch profits tax (and regular income tax) equal to 30 percent of the year's "dividend equivalent amount". The "dividend equivalent amount" is the corporation's effectively connected earnings and profits reduced (not below zero) by any increase for the year in its US net equity, and increased (within limits) by any decrease for the year in its US net equity.
The branch profits tax does not apply if it is inconsistent with existing US income tax treaties, if the foreign corporation is a qualified resident of the treaty country, except for treaty shopping situations.

Article 8 Related 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. In the case of the US, the provisions of section 192 of the Internal Revenue Code will apply.
The other State is required to make an appropriate downwards adjustment to taxable profits. There is provision for consultation on this point between the two tax authorities.
Note that bilateral advance pricing agreements can be made between and taxpayer and the two States.

Article 9 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 percent.
Paragraph (3) defines the term "dividends" to include income from shares or other rights (which are not debt-claims) which participate in profits. Also included is income from other corporate rights which is treated as income from shares under the law of the State in which the distributing company is tax resident.
Paragraph (4) provides that where, say, a US company receives a dividend from a Chinese company, and that dividend is effectively connected with a permanent establishment which the US 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 US company may be sourced from profits earned by a permanent establishment which that US company has in China, does not give China any taxing rights over that dividend, unless of course, it is received by Chinese shareholders.
The Protocol provides that the Treaty rate of withholding tax will not apply if a company becomes a resident of the US or China for the principal purpose of enjoying the withholding tax rate charged under this Treaty.
In accordance with the "saving clause" of paragraph 2 of the Protocol, the US retains the right to tax dividends derived by US citizens.

Domestic law

China

Article 4 of CITL: 10 percent withholding tax. This replaces the previous exemption from withholding tax for dividends.

United States

Withholding tax 30 percent. There is an exception where the paying company derives at least 80 percent of its income from active business carried on outside the US.

Article 10 Interest

See treaty text.

Maximum rate of withholding tax 10 percent providing the recipient is also the beneficial owner. However, interest arising in one of the States and paid to the Government of the other State is to be exempt from withholding tax. Interest in respect of a loan indirectly financed by (e.g. guaranteed or insured by) the Government of either China or the US is similarly exempt from withholding tax. The same treatment applies to interest received by the central banks and Government-owned institutions.

Interest is defined as income from debt-claims of every kind whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits. The term includes income from government securities, bonds and debentures and premiums and bonuses attaching to these securities.
There are the usual provisions such that interest received by a non-resident but which relates to a permanent establishment which that non-resident has in the other Contracting State is taxed under Article 7 and thus escapes withholding tax. Also, interest paid by an enterprise which is borne by a permanent establishment is deemed to arise in the State in which the permanent establishment is situated. Hence, if the permanent establishment and the recipient are in the same State, no withholding tax can arise.
As is usual under the Model Conventions, there is a provision limiting the treaty benefit to an arm's length amount of interest where there is a special relationship between the payer and the beneficial owner.
The Protocol provides that the Treaty rate of withholding tax will not apply if a company becomes a resident of the US or China for the principal purpose of enjoying the withholding tax rate charged under this Treaty.
In accordance with the "saving clause" of paragraph 2 of the Protocol, the US reserves the right to tax interest derived by US citizens.

Domestic law

China

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

United States

Withholding tax of 30 percent.
Certain interest is subject to a reduced rate of, or exemption from, withholding tax:

- Portfolio interest (defined in detail, but broadly where less than 10 percent of the paying entity is held by the recipient of the interest);
- Interest on US bank deposits;
- Interest on certain bonds issued at State level where the interest is exempt under US domestic law;
- Interest in respect of certain Treasury bills.

Article 11 Royalties

See treaty text.
Withholding tax is limited to 10 percent 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 percent rate) on 70 percent 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 (i.e. leasing payments), 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.
There is a further rule covering the position where sub-licenses are used at paragraph 5(b) 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. or perhaps at the dividend rate if treated under domestic law as a dividend.
The Protocol provides that the Treaty rate of withholding tax will not apply if a company becomes a resident of the US or China for the principal purpose of enjoying the withholding tax rate charged under this Treaty.

In accordance with the "saving clause" of paragraph 2 of the Protocol, the US reserves the right to tax royalties derived by US citizens.

Domestic law

China

Withholding tax of 10 percent.

United States

Withholding tax of 30 percent.

Article 12 Gains

See treaty text.

Generally this Treaty grants the right to tax capital gains to the State in which they arise. Subject to double tax relief, they may also be taxed by the State where the taxpayer is resident.

This reflects the UN Model Treaty on which this Article is based 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.

There is the usual rule that gains on alienation of movable (personal) 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.

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.

At paragraph 4 there is a rule to the effect that gains on the alienation of shares of a company whose value derives principally from real property in the other State may be taxed in the other State.

Gains from the disposal (alienation) out of a holding of 25 percent of the capital in any company may be taxed in the State in which the company is resident.

In accordance with paragraph 2 of the Protocol, the US reserves the right to tax the capital gains of its citizens.

Domestic law

China

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

United States

No tax on gains of non-residents unless included as FDAP income or except in connection with certain disposals of intellectual property.

Article 13 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 Chinese accountant with an office in the US will be taxable in the US on profits attributable to the US office. The attribution of profits is dealt with in the same way as for other business profits under the provisions of Article 7.

This treatment will also apply to professional services performed in the other State by individuals present in the other State for more than 183 days in aggregate in any 12 month period but only to that part of the income of the person which is derived in the other State.

The term "professional services" is defined to include especially independent scientific, literary, artistic, educational or teaching activities as well as the independent activities of physicians, lawyers, engineers, architects, dentists and accountants.

In accordance with paragraph 2 of the Protocol, the US reserves the right to tax its citizens.

Article 14 Dependent Personal Services

See treaty text.

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

- The recipient is present in the other State for no more than 183 days in the calendar year;
- The remuneration is paid by, or on behalf of, an employer not resident in the other State; and
- The remuneration is not deductible in computing the profits of 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.

The US reserves the right to tax its citizens, regardless of the length of stay.

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.

United States

Citizens and residents are ordinarily fully taxable on their income from outside the United States with the exemptions for foreign earned income and housing costs.

For any tax year in which an individual "qualifies", he may elect to exclude from gross income $91,400 (for 2009) (as adjusted for inflation) of foreign earned income. There is a separate exclusion for foreign housing costs for such qualified individuals.

"Foreign earned income" is earned income from foreign sources attributable to services performed during the "qualifying" period. Earned income means wages and other amounts received as compensation for personal services rendered. It does not include pensions or annuities or certain amounts paid by the US or federal agency to its employees.

An individual's foreign earned income exclusion for a tax year cannot exceed his foreign earned income for the year, as computed on a daily basis at an annual rate of $91,400 (for 2009). The sum of an individual's foreign earned income exclusion and housing costs exclusion and/or deduction for any tax year cannot exceed his foreign earned income for the year. Excess foreign earned income after the exclusions and/or deductions have been calculated may be eligible for the foreign tax credit.

For the tax years beginning after December 31, 2005, the amount of housing costs eligible for exclusion in a tax year is the excess of the individual's housing expenses for the year, over 16 percent of the amount (computed on a daily basis) of the foreign earned income exclusion limitation. (This is the base amount multiplied by the number of days in the tax year within the individual's period of foreign residence or presence.)

This excess is limited to 30 percent of the individual's foreign earned income exclusion.

A taxpayer qualifies for the foreign earned income and housing costs exclusions for a tax year if his "tax home" is in a foreign country and he is either:

(1) A US citizen who meets a foreign residence test. To meet this test, the individual must be a bona fide resident of one or more foreign countries for an uninterrupted period including an entire tax year.

(2) A US citizen or resident who meets a foreign presence test. To meet this test, the individual must, in any period of 12 consecutive months, be present in one or more foreign countries during at least 330 full days. This means physically present, including the time while on vacation or unemployed.

An individual's tax home is his home for purposes of deducting away-from-home travel expenses (i.e. principal place of business, regardless of where the family may reside). He has no tax home in a foreign country for any period his abode is in the US. But the fact that an individual is temporarily present in the US or maintains a US dwelling does not necessarily mean his abode is in the US

There are no special rules for inward expatriates in United States domestic law.

Article 15 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.

In accordance with paragraph 2 of the Protocol, the US reserves the right to tax its citizens.

Article 16 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 are made under the auspices of a cultural exchange programme between the two States.

In accordance with paragraph 2 of the Protocol, the US reserves the right to tax its citizens.

Article 17 Pensions and Annuities

See treaty text.

These are taxable only in the State where the recipient is resident. However, as per the UN Model, pensions paid from a State's social security system are taxable only in the paying State.

The US may not use the "saving clause" to tax its residents on social security payments paid by China.

Article 18 Government Employees and Pensions

See treaty text.

This Article deals with the taxation of remuneration and pensions paid by the government of a Contracting State with respect to the performance of governmental functions for that State.

Article 19 Teachers, Professors 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.

Such income is excepted from the "saving clause" of paragraph 2 of the Protocol, so that this rule continues to apply even if the professors or teachers become US residents provided they are not citizens or green card holders.

Article 20 Students and Trainees

See treaty text.

A student or business apprentice 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 education or training.

The exemption extends to grants or awards from tax-exempt organisations regardless of where they arise and to income from employment subject to a monetary limit of $5,000 or Chinese equivalent. This exemption only lasts for the time reasonably necessary to complete the study of training.

Such income is excepted from the "saving clause" of paragraph 2 of the Protocol, so that this rule continues to apply even if the students become US residents provided they are not citizens or green card holders.

Article 21 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 22 Elimination of Double Taxation

See treaty text.

China

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

United States

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

Tax sparing

It is not the policy of the US to grant tax sparing credits. However, the Exchange of Notes of April 30, 1984 provides that if, in future, the US does grant tax sparing to any other country, then a similar benefit will be accorded to China. To date, the US has continued to eschew tax sparing credits so that this "most favoured nation" clause has not come into effect.

This Article is not affected by the "saving clause". Thus, the benefits may be claimed by a US resident or citizen. Alternatively, a US resident or citizen may rely on the rules of the Code. However, the taxpayer may not make inconsistent choices between the rules of the Code and Agreement.

Article 23 Non-discrimination

See treaty text.

The usual OECD provisions, that nationals of one of the States shall not be subjected in the other State to any taxation or any requirement connected with tax, which is other or more burdensome than the taxation and connected requirements to which nationals of the other State in the same circumstances are or may be subjected.

There is an extension so that the principle of non-discrimination also applies to persons not resident of either the US or China.

Article 24 Mutual Agreement

See treaty text.

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

Article 25 Exchange of Information

See treaty text.
The scope of this Article is quite wide ranging in that it provides for exchange of such information as is "necessary for carrying out the provisions of the Agreement" and for the purposes of domestic law of the two States. 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*).

Article 26 Diplomats and Consular Officers

See treaty text.
This Article clarifies that the Agreement does not affect taxation privileges of diplomatic or consular officials under other special agreements or under international law.

Article 27 Entry into Force

See treaty text.
The Agreement is subject to approval in each Contracting State according to its legal requirements.

Article 28 Termination

See treaty text.
The Agreement remains in force indefinitely unless terminated by one of the Contracting States.

Article 29 Protocol

See treaty text.
Limitation of benefits
The 1986 Protocol expands on the simple limitation of benefits provision found at paragraph 7 of the Contemporaneous Protocol.
The provisions of the 1986 Protocol are intended to prevent residents of third countries from benefiting under this Convention, which is a reciprocal agreement between the two countries. Rather than trying to prove any intention of treaty shopping, the Article aims to restrict treaty shopping via a series of objective tests.
Individuals automatically qualify for treaty benefits but a number of tests are applied to determine whether persons other than individuals (principally companies) qualify for benefits.
In order to qualify for treaty benefits, at least one of these tests must be satisfied by a person other than an individual:

- Ownership/base erosion; and

- Publicly traded corporations (and their subsidiaries).

Note that this is a relatively short set of requirements compared with some other US treaties.
The "ownership/base erosion" test
Strictly speaking, this test can be applied to any person other than an individual. Both requirements of this test must be satisfied in order to qualify for treaty benefits.
Requirement 1: Ownership: 50 percent or more of the aggregate voting power and value of the person be owned directly or indirectly by persons who are themselves qualified persons: individuals

resident in China or the US, US citizens, companies as set out in subparagraph 1(b) of the 1986 Protocol or one of the States themselves.
Requirement 2: Erosion of the tax base: No more than 50 percent of the person's gross income for the taxable period is used (directly or indirectly) to meet liabilities to pay dividends interest and royalties to a person or persons who are not entitled to treaty benefits.

The "publicly traded" test

A company will be a qualified person if the principal class of its shares is listed on a recognised US or Chinese security exchange and is substantially and regularly traded on one or more recognised security exchanges.
In the case of the United States, "recognized securities exchange" means the NASDAQ System owned by the National Association of Securities Dealers, Inc. and any stock exchange registered with the Securities and Exchange Commission as a national securities exchange for purposes of the Securities Exchange Act of 1934.

The motive (competent authority) test

Even if neither of these two tests are satisfied, treaty benefits may still be available if the establishment, acquisition and maintenance of the entity and the conduct of is operations had genuine commercial motives. However, if the principal motive was to obtain benefits under this Treaty, then benefits will be denied.