

A new landscape of China's tax treaties: China signs the Multilateral Convention and reveals her positions

In brief

On 7 June 2017, the Commissioner of China State Administration of Taxation (SAT) together with representatives from 67 jurisdictions attended the OECD signing ceremony on the Multilateral Convention (the Convention¹ or the MLI). The MLI, which aims to swiftly modify bilateral tax treaties to implement the tax treaty-related BEPS recommendations, was released at the end of 2016 after negotiations involving over 100 countries and jurisdictions². The signing ceremony earmarked an important milestone in the tax treaty history, unfolding a new landscape of tax treaties internationally. It should be noted that when signing the MLI, China also signed on behalf of Hong Kong. After the signing ceremony, the 'MLI position' for each country and jurisdiction are published on the OECD website³. It should also be noted that these positions are only provisional and may still be subject to change before ratification. China has basically opted in to the provisions of the MLI which represent the minimum standards (e.g. the principal purpose test (PPT) for preventing treaty abuse and the requirement for the full implementation of Mutual Agreement Procedures (MAP)) and opting out of some of the provisions that are not mandatory (e.g. artificial avoidance of permanent establishment (PE)).

Both Chinese and foreign companies having cross-border transactions are urged to assess the impact on their existing or potential business structures against the measures in the MLI, as well as the relevant countries' or jurisdictions' provisional positions.

In detail

Background of the MLI

Some of the BEPS Action Plans cannot be implemented without amending existing tax treaties. While making amendments on a treaty-by-treaty basis (more than 3,000 bilateral treaties around the globe) would be burdensome and time-consuming, BEPS Action 15 explores the feasibility of developing an MLI to modify tax treaties swiftly. In line with this, an ad hoc Group composed of over 100 countries and jurisdictions (including China) was set up by the OECD Committee on Fiscal Affairs (CFA) and endorsed by the G20 Finance Ministers and Central Bank Governors in February 2015. After rounds of negotiation spanning more than 12 months, the MLI was finally concluded at the end of 2016.

BEPS measures covered in the MLI

The MLI includes four tax-related BEPS Action Plans as summarised below. For the detailed Article provisions of the MLI for each Action, please refer to the Appendix.

- Hybrid mismatches (Action 2): dealing with optional treaty provisions that relate to transparent entities, dual resident entities and the application of the exemption method to eliminate double taxation. This measure is optional and each jurisdiction can opt out of this measure.
Treaty Abuse (Action 6): requiring the adoption of anti-abuse rules to effectively address treaty shopping, such as the principle purpose test (PPT), the simplified limitation on benefits (LOB) test, and some other requirements like the minimum holding period for enjoying treaty benefits. The minimum requirement is to adopt the PPT while the simplified LOB test and other requirements are optional.
- Permanent Establishment (Action 7): providing stricter rules in determining a PE by addressing commissionaire arrangements and similar strategies, modifying the

specific activity exemptions, and introducing anti-splitting rules. Like Action 2, each jurisdiction can opt out of this measure.

- Improving Dispute Resolution (Action 14): requiring the full implementation of Mutual Agreement Procedures (MAP) in their tax treaties in good faith and setting a new standard for mandatory binding arbitration in MAP process. While improving MAP is mandatory, each jurisdiction may opt out of the mandatory binding arbitration.

How will the MLI work

The MLI does not substitute existing tax treaties. Rather, it supplements and ‘modifies’ those tax treaties with a series of BEPS-related provisions. It is designed as a modular with alternatives and participating countries and jurisdictions may opt in and out of the MLI’s different provisions.

With respect to the interaction between the MLI and existing tax treaties, compatibility provisions are provided for each rule, addressing how the rule interacts with provisions in the existing tax treaties which the MLI will modify. The OECD provides detailed explanatory statements to the MLI.

It can be expected that those multitudes of options will make the application of MLI highly complex. In some cases, a country or jurisdiction can choose to selectively opt in to an option on the condition that its tax treaty partners have made the same option. In other cases, the application of some rules can be asymmetrical, i.e. one treaty partner can opt in of one rule while the other treaty partner can opt in of different rule.

China’s MLI position

Upon signing the MLI, China submitted the provisional MLI positions regarding options to be deposited with the OECD. While the details of the positions in relation to each Article can be found in the Appendix, the most important ones include:

Covered tax agreement

China put all of its existing tax treaties into the covered tax agreement, except for the one with Chile and the one with India. For the China-Chile treaty, it is believed that this newly signed treaty has adopted BEPS recommendations in many aspects and there is no need to make any changes according to the MLI. For the China-India tax treaty, it is believed that bilateral instrument should be in place in the future to make sure that the tax treaty meets the minimum standards. It is interesting that both Chile and India intended to include China in its MLI position paper.

China’s three tax arrangements with Hong Kong, Macau and Taiwan (not effective) are not included in the covered tax agreement as these tax arrangements are not signed between sovereign countries. As the agreement between China and Hong Kong is very important in the treaty networks of each other, the two competent authorities may need to consider bilateral negotiation to include the relevant changes which both agree to in the MLI.

Treaty Abuse

China’s MLI position in relation to treaty abuse generally followed its current position in negotiating and re-negotiating tax treaties: 1) PPT is a minimum standard as required by BEPS Action 6, and China has been including such provisions in specific Articles of recently negotiated and re-negotiated tax treaties, as a minimum standard, China has extended the PPT to the application of all the provisions in the covered tax agreements; 2) China has not opted in of the simplified LOB clause and this is consistent with tax treaties that it has signed.

Besides that, China opted in to the minimum 365 days threshold for enjoying reduced withholding tax (WHT) rate on dividends. This is in line with China’s current practice based on either the text of the tax treaties, or the domestic interpretation rules under which the threshold for enjoying reduced WHT rate on dividends is exactly the same as

that in the MLI. Additionally, under the domestic interpretation rules, the threshold period for enjoying treaty benefit on capital gain from transfer of property-rich companies is three years which is a much longer period than that provided in the MLI. It is likely for this reason that, China opted out of the 365 days threshold period for enjoying treaty benefit on capital gain from transfer of property-rich companies.

Avoidance of PE

As China opted out of all the provisions (Article 12 to 15) in the avoidance of PE section, there is no immediate impact on foreign companies' PE position in China in the near future unless bilateral negotiation results in amendments to the specific China-foreign tax treaties. However, it should be noted that China's domestic treaty interpretation rules (Circular Guoshuifa [2010] No.75) already provided similar provisions to address the BEPS concerns including agency PE, preparatory and auxiliary activities, etc.

MAP

Before signing the MLI, some high-ranking Chinese tax officials have discussed publicly that China would unlikely accept arbitration because of sovereignty and resources concerns. As expected, China has opted out of the arbitration clause.

Effective date

The MLI needs to go through the legal ratification process in a jurisdiction domestically which will then notify the OECD of the completion of the ratification process before the changes implemented by the MLI on the Covered Tax Agreements become effective. In that respect, China will need to go through the necessary domestic legislative process to ratify the MLI and deposit its instrument of ratification to the OECD. In addition, the effective date of the MLI with respect to a particular Covered Tax Agreement of China will depend on when the MLI enters in force in both China and the other contracting jurisdiction of the covered tax agreement. According to the OECD, the first modifications to tax treaties are expected to enter into effect in early 2018.

The takeaway

It seems that China has opted out of many of the provisions that are not required under minimum standard, especially PE. However, even if tax treaty texts are not to be revised by the MLI, it is likely that China's tax authority would be more cautious when offering treaty benefits under this new landscape. More importantly, the final impact of the MLI on a particular tax treaty of China may depend not only on the MLI position of China but also the MLI position of the other contracting jurisdictions.

The implementation of MLI is the last puzzle to the BEPS project. China, as the vice Chair of the ad hoc Group, was not only heavily involved in the negotiation process but also took a leading role in developing the innovative international tax rules.

As commented by China's high-ranking tax official, the MLI is the third multilateral tax cooperation legal instruments signed by China over the last four years (the other two are on mutual administrative assistance and implementation on Common Reporting Standards, or CRS respectively). Together with China's tax treaties, exchange of information agreements and bilateral tax cooperation memos, it will not only bring immediate impact to the application of the tax treaties concerned but may also reshape China's international taxation rules in the long run.

For Chinese enterprises having or planning to have cross-border transactions, the MLI can be used not only as an instrument for mitigating cross-border tax risks and enhance tax compliance, but also as a support for resolving international tax disputes to protect taxpayers' rights.

Endnote

1. A list of signatories to the Convention can be accessed via this link:
<http://www.oecd.org/tax/treaties/beps-mli-signatories-and-parties.pdf>
2. The text of the MLI and its explanatory statement can be accessed via this link:
<http://www.oecd.org/tax/treaties/multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-beps.htm>
3. The MLI positions of China and other signatories (including Hong Kong) can be accessed via this link:
<http://www.oecd.org/tax/treaties/beps-mli-signatories-and-parties.pdf>

BEPS Measures	Convention Article	Content	China's provisional positions
	Article 2 - Interpretation of Terms	Agreements Covered by the Convention	102 tax treaties concluded by China as of November 2016 except for the tax treaties with Chile and India and the three arrangements with Hong Kong, Macau and Taiwan.
Action 2: Hybrid mismatches	Article 3 - Transparent entities	Income derived by or through a transparent entity or arrangement shall be considered to be income of a resident of a Contracting Jurisdiction.	Not adopted
	Article 4 - Dual resident entities	Competent authorities shall endeavour to determine the Contracting Jurisdiction of which a person shall be deemed to be a resident by mutual agreement. Otherwise, such person shall not be entitled to any relief or exemption under the tax treaty.	Adopted
	Article 5 – Application of methods for elimination of double taxation	Three options are provided in the Convention which shall only apply where the Contracting Party has chosen to apply and made such notification.	Not adopted
Action 6: Treaty Abuse	Article 6 – Purpose of a Covered Tax Agreement	A clear statement shall be contained that the Contracting parties that enter into a tax treaty intend to avoid creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including through treaty shopping	Adopted
	Article 7 – Prevention of treaty abuse:	Contracting parties should include one of the options below in their tax treaties: <ul style="list-style-type: none"> - a Principal Purpose Test (PPT) - a Simplified Limitation on Benefits (LOB) article combined with a PPT - a more complex LOB accompanied by either an anti-conduit rule or a PPT 	Adopted the PPT

	Article 8 - Dividend transfer transactions	The 365-day minimum holding period requirements for enjoying treaty benefits on dividends.	Adopted
	Article 9 - Capital Gains from Alienation of Shares or Interests of Entities Deriving their Value Principally from Immovable Property	The 365-day prior period requirement for exempting gains from alienation of shares of non-immovable property holding companies.	Not adopted
	Article 10 - Anti-abuse Rule for Permanent Establishments Situated in Third Jurisdictions	Anti-abuse rule for income allocable to a Permanent Establishment (PE) in a third jurisdiction where low tax is levied.	Not adopted
	Article 11 - Application of Tax Agreements to Restrict a Party's Right to Tax its Own Residents	Allowing Contracting Parties to tax their own residents under domestic law.	Adopted
Action 7: Permanent Establishment	Article 12 - Artificial Avoidance of Permanent Establishment Status through Commissionaire Arrangements and Similar Strategies	Stricter rules on determining a PE in commissionaire arrangement, etc in terms of the provision on agent and contract.	Not adopted
	Article 13 - Artificial Avoidance of Permanent Establishment Status through the Specific Activity Exemptions	Modifications of the specific activity exemptions with the introduction of an anti-fragmentation test.	Not adopted
	Article 14 - Splitting-up of Contracts	Anti-splitting rules to prevent avoidance of passing 12 month threshold for construction projects by splitting-up of contracts between associated enterprises.	Not adopted
	Article 15 - Definition of a Person Closely Related to an Enterprise	Definition of "closely related" for the purposes of Articles 12, 13 and 14	Not adopted
Action 14: Improving Dispute Resolution	Article 16 – Mutual agreement procedure (MAP)	Providing procedural and substantive requirements to fully implement MAP.	Adopted except for presenting the case to the competent authority of either Contracting State
	Article 17 - Corresponding adjustments	Competent Authorities should provide for appropriate corresponding adjustment in cases where they find that such adjustment is justified.	Adopted

	Article 18~26 - Arbitration	Provisions on setting a new standard for mandatory binding arbitration in MAP process.	Not adopted
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Let's talk

For a deeper discussion of how this issue might affect your business, please contact Kelvin Lee at +86 (10) 6533 3068 or via kelvin.lee@cn.pwc.com