CHINA

China and France Signed New Double Taxation Treaty

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On 26 November 2013, the governments of the PRC and France signed a new Double Taxation Treaty ("new DTT") to replace the old DTT which was signed by both governments on 21 February 1985. The new DTT incorporated new elements of a modern double taxation treaty and has made several important changes to the old DTT. The new DTT will become effective 30 days after both countries have gone through their respective domestic ratification procedures and have formally informed each other, which may still take some time.

We highlight below the following important changes in the DTT for your reference:

1. Tax Resident Status

   When determining the residence of a non-individual tax payer (e.g. a company tax payer), the criteria of "place of head office" is replaced by the criteria of "place of incorporation and place of effective management". Further, the old DTT does not provide specific rules in determining the tax resident status of an individual in case both countries under their respective tax law regard an individual to be their tax resident. The new DTT provides specific criteria in this respect, i.e. "permanent home", "center of vital interests", "habitual abode", and "nationality" shall be regarded as important to solve disputes in respect of the tax resident status of an individual. For tax payers other than individuals, "place of effective management" shall be the only criteria to solve tax resident disputes.

   Partnerships, groups of persons or similar entities may not be viewed as tax payers / tax residents in China or France (as the case may be) under their respective domestic tax law. Therefore, the question arises as to whether the DTT is applicable on the income of such entities. E.g. a French partnership may derive income from China and such income may be regarded as income of the partnership under PRC tax law. However, the partnership may not be viewed as a tax payer / tax resident in France. Instead, France may regard such income as the income of the partners, which

may or may not be French tax residents. The old DTT is silent on whether DTT protection shall be available to such partnership. The new DTT provides detailed rules to solve such cases.

2. Permanent Establishment (“PE”)

   a) Building site / installation PE

   To be consistent with other DTTs concluded by China, the new DTT extends the scope of a building site PE to also include “construction”, “assembly” and “connected supervisory activities”. Further, the duration threshold to constitute a PE of such type has been extended from the previous 6 months to 12 months.

   b) Service PE

   The duration threshold (regarding on-shore activities) for a Service PE has been changed from “6 months within any 12 months’ period” to “183 days within any 12 months’ period”. Under PRC tax law, for DTT purposes, “6 months” shall be counted on a calendar month basis where each calendar month in which there are personnel from the enterprise of the other country in China working on the project shall be counted as one month. Therefore, the change from “6 months” to “183 days” makes it less likely for a French enterprise to constitute a Service PE in China. Under the Protocal to the old DTT, on-shore supervisory activities related to supply of equipments shall not be regarded as constituting a PE, if the value of such activities is below 5% of the entire contract value. This stipulation has been deleted in the Protocal to the new DTT. Such change equals the treatment of French equipment suppliers in PE issues to these of their counterparts from most other treaty countries.

   c) Agency PE

   Under the Sino-French DTT, same as under other DTTs concluded by China, if an agent is empowered and regularly represents a French enterprise to conclude sales contracts in China in the name of that enterprise, the enterprise shall be regarded as having an Agency PE in China. However, if the agent is of an independent status, no Agency PE shall be constituted. Under the old DTT, an agent is regarded as not independent, if its activities are devoted wholly or almost wholly on behalf of the enterprise from the other country. However, the new DTT stipulates that the independent status shall not therefore be denied, if the commercial and financial conditions between such agent and the enterprise are made on an arm’s length principle.

3. Business Profits

   When calculating the taxable profits of a PE, deduction of expenses (including executive and general administrative expenses) occurred for the business of the PE shall be allowed, regardless of where such expenses are incurred. Under the old DTT, amounts charged to the PE (other than reimbursement of actual expenses) by the head office or other PEs shall not be deductible as expenses of the PE. Similarly, amounts charged by the PE to the head office and other PEs shall not be counted when calculating the PE’s taxable profits. The new DTT eliminates the above restrictions and exceptions and tend to treat the PE as a really separate entity for taxation purposes. Such change may not be important for most PEs of French enterprises in China since they are mostly taxed on a deemed profit method. However, for PRC PEs (e.g. a PRC representative office of a French law firm) which are taxed in China on an actual profit basis, the above change

may make a difference in the tax calculation.

4. Shipping and Air Transport

   The new DTT added a “Shipping and Air Transport” clause to reflect the content of the Sino-French treaties on income from international air and sea transportation, i.e. mutual tax exemption. However, these treaties on international transportation will remain effective after the new DTT.

5. Associated Enterprises

   The “Associated Enterprises” clause aims to address transfer pricing (“TP”) issues. I.e. adjustment of taxable profits made by one contracting country for TP reasons shall be allowed. The new DTT added that, in such case, the other country shall make an appropriate tax adjustment in the contrary direction.

6. Dividends

   Under the old DTT, dividend income can be taxed at the source country and the tax charged by the source country shall not exceed 10% of the gross dividend. The new DTT lowered the tax rate to 5% where the beneficiary owner of the dividend (being a company tax resident) directly holds 25% or more capital in the dividend-paying company. Otherwise, the tax rate shall still be 10%. It needs to be noted that the 5% tax rate does not apply to a partnership or a similar entity even though it may hold more than 25% capital in the dividend-paying company.

   The new DTT also addresses the issue of dividend income paid out by an investment instrument (e.g. real estate investment trusts) where the profits (out of which dividends are paid) are derived from real estates. Under certain circumstances, the beneficiary owner of the dividend may not be protected by the 10% or 5% tax rate for dividends received from the investment instrument.

   The new DTT denies the application of the dividend clause in case the creation or transfer of the relevant shares/rights is mainly aimed to enjoy the tax benefits under the dividend clause.

7. Interest

   Same as under the old DTT, the rate for income tax imposed on interest income by the source company is limited at 10%. Taxation right is waived by the source country for interest income received by other governments and certain government-owned financial institutions listed in the DTT. Compared with the old DTT, more such financial institutions have been expressly added to the list.

   The definition of the term “interest” also has been modified. In particular, “penalties for late repayment” and “payments for guaranteeing or insuring a loan” have been excluded from the scope of “interest”, i.e. the interest clause does not apply to them.

   Same as in the dividend clause, the new DTT denies the application of the interest clause if the relevant debt-claim is created or transferred mainly to enjoy the tax benefits under this clause.

8. Royalty

The tax levied by the source country for royalties is still limited to 10% of the gross amount. However, for rentals of equipments, the effective tax rate is reduced to 6% (according to the old and new Protocals to the DTT).

Same as in the dividend clause, the new DTT denies the application of the royalty clause if relevant right is created or transferred mainly to enjoy the tax benefits under this clause.

9. Capital Gains

Under both the old and new DTTs, gains from transfer of shares/rights of an entity (whose assets are mainly immovable properties) can be taxed by the country where the immovable properties are located. Compared with the old DTT, the new DTT provides specific rules and criteria to determine whether the assets are mainly immovable properties, i.e. more than 50% of the assets (directly or indirectly owned) are immovable properties at any time 36 months prior to the share/rights transfer.

For transfer of shares other than the above, the source country has the taxation right, if the relevant share-holding ratio is 25% or above. The new DTT provides more specific rules for the purpose of the 25% test, i.e. all shares **directly or indirectly** held shall be counted and such test shall be conducted at any time 12 months prior to the share transfer.

0. Independent Personal Services

Under the old DTT, the source country has the taxation right over independent service income, if the services are conducted via a fixed base located in that country or the individual stays in that country for more than 183 days **during the relevant calendar year**.

The new DTT changes the 183 days rule to “183 days in any **12 months’ period commencing or ending in the relevant fiscal year**”. Within such stipulation, if a French individual resident provides independent personal services in China (without a fixed base) and stays for more than 183 days in China during the 12 months’ period from 1 July Year 1 to 30 June Year 2, he may be taxed in China for his independent personal service income attributable to his work in China for all months of Year 1 and Year 2, even though he may not exceed 183 days respectively in Year 1 and Year 2 on a calendar year basis.

1. Employment Income

The new DTT also modifies the 183 days rule in a similar way as in the independent personal service clause. I.e. for a French individual, in order not to be taxed in China for his employment income, he must not stay in China for more than 183 days “**within any 12 months period commencing or ending in the relevant fiscal year**”. Under the old DTT, he only needs to avoid staying in China for more than 183 days within the relevant calendar year. Of course, to avoid being taxed in China, he must also meet the other two conditions, i.e. his employment is not paid or borne by a Chinese resident and is not borne by a PE or fixed base maintained by his employer in China.

Companies which dispatch their French resident employees to work in China shall pay close attention to this change when considering the PRC individual income tax implications of such employees.

2. Other Income

   Under the old DTT, the source country generally has the taxation right over “other income” generated from that country. The new DTT changed the general rule so that “other income” shall only be taxed at the home-country (of which the person receiving such income is a resident). However, exception is made where “other income” is earned via a PE or fixed base located in the source country. In such case, the “other income” shall be taxed as the PE’s profits.

3. Method of Eliminating Double Taxation

   Under the old DTT, where a PRC resident company receives dividend income from a French resident company, when calculating the tax credit amount, the corresponding French tax paid by the dividend-paying French company shall also be counted, **provided that the PRC company holds 10% or more shares in the French company**. The new DTT has changed the shareholding ratio requirement to 20%. This change is made because the PRC Corporate Income Tax Law (effective from 1 January 2008) also requires 20% shareholding ratio for such tax credit purpose.

   On the French side, there is one important change in the method of eliminating double taxation. I.e. the concept of “virtual tax credit” for **dividend, interest and royalty income** received from China has been eliminated in the new DTT. E.g. under the old DTT, for tax credit purpose, Chinese tax levied on a French company for PRC-sourced royalties is virtually regarded as 20% of the royalties, even though the Chinese tax actually levied may only be 10%. Such mechanism no longer exists in the new DTT, i.e. only Chinese tax **actually paid and borne** can be counted when determining tax credit in France. The effect of such change needs to be assessed taking into consideration French domestic tax law.

4. Miscellaneous Rule (anti-treaty shopping clause)

   The new DTT added a separate clause as Article 24 to deal with treaty-shopping conduct, i.e. any tax benefits under the DTT shall not be available if certain transactions or arrangements were mainly aimed to secure a more favorable tax position and obtaining such more favorable tax treatment in these circumstances would be contrary to the object and purpose of the relevant clauses of the DTT.

5. Exchange of Information / Assistance in Tax-Collecting

   There are some changes in the information exchange clause, e.g. the information that can be requested from the taxation authority of the other country is not subject to the limitation of Article 2 (Taxes Covered).

   The tax-collecting assistance clause is newly added. The competent taxation authorities of both countries shall further discuss on detailed procedures to implement this clause.

6. Entry into Force

   The new DTT shall enter into force on the 30th day after both countries have informed each other (through diplomatic channels) of the completion of their respective ratification procedures.

It may be possible to plan in advance to benefit from the change in the DTT. E.g. dividend distribution may be delayed to the future so that 5% withholding tax under the new DTT may apply. However, it is advisable that such planning is assisted by tax professionals to avoid or reduce the risks of being challenged by tax authorities.

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