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Welcome to White & Case's monthly China Tax Bulletin. This client bulletin includes updates and analyses on recent tax regulations, ensuring you stay up to date on tax developments important to your business.

Model Interpretations of Double Taxation Agreements Released – Part Three

This is our third and final instalment on Guoshuifa [2010] No. 75 ("**Circular 75**"). In the pervious two issues of our China Tax Bulletin, we focused on the interpretation of Article 5 (permanent establishment ("**PE**")), Article 10 (dividends), Article 11 (interest), Article 12 (royalties) and Article 13 (capital gains) of the China-Singapore double taxation agreement ("**DTA**"). In this issue, we will review Circular 75's interpretation of Article 4 (resident) of the China-Singapore DTA. As stated before, the interpretation under Circular 75 will also apply to other DTAs.

General Definition

Under Article 4(1) of the China-Singapore DTA, a resident of a jurisdiction means any person who is liable to tax under the laws of that jurisdiction. The term "person" refers to individuals, companies and other bodies of persons. In short, both individuals and entities could be residents within the meaning of the DTAs. Typical entity residents include corporations, associations and foundations. Trusts could also be residents, as long as the laws of their jurisdiction recognize so. Circular 75 does not address whether partnerships will be considered as residents.

The resident status does not necessarily lead to actual tax payments. While a resident must be liable to tax in its jurisdiction, such resident may or may not actually pay any tax. This is also true for qualified foundations or charity organizations. While those entities could be exempt from tax, they are generally considered residents under the DTAs. On the other hand, actual tax payments do not necessarily establish the resident status. For example, a Singapore citizen is liable to tax in China due to his or her presence in China for work. Such individual does not automatically become a resident of China. It will depend on whether the person meets with specified criteria.

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Individual Residents

An individual could qualify as a resident of China due to either her or his domicile or physical presence in China. Citizenship is not directly relevant to the residency determination. On a case-by-case basis, Chinese and foreign citizens could be residents or nonresidents of China. For this purpose, residents of Hong Kong, Macau and Taiwan are treated no differently from foreign citizens. This is why China's DTAs with other jurisdictions are inapplicable to residents of Hong Kong, Macau and Taiwan.

First, a domicile in China will cause residency. The term "domicile" generally means a permanent legal home. An individual has only one domicile in the world regardless of his or her physical presence. If an individual habitually resides in China out of family or economic reasons, such person will be deemed to have a domicile in China. This is the place the person expects to live and return to permanently. Despite this, such person is not required to actually live in China at all times under Guoshuifa [1994] No. 89. A domicile is not disrupted by any temporary overseas travel for education, work, family or leisure.

A Chinese citizen ordinarily has a domicile in China. This is not true as to overseas Chinese citizens who live outside China, Hong Kong, Macau and Taiwan. Under Guoshuifa [2009] No. 121, overseas Chinese citizens generally fall into one of the following categories:

- Chinese citizens who have obtained the legal rights to live in a foreign country permanently or for long-term and have lived consecutively in the foreign country for a period of two years, during which they have physically lived there for no less than 18 months cumulatively; or
- Absent the legal rights to live in a foreign country permanently or for long-term, Chinese citizens who have obtained the qualifications to live in the foreign country for a period of no less than 5 years, during which they have physically lived there for no less than 30 months cumulatively.

Second, physical presence in China could lead to residency. Circular 75 restates that an individual without a domicile in China will be considered a resident of China, as long as such person has stayed in China for 1 year or longer. The 1-year threshold is met, if the person stays in China for 365 days during a calendar year. In counting the number of days an individual is physically present in China, temporary absences from China are not excluded. Temporary absences include one single absence from China for a period of no longer than 30 days or multiple absences from China for an aggregated period of no longer than 90 days, in a calendar year.

Entity Residents

An entity will qualify as a resident of China due to either its registration or place of effective management in China. Registration means that such entity must be incorporated or established in China.

Permanent Establishment

Under Circular 75, a Permanent Establishment (**PE**) is not considered a resident within the meaning of the China-Singapore DTA. Indeed, a PE is not deemed to be separate from the company having the PE. The location of a PE does not decide whether to apply any particular DTA. What matters is the jurisdiction of the company having the PE. Where a Chinese resident enterprise has a PE in a third jurisdiction and receives income through the PE from Singapore, the China-Singapore DTA should apply. Similarly, where a Singapore resident enterprise has a PE in a third jurisdiction and receives income through the PE from China, the China-Singapore DTA should apply as well. The determination of a PE in a third jurisdiction apparently needs to consider China's DTA with such third jurisdiction.

What if a Chinese resident enterprise has a PE in Singapore? Where the PE derives income from a third jurisdiction, the DTA between China and such third jurisdiction will apply. Alternatively, where the PE derives income from China, then China will tax such income under the domestic tax laws. In this situation, the China-Singapore DTA will not apply, since this PE is not a resident of Singapore. It is only when the PE derives income from Singapore, that there will be an application of the China-Singapore DTA.

Dual Residents

A dual resident could complicate the application of DTAs. If a Singapore individual resident happens to be a resident of a third jurisdiction, his or her China-source income would present a question on which DTA will apply. Where such income is derived from the person's activities in the third jurisdiction, the DTA between China and the third jurisdiction will apply. If there is no DTA in place between China and the third jurisdiction, China can simply tax such income under the Chinese domestic tax law. On the other hand, where such income is derived from the person's activities in Singapore, the China-Singapore DTA will continue to kick in.

Individual Dual Residents

An individual could be a dual resident in both China and Singapore. To determine the ultimate resident status, Article 4(2) of the China-Singapore DTA specifies several factors to be applied in order of priority, including permanent home, center of vital interests, habitual abode, nationality and mutual agreement procedure. If there is a deadlock over any particular factor, the next factor will come to serve as a tie-breaker. Circular 75 provides further interpretations on those factors.

First, permanent home refers to any form of residence, including a leased house, apartment or room. Such residence must be in the nature of a permanent residence. An individual is supposed to live there long-term, rather than for a temporary duration for leisure or business reasons.

Second, center of vital interests is influenced by multiple parameters, including family and social relations, occupation, political, cultural and other activities, place of business, and place of property management. Among them, the most critical parameter is an individual's main activities. Such individual's center of vital interests is generally the country where the person lives, works, has a family and owns property.

Third, habitual abode will be relevant to the determination of the ultimate resident status in some circumstances. If an individual has dual permanent homes in both China and Singapore without a clear center of vital interests, the residency determination will consider the time spent in each permanent home as well as the time spent in different locations in each country. Alternatively, if an individual has no permanent home in either China or Singapore, the residency determination will consider the total time spent in each country regardless of the reasons. One typical example is an individual constantly shuttling between hotels in the two countries.

Fourth, nationality will decide the residency, if such individual has dual or no habitual abode in both China and Singapore.

Fifth, China and Singapore will seek to determine the residency in question through a mutual agreement procedure, if the above factors cannot solve the issue.

Entity Dual Residents

An entity could be a dual resident in both China and Singapore too. Under this circumstance, its place of effective management will be the determinative factor. Where there is a dispute in the place of effective management, China and Singapore could resort to a mutual agreement procedure.

Singapore Residents

The Singapore resident status is determined under the domestic laws of Singapore. Such status should be evidenced by a tax resident certificate issued by the Singapore tax authorities.

Our Observations

Circular 75 certainly helps better understand the concept of resident under China's DTAs with Singapore and other jurisdictions. In particular, the interpretations on PE's impact on residency as well as dual residents could provide significant practical value to taxpayers involved. Since Circular 75 does not elaborate on the place of effective management, taxpayers will need to refer to other tax circulars for details. It remains to be seen how partnerships are treated in the residency determination.

Tax Treaty Network of Hong Kong Further Expanded

Hong Kong concluded comprehensive DTAs with Brunei, the Netherlands and Indonesia in March 2010 (please refer to our China Tax Bulletin May 2010 for more information about those three DTAs) and thus increased the number of Hong Kong's DTAs from five to eight. Since then, Hong Kong has signed comprehensive DTAs with ten further jurisdictions, including Hungary, Kuwait, Austria, United Kingdom, Ireland, Liechtenstein, France, Japan, New Zealand and Switzerland. The key points of the new ten DTAs are highlighted as follows.

Service Permanent Establishment

Except for the Hong Kong-Japan DTA, all those DTAs include a service PE provision. Under this provision, a Contracting Party is entitled to tax income attributable to a service PE situated in that Contracting Party. A service PE will exist, if the provision of services for the same or connected projects generally lasts for a period or periods aggregating more than 183 days within any 12-month period. The Hong Kong-Kuwait DTA specifies a threshold of 180 days within any 12-month period, while the Hong Kong-France DTA mandates a threshold of 6 months within any 12-month period. Moreover, the Hong Kong-Switzerland DTA provides a threshold of 270 days within any 12-month period, which is the same as the threshold for a project PE.

Dividends, Interest and Royalties

The ten DTAs state the withholding tax rates applicable to dividends, interest and royalties, which are described in the following chart.

	Dividends	Interest	Royalties
Hong Kong	0%	0%	4.95%
Austria	0% / 10%	0%	3%
France	10%	0% / 10%	10%
Hungary	5% / 10%	0% / 5%	5%
Ireland	0%	0% / 10%	3%
Japan	5% / 10%	0% / 10%	5%
Kuwait	0% / 5%	0% / 5%	5%
Liechtenstein	0%	0%	3%
New Zealand	5% / 15%	0% / 10%	5%
Switzerland	0% / 10%	0%	3%
United Kingdom	0% / 15%	0%	3%

Those withholding tax rates need to be considered against Hong Kong's domestic rates in the absence of the DTAs, which are 0 percent, 0 percent, and 4.95 percent on dividends, interest, and royalties (to nonresident companies) respectively. The new DTAs mandate that the withholding tax rates not exceed the specified percentages. Sometimes, the new DTAs have more than one withholding tax rate with respect to dividends or interest.

- In the Hong Kong–Austria DTA, the default withholding tax rate of 10 percent on dividends will be reduced to 0 percent, if the beneficial owner is a company which holds directly at least 10 percent of the capital of the company paying the dividends.

- In the Hong Kong-France DTA, the default withholding tax rate of 10 percent on interest will be reduced to 0 percent, if such interest is paid to the government or designated financial institutions, or relates to a loan financed, guaranteed, or subsidized by the government.

- In the Hong Kong–Hungary DTA, the default withholding tax rate of 10 percent on dividends will be reduced to 5 percent, if the beneficial owner is a company which holds directly at least 10 percent of the capital of the company paying the dividends. In addition, the default withholding tax rate of 5 percent on interest will be reduced to 0 percent, if such interest is paid to the government or designated financial institutions.

- In the Hong Kong–Ireland DTA, the default withholding tax rate of 10 percent on interest will be reduced to 0 percent, if such interest is paid to the government, designated institutions, banks, and pension entities, or relates to a purchase money loan on equipment, merchandise, or service.

- In the Hong Kong-Japan DTA, the default withholding tax rate of 10 percent on dividends will be reduced to 5 percent, if the beneficial owner is a company which holds directly or indirectly at least 10 percent of the voting shares of the company paying the dividends. In addition, the default withholding tax rate of 10 percent on interest will be reduced to 0 percent, if such interest is paid to the government or designated financial institutions, or relates to a loan financed, guaranteed, or insured by the government or designated financial institutions.

- In the Hong Kong–Kuwait DTA, the default withholding tax rate of 5 percent on dividends will be reduced to 0 percent, if the beneficial owner is the government or qualified institution. In addition, the default withholding tax rate of 5 percent on interest will be reduced to 0 percent, if such interest is paid to the government or qualified institutions.

- In the Hong Kong–New Zealand DTA, the default withholding tax rate of 15 percent on dividends will be reduced to 5 percent, if the beneficial owner is a company which holds directly at least 10 percent of the capital of the company paying the dividends. In addition, the default withholding tax rate of 10 percent on interest will be reduced to 0 percent, if such interest is paid to the government or qualified institutions.

- In the Hong Kong–Switzerland DTA, the default withholding tax rate of 10 percent on dividends will be reduced to 0 percent, if the beneficial owner is (i) a company which holds directly at least 10 percent of the capital of the company paying the dividends, (ii) a pension fund or pension scheme or (iii) a designated financial institution.

- In the Hong Kong-United Kingdom DTA, the default withholding tax rate of 0 percent on dividends will be raised up to 15 percent, if dividends are paid out of income derived directly or indirectly from real property by a tax-exempt investment vehicle other than a pension scheme.

Capital Gains

Real Property Holding Company

Under those DTAs, a resident of a Contracting Party is subject to the withholding tax on capital gains derived from the disposition of a company's shares in the other Contracting Party, if the company derives more than 50 percent of its asset value directly or indirectly from real property situated in such other Contracting Party. Such company is sometimes labeled as a real property holding company by tax professionals, though it could achieve this status purely by accident.

The general rule will not apply to capital gains derived from the disposition of shares, if one of the following three exceptions is available: (i) those shares are quoted on agreed or recognized stock exchanges; (ii) the disposition or exchange takes place as a part of a reorganization, merger, scission, or similar transaction; or (iii) such company derives more than 50 percent of its asset value directly or indirectly from real property in which it carries on its business. The Hong Kong–Ireland DTA and the Hong Kong–Japan DTA only allow the first exception to the general rule. Under the Hong Kong-Japan DTA, to enjoy this exception, such resident and its related persons cannot own more than 5 percent of that class of the shares in a real property holding company. The Hong Kong–Liechtenstein DTA limits the second exception to a tax-free reorganization or transaction only.

Major Shareholder (Hong Kong–France DTA)

Under the Hong Kong–France DTA, a Contracting Party is entitled to tax capital gains only from the disposition of shares in a resident company by a nonresident major shareholder, who has a substantial participation in the resident company. The substantial participation refers to a right to receive at least 25 percent of the resident company's profits by the nonresident major shareholder and its related persons.

5-Year Holding Period (Hong Kong–Japan DTA)

Under the Hong Kong–Japan DTA, a Contracting Party is entitled to tax capital gains from the disposition of shares in a failing resident financial institution by a nonresident, who has held those shares for less than 5 years. The holding period starts from the date the Contracting Party provides substantial financial assistance to such failing resident financial institution. This rule does not apply to shares acquired or contracted prior to the effectiveness of the Hong Kong–Japan DTA.

Exchange of Information

All those DTAs incorporate an exchange of information ("**EOI**") article in accordance with the most recent OECD model languages. Moreover, on November 11, 2010, Hong Kong signed a protocol to update the EOI article in the Hong Kong–Luxembourg DTA, consistent with the recent trend of Hong Kong's DTA practice, as previously explained in our China Tax Bulletin July 2010.

Supplemental Arbitration

The Hong Kong–Liechtenstein DTA and the Hong Kong–Switzerland DTA follow the 2008 OECD Model Convention to include arbitration in the mutual agreement procedure article. So does the protocol to the Hong Kong–Luxembourg DTA. This way, arbitration could serve to address tax disputes that are not solved by a mutual agreement procedure.

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