

eJournal of Tax Research

Volume 9, Number 3

December 2011

(Special Edition: Double Tax Agreements in the Asia Pacific)

CONTENTS

245 Editorial

Nolan Cormac Sharkey and Kathrin Bain

247 Hong Kong's new tax treaty network

Jefferson Vanderwolk

254 A comparative study of the OECD model, UN model and China's treaties with respect to rights to tax income and capital

Bin Yang and Chun Ping Song

268 An Australia-Hong Kong double tax agreement: Assessing the costs and benefits

Nolan Cormac Sharkey and Kathrin Bain

294 Some distinctive features of Australian tax treaty practice: An examination of their origins and interpretation

C. John Taylor

339 Recent changes in international taxation and double tax agreements in Russia

Evgeny Guglyuvatyy

© School of Taxation and Business Law (Atax), Australian School of Business
The University of New South Wales

ISSN 1448-2398

A comparative study of the OECD model, UN model and China's treaties with respect to rights to tax income and capital

Bin Yang¹ and Chun Ping Song²

1. INTRODUCTION

As of December 31, 2010, China has signed eighty-nine tax treaties with other countries and two tax arrangements with its own special administrative regions, Hong Kong and Macau. All these tax treaties and internal tax arrangements have come into effect. As the largest developing country with a huge net inflow of foreign investment, it seems quite reasonable for China to stick to the UN model, which gives more weight to the source principle than the OECD model does. However, China's current tax treaties exhibit an opposite pattern. Most of China's tax treaties, especially those with the OECD member states, are very close to the OECD model though somewhat diversified; while those with the developing countries are quite flexible.

This article studies the similarities and differences of OECD model, UN model and China's tax treaties with respect to rights to tax income and capital. By explaining the underlying rationales through comparison, the article sheds considerable light on the policies China may adopt when signing new tax treaties. Sections 2 to 5 deal with the rights to tax income from immovable property, business profits, investment income (including dividends, interests and royalties) and capital gains respectively. Section 6 then concludes the article. We expect China to adopt a more aggressive yet flexible policy in the future

2. RIGHT TO TAX INCOME FROM IMMOVABLE PROPERTY

Due to the fact that there is always a very close economic connection between the source of this income and the State of source, Article 6 of both the OECD model and the UN model prescribes that "Income derived by a resident of a Contracting State from immovable property (including income from agriculture or forestry) situated in the other Contracting State may be taxed in that other State". This provision gives the State of source the exclusive right to tax, which applies to income from immovable property of an enterprise and income from immovable property serving for the

¹ Department of Public Finance, Xiamen University, Fujian, 361005, P.R. China and Department of Public Economics and Finance, Minjiang University, Fujian, 350108, P.R. China.

² Department of Public Finance, Xiamen University, Fujian, 361005, P.R. China.

performance of independent personal services. Income from immovable property which is attributable to a permanent establishment (PE for short hereinafter) shall be deemed as business profits, which are subject to different rules. The purpose of this provision is to ensure that the state of source has the right to tax any income from immovable property even if it is not attributable to a PE. The OECD model and The UN model have identical rules in this regard and China's treaties follow these rules without any reservation.

3. THE RESPECTIVE RIGHTS TO TAX BUSINESS PROFITS

3.1 The basic principles of allocating rights to tax business profits

The keys to deal with rights to tax business profits are the limitation levied by the state of source and the balance of fiscal interests of the state of source and the state of residence. Logically, three basic principles are to be followed in this respect: the PE principle for identifying the source of business profits, thus limiting the jurisdiction to tax of the state of source; the profits attribution principle and the independent enterprise principle for limiting the extent of right to tax of the state of source.

3.1.1 The PE principle

The OECD model and the UN model both state clearly that, "profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a PE situated therein. If the enterprise carries on business as aforesaid, the profits that are attributable to the PE may be taxed in that other State".³ This is the PE principle.

While the PE principle is a common recognition, the divergence lies in what constitutes a PE. The UN model, which attaches more importance to the capital importing countries (mostly developing countries), tries to enlarge the scope of a PE or uplift the restrictions on a PE compared to that of the OECD model. Assembly activities, duration of projects, furnishing of services, insurance business and agent sales are among the most controversial and negotiated subjects. The OECD model has generally more stringent rules for their recognition as a PE.

Although in general China would like to follow the UN model in that it's the largest developing country, it's actually quite flexible in this regard, either since it compromises with the other negotiating state, or since it carries on more activities through the potential PEs in the other negotiating state. For example, a duration of 6 months is required for a building site, a construction, assembly or installation project or supervisory activities in connection therewith to be recognised as a PE in the tax treaty with Nigeria; while a 9 month duration is required in the treaty with Qatar, which is different from that of both the OECD model and the UN model.

3.1.2 The profits attribution principle

As a natural extension of the PE principle, the state of source would tax the profits to the extent that they are attributable to a PE, profits that are not attributable to a PE shall be taxable only to the state of residence. But there are two different criteria on

³ Paragraph 1, Article 7 of both the OECD model (the version before 2010 unless otherwise indicated in context) and the UN model.

the attribution of profits to a PE. The OECD model adopts the economic connection principle in the attribution of profits. It stresses the economic connection of the business profits and the PE's activities, which follows that the state of source may only tax business profits arising from a PE's activities. In contrast, the UN model proposes a restricted force of attraction principle with stipulates that "the profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a PE situated therein".⁴ If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to (a) that PE; (b) sales in that other State of goods or merchandise of the same or similar kind as those sold through that PE; or (c) other business activities carried on the same or similar activities of in that other State of the same or similar kind as those effected through that PE."⁵ The UN model illustrates that if a non-resident enterprise carries on the same or similar activities of its PE by circumventing it, the profits thus gained shall also be attributable to the PE and be subject to tax accordingly. "The same or similar activities of a PE under the same or similar conditions" is the restriction of the force of attraction principle. If, for example, the activities of the enterprise are different from those of the PE, the profits should not be attributable to the PE.

In practice, most international tax treaties adopt the economic connection principle for the convenience of tax administration and promotion of economic efficiency. Some tax treaties try to curb tax avoidance by introducing a force of attraction principle with stringent restrictions. As stipulated in the international tax treaty between Germany and the Philippines, if it can be proved that the enterprise is engaging in the same or similar activities as the PE solely for the purpose of avoiding taxes of the state of source, then all the profits arising directly from those activities shall be taxed by the state of source. There are similar provisions in the bilateral tax treaties between Germany and Indonesia, India, Pakistan, Turkey, Papua New Guinea and Mexico.⁶

3.1.3 The independent enterprise principle and the arm's length principle

The PE is not an independent legal entity. Its business activities as well as business profits are controlled by the enterprise. In order to implement the PE principle and source jurisdiction to tax, a PE should be viewed as if it were a separate tax entity. It is required that a PE calculates its profits independently, as if it were a separate and independent enterprise. This is the independent enterprise principle and there are similar rules in both models.⁷ It follows naturally that in a PE's dealings with the enterprise, other parts of the enterprise, associated enterprises etc., the arm's length principle should be used to determine a PE's profits which shall be taxed accordingly in the state of source.

China, as a non-member state of the OECD, clarifies expressly in the 2010 OECD model that while it fully understands and respects the separate and independent enterprise principle underlying the new version of article 7, due to its tax administration capacity it reserves the right to adopt the previous version of the article

⁴ The general force of attraction principle gives the state of source an unrestricted right to tax the source income, regardless of its economic connection with a PE.

⁵ Paragraph 1, Article 7 of the UN model.

⁶ Klaus Vogel, *Klaus Vogel on Double Taxation Conventions* (Kluwer Law International, 1997) 421-422.

⁷ Paragraph 2, Article 7 of both the UN model and the OECD model.

and, in some cases, to resort to simpler methods for calculating the profits attributable to a PE.

3.2 On the calculation of the business profits of a PE

3.2.1 *The rules of deduction of expenses between a PE and the enterprise*

The PE is different in legal status from a normal independent enterprise. Should deductions be allowed for expenses paid to the head office, such as royalties, commission for management and interest on loans? It's a key question for the effective implementation of the arm's length principle.

The UN model stipulates clearly under Article 7(3) "In the determination of the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the business of the permanent establishment including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere. However, no such deduction shall be allowed in respect of amounts, if any, paid (otherwise than towards reimbursement of actual expenses) by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payments in return for the use of patents or other rights, or by way of commission, for specific services performed or for management, or, except in the case of a banking enterprise, by way of interest on moneys lent to the permanent establishment. Likewise, no account shall be taken, in the determination of the profits of a permanent establishment, for amounts charged (otherwise than towards reimbursement of actual expenses), by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payments in return for the use of patents or other rights, or by way of commission for specific services performed or for management, or, except in the case of a banking enterprise, by way of interest on moneys lent to the head office of the enterprise or any of its other offices".⁸

In 2010, the OECD model undertook a profound change in Article 7 by fully applying the arm's length principle in the determination of a PE's business profits. The new article 7 views a PE as a separate and independent enterprise. The attribution of profits to a PE will follow from the calculation of the profits (or losses) from all its activities, including dealings with other parts of the enterprise. The various dealings between a PE and its head office, such as franchising, patent leasing, providing services and loans, are recognised by the latest version, and the arm's length principle dictates whether or how much of the relevant expenses shall be deducted (or how incomes shall be calculated). The previous OECD model distinguishes itself from the UN model in that there are no restrictive clauses such as "no such deduction shall be allowed in respect of amounts, if any..." However, the OECD model does state similar but more specific views in its commentary.⁹

⁸ The corresponding provisions do not comprise formal provisions of the OECD model; rather they are to be found in its commentaries.

⁹ Commentaries on Paragraph 3, Article 7 of the OECD model.

3.2.2 The calculation of profits of mere purchase by a PE

In general, an organisation established solely for purchasing is not a PE. If a PE carries on purchasing in addition to other business activities, there are different views on whether the profits shall be attributed to the PE for purchasing. The UN model proposes clearly that the competent authorities of the Contracting States shall settle the question by mutual agreement.

The 2010 OECD model deleted the provision “no profits shall be attributed to a PE by reason of the mere purchase by that PE of goods or merchandise for the enterprise”¹⁰ for being inconsistent with the arm's length principle. The arm's length principle takes into account all activities of a PE's, which clearly includes purchasing, in determining its profits. Also, since a tax exemption restricted to purchasing activities undertaken for the enterprise would require that expenses incurred for the purposes of performing these activities be excluded in determining the profits of the PE, such an exemption would raise administrative problems. The profits from purchasing activities shall be determined by using the arm's length principle. In contrast, the previous OECD model stipulates that no profits shall be attributed to a PE by reason of the mere purchase by that PE of goods or merchandise for the enterprise. It's argued that if purchasing, being not a complete business cycle, is to be included in profit attribution, it will be very difficult to calculate the real profits.

3.2.3 Special methods for calculation of profits of a PE

The best way to determine the profit to be attributed to a PE is by looking into its accounting records on the basis of arm's length profit. If the accounting records don't exist or are unreliable, the total profits of the enterprise can also be apportioned to the PE by reference to various formulae. The UN model and the previous OECD model both clearly stipulate that “in so far as it has been customary in a Contracting State to determine the profits to be attributed to a PE on the basis of an apportionment of the total profits of the enterprise to its various parts, nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary; the method of apportionment adopted shall, however, be such that the result shall be in accordance with the principles contained in this article”. The profits to be attributed to the PE shall be determined by the same method year by year unless there is good and sufficient reason to the contrary.

The 2010 OECD model removed the profits apportionment method. It was necessary to delete the provision because its application had become very exceptional and because of concerns that it was extremely difficult to ensure that the result of its application would be in accordance with the arm's length principle. Since it is not allowed for the application of such fundamentally different methods, the OECD model avoids the need for such a provision.

3.3 The practices of China's treaties

China follows most of the provisions with respect to PEs and its business profits in the previous OECD model when signing international tax treaties, whilst some UN model clauses are also adopted in a few tax treaties with developing countries, and the

¹⁰ Paragraph 5, Article 7 of the OECD model.

internal tax agreements with Hong Kong and Macao after 2002. For example, China's tax treaties with Nigeria, Algeria, Mexico, Sri Lanka, Morocco, Kyrgyzstan, Bahrain, Tunisia, Oman,¹¹ Kazakhstan,¹² Venezuela, Moldova,¹³ Hong Kong and Macao rule that no deduction shall be allowed in respect of amounts, if any, paid by the PE to the head office of the enterprise, by way of royalties, fees or other similar payments in return for the use of patents or other rights, or by way of commission, for specific services performed or for management, or, except in the case of a banking enterprise, by way of interest on moneys lent to the PE. The tax treaty between China and Indonesia explicitly states the abandonment of using any force of attraction principle; the tax treaty between China and the Philippines allows an income tax, in addition to the enterprise income tax, not exceeding 10% of the gross amount of the profits repatriated from the branches to its head office.

3.4 An exception to the PE principle-international transportation

International shipping and air transportation usually involve many countries. An enterprise may have branches in different countries and a business activity may involve many countries. Therefore, the PE principle may require that the business profits be taxed in many countries. On the one hand, it is difficult to determine the apportionment of profits to the involved countries (thus the PEs). But on the other hand, the total taxes thus incurred may be too heavy a burden for the enterprise to bear, which in some cases may even outrun its accounting profits. Since it is common knowledge that the international transportation industry earns a relatively low profit, it's reasonable to tackle its international taxes, which under the PE principle would be overwhelmingly heavy, in a different way for its better development.¹⁴

The OECD model states that "Profits from the operation of ships or aircraft in international traffic shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated. If the place of effective management of a shipping enterprise or of an inland waterways transport enterprise is aboard a ship or a boat, then it shall be deemed to be situated in the Contracting State in which the home harbor of the ship or boat is situated, or, if there is no such home harbor, in the Contracting State of which the operator of the ship or boat is a resident".

Two alternatives are given in the UN model, namely Article 8 (alternative A) and Article 8 (alternative B). Alternative A is the same as the OECD model. Alternative B has special rules and states "Profits from the operation of ships in international traffic shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated unless the shipping activities arising from such operation in the other Contracting State are more than casual. If such activities are more than casual, such profits may be taxed in that other State. The profits to be taxed in that other State shall be determined on the basis of an appropriate allocation of the overall net profits derived by the enterprise from its shipping operations. The tax computed in accordance with such allocation shall then be reduced by ___ per cent. (The percentage is to be established through bilateral negotiations)".

¹¹ The treaty doesn't mention the exception of the banking or financial institutions with respect to interest.

¹² As above.

¹³ As above.

¹⁴ Jin Zhi Liu (translator), *Commentaries of UN model Tax Convention between Developed and Developing Countries* (China Financial & Economic Publishing House, 1996) 56.

Although most of China's treaties confer the right to tax to the state of residence, many other rules are also adopted. For example, the rights to tax in treaties between China and Qatar, Venezuela and Laos are conferred to the place of head office, whilst in treaties with Algeria, Morocco and Tunisia such rights are conferred to the place of effective management. The tax treaty between China and Indonesia is relatively special, which stipulates that "Profits from sources within a Contracting State derived by an enterprise of the other Contracting State from the operation of ships in international traffic may be taxed in the first-mentioned State, but the tax imposed shall be reduced by an amount equal to 50 per cent thereof".

4. RIGHTS TO TAX INVESTMENT INCOME

Two methods are used with respect to the taxation of investment income. The first one is to levy a withholding income in the state of source. The income is subject to a flat rate of income tax according to its total amount, with the beneficiary owner as the taxpayer and the payer as the withholding agent. Usually there will be due credits for these taxes so paid in the final settlements of the state of residence. This is the reason why it's called a "withholding tax". The second one is to levy an income tax with regard to business profits in the state of source. If the beneficial owner of the investment income, being a resident of a Contracting State, carries on business in the other Contracting State in which the investment income arises through a PE situated therein and the right or property in respect of which the royalties are paid is effectively connected with such PE, the investment income shall be treated as business profits and taxed accordingly. In order to avoid double taxation, first, it is necessary to fix the source of investment income. Moreover a set of rules for harmonisation need to be established to ensure that if contracting states have overlaps with respect to the source of such income, the investment income is allocated to only one source. Second, the respective rights to tax investment income may be given to the state of source or the state of residence.

4.1 The basic principles of allocating rights to tax investment income

Both the OECD model and the UN model have three special provisions respectively for dividends, interest and royalties. The UN model gives the rights to tax to both states – i.e. both the source jurisdiction as well as resident jurisdiction. No exception is made in respect to royalties. Granting rights to both states fully indicates the fact that income of franchising comes from the state of source, but the development of propriety rights such as patents and technical know-how results in large expenditures in the state of residence, making that state eligible to have a share of tax revenues. In contrast, an exclusive right to tax with regard to royalties is conferred to the state of residence in the OECD model, denying the source jurisdiction the right to tax. The income from franchising is recognised as coming from the state of residence where the beneficiary owner is a resident, since the propriety rights are usually developed in that state with a big investment over a long period while assuming big risks.

A reasonable and plausible solution here is to share the rights to tax: the state of source has the priority to tax royalties but at a low tax rate, while the state of residence may also gain some tax revenues. The priority to tax will encourage the state of source (developing countries in most cases) to introduce the advanced technologies and achievements, which also entitles them to have a macro regulation on its economic development and selective introduction of technologies. Moreover, the source jurisdiction can fight tax avoidance more effectively. However, as the country where

the beneficiary owner is a resident does account for the production of propriety rights, it too should also have due rights to tax because it provides public services and assumes risks for the development of these rights. China has been following the UN definition of royalty and insisting on granting the state of source the right to tax.

4.2. The respective rights to tax investment income

It follows to set a limitation on the source jurisdiction to tax investment income with respect to tax rates when the state of source and the state of residence both have rights to tax. Since the state of source has the natural privilege to tax in advance, the state of residence would have nothing to tax if the source jurisdiction taxes were not subject to a tax rate ceiling. It is customary that income is subjected to limited taxation in the state of source to make sure that the fiscal interests are balanced between the states.

The UN model and the OECD model diverges on the extent of the limitation. The OECD model deprives the state of source the right to tax royalties, while setting a strict limitation on the withholding tax rates. The OECD model stipulates that “the state of source must limit its tax to 5 per cent of the gross amount of the dividends, where the beneficial owner is a company that holds directly at least 25 per cent of the capital of the company paying the dividends, and to 15 per cent of their gross amount in other cases”.¹⁵ This article is definitely beneficial to the state of residence.

The UN model relaxes the limitation. It lowers the shareholding of the company paying the dividend to 10% for a tax preference. Moreover, no specific ceilings were set on the withholding tax rates with respect to investment income, which generally encourages the state of source to negotiate for higher tax revenues.

4.3. The practices of China's treaties

China insists on the source jurisdiction to tax investment income (including royalties), while accepting a reasonable limitation on the withholding tax rate. Apart from the fact that “interest arising in a Contracting State and paid to the Government of the other Contracting State, a local authority or the Central Bank thereof or any financial institution wholly owned by the Government of the other Contracting State, or paid on loans guaranteed or insured by the Government of a Contracting State, a local authority or the Central Bank thereof or any financial institution wholly owned by the Government of such Contracting State, shall be exempt from tax in the first mentioned State”, China certainly denies the state of residence the exclusive right to tax investment income.

The first two tax treaties of China were with Japan in 1983 and with United States in 1984. Since then, China has been active in entering tax treaties. With the exception of Chile, the other 32 OECD member states (including the former Czech Republic) have had tax treaties with China. Beginning in around 2000, China has been focusing on establishing tax treaties with developing countries: 35 of its last 39 agreements after 1996 were with developing countries. Table 1 presents an overview of China's tax treaties since 2000.

¹⁵ Paragraph 2, Article 10 of the OECD model.

Table 1: An overview of China's tax treaties after 2000

Country	Date of Signature	Tax on Capital?	Withholding Taxes ¹			Taxation of Capital Gains ²	Tax Spar-ing?
			Dividends	Inter-est	Royal-ties		
Tajikistan	2008.08.27	YES	10%(5%,25%)	8%	8%	OECD	NO
Singapore	2007.07.11	NO	10%(5%,25%)	10% (7%)	10%	UN, 25%	YES
Algeria	2006.11.06	YES	10%(5%,25%)	7%	10%	OECD	NO
Hong Kong	2006.08.21	NO	10%(5%,25%)	7%	7%	UN, 25%	NO
Saudi Arabia	2006.01.23	YES	5%	10%	10%	UN, 25%	YES
Mexico	2005.09.12	NO	5%	10%	10%	UN, ?%	NO
Georgia	2005.06.22	YES	10%(5%,10%; 0, 50%)	10%	5%	OECD	NO
Barbados	2005.05.15	NO	5%	10%	10%	OECD	NO
Azerbaijan	2005.03.17	NO	10%	10%	10%	OECD	NO
Brunei	2004.09.21	NO	5%	10%	10%	OECD	YES
Albania ²	2004.09.13	YES	10%	10%	10%	OECD	NO
Macao	2003.12.27	NO	10%	10%	10%	UN, 25%	NO
Trinidad and Tobago	2003.09.18	NO	10%(5%,25%)	10%	10%	OECD	YES
Morocco	2002.08.27	NO	10%	10%	10%	OECD	YES
Sri Lanka	2003.08.11	NO	10%	10%	10%	UN, 25%	YES
Kirgiz	2002.06.24	NO	10%	10%	10%	UN, 25%	NO
Greece	2002.06.03	NO	10%(5%,25%)	10%	10%	OECD	NO
Bahrain	2002.05.16	NO	5%	5%	10%	UN, 25%	NO
Iran	2002.04.16	NO	10%	10%	10%	OECD	NO
Tunisia	2002.04.16	NO	8%	10%	10% (5%)	OECD	YES
Nigeria ³	2002.04.15	NO	7.50%	7.5%	7.5%	OECD	NO
Oman	2002.03.25	NO	5%	10%	10%	UN, 25%	YES
Indonesia	2001.11.07	NO	10%	10%	10%	OECD	NO
Kazakhstan	2001.09.12	NO	10%	10%	10%	OECD	NO
Venezuela	2001.04.17	YES	10%(5%,10%)	10%	10%	OECD	NO
Cuba	2001.04.13	NO	10%(5%,25%)	7.5%	5%	OECD	YES
Qatar	2001.04.02	NO	15%	10%	10%	UN, 25%	NO
Moldova	2000.06.07	NO	10%(5%,25%)	10%	10%	UN, 25%	NO

Source: State Administration of Taxation. Current as at 31 December 2010.

Table 1 Notes:

¹ There are a few specialties with respect to investment income of the relative articles of China's treaties. First, the dividends generally don't include the "jouissance" shares or "jouissance" rights, mining shares, founders' shares as expressed in the OECD model. Second, China has been following the UN definition of royalty and insists on the giving the state of source rights to tax.

² The treaty with Albania contains interest in a partnership or trust.

³ The tax treaty between China and Nigeria uses only the first three provisions of the article "capital gains" of the OECD model.

China adopts a country by country policy while negotiating the withholding tax rate of investment income of foreign residents. This is mainly determined by the fact that China holds quite different positions with different countries in international economic relations: while the developed countries (and the OECD member states in particular), are among the major investors of China, the developing countries are generally the host countries of China's investment. Regarding whether a tax preference is given to the dividend withholding tax rate based on level of ownership, China's tax treaties can be classified into two modes of six categories, discussed below.¹⁶ It's worth noting that the unified corporate income tax in 2008 dictates a 10% withholding tax rate and it shall prevail over any higher withholding tax rates, if any, in China's tax treaties.

4.3.1. A withholding tax preference for dividends of a high holding equity

The first category: a 5% withholding tax if the beneficial owner is a company (other than a partnership) which holds directly at least 25% of the capital of the company paying the dividend and 15% in all other cases, and a 10% withholding tax rate for both interest and royalties. For example, the treaties with South Korea, Armenia, Iceland, Lithuania, Latvia, Estonia are of this kind. There are also some minor exceptions as well. For example, the treaty with Austria gives only a 7% tax preference for a holding equity of at least 25%; the treaty with Canada requires only a 10% holding equity for a tax preference for dividends; the treaty with Luxemburg gives a 30% discount for the withholding tax of royalties.

The second category: a 5% withholding tax if the beneficial owner is a company (other than a partnership) which holds directly at least 25% of the capital of the company paying the dividend and 10% in all other cases, and separate withholding tax rates for interest and royalties. For example, the treaties with Trinidad, Tobago, Moldova and Greece prescribe a 10% withholding tax rate; the treaty with Tajikistan an 8% tax rate; the treaty with Cuba imposes a 7.5% tax rate for interest and 5% for royalties; and the treaty with Hong Kong imposes a 7% withholding tax rate. The treaty with Singapore stipulates a 7% withholding tax rate for interest paid to a bank or any other financial institutions and 10% withholding tax rate in all other cases.

4.3.2. No withholding tax preference for dividends of a high holding equity

The third category: a 10% withholding tax rate for all kinds of investment income. For example, the treaties with Japan, the Czech Republic, Slovakia, Cyprus, Hungary, India, Russia, Malta, Belarus, Vietnam, Turkey, Ukraine, Uzbekistan, Bangladesh,

¹⁶ A 10% withholding tax rate for all kinds of investment income was stipulated in the new Chinese Enterprise Income Tax Law since 2008. This rule shall prevail over any higher withholding tax rates, if any, in China's tax treaties.

Portugal, Seychelles, Philippines, Ireland, South Africa, Barbados, Azerbaijan, Albania, Sri Lanka, Morocco, Indonesia, Kazakhstan, Kyrgyzstan, Iran, Nigeria and Macau are all of this kind.

The fourth category: a 10% withholding tax rate for all kinds of investment income, while actually a 30%-40% discount in tax payable is given to royalties arising from using industry, commercial and scientific equipment. The treaties with the United States, the United Kingdom, France, Belgium, Germany, Finland, Denmark, Sweden, Italy, Netherlands, Poland, Bulgaria, Switzerland and Spain are all of this kind. The treaty with Israel gives another preference of 7% for the interest paid to a bank or any other financial institutions; while the treaty with Malaysia stipulates a 15% withholding tax rate for royalties arising from the use of cultural copyrights.

The fifth category: a 15% withholding tax rate for dividends and a 10% withholding tax rate for interest and royalties. For example, the treaties with Norway, New Zealand, Australia, Papua New Guinea, Qatar are all of this kind.

The sixth category: a 5% withholding tax rate for dividends and a 10% withholding tax rate for interest and royalties. For example, the treaties with Mongolia, Mauritius, Croatia, Slovenia, Yugoslavia, Sudan, Macedonia, Laos, Saudi Arabia, Mexico, Brunei, Oman Barbados and are all of this kind.

We notice a strong resemblance between China's treaties with the OECD member states and the OECD model, while the other treaties diversify greatly and are difficult to be classified. However, it is worthwhile to note that an anti-avoidance clause was directly added to the articles with respect to investment income in China's newly signed treaties with Singapore and Nigeria. It denies the application of relevant articles if the rights giving rise to the dividend, interest or royalty were created or assigned mainly for the purpose of taking advantage of the treaty and not for bonafide commercial reasons. Although the rules are quite elementary and more observations are needed to determine its application, it is quite evident that China has been giving more concern to combatting international tax evasion and avoidance

5. THE RESPECTIVE RIGHTS TO TAX CAPITAL GAINS

Both the OECD model and the UN model give the exclusive right to tax income from immovable property to the state of source, which is followed by China. However, the two models diverge on the respective rights to tax income from the alienation of immovable property.

The four identical aspects are as follows: 1) Gains derived by a resident of a Contracting State from the alienation of immovable property and situated in the other Contracting State may be taxed in that other State. 2) Gains from the alienation of movable property forming part of the business property of a PE which an enterprise of a Contracting State has in the other Contracting State or of movable property pertaining to a fixed base available to a resident of a Contracting State in the other Contracting State for the purpose of performing independent personal services, including such gains from the alienation of such a PE (alone or with the whole enterprise) or of such fixed base, may be taxed in that other State. 3) Gains from the alienation of ships or aircraft operated in international traffic, boats engaged in inland waterways transport or movable property pertaining to the operation of such ships, aircraft or boats, shall be taxable only in the Contracting State in which the place of

effective management of the enterprise is situated¹⁷ or only in the Contracting State in which the enterprise is a resident. 4) Gains derived by a resident of a Contracting State from the alienation of shares deriving more than 50% of their value directly or indirectly from immovable property situated in the other Contracting State may be taxed in that other State.¹⁸

The differences lie in the taxation of income from alienation of shares or comparable interests. First, the UN model expands the right to tax of the state of source, in that it may tax gains from the alienation of interests in partnerships, trusts and estates which principally own immovable property situated therein. That is to say gains, in whatever form, from the immovable property situated in a Contracting State may be taxed in that State. Secondly, the UN model stipulates that gains from the alienation of shares, other than those shares of principally immovable property owning companies, representing a participation of ___ per cent (the percentage is to be established through bilateral negotiations) in a company which is a resident of a Contracting State may be taxed in that State.¹⁹ The OECD model does not distinguish those capital gains in its formal provisions; instead it claims that the contracting states are free to do so through bilateral negotiations.

China's treaties differentiate in this regard. Some treaties follow the UN model, which requires that "Gains from the alienation of shares other than those mentioned in paragraph 4 representing a participation of 25% in a company which is a resident of a Contracting State may be taxed in that State". By way of example, this is the case in tax treaties with United States, Italy, Czech Republic, Sri Lanka, Oman, Moldova, Kyrgyzstan, Bahrain, Hong Kong, Macao. However, some treaties do not distinguish shares of capital not represented by immovable property, such as the tax treaties with Australia, Azerbaijan, Albania, Morocco, Indonesia, Kazakhstan, Kyrgyzstan, Iran, Japan, Yugoslavia, Netherlands, Tajikistan, Algeria, Georgia, Brunei, Trinidad and Tobago, Venezuela, Cuba, Barbados, and Tunisia. These treaties follow the OECD model.

In brief, two methods with respect to the taxation of capital gains are used in China's treaties (see Table 1). The first is to follow the standard of the OECD model, although sometimes with slight variations, which is denoted by OECD in the table; the second is to follow the standard of the UN model with a holding equity of at least 25%, denoted by UN, 25% in the table. There are also two special cases, the treaty with Mexico does not lay out the specific extent of participation in a company for the gains to be taxable in the state of source; and article 13 of the treaty with Nigeria only contains the first three paragraphs of that in OECD model. Although the two models both claim that "Gains from the alienation of any property other than that referred to in the model shall be taxable only in the Contracting State of which the alienator is a resident", China reserves the right for the state of source to tax in this regard.

¹⁷ Paragraphs 1, 2 and 3, Article 13 of the OECD model and the UN model.

¹⁸ The OECD model's rule of "deriving more than 50 per cent of their value directly or indirectly from immovable property" is the same as that of the UN model: the property of which consists principally of immovable property, as is described in its commentaries.

¹⁹ Paragraph 5, Article 13 of the UN model.

6. CONCLUSION

The dual fundamental purposes of the double taxation treaties are: eliminating international double taxation so as to guarantee that the income from international transactions shall be taxed only once; and reconciling contradictions of sovereign states so as to distribute income tax revenues of international economic activities properly. The prevailing view regarding tax treaties assume that they benefit every country involved. However, under the worldwide tax competition for highly mobilized capital, each country has been driven to take unilateral measures, such as tax credits and tax exemptions for foreign investments, which have eliminated international double taxation to a great extent. In this respect, the tax treaties serve less the economics goal of eliminating double taxation, but rather the function of redistributing tax revenues. Dagan even proved that tax treaties have much more cynical consequences, particularly redistributing tax revenues from the poorer countries to the richer signatory countries.²⁰ Empirical researches also reveal an insignificant effect of tax treaties on FDI growth.²¹

Tax treaties have many other benefits as well, such as coordinating tax terms between the contracting countries, improving tax administration, the introduction of tax sparing, recognition of the international community and ensuring greater certainty for taxpayers. These positive effects are of greater importance to developing countries than to developed countries, which partly explains why some countries enter into tax treaties even in the will experience a loss of tax revenue.

We expect China to adopt a more aggressive yet flexible policy in the future. The economic growth of China has dramatically reduced the benefits of tax treaties in two respects. First, the economic gains arising from tax treaties are trivial and still decreasing. Secondly, the mutual benefits of tax treaties are of decreasing importance to China for its ever frequent international communication. It is in this sense that the tax treaties have largely become an agreement of tax revenue distribution to China, and China is expected to be more aggressive yet flexible according to its positions in international economic activities.

²⁰ Tsilly Dagan, 'The Tax Treaties Myth' (2000) 32 *New York University Journal of International Law and Policy* 939-996.

²¹ Ronald B. Davies, 'Tax Treaties, Renegotiations, and Foreign Direct Investment' (2003) 33 *Economic Analysis and Policy* 251-273.

7. REFERENCES

7.1 Books

Bin Yang, *International Taxation* (Fudan University Press, 2004).

Bin Yang, *A Comparative Study on the Rules and Administration of the International Taxation System* (China Tax Publishing House, 2003).

7.2 Journal articles

Ronald B. Davies, 'Tax Treaties, Renegotiations, and Foreign Direct Investment' (2003) 33 *Economic Analysis and Policy* 251–273.

Tsilly Dagan, 'The Tax Treaties Myth' (2000) 32 *New York University Journal of International Law and Policy* 939-996.

7.3 OECD publications

OECD, *Attribution of Profit to a Permanent Establishment Involved in Electronic Commerce Transactions* (OECD, 2001).

OECD Centre for Tax Policy and Administration, *2010 Report On The Attribution Of Profits To Permanent Establishments* (OECD, 2010).

OECD Centre for Tax Policy and Administration, *The Transfer Pricing Guidelines For Multinational Enterprises and Tax Administrations* (OECD, 2010).

Klaus Vogel, *Klaus Vogel on Double Taxation Conventions* (Kluwer Law International, 1997).

7.4 Model tax conventions

OECD, *Model Tax Convention on Income and on Capital* (OECD, 2010).

United Nations, *Model Tax Convention between Developed and Developing Countries* (UN, 2001).

Jin Zhi Liu (translator), *Commentaries of UN model Tax Convention between Developed and Developing Countries*, (China Financial & Economic Publishing House, 1996).