



New Tax Treaty Guidance Issued by China Provides Insight on US-China Tax Treaty Language Applicable to the Establishment of a Service Permanent Establishment in China

In recent months, the China State Administration of Taxation (“SAT”) issued a set of Departmental Interpretation Notes (“DIN”) on the Double Tax Agreement (“DTA”) concluded between China and Singapore by way of a Tax Circular Guoshuifa [2010] No.75 (“Circular 75”).

As discussed in detail below, Circular 75 is noteworthy for US law firms since it provides guidance that may be applied by Chinese local-level tax bureaus to determine whether the firm has created a permanent establishment in China under the China-US Tax Treaty.

Background

The China-Singapore DTA contains a number of provisions and terms that are similar to those found in the China-US DTA. While the precedential effect of an official interpretation with respect to a specific tax treaty would not normally apply when interpreting provisions contained in another tax treaty entered into with a different nation, Circular 75 states that where an article in another DTA is similar to an article in the China-Singapore DTA, the interpretations and guidelines in the DIN should be applied. Moreover, Circular 75 makes clear that such interpretations and guidelines should **prevail** where they are different from those stated in previous tax circulars. Thus, US law firms may expect that Circular 75 will be applied by the SAT when interpreting similar provisions found in the US-China DTA.

Since Circular 75 provides guidance on the “same or connected project” standard for determining whether a Service Permanent Establishment (“PE”) has been created under the China-Singapore DTA, and the US-China DTA contains similar language in its Service PE provision, the relevant guidance provided in Circular 75 may likewise apply to interpreting the US-China DTA. This is especially important to US law firm clients since it is the “same or connected project” benchmark that most firms constantly juggle in order to avoid having a PE in China.

Overall review of the PE concept

An important article in all DTAs is the PE article, which is used to determine under what circumstances a Contracting State has the right to tax the business profits of a resident enterprise of the Other Contracting State. In the past, it has always been difficult for the Chinese local-level tax bureaus to assess the existence of a PE in a consistent way due to lack of specific guidelines, sufficient technical knowledge, and experience in assessing whether a PE exists. Circular 75 provides Chinese local-level tax bureaus with the official SAT interpretation of the PE concept and practical guidelines for making a PE determination.

The China/Singapore DTA, like the US-China DTA, recognizes the establishment of a PE through service activities performed in the Contracting State (a “Service PE”)¹. Whereas the China-Singapore DTA defines a Service PE using a “183 day threshold,” the US-China DTA instead uses the phrase “more than six months.” However, both treaties invoke a “same or connected project” standard to determine

¹ Article 5, Section 3(c) of the US-China DTA provides, in relevant part, that a PE includes:
See Art. 5, Sec. 3(c), United States - The People’s Republic of China Income Tax Convention (Jan. 1, 1987), <http://www.irs.gov/pub/irs-trty/china.pdf>

whether a Service PE has been created. Therefore, Circular 75 provides both guidance and insight as to what China deems to be “the same or a connected project.” In light of the language in the DIN that Circular 75 should be applied when interpreting similar articles found in other DTAs, US law firms should strive to maintain an appropriate level of activities in China with respect to their in-country projects so as to fall outside the Service PE standard enunciated in Circular 75.

Circular 75’s Guidance for Establishing the Existence of a Service PE “183-day” threshold

Under Article 5, paragraph 3(b) of the China-Singapore DTA, a PE includes the furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only if such activities of that nature continue (for the same or a connected project) within a Contracting State for a period or periods aggregating more than 183 days within any twelve-month period.

Therefore, the provision of services by a Singapore resident will constitute a PE in China only if it lasts for more than 183 days within any 12 months. The DIN clarifies the following for calculating the 183 day standard:

- The 183 days should be counted from the date on which the first employee of a Singaporean enterprise arrives in China to provide the services, and ends on the date on which the services are completed and delivered.
- All days spent in China by employee(s) of the Singaporean enterprise on the same project should be counted; if more than one employee works in China on the same day, that day should be counted as one day but not repeatedly (i.e., do not count per person per day).
- Where a service project lasts for several years, the 183 days will be calculated on a rolling basis; and if the 183- day threshold is met within any 12-month period, all the services performed for the same or connected project shall be regarded as a PE.

PwC understands that the SAT has reiterated these basic principles in the DIN because some Chinese local-level tax bureaus were interpreting them differently. However, the DIN is silent on the treatment of public holidays, weekends or other days when an employee is off duty in China. As these days are not specifically excluded in the DIN, it is likely that the Chinese local-level tax bureau would continue to count them in the total number of days.

At present, only a few China DTAs, e.g., Singapore, Hong Kong, Belgium, etc. contain the “183-day” threshold for the determination of a Service PE. Most China DTAs generally adopt a “6-month” threshold. Therefore, the above interpretation on the “183-day” threshold would only directly apply to those few DTAs and the interpretation of the “6-month” threshold which was provided in a SAT tax circular (Guoshuihan [2007] No. 403 (“Circular 403”)) appears to remain valid. *This interpretation was considered to be inconsistent with the international practice and has caused a lot of disputes between the Chinese local-level tax bureaus and some non-residents during the past three years. It is possible that the SAT may accept the counting of “6-months” as “183-days” if non-residents providing services in those jurisdictions object to the 6-month threshold counting method adopted in Circular 403.

* According to Circular 403, in counting the 6 month threshold, the month during which an employee first arrives in China to work on a project to the month when the service is completed and the employee leaves China shall be the relevant counting period. If, during that period, no services are rendered in China on that project by any employees for a period of 30 consecutive days, one month can be deducted. As a result, even if an employee is present in China for one day in a particular month, that could still be regarded as “one month.”

“Same or a connected project”

The 183-day threshold should apply to services performed for the “same or a connected project” that bears a commercial coherence. Whether projects are the “same or connected” should depend on the facts and circumstances of each case.

Circular 75 is the first time the SAT states its position on the factors it would evaluate in determining whether projects are “connected projects.” The DIN has listed out the following factors which should be considered comprehensively in assessing “connected projects” for the purpose of determining whether a Service PE has been established:

- Whether the projects are covered by a single master contract?
- Where the projects are covered by different contracts, whether these contracts were concluded with the same/related person; and whether the execution of one project is prerequisite to another?
- Whether the nature of work is the same under different projects?
- Whether the services under different projects are performed by the same group of people?

Basically, the SAT is in line with relevant OECD commentary. As mentioned above, this serves as a guideline to the Chinese local-level tax bureaus so that they will be able to evaluate when it is appropriate to challenge projects undertaken by a non-resident for the same Chinese enterprise as being connected. US law firms should take these factors into consideration for any potential projects in China so as to manage the Service PE exposure risk. However, it is still possible that these factors could still be interpreted differently by the Chinese local-level tax bureaus upon their implementation.

“Through Employees or other personnel engaged by the enterprise”

In addition to the “same or connected projects” standard, the US-China DTA Service PE provision contains similar language addressed in Circular 75, regarding services performed “by an enterprise through employees or other personnel engaged by the enterprise ...” Circular 75 explains that under the China-Singapore DTA, the term “employee and other personnel” is defined as an employee of the treaty resident enterprise (“Treaty-RE”) and other individuals controlled by and receiving instructions from the enterprise. This definition is consistent with that in the OECD commentary.

It appears that the SAT intends to clarify that an employee and other personnel (individuals) engaged by the enterprise should perform services on behalf of the enterprise and their work should be exercised under the supervision, direction or control of that same enterprise. Therefore, as discussed in Circular 75, when a Singaporean enterprise outsources part of its services to a third party, the services performed by the employees of the third party should not be taken into account for determining the existence of a Service PE as long as the Singapore enterprise does not have control over the work of these individuals. Although the DIN has not made it clear about what is meant by “control and receiving instructions,” it may be useful to make reference to the OECD commentary for further guidance and interpretations. However, some Chinese local-level tax bureaus may continue to include subcontractors, despite the issuance of Circular 75.

Application to US Law Firms

In an effort to avoid establishing a Service PE in China, most US law firms operate in China through representative offices. Generally, partners and associates from other countries fly in and out of China for client meetings of limited duration. Firms carefully log and keep track of their lawyers' days in country in the event a Chinese local tax bureau asserts that a Service PE has been established through the firm's activities. In the event this occurs, the guidance provided in Circular 75 can be used in negotiations with the local tax bureau to assert that a Service PE has, in fact, not been established. Circular 75 can also be used when contracting with third party providers in China so as to avoid having the subcontractor's employees deemed to be employees of the firm.

PwC's team of professionals is ready to assist its law firm clients in providing services to their clients in China and in evaluating ways to minimize the creation of a Service PE. Please contact Stanley Kolodziejczak at (646) 471-3160, Gregg Sincoff at (646) 471-1335 or Nancy Regan at (646) 471-6104 in New York; and Rex Chan at +86 (10) 6533 2022, and Michael Ho at +86 (10) 6533 2783 in China.

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