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Wei Cui
Allard School of Law at the University of British Columbia, cui@allard.ubc.ca

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The China-United Kingdom Income Tax Treaty (2011)

Wei Cui*
*Associate professor, China University of Political Science and Law, Beijing, China and Senior International Tax Consultant, Clifford Chance, Beijing. The author would like to thank Robert Sharpe and Rachel Pitfield, Clifford Chance, London, for research assistance, and Professors Kees van Raad and Brian Arnold for comments on an earlier version of this article. All remaining errors are the author's. The author can be contacted at weicuibj@gmail.com.

The author, in this article, considers some of the key features of the China-United Kingdom Income Tax Treaty (2011), with particular reference to the provisions on technical fees, permanent establishments, passive and other income, and anti-avoidance rules.

1. Introduction

On 27 June 2011, the China-United Kingdom Income Tax Treaty (2011) (the "2011 Treaty")[1] was signed. The United Kingdom completed its domestic ratification procedures in November 2011,[2] but, as at the time of the writing of this writing, the 2011 Treaty had not yet entered into force. In contrast to several other new or revised tax treaties that China has signed that await ratification,[3] China's State Administration of Taxation (SAT), which is normally responsible for the negotiation of tax treaties, has yet to release the Chinese version of the 2011 Treaty. The 2011 Treaty's effective date is, therefore, still unknown.

On 27 February 2013, a Protocol amending the 2011 Treaty (the

1. *Agreement between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the People's Republic of China for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and on Capital Gains* (27 June 2011), Treaties IBFD [hereinafter: *P.R.C.-U.K. Income Tax Treaty* (2011)].
2. UK: Double Taxation Relief and International Tax Enforcement (China) Order 2011 (S. I. 2011/2724), available at www.legislation.gov.uk/uksi/2011/2724/pdfs/uksi_20112724_en.pdf.
3. For instance, the tax treaties that China has concluded with Ethiopia (2009), Belgium (2009), Zambia (2010), Syria (2010) and Malta (2010), *See* www.chinatax.gov.cn/n8136506/n8136593/n8137537/n8687294/index.html for a list of published Chinese tax treaties in-force and pending.

"Protocol (2013)"),[4] was signed and was immediately announced by both governments the next day. The amendment modifies a provision in the Dividend article in the 2011 Treaty (further discussed in section 4.) that appeared to be unusually favourable to UK investors, and was presumably requested by China. This development suggests that the parties have had occasion recently to revisit and agree their positions. Accordingly, the respective ratifications of the 2011 Treaty may, at the time of the writing of this article, not be too distant.

This article examines select aspects of the 2011 Treaty, which constitutes a substantial revision of the existing treaty between the two countries, the China-United Kingdom Income Tax Treaty (1984) (the "1984 Treaty").[5] The 1984 Treaty , signed on 26 July 1984 and taking effect for both countries in 1985,[6] was the fourth comprehensive tax treaty concluded by China and, along with the China-Japan Income Tax Treaty (1983),[7] one of the first of China's tax treaties to take effect. It is not the intention of this article to comprehensively list of the major changes in the 2011 Treaty (what is a "major" change depends, in any case, on the perspective adopted).[8] Instead, this article focuses on several features of the 2011 Treaty that are unusual with regard to either China or the United Kingdom, and sometimes for both countries. Many of these features also raise issues of interpretation that apply to many

4. *Protocol amending the Agreement between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the People's Republic of China for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and on Capital Gains* (27 Feb. 2013), Treaties IBFD, also available at www.hmrc.gov.uk/taxtreaties/signed/china-uk-protocol.pdf.

5. *Agreement between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the People's Republic of China for the Reciprocal Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and Capital Gains* (26 July 1984), Treaties IBFD [hereinafter: *P.R.C.-U.K. Income Tax Treaty* (1984)].

6. The *P.R.C.-U.K. Income Tax Treaty* (1984) was amended by *Protocol Amending the Agreement between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the People's Republic of China for the Reciprocal Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and Capital Gains* (2 Sept. 1996), Treaties IBFD [hereinafter: *Protocol (1996) to the P.R.C.-U.K. Income Tax Treaty* (1984)].

7. *Agreement between the Government of Japan and the Government of the People's Republic of China for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income* (6 Sept. 1983), Treaties IBFD.

8. Important changes between the *P.R.C.-U.K. Income Tax Treaty* (2011) and the *P.R.C.-U.K. Income Tax Treaty* (1984) that are not considered in this article include: (1) changes to the Business Profits article to acknowledge both the deductibility of arm's-length expenses (also confirmed through an explicit provision for such deductibility in the Non-Discrimination article) and the method of attribution by apportionment; (2) the provision for coordinated adjustments, including through competent authority consultation, in determining the profits of associated enterprises; (3) the deletion of exemptions for teachers and researchers and the curtailing of exemptions for students, with grandfathering for individuals entitled to relevant benefits before the *P.R.C.-U.K. Income Tax Treaty* (2011) takes effect; (4) extending the scope of mutual agreement procedures; (5) the deletion of tax sparing provisions in the Elimination of Double Taxation article; and (6) an extensive updating of the Exchange of Information article to reflect current OECD norms.

other tax treaties.[9] In the following four sections, the author examines these features, i.e. the now-deleted Technical fees article (*see* section 2.), and the Permanent Establishment (PE) article (*see* section 3.), the passive and other income articles (*see* section 4.) and the anti-avoidance provisions (*see* section 5.) of the 2011 Treaty.

2. Technical Fees

The deletion of the Technical fees article in the 2011 Treaty is likely to be unsurprising to many readers. A similar article appears in only twice in China's tax treaties, i.e. the China-India (1994)[10] and China-Pakistan (1989)[11] Income Tax Treaties, and the United Kingdom has abandoned the use of such an article in its recent tax treaties. The significance of this article in the 1984 Treaty has also diminished over the years due to the application of the PE and royalties articles. However, the process by which this has happened involves an interesting history of both bilateral negotiations and treaty interpretation in China. Some of this history is considered here, lest it be (further) buried and forgotten following the deletion of the Technical fees article.

Article 13(3) of the 1984 Treaty, before its amendment in the Protocol (1996), defined "technical fees" as:

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> ... payments of any kind to any person in consideration for any services of a technical, supervisory or consultancy nature, including the use of, or the right to use, information concerning industrial, commercial or scientific experience, but it does not include payments made to an employee of the person making the payments for dependent personal services mentioned in Article 16.

In the very first domestic guidance on treaty interpretation issued by the Chinese government,[12] the Ministry of Finance announced that

9. *See* the discussions of the criteria in respect of independent agency (in section 3.), the "special relationship" limitation in the Other Income article (in section 4.) and the "purpose of creation or assignment" rule (in section 5.).
10. *Agreement between the Government of the Republic of India and the Government of the People's Republic of China for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income* (18 July 1994), Treaties IBFD.
11. *Agreement between the Government of the People's Republic of China and the Government of the Islamic Republic of Pakistan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income* (27 Dec. 1989), Treaties IBFD.
12. Tax Administration of the Ministry of Finance, Opinion regarding the Treatment of Certain Issues in the Implementation of the China-Japan and China-UK Treaties ([85] Caishuiwaizi 042, 26 Mar. 1985).

supervisory activities related to "a building site or a construction, installation or assembly project" should be taxed under the Technical fees article and the PE rule in article 5(3) of the 1984 Treaty, according to which such a site or project constitutes a PE only if lasted for more than six months, did not apply.[13] Presumably, this meant that whether or not supervisory activities constituted a PE was not subject to the six-month rule, but, rather, to the other provisions of article 5, for example, a fixed place PE could exist despite a duration of less than six months. This appears to be a literally correct reading of the 1984 Treaty, given the absence of any reference to supervisory activities in article 5 of that tax treaty and the explicit reference to such activities in the Technical fees article. There was, however, a hidden misunderstanding. In 1990, the SAT released an internal circular[14] stating that the lack of prior negotiating experience on China's part had resulted in divergent interpretations of the 1984 Treaty and problems regarding its implementation. It was also disclosed that, at meetings between the tax authorities of China and the United Kingdom held in London between 16 and 19 July 1990, the parties had engaged in "pragmatic discussions" and reached agreement regarding "a majority of issues", while further discussions were to be had regarding outstanding disagreements. One of the several agreed outcomes of the London meeting, was that without revising the text of the 1984 Treaty, article 5 would be applied to supervisory activities "in specific implementation".[15] If supervisory activities were carried out under a contract that included "contractual engineering"[16] activities, the determination of whether or not the activities constituted a PE should be made according to the six-month rule in article 5(3). If a PE was found to exist, fees for supervisory activities would be taxed as business profits, otherwise, the fees were to be taxed under the Technical fees article.

A second outcome of the 1990 London consultation concerned yet another unintended encroachment of the Technical fees article on another article of the 1984 Treaty. Specifically, it was agreed that fees for the use of "information concerning industrial,

13. Id, sec. 2(5).
14. SAT, Notice Regarding the Interpretation of Certain Provisions in the China-UK Tax Treaty (Guoshuihanfa [1990]1097, 8 Aug. 1990).
15. Id, sec. 1(3).
16. That is "a building site or a construction, installation or assembly project". For the use of the term "contractual engineering" to refer to article 5(3) activities, *see* SAT, Annotations on the Provisions of the Agreement between the Government of the People's Republic of China and the Government of the Republic of Singapore for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and of the Protocol thereto, Guoshuifa [2010] 75 (16 July 2010).

commercial or scientific experience" should be covered by the Royalties article (article 12) of the 1984 Treaty, instead of the Technical fees article. Which article applied was important, as the tax rate on technical fees was set at a maximum of 7%, whereas for royalties (other than equipment rentals) the maximum was 10%. According to the SAT Circular, the parties agreed that "so as not to have to amend the language of the treaty", both sides would, during the "actual implementation" of the 1984 Treaty, interpret "information concerning industrial, commercial or scientific experience" as a form of proprietary technology. This extraordinary tacit understanding was not evidenced by any published instrument in the 1984 Treaty. Interestingly, the Protocol (1996) amending the 1984 Treaty formalized the solution by transferring the language regarding "information concerning industrial, commercial or scientific experience" from its unintended place in the Technical fees article to the Royalties article.[17] However, nothing was done to codify the understanding that supervisory activities in relation to "a building site or a construction, installation or assembly project" would be subject to the six-month rule of article 5(3). This mutual understanding is now only explicitly reflected in the language of the new article 5(3) in the 2011 Treaty.

The 1990 consultation on the Technical fees article also led to the first statement by the Chinese tax authorities regarding the boundary between technical services and royalties. Even today, there is little guidance within the context of Chinese domestic law regarding how this difficult distinction is to be drawn. And in the context of treaty interpretation, it was not until 2009 that the SAT offered substantial guidance.[18] However, in 1990, the SAT was prompted to state, in connection with the 1984 Treaty, that technical services did not include services rendered for purposes of transferring proprietary technology, which would, rather, be covered by the Royalties article, while services provided in connection with hardware should be regarded as technical services.[19]

All of these interpretations reduced the scope of application of the Technical fees article. However, there is a more fundamental issue affecting the article's significance that was not resolved until 2011. The article deems technical fees to arise in the state of the payer, even if services are provided entirely outside that

17. Art. 4 *Protocol (1996) to the P.R.C.-U.K. Income Tax Treaty* (1984).
18. Guoshuihan (2009) No. 507 (SAT, 14 Sept. 2009) (Notice on Questions concerning the Implementation of the 'Royalties' Article under Tax Treaties)
19. By implication, services provided in connection with software are likely to be covered by the Royalties article. *See* Guoshuihanfa [1990]1097, *supra* n. 14, at sec. 1(2).

state. Consequently, if services are provided to a Chinese party but are performed entirely outside of China, would the fees be taxable? The answer depends, of course, also on Chinese domestic law. Before 1991, technical fees not connected with a PE in China were explicitly exempt from taxation in China.[20] After that, Chinese domestic income tax law in respect of both enterprises and individuals also sourced income for services to the place where the services were performed. This meant that income for services performed by non-residents outside China would not be taxable under Chinese domestic law. Assuming that, as a matter of general principle, a tax treaty cannot bestow on a state any taxing power that it has not exercised under its domestic law, the Technical fees article should not have had the effect of extending China's authority to tax technical services provided outside China. However, it was unclear whether or not this general principle applied in China. It was only as recently as 2011 that the SAT explicitly confirmed that, even if a Technical fees article deemed certain fees for services provided outside China to arise within China, thereby giving China the right to tax under the tax treaty, Chinese domestic rules should be applied and such fees should not be taxed.[21] The 2011 guidance only has effect from 16 March 2011 and it is likely that Chinese tax agencies had sometimes regarded the Technical fees article as giving them a taxing right that they did not have under domestic law.

The deletion of the Technical fees article in the 2011 Treaty still leaves one question unanswered, i.e. how income that would have been classified as technical fees under the 1984 Treaty should be taxed under the 2011 Treaty. It should be noted that the SAT has already stated elsewhere[22] that at least some of the services classified as generating technical fees would, in the absence of a Technical fees article, be classified as business profits. This is surely correct in the most common cases, i.e. technical fees provided cross-border are rarely not part of the "profit of an enterprise".[23] On the other hand, it is conceivable that some technical fees could not be characterized as business profits. In, but only in, such cases, what would have been classified under a Technical fees article could fall under the Other Income article,

20. *See* [85] Caishuiwaizi 042, *supra* n. 12, at sec. 5(2).
21. SAT Bulletin [2011] 19, Bulletin Regarding Certain Issues in the Implementation of the Technical Fees Article of the China-UK Treaty and Certain Other Bilateral Tax Treaties (16 Mar. 2011).
22. *See* Guoshuihan (2009) No. 507, *supra* n. 18, at sec. 6.
23. *See* K. van Raad, *Coherence among the OECD Model's Distributive Rules: the "Other" State and Income from Third Countries*, in *Essays on Tax Treaties: A Tribute to David A. Ward* ch. 4 (G. Maisto, A. Nikolakakis, and J. Ulmer, eds.,Can. Tax Found. & IBFD 2013).

which the 2011 Treaty now contains.[24]

3. PEs

The 2011 Treaty amends article 5 of the 1984 Treaty in several important aspects. First, a building site, a construction, assembly or installation project or connected supervisory activities now constitute a PE only if they continue for more than 12 months, as opposed to six months. Second, a standard "services PE" clause has been added, such that services provided in a state for periods aggregating 183 days or more in any 12-month period give rise to a PE. These changes are in line with recent treaty practices of both China and the United Kingdom, as well as with the OECD Model (2010),[25] in the case of the 12-month-period for construction site PEs, and the UN Model (2011),[26] in the case of service PEs.

A third change to article 5 in the 2011 Treaty, however, introduces something new. In article 5(6), which provides that agents of an independent status do not create a PE, new wording (shown in italics) has been added as to what does not qualify as an independent agent:

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> However, when the activities of such an agent are devoted wholly or almost wholly on behalf of that enterprise, *and conditions are made or imposed between that enterprise and the agent in their commercial and financial relations which differ from those which would have been made between independent enterprises,* he will not be considered an agent of an independent status within the meaning of this paragraph.

The italicized text is derived from the revision to article 5(7) of the UN Model (2001),[27,28] but has only infrequently been used by China and the United Kingdom in previous tax treaties. With regard to for the United Kingdom, it has appeared in the tax treaties concluded with Kuwait (1999), Jordan (2001) and Libya (2008) and,

24. The new Other Income article in the *P.R.C.-U.K. Income Tax Treaty* (2011) generally allocates taxing rights to the resident state, unless the income is connected with a PE in the other contracting state. However, as discussed in sections 4. and 5., this treatment is qualified by a beneficial ownership requirement, a "special relationship" limitation, and an anti-abuse rule that examines the "purpose of the creation or assignment" of the right in respect of which income is paid.
25. *OECD Model Tax Convention on Income and on Capital* (22 July 2010), Models IBFD.
26. *UN Model Tax Convention on Income and on Capital* (1 Jan. 2011), Models IBFD.
27. *UN Model Tax Convention on Income and on Capital* (1 Jan. 2001), Models IBFD.
28. For a fascinating discussion of the history of the "wholly or almost wholly" provision in article 5(7), *see* R. Vann, *The UN Model and Agents: "Wholly or Almost Wholly"*, in Maisto, Nikolakakis & Ulmer eds., supra n. 23, at ch. 5.

with regard to China, it has appeared in the tax treaties concluded with Nigeria (2002), Morocco (2002), Azerbaijan (2005) and Singapore (2007). Both the language and the rationale for the introduction of this revision into the UN Model (2001) are problematic, and its interpretation in practice is likely to give rise to confusion.

On the face of it, the issue of whether an agent is an independent one (or whether it is, instead, dependent on the principal) is orthogonal to the issue of whether the agent and principal deal on arm's-length terms. An employee is a paradigm example of a dependent agent, but an employee is entirely capable of dealing with the employer on arm's-length terms in the employment relationship, for example, compensation, duties and obligations can be determined entirely in accordance with market practice. The fact that the principal pays the agent market compensation should not, therefore, affect the determination of whether or not the agent is dependent. In the traditional understanding of what makes an agent dependent for purposes of article 5, as is evidenced by the Commentary on Article 5(5) of the OECD Model, which is also quoted in the Commentary on Article 5(5) of the UN Model, the key issues are: (1) whether the agent's commercial activities for the principal are subject to detailed instructions or to comprehensive control; (2) whether the entrepreneurial risk of the relevant activity is borne by the agent or principal; and (3) whether the agent's activities on behalf of the principal are undertaken in the ordinary course of the agent's business.[29] The fact that the activities of the agent are performed wholly or almost wholly on behalf of only one principal is believed to reduce the likelihood of independent agency.[30] Presumably, this is because having only one principal increases the likelihood that the agent is subject to comprehensive control (criterion (1)) and reduces its capacity to bear risk (criterion (2)). The agent would also not have its own ordinary course of business among which are that it serves the principal (criterion (3)).[31] Apparently, the presumption of the lack of dependence of a "single-principal agent" at one point seemed

29. *See* of the *OECD Model Tax Convention on Income and on Capital: Commentary on Article 5(6)* paras. 38-38.8 (22 July 2010), Models IBFD and *UN Model Tax Convention on Income and on Capital: Commentary on Article 5* paras. 30-33 (1 Jan. 2011), Models IBFD. These criteria are incorporated into China's interpretation of the criteria for independent agents for the purposes of article 5. *See* Guoshifa [2010] 75, *supra* n. 16, annotations on Article 5(6).

30. But having multiple principals is not itself sufficient to establish independence. *See* para. 38.6 *OECD Model: Commentary on Article 5(5)* (2010).

31. Although why this should matter is a question that can be raised regarding the "ordinary course of business" test in general. *See* the discussion the three subsequent paragraphs in this article.

to be so strong that, in the UN Model (1980)[32] as well as many tax treaties, including the 1984 Treaty, such an agent is explicitly stated not to be independent, even though, under the OECD Commentary on Article 5, this factor should not be "decisive".

However, the UN Model (2001) inserted the arm's-length requirement to mitigate the presumption of non-independence in respect of a single-principal agent.[33] The rationale given is, first that it is "anomalous ... that if the number of enterprises for which an independent agent was working fell to one, the agent would, without further examination, be treated as dependent". In order to address this anomaly, it is stated that "the essential criterion for automatically treating an agent as not being of 'an independent status' is the absence of the arm's-length relationship". This is a puzzling statement. Some might find it persuasive that having only one principal may not be conclusive evidence regarding the satisfaction of criteria (1) to (3), i.e. control, risk, and ordinary course of business, in the preceding paragraph and that an irrefutable presumption may result in errors. Nevertheless, it is unclear as to how an arm's-length relationship bears on the three traditional criteria for agency independence. Consider, for example, the question of whether or not a subsidiary can be an independent agent of the parent. The answer is yes[34] if the same criteria, for example, those regarding control, risk and ordinary course of business, applying to unrelated enterprises are satisfied. However, whether or not the subsidiary's activities are wholly or almost wholly taken on behalf of the parent, it could certainly be the case that "conditions [are] imposed ... in their commercial and financial relations which differ from those which would have been made between independent enterprises". In other words, it appears that a subsidiary may deal with its parent on non-arm's-length terms, for example, by receiving insufficient consideration by market standards, and yet still act as an independent agent that has control, bears risk and serves other principals. Why, then, should the presence of non-arm's-length dealing suddenly become relevant when there is only one (or almost only one) principal?

Accordingly, the language in article 5(7) of the UN Model (2001), which was introduced into article 5(6) of the 2011 Treaty, arguably contains a non-sequitur. The significance of this language lies

32. *UN Model Tax Convention on Income and on Capital* (1 Jan. 1980), Models IBFD.
33. *UN Model Tax Convention on Income and on Capital: Commentary on Article 5* paras. 32 and 33 (1 Jan. 2001), Models IBFD.
34. Para. 38.1 *OECD Model: Commentary on Article 5* (2010).

in the fact that it is likely to be read as not just relevant to applying the presumption of dependence in the case of a single-principal agent, but as also relevant to the determination of the nature of independent agency in general. In a rather inchoate way, it may give rise to the intuition that arm's-length dealing in itself counts against the characterization of agency as dependent.

This intuition could be tempting to resort to in connection with certain other anomalies that tax treaties themselves create. Consider the situation in which enterprise X of Country B has a fixed place of business in Country A , which constitutes a PE of enterprise X in Country A. The PE provides various services exclusively, for example, consulting and market information, to enterprise X's headquarters in Country B. An affiliate of enterprise X, enterprise Y, which is also resident in Country B, wishes to avail itself of the services provided by enterprise X, and considers the possibility of getting it from enterprise X via enterprise X's PE in Country A. From the perspective of enterprise X and enterprise Y, this is a commercially sensible business arrangement and enterprise Y may be willing to pay an arm's-length price for the services. But there is a substantial risk that the arrangement could give rise to a PE for enterprise Y in Country A. The reason for this is that, while enterprise X provides the services for itself through the PE in Country A, according to standard interpretations of the independent agent exception to PEs[35] this is not in the "ordinary course of business" in which X can be said to provide the services to others. Accordingly, there is a risk that enterprise X could be treated as a dependent agent of enterprise Y if it were to provide the services to enterprise Y via its PE in Country A. In order to reduce enterprise Y's PE risk from this apparently innocuous arrangement, it may be tempting to structure the dealing between enterprise X and enterprise Y on an arm's-length basis, and seek comfort from that. However, the anomaly in the case in question really arises because of the "ordinary course of business" requirement and has nothing to do with non-arm's-length dealing. In order to see the difference between the two issues, it should be noted that country A may require enterprise X and enterprise Y to deal on an arm's-length basis with regard to the services provided from Country A for purposes of computing the profits attributable to the PE, even if enterprise Y is not deemed to have a PE in Country A by virtue of the contract

35. *See* the example of the commission agent in paragraph 38.7 of the *OECD Model: Commentary on Article 5* (2010).

with enterprise X.

Accordingly, by adding the new language on arm's-length dealings to article 5(6) of the 2011 Treaty, both China and the United Kingdom may have inadvertently fallen deeper into this conceptual morass.

4. Passive and Other Income

With regard to passive income, the most substantial changes effected by the 2011 Treaty relate to dividends and capital gains.[36] Specifically, in respect of dividends, the maximum withholding tax rate for a greater than 25% shareholders is reduced from 10% to 5%. In the original version of the 2011 Treaty, The shareholding percentage took into account both direct and indirect ownership, making this aspect of the 2011 Treaty more favourable to UK investors[37] than similar provisions in China's other recent tax treaties, for example those with Hong Kong (2006), Singapore (2007) and Belgium (2009). However, this was modified by the Protocol (2013), which restores the shareholding percentage requirement to a direct ownership of no less than 25%, consistent with the other recent tax treaties. Meanwhile, a specific provision in respect of real estate investment trust (REIT) distributions[38] caps the withholding tax rate on REIT distributions at 15%. While this appears to be the first time that a provision regarding REITs has been included in a Chinese tax treaty, it is not an uncommon provision in UK tax treaties.

What is more remarkable is a new paragraph that exempts the governments and state-owned entities of both countries from tax on dividends received from companies resident in the other country. Article 10(3) of the 2011 Treaty states that:

> **[PCD single spaced]**
> ... dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State shall be taxable only in that other Contracting State

36. Professor van Raad drew the author's attention to the fact that in articles 10(1), the formulation "dividends derived by ... a resident of the other Contracting State" in the *P.R.C.-U.K. Income Tax Treaty* (1984) has been changed to "dividends paid..to a resident of the other Contracting" in the *P.R.C.-U.K. Income Tax Treaty* (2011), and that the same changes were made to articles 11(1) and 12(1). While this conforms the relevant provisions of the *P.R.C.-U.K. Income Tax Treaty* (2011) to the *OECD Model*, whether it is an improvement is open to debate.

37. The current benefit for Chinese investors in UK companies is limited because of the current UK tax exemption for dividends paid by UK companies to foreign shareholders.

38. Art. 10(2)(b) *P.R.C.-U.K. Income Tax Treaty* (2011). Specifically, "an investment vehicle which distributes most of [its] income or gains annually and whose income or gains from ... immovable property is exempted from tax".

> if the beneficial owner of the dividend is the Government of that other Contracting State or any of its institutions; or other entity the capital of which is wholly-owned directly or indirectly by the Government of that other Contracting State.

As unusual as this provision may appear, it is not new in tax treaties. For instance, the China-Saudi Arabia (2006)[39] and United Arab Emirates-Vietnam (2009)[40] Income and Capital Tax Treaties contained identical or similar provisions for dividend exemptions. In a larger number of tax treaties, several countries, for example, Singapore, have negotiated dividend tax exemptions for governments and specific listed state-owned entities. Some countries may take the view that there is little policy reason to offer exemptions to governments and state-owned entities with regard to one type of investment income[41] but not others, and have negotiated treaty-based exemptions for dividend, interest, capital gains[42] and even all income derived by governments and "their institutions".[43] Awareness of (and interest in) this practice may still be limited among the OECD member countries, although growing.[44] Once this practice is taken into account, the most surprising aspect of the dividend exemption for governments and state-owned entities in the 2011 Treaty is not its appearance, but, rather, the fact that it has been introduced at a time when the United Kingdom exempts dividends paid by UK companies to foreign investors. This means that the immediate beneficiaries of the new article 10(3) are UK government institutions and UK state-owned entities, and not their Chinese counterparts, even though the latter are more numerous and

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39. *Agreement between the Government of the Kingdom of Saudi Arabia and the Government of the People's Republic of China for the Avoidance of Double Taxation and the Prevention of Tax Evasion with respect to Taxes on Income and on Capital* (23 Jan. 2006), Treaties IBFD.

40. *Agreement between the Government of United Arab Emirates and the Government of the Socialist Republic of Vietnam for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and on Capital* (16 Feb. 2009), Treaties IBFD.

41. There is a well-known and long-standing practice in tax treaties of providing a tax exemption for interest on loans where either the borrower or the lender is a contracting state's government.

42. *See*, for example, *Agreement between the Government of Canada and the Government of the State of Kuwait for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and on Capital* art. 21 (28 Jan. 2002), Treaties IBFD.

43. *See Convention between the Government of the Republic of India and the Government of the People's Republic of Bangladesh for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income* (27 Aug. 1991), Treaties IBFD and *Agreement between the Government of the Republic of India and the Government of the United Arab Emirates for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and on Capital* (29 Apr. 1992), Treaties IBFD.

44. *See* OECD, *Discussion Draft on the Application of Tax Treaties to State-Owned Entities, Including Sovereign Wealth Funds* (OECD 2009), International Organizations' Documentation IBFD, also available at www.oecd.org/document/57/0,3746,en_2649_33747_44120057_1_1_1_1,00.html, which had the intention of revising the *OECD Model: Commentaries* in specifically addressing state-owned entities, proposed in 2009 and largely adopted in the *OECD Model: Commentaries* (2010).

have much larger current overseas investments.

It is useful to compare the dividend exemption in article 10(3) of the 2011 Treaty with an analogous interest exemption in article 11(3). The 2011 Treaty extends a previous exemption regarding interest income "derived by a Government, a political sub-division or local authority thereof, and the Central Bank or any agency of the Government" to "entities wholly owned by" such government persona. Accordingly, a sovereign wealth fund from China is exempt from tax on interest received from a UK borrower under the 2011 Treaty, whereas, under the 1984 Treaty, it might not be.[45] The commercial significance of the revised article 11(3) is, therefore, greater than that of the new article 10(3). It can only be hoped that whether or not anything is intended by the differences in wording between the two exemptions, i.e. how is the concept of the "institutions" of a government under article 10(3) to be interpreted, and does ownership under article 11(3) encompass indirect ownership, will be clarified in the future.

With regard to capital gains, except for a paragraph addressing gains from the alienation of ships or aircraft, the 1984 Treaty only states that "gains which arise in a Contracting State may be taxed by that State in accordance with the provisions of its domestic law". The 1984 Treaty also does not contain an Other Income article and, therefore, does not place a limit, with regard to income not dealt with elsewhere in the tax treaty, on the domestic law of a contracting state with regard to the taxation of income or gains arising in that state. The 2011 Treaty reverses this approach and gives priority to the residence state to tax residual capital gains and other income, which is consistent with the provisions of the OECD Model. The revised Capital Gains article reserves to the resident state the exclusive taxing right over capital gains from the alienation of property other than immovable property, property connected to a PE or fixed base, the shares of land-rich companies, and the shares of companies of the other contracting state held by substantial (25% or more, including both direct and indirect holdings) shareholders. This allocation of taxing rights in respect of capital gains is not unusual for either China or the United Kingdom and it can be expected that the application of the article

45. Even under article 11(3) of the *P.R.C.-U.K. Income Tax Treaty* (1984), "interest ... derived by ... [a] resident of that other Contracting State with respect to debt-claims of that resident which are financed...by the Government of that other Contracting State ... shall be exempt from tax in the first-mentioned Contracting State". If a debt-claim held by a sovereign wealth fund is financed by (the equity capital of) its government shareholder (which it is likely to be), any interest should be exempt. In any case, the *P.R.C.-U.K. Income Tax Treaty* (2011) extends this aspect of the interest exemption as well, to debt-claims financed by a wholly-owned entity.

in China, where, in contrast to the United Kingdom, capital gains arising from the alienation of shares by non-residents are taxable, will be carried out with familiarity. In contrast, the Other Income article (article 21) of the 2011 Treaty adopts an approach that is still unusual in the tax treaties that China has concluded, in that it gives the resident state exclusive taxing rights for income not dealt with elsewhere in a tax treaty, except for income connected with a PE in the other contracting state. This addition makes the 2011 Treaty a particularly favourable one among the tax treaties concluded by China with its major treaty partners.[46]

In addition, with regard to the Other Income article, as the allocation of exclusive taxing rights over other income to the resident state is still an exception to China's general treaty policy, it is unsurprising that the following limitation on such an allocation appears in article 21(3) of the 2011 Treaty, the author believes, for the first time in the tax treaties concluded by China:

> **[PCD single spaced]**
> Where, by reason of a special relationship between the resident referred to in paragraph 1 and some other person, or between both of them and some third person, the amount of the income referred to in that paragraph exceeds the amount (if any) which would have been agreed upon between them in the absence of such a relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such a case, the excess part of the income shall remain taxable according to the laws of each Contracting State, due regard being had to the other applicable provisions of this Agreement.

Although this language is not uncommon for the tax treaties concluded by the United Kingdom,[47] its interpretation raises interesting questions. The provision is modelled on similar provisions in articles 11 (Interest) and 12 (Royalties) of the OECD Model.[48] Both the Commentaries on the OECD Model and the Commentaries on the UN Model suggest that its recommended adoption

46. Other tax treaties that give the resident state exclusive right to tax (non-PE-related) other income include *Agreement between the Government of Ireland and the Government of the People's Republic of China for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income* (19 Apr. 2000), Treaties IBFD, *Agreement between the Government of the People's Republic of China and the Government of Malta for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income* (23 Oct. 2010), Treaties IBFD [hereinafter: *P.R.C.-Malta Income Tax Treaty*] and possibly others.

47. A cursory search suggests that, in addition to the United Kingdom, Japan has also routinely adopted this paragraph in the Other Income article of the tax treaties that it has recently negotiated.

48. *See* Arts. 11(6) and (12 (4) *OECD Model* (2010).

is motivated by non-traditional financial instruments, i.e. the income generated by way of which may, presumably, defy classification by the other traditional distributive articles.[49] Both the language of the provision and its purported motivation imply a particular conception of the type of income included in the scope of article 21. According to this concept, such income simply has a character that makes the other "distributive rules" of a tax treaty, for example, articles 6 to 20 of the OECD Model, inapplicable. Nonetheless, such income is similar to interest or royalties in that one of the contracting states can be said to be the source of the income. The effect of the Other Income article is to provide for a zero rate of withholding by the source state. Alternatively, the source state may adopt a lowered, negotiated rate of withholding.[50] Along these lines, the source state of the "other income" would yield some of its taxing right to the resident state only with regard to that portion of the income that conforms to arm's-length standards.

As treaty specialists recognize, however, the Other Income article is broader in scope. It covers types of income that fall outside the scope of the other distributive rules of a tax treaty not by virtue of their character, but by virtue of the lack of a specific nexus with a contracting state. In other words, many of the other distributive rules of tax treaties are incomplete,[51] as they allocate taxing rights between source and residence states only with regard to income with particular characters and particular connections with the "source state". As a result, article 21 is necessary to address another type of situation, where an item of income arises in a third state, and the intention is to give only the resident state, among the two contracting parties to a tax treaty, the taxing right.[52] Examples include rent paid by a resident of a contracting state for the use of immovable property situated in a third state[53] and the income from third states of a dual resident who is deemed to be a resident of one of the contracting states through the application of the treaty tie-breaker rules.[54] In these

49. *See* paragraphs 7-10 of the *OECD Model: Commentary on Article 21* (2010) and paragraph 6 of the *UN Model: Commentary on Article 21* (2011).
50. Para. 6 *UN Model: Commentary on Article 21* (2011).
51. The main exceptions are the rules for business profits and income from employment. Articles 7 and 15 allocate the taxing rights regarding to these two types of income in all cases, either to the resident state or to the PE state or the place where the employment is exercised. Articles 8 and 17 also provide a comprehensive allocation and leave no scope for article 21.
52. *See* paragraph 1 of the *OECD Model: Commentary on Article 21* (2010), which states that "[t]he scope of the Article is not confined to income arising in a Contracting State; it extends also to income from third States".
53. Para. 2 *UN Model: Commentary on Article 21* (2011).
54. Para. 1 *OECD Model: Commentary on Article 21* (2010).

cases, the source state that is not a contracting state in respect of the tax treaty in question presumably has its own taxing rights. The function of the Other Income article is not for one contracting state cede its primary taxing right as the source state to the other contracting state as the residence state, but, rather, to limit the number of states with secondary, non-source state taxing rights.[55]

The question that arises is how does the "special relationship" limitation on the operation of the Other Income article apply to income from third countries? Where a payment is excessive under arm's-length standards, do the two treaty partner states, neither of which can claim to be "the source state", have equal rights to tax the income, despite one being the residence state and the other not? Take the example of the taxpayer who is a dual resident of both State A and State B and who is deemed to be resident in State B for purposes of the State A-State B Tax Treaty. Both State A and State B would be entitled to subject the taxpayer to residence-based taxation on any "excessive other income" derived from third states under the "special relationship" limitation in article 21. Is this result the appropriate policy outcome? It is not at all clear why this should be. Consider another example, where a resident of State A rents from a resident of State B property situated in State C. Suppose that the rental payment is excessive due to a special relationship between the payer and payee and that State A's domestic law considers the source of the rent to be the residence of the payer. Here, the adoption of the "special relationship" limitation in article 21 means that State A's source rule effectively applies to the "excessive" portion of the rental payment. This may be the right policy outcome if the "excessive" portion should be regarded as somehow not sourced in State C but "really" sourced in State A, for example, the excess is attributable to the special relation between payer and payee but not to the underlying business involving the property in State C. But whether or not this is the case depends on ascertaining further facts. It is not at all clear that an automatic limitation on the Other Income article is the best way to deal with this situation, especially given that State C may also exercise full taxing rights with regard to the "excessive rent".

In summary, how to appropriately apply the limitation on the general rule regarding Other Income in situations involving "special relationships", so that it does not apply in circumstances in which

55. Van Raad, *supra* n. 23, argues that this function of article 21 is "awkward" and perhaps originally unintended.

it is not supposed to,[56] must be resolved by the treaty partners. China has not made any pronouncement on this issue and how the UK tax authorities apply the "special relationship" limitation to cases in which "other income" arises in third states is also unknown.

5. Anti-Avoidance Provisions

The 2011 Treaty adds an anti-avoidance provision to the Dividend, Interest, and Royalties articles. This provision is also incorporated into the new Other Income article. The formulation of the anti-avoidance provision is illustrated by article 10(7):

> **[PCD single spaced]**
> The provisions of this Article shall not apply if it was the main purpose or one of the main purposes of any person concerned with the creation or assignment of the shares or other rights in respect of which the dividend is paid to take advantage of this Article by means of that creation or assignment.

Similar provisions have been included in the passive income articles in UK tax treaties, going as far back as the Ireland-United Kingdom Income Tax Treaty (1976),[57,58] well before such a provision was discussed in paragraph 21.4 of the Commentary on Article 1 of the OECD Model (2003).[59,60] However, this anti-avoidance rule has been incorporated only in four of the other tax treaties concluded by China, all of which postdate the OECD Commentary on Article 1 (2003) and were renegotiated tax treaties, i.e. the tax treaties with Singapore (2007), Belgium (2009), Finland (2010) and Malta (2010).[61] It is worth reflecting on the significance of this

56. Another issue that should be noted that paragraph ~~**[what?]**~~ 9 of the *OECD Model: Commentary on Article 21* (2010) states that "[a]lthough the restriction could apply to any income otherwise subject to Article 21, it is not envisaged that in practice it is likely to be applied to payments such as alimony payments or social security payments". It is, however, unclear, how such "understanding" is to be enforced, given that it is evidently contrary to the language of the treaty text.

57. *Convention between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the Republic of Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and Capital Gains* (2 June 1976), Treaties IBFD.

58. In fact, it appears that up to 1994, the rule was largely a creature of UK tax treaties, with Malta adding a few more.

59. *OECD Model Tax Convention on Income and on Capital: Commentary on Article 1* (28 Jan. 2003), Models IBFD.

60. First in OECD, *Restricting the Entitlement to Treaty Benefits* (OECD 2002), International Organizations' Documentation IBFD (adopted by the OECD Committee on Fiscal Affairs on 7 November 2002) and then in the OECD, *2002 Update to the Model Tax Convention* (OECD 2002) (adopted by the Council of the OECD on 28 January 2003).

61. As, among these tax treaties, the allocation of general taxing rights with respect to Other Income to the resident state is only adopted in *P.R.C.-Malta Income Tax Treaty*, the language has only appeared in the Other Income article of that tax treaty.

disparity, especially given the fact that the United Nations, in the Commentary on Article 1 of the UN Model (2011), suggests that this particular anti-avoidance rule may be especially appropriate for developing countries, i.e. "[taking into] account of their ability to administer the various approaches" in countering treaty shopping. This is because, for such countries, "it may be difficult to apply very detailed rules that require access to substantial information about foreign entities". The "more general approach ... proposed in paragraph 21.4 [of the OECD Commentary on Article 1] might be more adapted to their own circumstances".[62]

The more detailed anti-avoidance rules discussed in the UN Commentary on Article 1 (2011) include "look-through" and "subject-to-tax" approaches for dealing with conduit arrangements, extensive limitation of benefits clauses and language relating to specific foreign preferential regimes.[63] The implementation of such treaty-based rules may require information as to the financial operations, ownership and other features of (including legal regimes applying to) the treaty benefit claimant. But as long as the question of whether or not the grant of treaty benefits is appropriate is broached, it appears that government access to information should not be a problem if the burden of proof lies with the taxpayer. If, on the other hand, the burden of proof is assumed to fall on the government, establishing that a main purpose of the person "concerned with the creation or assignment of rights" was to take advantage of a treaty provision is, in most circumstances, not an easy task. The main purpose test is presumably objective, thereby requiring a consideration of all of the circumstances.

Perhaps, one way to view the relationship between anti-avoidance rules and the "more detailed" rules discussed in the Commentaries on the OECD Model and Commentaries on the UN Model is to analogize it to the relationship between general anti-avoidance rules (GAARs) and specific anti-avoidance rules (SAARs). The creation or assignment of a right to achieve a tax advantage sounds like "an arrangement". Many GAARs currently used in the world refer to artificial arrangements with a main purpose of tax avoidance. The Chinese GAAR, for example, is targeted at instances "where an enterprise enters into [an] arrangement without reasonable commercial purpose and this results in a reduction of taxable gross

62. Para. 57 *UN Model: Commentary on Article 1* (2011).
63. These options are taken from paragraphs 13-21.3 of the *OECD Model: Commentary on Article 1* (2010).

income or taxable income".[64] An "arrangement without a reasonable commercial purpose" is defined as one "the primary purpose of which is to reduce, avoid or defer tax payments".[65] The rule seeking the "purpose of creation or assignment" may, therefore, be regarded as a GAAR applied to particular types of income. SAARs, in contrast, describe the features of specific abusive transactions to limit their effect. Very few people would be willing to claim that GAARs are easier to administer than SAARs. They may be easier to announce, but, due to limitations in information and research resources at the legislative or rulemaking stage, tax authorities (from both developed and developing countries) may be hesitant to endorse and to commit to the enforcement of particular SAARs, and GAARs may help to postpone the task of adopting such specific formulations. However, when GAARs are implemented, specific criteria must still be adopted and applied, and factual investigation regarding the particular case is unavoidable. The parsimony of GAARs is manifest at the legislative stage, not at the implementation stage. In fact, where tax avoidance arrangements tend to resemble one another and do not always display unique relevant features, it may be better for resource and capacity-restrained tax authorities to adopt detailed rules in advance, instead of having to formulate appropriate criteria under a GAAR.[66]

Rather than being the easier of the two types of anti-avoidance rules to implement, GAARs are commonly understood as a backstop for SAARs. When implementing detailed rules is insufficient, tax authorities may want to have an additional mechanism by considering taxpayer intent. GAARs complement, but do not substitute, SAARs. If this is right, contrary to what the Commentaries on the UN Model cited earlier in this section implies, it makes perfect sense that a developed country like the United Kingdom, which has an experienced and resourceful tax administration, would be more willing than China to incorporate the "purpose of creation or assignment" rule in its tax treaties. In other words, the United Kingdom has the capacity to implement both SAARs and GAARs.[67]

What does this analysis reveal as to the significance of the use,

64. CN: Enterprise Income Tax Law (promulgated by the National People's Congress, 16 March 2007, effective 1 January 2008), art. 47. In such situations, "tax agencies shall have the authority to make adjustments using appropriate methods".

65. CN: Regulation on the Implementation of the Enterprise Income Tax Law (promulgated by the State Council, 6 December 2007, effective 1 January 2008), art. 120.

66. *See*, generally, L. Kaplow, *Rules versus Standards: An Economic Analysis*, 42 Duke L. J. 3, pp. 557-629 (1992).

67. It is an interesting question, but beyond the scope of this article, as to how the United Kingdom has implemented the "purpose of creation or assignment" rule in the past.

in four different articles in the 2011 Treaty, of the rule referring to "purpose of creation or assignment"? First, with regard to all dividends, interest, royalties and other income, the 2011 Treaty arguably contains a SAAR of sorts, i.e. the concept of beneficial ownership.[68] China's SAT has interpreted this concept, in the context of all tax treaties, to encompass a rich set of requirements,[69] such that conduit companies can never be beneficial owners, and even a set of limitation-of-benefits-like tests must be applied. While these interpretations may be controversial, they borrow precisely from the "more detailed" rules for countering treaty shopping in the Commentaries on the OECD Model and the Commentaries on the UN Model. The role of beneficial ownership as a SAAR has also been enhanced in the United Kingdom post *Indofood* (2006).[70] It could, therefore, be expected that "purpose of creation or assignment" rule would apply when the beneficial ownership determination is believed to be insufficient or generate inappropriate results.

Second, insofar as the contracting states have already adopted GAARs under their domestic laws, and China has, and the United Kingdom is considering the adoption of one,[71] the "purpose of creation or assignment" rule does not add a separate, treaty-based anti-avoidance instrument. In this connection, it is notable that the 2011 Treaty requires no competent authority consultation in the application of the rule.[72] The effect of the introduction of the rule in articles 10 to 12 and 21 may, therefore, be comparable to another newly introduced anti-avoidance provision that applies to the whole of the 2011 Treaty. This is the new article 23 (Miscellaneous Rule), which reads as follows:

> **[PCD single spaced]**
> Nothing in this Agreement shall prejudice the right of each Contracting State to apply its domestic laws and measures concerning the prevention of tax evasion and avoidance, whether or not described as such, insofar as they do not give rise to taxation contrary to this Agreement.

68. It should be noted that the concept of beneficial ownership is not used in the Other Income article in the *OECD Model* and the *UN Model*.
69. The basic Chinese rules regarding beneficial ownership under tax treaties are in SAT, Notice on How to Interpret and Determine "Beneficial Owners" in Tax Treaties, Guoshuihan [2009] 601 (27 Oct. 2009) and SAT, Bulletin Regarding the Determination of "Beneficial Owners" in Tax Treaties, Bulletin No. 30, 2012 (29 June 2012).
70. UK: CA, 2 Mar. 2006, *Indofood International Finance Limited v. JPMorgan Chase Bank NA, London Branch*, [2006] EWCA Civ 158, Tax Treaty Case Law IBFD.
71. *See* www.hm-treasury.gov.uk/tax_avoidance_gaar.htm.
72. Numerous UK tax treaties do impose this requirement for applying the "purpose of creation or assignment" rule.

The language of article 23, which appears for the first time in a UK tax treaty and in China's tax treaties for only the sixth time,[73] arguably only reiterates certain widely agreed principles already articulated in the Commentaries on the OECD Model.[74] The legal significance of its incorporation in the text of the tax treaty is still unclear. But one possible interpretation is that it reflects an understanding between the contracting states that the application of various anti-avoidance rules, whether based on the tax treaty or domestic law, should be on a mutually acceptable basis and that it is when anti-avoidance efforts are pursued this way that the contracting state seeking to deny treaty benefits has the support of the other contracting state.

6. Conclusions

The importance of the Chinese and UK economies, as well as the volume of trade and investment between the two countries, suggest that the 1984 Treaty embodies an important treaty relationship for both countries. Within this relationship, the countries have demonstrated an ability and a willingness to resolve differences in understanding, both through the amendment of the tax treaty and other informal arrangements.[75] While the 2011 Treaty still contains mostly standardized provisions and few aspects of the tax treaty can be said to be truly novel (the inclusion of indirect shareholding in calculating ownership percentages for purposes of the reduced rate on dividends, now reversed by the Protocol (2013), would have been such a novelty), it has clearly been updated to more recent treaty norms. The 2011 Treaty, therefore, represents a promising framework for the further elaboration of the benefit of UK and Chinese taxpayers doing business with one another.

73. With the exception of *Arrangement between the Mainland of China and the Hong Kong Special Administrative Region for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income* (21 Aug. 2006) Treaties IBFD, all of China's tax treaties in which the article 23 language appears also contain the "purpose of creation or assignment" rule for passive income.

74. *See* paragraphs 9.1-9.2 and 22-22.2 of the *OECD Model: Commentary on Article 1* (2010).

75. *See* the discussion in section 2. with regard to the correction of the reported misunderstanding in respect of the *P.R.C.-U.K. Income Tax Treaty* (1984) regarding technical fees.