

China ratified BEPS Multilateral Convention, opening a new chapter of China's tax treaties

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In brief

On 25 May 2022, China ratified the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (BEPS)¹ (the Convention, the MLI or Multilateral Instrument) and deposited its instrument of ratification² to the OECD. The instrument sets out the respective MLI positions of Mainland China and Hong Kong Special Administration Region (SAR) for the covered tax agreements. For Mainland China, the Convention will enter into force on 1 September 2022. For Hong Kong SAR, it will become effective on 1 September 2022 upon the completion of the relevant local legislative process³.

The ratification of the MLI is an important step in the implementation of the BEPS Action Plans in Mainland China. The instrument of ratification sets out the position adopted by Mainland China and the tax treaties covered. There is little difference between the ratified version and the version signed by China on 7 June 2017. It only adds some newly signed tax treaties and takes out some invalid ones, and the position adopted by Mainland China has not changed. Mainland China has basically opted in to the provisions of the Convention which represent the minimum standards (e.g., the determination of tax residency for dual resident entities by mutual agreement, the Principal Purpose Test (PPT) for preventing treaty abuse and the requirement for the full implementation of Mutual Agreement Procedures (MAP)), and opted out of some of the provisions that are not mandatory (e.g. artificial avoidance of Permanent Establishment (PE) and arbitration clause).

If both parties to a bilateral tax treaty have ratified the Convention and adopted the same positions, and the Convention has come into force, the relevant tax treaty provisions would need to be revised simultaneously. Both Chinese and foreign companies having cross-border transactions are urged to assess the relevant jurisdictions' position and effective situation, and the impact on their businesses and structures against the measures in the Convention.

In detail

Background of the MLI

Some of the BEPS Action Plans cannot be implemented without amending existing tax treaties. While making amendments on a treaty-by-treaty basis (thousands of bilateral treaties around the globe) would be burdensome and time-consuming, BEPS Action 15 explores the feasibility of developing a multilateral instrument to modify tax treaties swiftly. At the end of 2016, OECD released the text of the Convention and its explanatory statement. The MLI does not substitute existing tax treaties. Rather, it supplements and "modifies" those tax treaties with a series of BEPS-related provisions.

As of 1 June 2022, 99 tax jurisdictions, including China, have signed the Convention⁴, covering more than 1,820 tax treaties worldwide. And over 880 treaties concluded among the 76 jurisdictions have ratified, accepted or approved the Convention.

BEPS measures covered in the MLI

The Convention includes four tax-related BEPS Action Plans as summarised below. For the detailed Article provisions of the Convention for each Action, please refer to the Appendix.

- Hybrid mismatches (Action 2): dealing with optional treaty provisions that relate to transparent entities, dual resident entities and the application of the exemption method to eliminate double taxation. This measure is optional, and each jurisdiction can opt out of this measure.
- Preventing treaty abuse (Action 6): requiring the adoption of anti-abuse rules to effectively address treaty shopping, such as the PPT, the simplified limitation on benefits (LOB) test, and some other requirements like the minimum holding period for enjoying treaty benefits. The minimum requirement is to adopt the PPT while the simplified LOB test and other requirements are optional.
- Artificial avoidance of PE (Action 7): providing stricter rules in determining a PE by addressing commissionaire arrangements and similar strategies, modifying the specific activity exemptions, and introducing anti-splitting rules. Each jurisdiction can opt out of this measure.
- Improving dispute resolution (Action 14): requiring the full implementation of MAP in their tax treaties in good faith and setting a new standard for mandatory binding arbitration in MAP process. While improving MAP is mandatory, each jurisdiction may opt out of the mandatory binding arbitration.

Mainland China's MLI position

Compared with the version signed in 2017, China's latest ratification instrument of the Convention contains no change in terms of the MLI position, with only slight modifications on covered tax agreements. We provide below our overall observation of China's MLI position. Please refer to the Appendix "Mainland China and Hong Kong SAR's positions under the MLI" for the detailed positions relating to each Article.

Covered tax agreements

Among the over 100 tax treaties concluded by Mainland China, China's instrument of ratification has covered 100 treaties, except for seven already in force (Chile, India, New Zealand, Spain, Republic of the Congo, Angola and Rwanda) and two not yet in force (Kenya and Argentina). Most of the tax agreements not covered were signed in recent five years or have been updated through new protocols, which have already adopted the minimum standards recommended by BEPS in many aspects. That might be the reason why they are not included in China's instrument of ratification. In addition, China's three tax arrangements with Hong Kong SAR, Macau SAR and Taiwan (not effective) are not included in the covered tax agreements as these tax arrangements are not signed between sovereign countries. However, Mainland China, Hong Kong SAR and Macau SAR have already signed new protocols in 2019 to reflect the BEPS recommendations in their tax arrangements.

Hybrid mismatches

For dual resident entities, the MLI requires that the competent authorities of the contracting jurisdictions shall consider the place of effective management, the place where it is incorporated or otherwise constituted and any other relevant factors, and endeavour to determine by mutual agreement the entity's tax residence. China has adopted this provision. It should be noted that if both contracting jurisdictions fail to reach an agreement on the issue, such entity shall not be entitled to any treaty benefits.

China has not adopted the other optional measures under the hybrid mismatch action.

Preventing treaty abuse

China's position in the instrument of ratification on preventing treaty abuse generally follows its current position on newly negotiated or renegotiated tax treaties.

- 1) As a minimum standard, China has opted for the PPT whereby a treaty benefit may be denied if obtaining that benefit was one of the principal purposes of any arrangement or transaction, unless granting of such benefit in the circumstances would be in accordance with the object and purpose of a tax treaty. Similar provisions can also be found in China's recently negotiated or renegotiated tax treaties. The adoption of the PPT in MLI will apply to all covered tax agreements mentioned in China's instrument of ratification.

2) China has not opted for the simplified LOB rule, which is basically in line with the position reflected in recent tax treaties it has signed.

From the perspective of dividend, China has opted for the minimum standard, i.e., the 365-day shareholding period for enjoying a reduced withholding tax rate on dividends. This is in line with China's current practice based on either the text of recent tax treaties or domestic interpretation rules.

From the perspective of capital gain, pursuant to the domestic interpretation rules, tax treaty protection on income from alienation of shares of non-immovable property rich companies may apply if, at any time during the three-year period prior to the transfer, less than 50% of the fair value of the assets of the invested foreign entity is derived directly or indirectly from immovable properties located within the territory of China. Obviously, this rule is more stringent than the one-year threshold period provided in the MLI. It is likely for this reason that, China opted out of the one-year threshold period for enjoying treaty benefit on capital gain from transfer of non-immovable property rich companies.

Artificial avoidance of PE

As China opted out of all the provisions (Article 12 to Article 15) in the avoidance of PE section in MLI, there is no immediate impact on foreign companies' PE position in China in the near future unless bilateral negotiation results in amendments to the specific China-foreign tax treaties. However, it should be noted that China's domestic treaty interpretation (Circular Guoshuifa [2010] No.75) has already provided similar provisions to address the BEPS concerns including agency PE, preparatory and auxiliary activities.

Improving dispute resolution

China has adopted the full implementation of MAP in good faith required by the Convention; and has allowed appropriate corresponding adjustments in cases such adjustment is justified. However, China has opted out of the mandatory arbitration provisions of the Convention.

Hong Kong SAR's MLI position

Hong Kong SAR has expressed its own position on each article of the MLI, covering 39 double tax agreements already in force, not covering four double tax agreements signed in recent four years already in force (Estonia, Finland, Georgia and Serbia) and the tax arrangements with Mainland China and Macau SAR. Please refer to Appendix "Mainland China and Hong Kong SAR's positions under the MLI" for the detailed position in relation to each Article.

The application of the MLI and effective date

The MLI is designed as a modular with alternatives and participating jurisdictions may opt in to and out of the MLI's different provisions. It can be expected that those multitudes of options in different provisions will make the application of MLI highly complex. In some cases, a jurisdiction may opt in to the same option as its tax treaty partners. In other cases, the application of some rules can be asymmetrical, i.e., one treaty partner can opt in to one rule while the other treaty partner can opt in to a different one. Although the Convention per se enters into force on 1 September 2022 for Mainland China and Hong Kong SAR, the effective date of MLI with respect to a particular covered tax agreement will depend on when the Convention enters in force in both China and the other contracting jurisdiction, whether the instrument of ratification of both apply to this particular tax treaty, and whether both have opted in to the same option for a particular provision. In other words, provided that the instrument of ratification in the two contracting jurisdictions are both effective and apply to the covered tax agreement, the agreement will be modified only if both opt to apply the same option for the same provision. The OECD's website provides a Step-by-step tool on the application of the MLI⁵. For example, although China's instrument of ratification covers China-Germany treaty, Germany's instrument does not include that treaty, so the China-Germany treaty will not be amended according to the MLI. To help stakeholders directly and timely understand the impact of the MLI on the terms of bilateral tax treaties, OECD provides a regularly updated MLI matching database⁶ for public inquiry.

It should also be noted that, according to the Step-by-step tool, on the condition that the MLI has entered into force on or before 1 September 2022 for both contracting jurisdictions, the MLI provisions will have effect at different moment with respect to taxes withheld at source and to all other taxes. The details for Mainland China and Hong Kong SAR are as follows:

Mainland China:

- The provisions related to taxes withheld at source will apply on or after the first day of the next **calendar year**, so it will apply to transactions on or after **1 January 2023** in Mainland China.

- The provisions related to other taxes will have a six-month holding period. Specifically, the provisions will apply to taxable periods beginning on or after the expiration of 6 months from the effective date of the Convention, so it will apply to transactions on or after **1 January 2024** in Mainland China.

Hong Kong SAR:

- The provisions related to taxes withheld at source will apply on or after the first day of the next **taxable period**, so it will apply to transactions in a year of assessment beginning on or after **1 April 2023** in Hong Kong SAR.
- The provisions related to other taxes will apply to taxable periods after the expiration of 6 months from 30 days after the receipt by the OECD depository of the notification that Hong Kong SAR has completed its internal procedure for entry into force of the Convention. Therefore, it will apply to transactions in a year of assessment beginning on **1 April 2023** at the earliest in Hong Kong SAR.

The takeaway

The ratification of the Convention reflects China's determination to participate in the fight against BEPS and will open a new chapter for China's tax treaty. China has opted out of most of the provisions that are not required under the minimum standard, especially PE. However, even if tax treaty texts are not to be revised by the MLI, it is likely that the China's tax authority would be more cautious in granting treaty benefits under this new landscape.

In addition, with regard to the PPT adopted by China, it may be subjective to a certain extent because it requires tax authorities to judge the principal purpose of the arrangement considering various facts and circumstances. Applicants for treaty benefits need to pay more attention to the commercial purpose and substance of the business arrangement and transaction structure, and retain relevant supporting documents, so as to reduce the uncertainty of tax treatment.

For Chinese enterprises having or planning to have cross-border transactions, the MLI can be used not only as an instrument for mitigating cross-border tax risks and enhancing tax compliance, but also as a support channel for resolving international tax disputes to protect taxpayers' rights.

It is noteworthy that the impact of the Convention on a particular double tax agreement may depend not only on the MLI position of China but also that of the other contracting jurisdiction. In addition to referring to the OECD MLI matching database, we also expect that the State Taxation Administration of China publish detailed guidance to help enterprises and individuals to check and understand the MLI's amendments to specific tax treaties more easily.

Appendix:

Mainland China and Hong Kong SAR's positions under MLI

BEPS measures	Article	Provision	Mainland China's position	Hong Kong SAR's position
	Article 2 - Interpretation of Terms	Agreements covered by the Convention	Covering 100 tax treaties concluded by China as of 25 May 2022, except for the tax treaties with Chile, India, New Zealand, Spain, Kenya, Republic of the Congo, Angola, Argentina, Rwanda, Gabon, Uganda and the three tax arrangements with Hong Kong SAR, Macau SAR and Taiwan	Covering 39 tax treaties concluded by Hong Kong SAR as of 25 May 2022, except for the tax treaties with Estonia, Finland, Georgia, Serbia and the two tax arrangements with Mainland China and Macau SAR

BEPS measures	Article	Provision	Mainland China's position	Hong Kong SAR's position
Action 2: Hybrid mismatches	Article 3 - Transparent Entities	Income derived by or through a transparent entity or arrangement shall be considered to be income of a resident of a contracting jurisdiction.	Not adopted	Not adopted
	Article 4 - Dual Resident Entities	Competent authorities shall endeavour to determine the contracting jurisdiction of which a person shall be deemed to be a resident by mutual agreement. Otherwise, such person shall not be entitled to any relief or exemption under the tax treaty.	Adopted	Not adopted
	Article 5 - Application of Methods for Elimination of Double Taxation	Three options are provided in the Convention which shall only apply where the contracting jurisdiction has chosen to apply and made such notification.	Not adopted	Not adopted
Action 6: Treaty abuse	Article 6 - Purpose of a Covered Tax Agreement	A clear statement shall be contained in the preamble that the contracting jurisdictions intend to avoid creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including through treaty shopping.	Adopted	Adopted. The tax treaty with Belarus already contains such preamble statement, so the effect of the adoption is on the remaining 38 covered treaties.
	Article 7 - Prevention of Treaty Abuse	Contracting Jurisdictions should include one of the options below in their tax treaties: <ul style="list-style-type: none"> - PPT - a Simplified LOB article combined with a PPT - a more complex LOB accompanied by either an anti-conduit rule or a PPT 	Adopting the PPT	Adopting the PPT but not the LOB rule. The tax treaties with Belarus and Pakistan already contain the PPT, so the effect of the adoption is on the remaining 37 covered treaties.

BEPS measures	Article	Provision	Mainland China's position	Hong Kong SAR's position
	Article 8 - Dividend Transfer Transactions	The 365-day minimum holding period requirement for enjoying treaty benefits on dividends	Adopted	Not adopted
	Article 9 - Capital Gains from Alienation of Shares or Interests of Entities Deriving their Value Principally from Immovable Property	The 365-day prior period requirement for exempting gains from alienation of shares of non-immovable property holding companies	Not adopted (Note: China has a stricter three-year period under its domestic law.)	Not adopted
	Article 10 - Anti-abuse Rule for Permanent Establishments Situated in Third Jurisdictions	Anti-abuse rule for income allocable to a PE in a third jurisdiction where low tax is levied	Not adopted	Not adopted
	Article 11 - Application of Tax Agreements to Restrict a Party's Right to Tax its Own Residents	Allowing contracting jurisdictions to tax their own residents under domestic law	Adopted	Not adopted
Action 7: Avoidance of Permanent Establishment Status	Article 12 - Artificial Avoidance of Permanent Establishment Status through Commissionaire Arrangements and Similar Strategies	Stricter rules on determining a PE in a commissionaire arrangement, etc. in terms of the provision on agent and contract	Not adopted	Not adopted
	Article 13 - Artificial Avoidance of Permanent Establishment Status through the Specific Activity Exemptions	Modifications of the specific activity exemptions with the introduction of an antifragmentation test	Not adopted	Not adopted
	Article 14 - Splitting-up of Contracts	Anti-splitting rules to prevent avoidance of exceeding the 12-month threshold for construction projects by splitting up contracts between associated enterprises	Not adopted	Not adopted
	Article 15 - Definition of a Person Closely Related to an Enterprise	Definition of "closely related" for the purposes of Articles 12, 13 and 14 of the Convention	Not adopted	Not adopted

BEPS measures	Article	Provision	Mainland China's position	Hong Kong SAR's position
Action 14: Improving Dispute Resolution	Article 16 - Mutual Agreement Procedure	Providing procedural and substantive requirements to fully implement MAP	Adopted except for presenting the case to the competent authority of either contracting state	Adopted. Most of the covered tax treaties already contain similar description with the exception of the tax treaties with Belgium, Italy, Mexico and New Zealand. Hence the adoption affects these 4 treaties.
	Article 17 - Corresponding Adjustments	Competent authorities should provide for appropriate corresponding adjustment in cases where they find that such adjustment is justified.	Adopted	Adopted. All of the existing tax treaties already contain the provision.
	Articles 18 to 26 - Arbitration	Provisions on setting a new standard for mandatory binding arbitration in MAP process	Not adopted	Not adopted

Endnote

- The Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (English Text): <https://www.oecd.org/tax/treaties/multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-BEPS.pdf>
The Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (Chinese Translation): <https://www.oecd.org/tax/treaties/beps-multilateral-instrument-text-translation-chinese.pdf>
Explanatory Statement to the Multilateral Convention: <https://www.oecd.org/tax/treaties/explanatory-statement-multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-BEPS.pdf>
- BEPS MLI Position- Mainland China Instrument Deposit (Chinese and English Version): <https://www.oecd.org/tax/treaties/beps-mli-position-china-instrument-deposit.pdf>
BEPS MLI Position- Hong Kong SAR Instrument Deposit (Chinese and English Version): <https://www.oecd.org/tax/treaties/beps-mli-position-hong-kong-instrument-deposit.pdf>
- For Hong Kong SAR, an order would be made by the Chief Executive in Council under Section 49 of the Inland Revenue Ordinance to give effect to the MLI. The order would be subject to the negative vetting by the Legislative Council.
- Signatories and Parties to the Multilateral Convention: <https://www.oecd.org/tax/treaties/beps-mli-signatories-and-parties.pdf>
- The Step-by-step tool on the application of the MLI: <https://www.oecd.org/tax/treaties/step-by-step-tool-on-the-application-of-the-MLI.pdf>
- The MLI Matching Database: <https://www.oecd.org/tax/treaties/mli-matching-database.htm>

Let's talk

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