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The Concept of Permanent Establishment in China's Tax Treaties

by Jinyan Li†

INTRODUCTION

The People's Republic of China has recently entered into treaties with more than twenty states on the subjects of double taxation and the evasion of income and capital taxes. Already in force are treaties with Canada, Czechoslovakia, Denmark, Finland, France, the Federal Republic of Germany, Japan, Malaysia, Norway, Singapore, Sweden, Thailand, the United Kingdom, and the United States. Given that the fundamental laws which govern the taxation of foreign investment and business in China have been in existence for such a short time, China has been remarkably quick in instituting a program for the negotiation of tax treaties.

"Permanent establishment" is the term used in all of the treaties signed by China to determine whether the profits of an enterprise of a treaty state may be taxed in China. Because it is so commonly used, the precise definition of the term has always been a key issue in treaty negotiations. Only if an enterprise of a treaty state carries on business through a permanent establishment in China will its profits from business be taxable there. In this respect, China's treaties therefore follow the general rule adopted in virtually all tax treaties negotiated during the past two decades. As with other developing countries, China has sought to have the term defined as broadly as possible in its treaties. China has been relatively successful in obtaining a broad definition, such that in practice, the jurisdiction to tax the business income of foreign enterprises from treaty states differs little from that provided under China's domestic tax laws where no treaty is applicable.

China's tax treaties generally adhere to the principles set forth in the model tax treaties of the Organization for Economic Cooperation and Development [hereinafter OECD]¹ and the United Nations [hereinafter UN].² The

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1. Organization for Economic Cooperation and Development, Model Double Taxation Convention on Income and Capital 1977, *reprinted in* 1 TAX TREATIES (CCH) ¶ 151 (1980), RHOADES & LANGER, 3 INCOME TAXATION OF FOREIGN RELATED BUSINESS TRANSACTIONS §§ 15.01-15.01[30] (1985) [hereinafter OECD Model].

2. U.N. Model Double Taxation Convention Between Developed and Developing Countries, U.N. Doc. ST/ESA/102, U.N. Sales No.E. 80.XVI.3 (1980), *reprinted in* 1 TAX TREATIES

definition of permanent establishment adopted by these models will first be examined briefly before considering the term as employed in China's tax treaties.

I.

THE OECD MODEL DEFINITION OF PERMANENT ESTABLISHMENT

Under the OECD Model definition, there are two possible theories under which a permanent establishment may be found. An enterprise from a contracting state is normally deemed to have a permanent establishment in another contracting state if it satisfies either a "fixed place of business" test or an "agency/relationship" test.³ These two theories are then limited by a third test which examines the nature of the activities undertaken by the enterprise in question.⁴

A. Fixed Place of Business

The OECD Model sets forth three conditions which are dispositive of permanent establishment status under the fixed place of business theory and which therefore make the enterprise subject to taxation at the source of income. These are: (i) a "place of business" must exist (i.e., a facility such as physical premises or, in certain instances, machinery, or equipment);⁵ (ii) this place of business must be "fixed," (i.e., it must be established at a distinct place with a certain degree of permanence);⁶ and (iii) the business of the enterprise must be carried on through this fixed place of business.⁷

The OECD Model provides that the following physical sites constitute a permanent establishment: a place of management, a branch, an office, a factory, a workshop, a mine, an oil or gas well, a quarry, or any other place of extraction of natural resources.⁸ A building site or a construction or installation project is deemed to be a permanent establishment if it continues for more than a specified time, normally twelve months.⁹

(CCH) ¶ 171 (1982), RHOADES & LANGER, *supra* note 1, § 15.06-15.06[28] (1981) [hereinafter UN Model].

3. D. DAVIES, *PRINCIPLES OF INTERNATIONAL DOUBLE TAXATION RELIEF* 115 (1985).

4. *Id.*

5. See ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, REPORT OF THE OECD COMMITTEE ON FISCAL AFFAIRS, MODEL DOUBLE TAXATION CONVENTION ON INCOME AND ON CAPITAL, Annex II at 59 (commentaries on the articles of the Model Convention) (1977).

6. *Id.*

7. *Id.*

8. OECD Model, *supra* note 1, art. 5(2).

9. *Id.* art. 5(3).

B. Agency/Relationship

Where an enterprise of a treaty state does not maintain a fixed place of business in another treaty state, the enterprise may still be deemed to have maintained a permanent establishment by virtue of the presence and activity of an agent. If a dependent agent acts on behalf of an enterprise and has habitually exercised the authority to conclude contracts in the name of that enterprise, the principal is deemed to have a permanent establishment with respect to any activities undertaken by the agent.¹⁰ However, the execution of business through a broker, general commission agent, or other independent agent will not create a permanent establishment if the agent acts in the ordinary course of his business.¹¹

The OECD Model also recognizes the independent identity of separately incorporated entities, such as parent and subsidiary corporations, for tax purposes. It expressly states that the mere existence of separately incorporated entities under common control will not by itself constitute a permanent establishment.¹²

C. Nature of Activities

The final test under the OECD Model concerns the nature of the activities carried on by the enterprise in question. Certain business activities conducted by an enterprise of a treaty state in another treaty state are not regarded as constituting a permanent establishment, even if the activity is carried on through a fixed place of business or by an agent.¹³ These activities can be broadly characterized as being of a preparatory or auxiliary nature, such as storing, displaying, or delivering goods from a facility, purchasing goods, or collecting information.¹⁴

The OECD Model also recognizes that a combination of activities in a fixed place of business may not necessarily create a permanent establishment. If the overall activity resulting from this combination is of a preparatory or auxiliary character, a permanent establishment will not be found.¹⁵

II.

COMPARING THE UN MODEL DEFINITION OF PERMANENT
ESTABLISHMENT

The OECD Model was drafted by representatives of its member states and has been closely adhered to in tax treaties entered into between OECD members. The membership of the OECD consists generally of developed

10. *Id.* art. 5(5).
 11. *Id.* art. 5(6).
 12. *Id.* art. 5(7).
 13. *Id.* art. 5(4).
 14. *Id.* art. 5(4)(a)-(e).
 15. *Id.* art. 5(4)(f).

countries.¹⁶ Because income generally flows in both directions between developed countries, it should make relatively little difference to them whether their treaties emphasize source or residence jurisdiction. The flow of income between a developing and a developed country, however, is commonly unidirectional, with income flowing from the host country to the investor's home country, the developed country. Developing countries may, therefore, prefer a lower threshold for the determination of permanent establishment, in order to expand their source jurisdiction and increase fiscal revenue. The UN Model reflects this preference and provides a definition of permanent establishment which, while paralleling the OECD Model in construction, is more comprehensive in scope.

A. Fixed Place of Business

Whereas the OECD Model employs only the term "installation project," the UN Model's parallel section includes the term "assembly project" and "supervisory activities" in connection with a "building site, a construction, installation or assembly project."¹⁷ Significantly, the length of time for which an activity must continue in order to be considered a permanent establishment is reduced in the UN Model from twelve to six months.¹⁸

B. Agency/Relationship

The UN Model departs substantially from the OECD Model by expanding the concept of "dependent agent" to include both an agent who has habitually exercised a general authority to conclude contracts on behalf of the principal and an agent who, while not having such authority, maintains a stock of goods from which delivery on behalf of the principal is made.¹⁹

Furthermore, the UN Model enlarges the scope of the term permanent establishment by providing that when the activities of an independent agent are exercised wholly or almost wholly on behalf of an enterprise of the treaty state, the agent will be deemed to be a dependent agent.²⁰ A dependent agency relationship will also be found where activities are exercised wholly or

16. The Organization for Economic Cooperation and Development [hereinafter OECD] was established in 1961 to promote economic and social welfare in member countries, and to stimulate and harmonize efforts on behalf of developing nations. Nearly all the industrialized "free market" countries belong, with Yugoslavia as an associate member. OECD collects and disseminates economic and environmental information. Members in 1987 were: Australia, Austria, Belgium, Canada, Denmark, Finland, France, the Federal Republic of Germany, Greece, Iceland, Ireland, Italy, Japan, Luxembourg, Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, the United Kingdom, the United States, and Yugoslavia (special member). WORLD ALMANAC AND BOOK OF FACTS 741 (1988).

17. UN Model, *supra* note 2, art. 5.

18. *Id.* art. 5(3)(a).

19. *Id.* art. 5(5).

20. *Id.* art. 5(7).

almost wholly on behalf of a group of centrally controlled affiliated corporations.²¹

Agency relationships for the sale of insurance are also dealt with differently under the two models. Under the OECD Model, insurance premiums are taxable in the source country only if the insurance company has an agent therein authorized to conclude contracts on its behalf or if the insurance company is otherwise deemed to have a permanent establishment.²² The UN Model adds the further provision that, except when reinsuring, an insurance enterprise of a contracting state has a permanent establishment in the other contracting state if it collects premiums in that state's territory or insures risks situated therein through a person other than an independent agent.²³

C. *Nature of Activities*

The UN Model is usually analogous to the OECD Model with respect to the type of preparatory or auxiliary activities which are excluded from the definition of permanent establishment. In the UN Model, however, the furnishing of services, including consulting services, for the same or connected projects (something which is not specifically covered in the OECD model²⁴), is treated as a permanent establishment if such activity continues for more than six months.²⁵

III.

PERMANENT ESTABLISHMENT UNDER CHINA'S TAX TREATIES

As in most treaties entered into between developing and developed countries, the definition of permanent establishment found in China's tax treaties is a blend of the OECD and the UN Model conventions.

A. *Fixed Place of Business*

A permanent establishment is commonly defined to expressly include a fixed place of business through which the business of an enterprise is wholly or partly carried on, such as: (i) a place of management, a branch, an office, a factory, a workshop, a mine, an oil or gas well, a quarry or any other place of extraction of natural resources;²⁶ (ii) a farm or plantation;²⁷ (iii) a building site, a construction, assembly or installation project, or supervisory activities

21. *Id.*

22. *See supra* notes 1-12 and accompanying text.

23. UN Model, *supra* note 2, art. 5(6).

24. OECD Model, *supra* note 1, art. 5.

25. UN Model, *supra* note 2, art. 5(3)(b).

26. Protocol for the Avoidance of Double Taxation, Nov. 23, 1985, People's Republic of China-Malaysia, art. 5(2)(g), — U.N.T.S. —.

27. *Id.*

in connection therewith, but only where such site, project, or activities continue for a period of more than six months;²⁸ or (iv) an installation or structure used for the exploration or exploitation of natural resources.²⁹

B. Agency/Relationship

The activities of a dependent agent of a given enterprise constitute a permanent establishment of the enterprise if the agent is acting in China on behalf of the enterprise and if the agent has the authority and habitually exercises that authority to conclude contracts in the name of the enterprise.³⁰ As under both the OECD and UN models, permanent establishment will not be found where the agent's activities are restricted to those which themselves do not create a permanent establishment.³¹

China's tax treaties generally provide that an enterprise of a treaty state shall not be deemed to have a permanent establishment in China by mere virtue of the fact that the enterprise carries on business in China through a broker or general commission agent of independent status, provided that such person is acting in the ordinary course of his business.³² However, if the activities of such an agent are exercised wholly or almost wholly on behalf of that enterprise, he will lose his status as an independent agent.³³

28. The treaty with France provides, however, that the supervision of equipment or of an industrial or commercial plant assembly project by a French or Chinese enterprise which sells the equipment or other materials will not be deemed to be a permanent establishment if the cost charged for such supervision is less than five percent of the total sales price and is considered to be auxiliary to the sale. See Protocol for the Avoidance of Double Taxation, May 30, 1984, People's Republic of China-France, art. 1, 1985 Recueil des Traités (Fr.) No. —, — U.N.T.S. —, reprinted in INT'L BUREAU FISCAL DOC., EUR. TAX'N., Supp. Serv. Sec. C-4 (1985) (unofficial English translation).

29. Agreement for the Avoidance of Double Taxation, July 26, 1984, People's Republic of China-United Kingdom, art. 5(2)(g), 1985 Gr. Brit. T.S. No. 7 (Cmd. 9439), Europ. T.S. No. 10, reprinted in INT'L BUREAU FISCAL DOC., EUR. TAX'N., Supp. Serv. Sec. C-9 (1985). In both the Agreement for the Avoidance of Double Taxation, Apr. 30, 1984, People's Republic of China-United States, art. (5)(3)(b), — U.S.T. —, T.I.A.S. No. —, reprinted in 1 TAX TREATIES (CCH) ¶¶ 1401-1431 (1986), and the Agreement for the Avoidance of Double Taxation, Mar. 26, 1986, People's Republic of China-Denmark, art. 5(3)(b), Europ. T.S. No. 3, the words "drilling rig or ship" are used instead of "structure," and the proviso is added that it will constitute a permanent establishment only if used for a period in excess of three months.

30. Treaties with Denmark and the United States add a further condition that the agent will not be considered an agent with independent status if it is shown that the transactions between the agent and the enterprise have not been made at arm's length. See Agreement for the Avoidance of Double Taxation, Mar. 26, 1986, People's Republic of China-Denmark, art. 5(6), Europ. T.S. No. 3; Agreement for the Avoidance of Double Taxation, Apr. 30, 1984, People's Republic of China-United States, art. 5(6), — U.S.T. —, T.I.A.S. No. —, reprinted in 1 TAX TREATIES (CCH) ¶¶ 1401-1431 (1986).

31. *Id.*

32. See treaties cited *infra* note 35.

33. It should be noted that under the China-Japan Treaty, if a dependent agent regularly secures orders in China wholly or almost wholly for a Japanese enterprise or for that enterprise and other enterprises which control or are controlled by that enterprise, he shall be deemed to constitute a permanent establishment in China. See China-Japan Treaty, *infra* note 35, art. 5(6).

China's tax treaties follow the UN and OECD Models with regard to parent and subsidiary corporations. One company may control another company in the contracting state or may be controlled by that company, without either company constituting a permanent establishment of the other's home state.³⁴

C. *Nature of Activities*

As in the UN Model, China's tax treaties generally provide that services, including consulting services, furnished by an enterprise through employees or other personnel engaged by the enterprise for a period or periods aggregating more than six months within any twelve month period constitute a permanent establishment.³⁵

The following activities are specifically excluded from the definition: (i) the maintenance of a fixed place of business solely for the purpose of storing, displaying, delivering, or purchasing goods or merchandise, collecting information for the enterprise, or carrying on any other activity of preparatory or auxiliary character,³⁶ and (ii) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display, delivery, or processing by another enterprise.³⁷

Treaties with Denmark, Finland, the Federal Republic of Germany, Singapore, Sweden, the United Kingdom, and the United States further provide that the term permanent establishment does not include the maintenance of a fixed place of business solely due to any combination of activities mentioned above, provided that the overall activity of the fixed place of business resulting from the combination is of a preparatory or auxiliary character.³⁸

34. See treaties cited *infra* note 35.

35. Convention for the Avoidance of Double Taxation, Apr. 18, 1985, People's Republic of China-Belgium, art. 5(3)(b), J.O. —, Europ. T.S. No. 2, *reprinted in* INT'L BUREAU FISCAL DOC., EUR. TAX'N., Supp. Serv. Sec. C-2 (1986) (unofficial English translation); Agreement for the Avoidance of Double Taxation, Mar. 26, 1986, People's Republic of China-Denmark, art. 5(3)(c), Europ. T.S. No. 3; Agreement for the Avoidance of Double Taxation, May 12, 1986, People's Republic of China-Finland, art. 5(3)(b), Europ. T.S. No. 3; Agreement for the Avoidance of Double Taxation, May 16, 1986, People's Republic of China-Sweden, art. 5(3)(b), Europ. T.S. No.9; Agreement for the Avoidance of Double Taxation, Apr. 30, 1984, People's Republic of China-United States, art. 5(3)(c), — U.S.T. —, T.I.A.S. No. —, *reprinted in* 1 TAX TREATIES (CCH) ¶¶ 1401-1431 (1986). The treaty with Japan makes the same provision except that no permanent establishment exists for consultancy services in connection with the sale or lease of equipment. Protocol for the Avoidance of Double Taxation, Sept. 6, 1983, People's Republic of China-Japan, art. 1, — U.N.T.S. —, *reprinted in* 23 I.L.M. 120 (1983) [hereinafter China-Japan Treaty].

36. See treaties cited *supra* note 35.

37. See *id.*

38. See *id.*

IV.

GUIDELINES FOR INTERPRETATION OF PERMANENT
ESTABLISHMENT BY THE CHINESE AUTHORITIES

China is only now gaining experience in the interpretation of tax treaties. To assist tax bureaus in the effective implementation of the treaties, the General Taxation Bureau of the Ministry of Finance has issued notices for use in interpreting the tax treaties,³⁹ a number of which provide specific guidance in interpreting the term permanent establishment.

*A. Duration of a Building Site, Construction, Assembly
or Installation Project*

In determining the duration of a project, the first day of a site, project or supervisory activity is the day on which the contract was first implemented, including preparatory activities.⁴⁰ The final day is the day on which the work, including test runs, is completely finished, handed over and put into use.⁴¹ Wherever such site, project or supervisory activity continues for more than six months, it shall constitute a permanent establishment.⁴² Where the term of the project spans two fiscal years, the period is computed as a single, continuous period.⁴³ After the first day of the project, work stoppage during construction caused by weather or delayed shipments of materials or machinery do not affect the running of the six-month period unless the project is terminated and personnel and equipment are completely withdrawn.⁴⁴

Where an enterprise of the treaty state undertakes two or more successive work contracts for the same site or the same project in China, the period shall be computed from the start of the first project until the completion of the last contract.⁴⁵ Contracts are successive if the relevant projects covered by each contract form part of the same complete piece of work geographically and commercially.⁴⁶

In some cases, an enterprise of a treaty state may wish to subcontract part of the project work to another enterprise. If the subcontractor starts working earlier than the main contractor, the period of the project contracted

39. See, e.g., An Opinion on Several Questions Concerning the Thorough Implementation of the China-Japan and China-United Kingdom Tax Treaties, (85) *Cai Shui Wai Zi* No. 042 (Mar. 26, 1985); Notice of the Interpretation of Several Articles of Tax Treaties for Implementation, (86) *Cai Shui Xie Zi* No. 015 (Sept. 15, 1986); Notice Concerning the Implementation of Several Articles of Agreements for the Avoidance of Double Taxation, (88) *Cai Shui Xie Zi* No. 002 of (Jan. 13, 1988).

40. (85) *Cai Shui Wai Zi* No. 042, *supra* note 39, art. 2(1).

41. *Id.*

42. *Id.*

43. *Id.*

44. *Id.*

45. (85) *Cai Shui Wai Zi* No. 042, *supra* note 39, art. 2(2); (86) *Cai Shui Xie Zi* No. 015, *supra* note 39, art. 2(2).

46. *Id.*

by the main contractor shall be computed from the date on which the subcontractor starts working.⁴⁷

B. *Place of Extraction of Natural Resources*

In all of China's tax treaties a mine, an oil or gas well, a quarry or any other place of extraction of natural resources, through which the business of a foreign enterprise is wholly or partly carried on in China, is treated as a permanent establishment of the enterprise.⁴⁸ The place of extraction of natural resources is considered to be a permanent establishment only where the foreign enterprise, by virtue of its investment, has a right to exploit and develop the resources for business purposes.⁴⁹ Where a foreign enterprise merely contracts with a Chinese entity to exploit the natural resources, the foreign contractor will not be regarded as having a permanent establishment unless the contracted project lasts for more than six months.⁵⁰

C. *Services*

Generally, China's tax treaties usually provide that the furnishing of personal services for a project by an enterprise of a treaty state constitutes a permanent establishment if such activities should continue for more than six months within any twelve-month period.⁵¹

The interpretation notices construe the term "furnishing of personal services" to incorporate consulting services or technical services for a construction project that is already in progress.⁵² Such consultation includes reforming China's construction engineering or present production technology. It includes consultation on business management and feasibility analyses for the selection of technology, investments, and designs.⁵³ It also includes the furnishing of technical assistance by foreign enterprises to Chinese enterprises to redesign, readjust, or experiment with the manufacturing equipment or products of these enterprises.⁵⁴

The computation of the duration of services is made without restriction of the taxable or calendar year and commences from the month in which services under the contract are first provided.⁵⁵

47. (86) *Cai Shui Xie Zi* No. 015, *supra* note 39, art. 2(4); (85) *Cai Shui Wai Zi* No. 042, *supra* note 39.

48. (85) *Cai Shui Wai Zi* No. 042, *supra* note 39, art. 3(2).

49. Article 9 of the Constitution of the People's Republic of China declares that all natural resources belong to the state. Therefore, a foreign enterprise cannot own natural resources in the People's Republic of China.

50. (85) *Cai Shui Wai Zi* No. 042, *supra* note 39, art. 3(1).

51. (86) *Cai Shui Wai Zi* No. 015, *supra* note 39, art. 3.

52. *Id.* art. 3(1).

53. *Id.* art. 3(2).

54. *Id.* art. 3(2).

55. *Id.* art. 3(3).

V.

ESTABLISHMENT UNDER CHINESE DOMESTIC TAX LAWS

China does not have to make any major concessions in accepting the normal definition of permanent establishment as used in most treaties between developing and developed countries, since the Foreign Enterprise Income Tax Law [hereinafter FEIT Law]⁵⁶ generally limits the taxation of business income of a foreign enterprise carrying on business in China to those profits associated with an establishment in China.⁵⁷ The definition of permanent establishment in China's tax treaties modifies the domestic tax rules insofar as they apply to residents of treaty states.⁵⁸ Establishments are defined as organizations, places, or business agents established in the Chinese territory by a foreign enterprise and engaged in production and business operations.⁵⁹ Such organizations and places mainly include management offices, branches, representative offices, factories, and places where natural resources are exploited and where contracted projects for building, installation, assembly and exploration are in operation.⁶⁰

Despite the apparently broad definition, as discussed below, the Chinese authorities have interpreted the term "establishment" quite narrowly. In practice, this term seems to correspond closely to the notion of permanent establishment used in tax treaties generally and may be less extensive than the definition commonly given in those treaties signed by China specifically. Establishments are interpreted so as not to include the following: (i) sales to and purchases from China;⁶¹ (ii) compensation trade with China;⁶² (iii) simple

56. The Foreign Enterprise Income Tax Law of the People's Republic of China (adopted December 13, 1981 at the fourth session of the Fifth National People's Congress) [hereinafter FEIT Law]; Detailed Rules and Regulations for the Implementation of the Foreign Enterprise Income Tax Law of the People's Republic of China (approved Feb. 17, 1982, by the State Council and promulgated Feb. 21, 1982, by the Ministry of Finance) [hereinafter FEIT Regulations]. For a discussion of this tax, see Easson & Li, *Taxation of Foreign Business and Investment in the People's Republic of China*, 7 NW. J. INT'L L. & BUS. 666, 676-81 (1986); and Easson & Li *The Evolution of the Tax System in the People's Republic of China*, 23 STAN. J. INT'L L. 399, 426-29 (1987).

57. FEIT Law, *supra* note 56, art. 1.

58. The interpretation notice, (86) *Cai Shui Xie Zi* No. 015, *supra* note 39, states that unless a treaty provides otherwise, branch offices located in a third country which are "part of the same legal entity" as their head office located in a treaty signatory state can enjoy the tax treatment under the treaty for branch office transactions conducted in China. The same rule does not apply to subsidiaries located in third countries. It also states that personnel who are residents of a treaty signatory country but who are employed in a branch office or providing independent personal services in a third country cannot take advantage of treatment under the treaty if they are taxed as residents in the third country.

59. FEIT Regulations, *supra* note 56, art. 2.

60. *Id.*

61. Gelatt & Theroux, *Tax Treatment in China*, CHINA BUS. REV. 22, 23 (Jan.-Feb. 1984).

62. *Id.* at 25.

technology transfer to China;⁶³ and (iv) representative offices of foreign enterprises that do not engage in "production or business operations."⁶⁴

Where a foreign enterprise contracts with a Chinese entity to provide construction, engineering, or other project design activities, the foreign enterprise will not be treated as having a permanent establishment in China if all of the design work is conducted outside of China.⁶⁵ No establishment will be deemed to exist even when the investigating and preparatory work is done in China before the actual design work has commenced.⁶⁶ However, should the foreign enterprise send personnel to China to explain their drawings and provide technical guidance, supervision, or management for their execution, this would constitute an establishment in China.⁶⁷ Consequently, the foreign enterprise would be liable for foreign enterprise income tax on its design fees received therefrom.

Foreign enterprises involved in construction projects or in oil or mineral exploration do not fall into the exceptions noted above and are therefore regarded as having establishments for the purposes of the FEIT Law.⁶⁸ Similarly, enterprises engaging in contractual joint ventures with a Chinese entity are considered to have an establishment in China.⁶⁹ Foreign enterprises contracting with a Chinese enterprise for a service project, the sole or primary purpose of which is to perform services in China, have also been deemed an establishment for the purposes of the FEIT Law,⁷⁰ as have foreign enterprises receiving management fees for services furnished in China.⁷¹

The FEIT Law does not prescribe a minimum period within which a contracted project can be completed without creating an establishment.⁷² In practice, Chinese tax officials apply a four-month rule where no treaty is applicable, as opposed to the six-month period normally prescribed by treaty.⁷³

63. *Id.* at 23. A twenty percent withholding tax is levied on royalties received by the foreign transferor from China under Article 11 of the FEIT Law. Under tax treaties, the withholding rate is generally reduced to ten percent under tax treaties.

64. The Chinese tax authorities do not view the representative offices of foreign industrial and manufacturing enterprises as "operating" establishments under the FEIT Law. Rather, they treat them as liaison centers, engaging in market development and exploration of business opportunities. See generally Gelatt & Theroux, *supra* note 61, at 23-26.

65. Notice Regarding Design Fees Obtained from Construction and Contracted Projects Issued by the General Taxation Bureau of the Ministry of Finance on July 15, 1986, effective on July 1, 1986, (86) *Cai Shui Wai Zi* No. 172.

66. *Id.*

67. *Id.*; see also Ministry of Finance Notice, (86) *Cai Shui Wai Zi* No. 067.

68. FEIT Regulations, *supra* note 56, art. 2.

69. Notification Regarding Policy and Practice in Connection with the Levy of Income Tax Levied on Enterprises with Foreign Investment Issued by the General Taxation Bureau of the Ministry of Finance on Feb. 22, 1987, (87) *Cai Shui Wai Zi* No. 033, art. 3. This provision benefits foreign enterprises, because they can be taxed on fifteen percent of net profit instead of twenty percent withholding tax on gross income.

70. *Id.*

71. *Id.*

72. See FEIT Law, *supra* note 56.

73. This information on practices of Chinese tax officials is derived from the author's own experience.

The concepts of dependent and independent agents are not used in the FEIT Law, but Chinese tax authorities have found an establishment to exist when an agent sets up an independent place of business in China with the sole or primary function of selling a foreign enterprise's products or the maintenance of and sale of parts for that enterprise's machinery.⁷⁴

The standing of foreign representative offices used to be rather complicated and was only clarified by the adoption of the Provisional Regulations in May 1985.⁷⁵ Before adoption of the regulations, these offices were not normally subject to FEIT because they were prohibited from engaging in "direct business operations"⁷⁶ and were therefore tax exempt. This exemption may have been made on the presumption that their activities were not revenue-producing although many of them did in fact perform various kinds of business activities.

Under the Provisional Regulations, representative offices are treated differently depending on the nature of their activities. Those engaged in such activities as conducting market surveys or providing business information, business liaisons, consultation, and other services on behalf of their home offices are not regarded as establishments and are exempt from income tax provided that they receive no payments as such for that work.⁷⁷ To the extent that the office provides a wider range of services or receives commissions, rebates, or fees, it will constitute an establishment under the FEIT Law.⁷⁸ Such fees include payments by scheduled installments or payments in accordance with the volume of the commissioned services.⁷⁹

VI.

CONCLUSION

Chinese tax law is remarkably concise and relatively easy to understand. The simple wording of the law creates some ambiguities, however, and may present some problems to western taxpayers and their legal counsel, especially in cases where the official interpretation is not published.

In general, the treaties which the People's Republic of China has signed have moved that country closer to a truly international tax practice by adopting a definition of permanent establishment derived from the OECD and UN

74. See FEIT Law, *supra* note 56. This information on the practices of Chinese tax officials is derived from the author's own experience.

75. Provisional Regulations for Collection of Consolidated Industrial and Commercial Tax and Enterprise Income Tax from Resident Representative Offices of Foreign Enterprises (issued May 15, 1985, by the Ministry of Finance) [hereinafter Provisional Regulations] (document on file in the offices of the *International Tax & Business Lawyer*).

76. Procedures of the State Administration for Industry and Commerce of the People's Republic of China for the Registration and Administration of Resident Representative Offices of Foreign Enterprises, art. 3 (promulgated March 5, 1983 by the State Council)(document on file in the offices of the *International Tax & Business Lawyer*).

77. Provisional Regulations, *supra* note 75, § 1.

78. *Id.* § 2.

79. *Id.*

model conventions. These treaties have clarified the jurisdictional boundaries of domestic tax laws, as they modify the domestic tax rules to the extent that they apply to residents of treaty states. An important part of this clarification is the comprehensible and consistent definition which now attaches to permanent establishment.