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A new double taxation convention between Spain and China takes effect

Legal Flash Financial and Tax Law

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On March 30, 2021, the Official Gazette of the Spanish State published the text of the new convention, which brings in a number of substantial changes compared to the previous agreement

- The new double taxation convention between Spain and China is intended to align the bilateral taxation framework with the current economic context and the guidelines on international taxation being set by the OECD.
- The two countries signed the new convention over two years ago after more than three years of negotiations, and it was published in the Official Gazette of the Spanish State on March 30, 2021.
- The new convention entered into force on May 2, 2021, except for taxes not withheld at source, the effects of which will arise for fiscal years beginning from May 2, 2021.
- The impact of the changes requires extensive analysis.

Signature and entry into force of the convention

The new convention is the outcome of negotiations which began in Beijing in 2015 with the aim of aligning the bilateral taxation framework with the current economic context and the guidelines on international taxation being set by the OECD. Its entry into force repeals the previous convention signed in 1990.

The convention entered into force on May 2, 2021. As an exception, with regard to taxes not withheld at source (such as corporate income tax), the effects will arise for fiscal years beginning from May 2, 2021. In any event, at the date of issuance of this document, China had not officially published the notification of the entry into force of the new convention, as required for the Chinese tax authorities to recognize its application there.

The significance of the new convention is not confined to the changes made to the text of the articles, but it is also a shift in the model followed: while the previous convention was based on the UN Model Convention, the new version draws on the OECD Model Convention, and is in many aspects aligned with the Spanish position under the Multilateral Instrument (MLI) currently under consideration by the Spanish Parliament.

Main modifications made by the new convention

- Subjective scope of application / persons covered (article 1)

  In line with the Spanish position under the MLI and the 2017 OECD Model Convention, income obtained by an entity or instrument that is fiscally transparent, whatever the jurisdiction of incorporation or establishment, is understood to be obtained by a person resident in a contracting State to the extent that such income is treated in that State as the income of a resident for taxation purposes.

  However, this requires a careful analysis of the practical application of this clause in light of the internal regulations of each State, in particular for investments in Spain that are structured from China by means of partnerships established in a third State (conversely, Spanish investment in China via partnerships is very uncommon).

- Target scope of application / taxes included (article 2)

  Unlike the previous convention, the new text confines its scope of application to income taxes and does not cover the taxation of assets, which means that Spain can tax assets located in Spanish territory owned by residents in China. China could do the same to assets owned by persons resident in Spain, although at present there is no equivalent to the Spanish wealth tax.

- Permanent establishments (article 5)

  - Construction, installation or assembly works, and the associated inspection activities will constitute permanent establishments (PE) if they last more than 12 months (it was just six months under the previous convention). We should mention the Chinese order interpreting the convention between China and Singapore (*Guo Shui Fa [2010] No. 75*), whose contents have been extended to other conventions with identical or similar articles. Among other matters, this circular interprets various aspects regarding the concept of a construction works PE, such as the calculation of the duration of the works. It remains to be seen whether the Chinese authorities will continue applying the guidelines of this circular to the new convention with Spain, despite the modification made and the guidelines of the 2017 OECD Model Convention itself, which are not necessarily aligned with the *Guo Shui Fa [2010] No. 75*.

- The new convention maintains the possibility for service provisions that involve the posting of internal or external personnel in connection with one single project or related projects to constitute a PE if the postings exceed a certain duration. The new development here is that the period is set at 183 days (during any 12 months), rather than the six months established in the previous convention. This change reflects the interpretation of this point that the Chinese tax authorities had been applying to the previous convention in a number of circulars.
- In line with the Spanish position under the MLI, the concept of PE as a dependent agent includes those cases where the agent performs a key role to allow another to fulfill contracts with no substantial modification, as well as cases of indirect representation (the commission agent acts in its own name but on behalf of the principal).

› International transportation (article 8)

Profits obtained through international transportation activities (by sea and air, and now also by road and rail under the new convention) are taxable only in the State of residence of the company earning them. We should recall here the Chinese government's One Belt-One Road (or New Silk Road) initiative, and the fact that Spain is the destination for one of the railway networks of this economic corridor between China and Europe launched in 2013.

› Associate companies (article 9)

The convention includes a second subsection to record the correlated bilateral adjustment that applies where one of the States adjusts the profits of a company from a State to include profits that have already been taxed at another company in the other State.

› Dividends (article 10)

The distribution of dividends to a resident (a legal entity other than a partnership) in one contracting State that has a direct stake of at least 25% in the share capital of an entity in the other contracting State during the 365 days prior to the distribution has fallen from 10% (previous convention) to 5% (new convention).

We cite the Chinese regulatory provision that allows deferral of payment of withholdings at source in cases of reinvestment in Chinese territory, if certain requirements are fulfilled.

- Interest (article 11)

  The text includes the exemption of interest paid in connection with sales of commercial or scientific equipment on credit.

- Royalties (article 12)

  The use and the assignment of the use of industrial, commercial and scientific equipment is excluded from the definition of royalties. The new convention thus follows the OECD Model, which establishes for such income a system of exclusive taxation by the State of residence of the recipient of the returns.

- Capital gains (article 13)

  - In the transfer of the stake in any entity where more than 50% of the value comes directly or indirectly from real estate assets located in a contracting State, this State is entitled to tax the gains obtained. The previous convention established a different formula, with reference to a situation where the company assets mainly comprise real estate (located in the other contracting State, directly or indirectly). This aligns the text with the 2017 OECD Model Convention.

  - The new Double Taxation Convention (DTC) also excludes from the calculation of 50% the value of real estate used for economic activities, this being the first time that China has recognized such a provision in its conventions.

  - Lastly, the convention maintains the taxation at source of capital gains from the transfer of a substantial stake (at least 25%, held directly or indirectly) in the share capital of an entity resident in the other contracting State, but includes the reference to the timeframe of 365 days prior to the transfer. This rule does not apply if the transfer involves shares in companies largely and regularly listed on a recognized market, provided that the sale does not account for more than 3% of the value of the listed shares.

- Obligation to correct double taxation (article 23)

  The new text eliminates the progressive exemption as a means of eliminating double taxation with regard to certain yields obtained by tax residents in Spain, the applicable method being limited imputation. This is a change with a substantial impact for tax residents in Spain performing occasional postings to China for which they would be subject to personal taxation there.

- Anti-abuse rules (articles 24 and 25)

  In line with Spain's position in the MLI, a general anti-abuse rule was applied that denies the benefits of the DTC when it is reasonable to conclude that the convention or transaction that generates the right to the benefit is primarily intended to obtain that benefit, except when it is determined that the specific case is aligned with the scope and purpose of the convention's clauses.

It also expressly recognizes the authority of the States to apply domestic legislation in this respect, provided that this does not give rise to taxation in breach of the convention. We should, for example, highlight the Chinese regulatory provision that allows taxation at source of certain indirect transfers of holdings in Chinese companies by foreign entities, where certain circumstances exist that would allow the operation to be deemed abusive.

- Exchange of information (article 28)

  Exchange of information obligations are reinforced. The arrangements that both States establish in their domestic legislation to fulfill this convention obligation are of particular importance.

- Protocol

  - The Protocol establishes with regard to articles 10 (dividends), 11 (interest) and 12 (royalties) that the limitation on withholding rates (on the understanding that the recipient qualifies as the effective beneficiary of such income) will apply directly, and not by means of the procedure of collection and subsequent reimbursement in those cases where these rates are lower than those established in the internal legislation of each contracting State (i.e., in the case of China 10%, in general). Note in this regard that China replaced the internal procedure of prior authorization for the application of the benefits of conventions to avoid double taxation by a system of mere notification, which has been considerably simplified through the changes introduced on January 1, 2020.
  - The Protocol also sets out a list of entities recognized for these purposes as state-owned entities entitled to exemption at source for dividends and interest under articles 10 and 11.

Finally, we should bear in mind that, over the years, the Chinese government has issued numerous orders and circulars for the interpretation of the double taxation conventions it has signed. The changes introduced by the new convention could make some of these interpretations obsolete, requiring consideration of any new guides that may be published in China.

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