TREASURY DEPARTMENT TECHNICAL EXPLANATION OF THE AGREEMENT BETWEEN THE GOVERNMENT OF THE UNITED STATES OF AMERICA 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

GENERAL EFFECTIVE DATE UNDER ARTICLE 27: 1 JANUARY 1987

The Agreement, an accompanying Protocol, and an exchange of letters were signed in Beijing on April 30, 1984. Hereafter, the term "Agreement" refers to the three documents. The term "Agreement" has the same meaning as "Treaty" or "Convention", and the Agreement is subject to the same ratification requirements and has the same force as a Convention or Treaty.

The Agreement is based on the model income tax conventions published by the Organization for Economic Cooperation and Development in 1977, the United Nations in 1980, and the U.S. Treasury Department in 1981.

This technical explanation is an official guide to the Agreement. It reflects policies behind particular provisions as well as understandings reached with respect to the interpretation and application of the Agreement.

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ARTICLE 1
Persons Covered

This article states the general rule that persons affected by the Agreement are residents of the United States or China or of both countries. The term "resident" is defined in Article 4. Certain articles may also apply to nonresidents; see, for example, Article 23, which concerns nondiscrimination, and Article 25, concerning exchanges of information. Article 1 is supplemented by Articles 1 and 2 of the Protocol.

Article 1 of the Protocol provides that the Agreement does not restrict any benefits provided by the laws of either Contracting State or by any other agreement between the Contracting States. This rule reflects the principle that a double taxation agreement should not increase the overall tax burden which would result in the absence of the Agreement. For example, if the Agreement permits a Contracting State to tax an item of income which under the law of that State is exempt from tax, the statutory exemption applies. A U.S. taxpayer, however, may not make inconsistent choices between the rules of the Internal Revenue Code ("the Code") and the rules of the Agreement.

Article 2 of the Protocol is a simplified version of the traditional "saving clause" which preserves the right of the United States to tax its citizens and residents under its domestic law. The rule is drafted unilaterally, as China does not tax on the basis of citizenship and does not consider such a provision necessary to preserve its taxation of, and implement the Agreement with respect to, Chinese residents. The reference to "citizens" of the United States is understood by the parties to include former citizens whose loss of citizenship had as one of its principal purposes the avoidance of U.S. tax. Such former citizens are taxable in accordance with section 877 of the Code. Certain benefits of the Agreement are available to U.S. residents, as defined in Article 4 of the Agreement. Those benefits are the right to a correlative adjustment of tax liability as provided in paragraph 2 of Article 8, the exemption from U.S. tax of Chinese social security benefits provided in paragraph 2 of Article 17, the provisions concerning government employees, teachers and students of Articles 18, 19 and 20, and the benefits of Articles 22, 23, 24 and 26 concerning, respectively, relief from double taxation, nondiscrimination, the mutual agreement procedure, and diplomats. Further, it is understood that the benefits of the provisions concerning relief from double taxation, nondiscrimination, and the mutual agreement procedure will also be available to nonresident U.S. citizens to the extent applicable under the specific terms of those articles.

ARTICLE 2
Taxes Covered

Paragraph 1 of this article enumerates the existing taxes to which the Agreement applies in each Contracting State. In the United States, these are the Federal income taxes imposed by the Code. As explained in Article 3 of the Protocol, U.S. social security taxes are not covered by the Agreement. The personal holding company tax and the accumulated earnings tax are also not covered by the Agreement, except that they will not apply to a Chinese company which is wholly owned, directly or indirectly, by individual residents of China who are not U.S. citizens or by the Government of China or a wholly owned agency thereof.

The Chinese taxes covered by the Agreement are the individual income tax, the income tax concerning joint ventures with Chinese and foreign investment, the income tax concerning foreign enterprises, and the local income tax.

Paragraph 2 provides that the Agreement shall also apply to taxes imposed after the date of signature of the Agreement, provided that they are substantially similar to those enumerated in paragraph 1. The competent authorities agree to notify each other of substantial changes in their respective income tax laws.

ARTICLE 3
Definitions

Article 3 defines some of the principal terms used throughout the Agreement. Unless the context otherwise requires, the terms defined in this article have a uniform meaning throughout the Agreement. A number of important terms are defined in other articles. For example, the term "resident of a Contracting State" is defined in Article 4, and the term "permanent establishment" is defined in Article 5. The terms "dividends," "interest," and "royalties" are defined in Articles 9, 10, and 11, respectively.

The geographical territory of the two Contracting States is defined to include their continental shelf areas to the extent consistent with international law and their respective domestic laws. Thus, for example, activities taking place on the seabed or subsoil beyond the territorial sea of the United States will be considered to take place within the United States for purposes of the Agreement, provided that the United States has jurisdiction over such areas in accordance with international law and U.S. domestic law. The United States will interpret this definition in accordance with section 638 of the Internal Revenue Code and the regulations thereunder. The "United States" does not include Puerto Rico, the Virgin Islands, Guam, or any U.S. territory or possession. The "People's Republic of China" does not include Hong Kong, as Chinese tax laws are not in effect there. Moreover, in accordance with the Agreement between the United Kingdom and China on the future of Hong Kong, the taxes imposed by the Hong Kong Special Administrative Region will continue to be independent of the tax laws of the Central People's Government, and therefore the Agreement will not apply to Hong Kong even after 1997.

The term "person" includes an individual, a company, a partnership, and any other body of persons. It also includes, as provided in Article 4 of the Protocol, an estate or a trust. The term "person" is important because the Agreement applies to "persons" who are residents of one or both Contracting States and residence in a State is defined in terms of "persons" meeting certain criteria. A “company” is any entity treated as a corporation for tax purposes.

The term "nationals" means individuals having the nationality of a Contracting State and legal entities deriving their status as such from the law in force in a State.

The competent authority in the case of China is the Ministry of Finance or its authorized representative and in the case of the United States is the Secretary of the Treasury or his authorized representative.

Paragraph 2 provides that, in the case of a term not defined in the Agreement, the domestic tax law of the State applying the Agreement shall control, unless the context requires a different interpretation or unless the competent authorities agree on a common meaning in accordance with paragraph 3 of Article 24 (concerning the mutual agreement procedure).

The Agreement does not include a definition of the term "international traffic" because that definition, as well as the substantive rules concerning the taxation of international shipping and air transport income, is contained in the Agreement Between the Government of the United States of America and the Government of the People's Republic of China with Respect to Mutual Exemption From Taxation of Transportation Income of Shipping and Air Transport Enterprises, which was signed on March 5, 1982 and entered into force on September 23, 1983.

ARTICLE 4
Residence

This article defines those persons who are residents of a Contracting State and thus entitled to the benefits of the Agreement. The definition begins with a person's liability to tax under domestic law. Paragraph 1 lists several criteria which may be used in domestic law to determine residence for tax purposes. Citizenship is not one of the criteria; thus a U.S. citizen resident in a third country is not treated as a U.S. resident for purposes of this Agreement. The reference to persons "liable to tax" is not meant to exclude organizations of either country which are tax-exempt under special provisions of its domestic law, such as charities. However, it would not include a person liable to tax only in respect of income from sources in the taxing country, such as a resident of a third country subject to tax in the United States or China only on a source basis. A U.S. partnership, estate or trust is a resident only to the extent that the income it derives is subject to tax either in the hands of the entity or of its partners or beneficiaries.

Paragraph 2 provides that, where an individual is considered to be a resident of both Contracting States under their respective domestic laws, the competent authorities shall consult together to determine of which State the individual shall be a resident for purposes of the Agreement. In making that determination, the competent authorities will be guided by the rules

of paragraph 2 of Article 4 of the United Nation's Model Double Taxation Convention between Developed and Developing Countries. (See Article 5 of the Protocol.) Those rules are the same as the rules contained in the corresponding paragraph of the OECD and U.S. Models. The first test is where the individual has his permanent home. If he has a permanent home in both countries the second test is where his personal and economic ties are closer (center of vital interests). If that test is inconclusive, or if the individual does not have a permanent home in either State, the next test is his place of habitual abode. The fourth test is nationality. If the individual is a national of both States or of neither of them, the competent authorities are instructed to settle the issue so as to assign a single State of residence. Once established under this article, the residence of the individual remains the same for all purposes of the Agreement.

For U.S. tax purposes, a company is a resident of the United States if it is created or organized under the laws of a state or the District of Columbia. For Chinese tax purposes, a company is a resident of China if its place of management (head office) is in China. Under paragraph 3, where a company is a resident of both Contracting States under their respective domestic laws, the competent authorities will attempt to determine a single State of residence through consultations. However, it would not be the policy of the U.S. competent authority to agree to treat an entity incorporated in the United States as not a U.S. resident. If the competent authorities are unable to reach Agreement, the company will not be considered a resident of either State for purposes of enjoying benefits under the Agreement. Thus, for example, dividends paid to a resident of China by a dual resident company would be eligible for the reduced U.S. withholding rate of 10 percent. However, if a dual resident corporation paid a dividend to a U.S. resident, the statutory U.S. tax would apply with respect to that dividend. Dividends, interest or royalties arising in either Contracting State and paid to a dual resident corporation are not entitled to the reduced rates provided for in the Agreement.

Paragraph 4 deals with a case where a company is a resident of the United States for purposes of the Agreement, but is also a resident of a third country under another tax treaty between China and the third country (*e.g.*, a corporation created under U.S. law but having its head office in Japan). Instead, the Agreement between China and the third country will prevail, and the company will be considered a resident of the third country and not of the United States for purposes of this Agreement. Thus, the company will receive the benefits of the other Agreement between China and the third country.

ARTICLE 5
Permanent Establishment

The rules for taxation by a Contracting State of business income derived by a resident of the other State utilize the concept of a "permanent establishment." This article illustrates that concept.

Paragraph 1 defines a permanent establishment in general terms as a fixed place of business through which the business of an enterprise is wholly or partly carried on.

Paragraph 2 contains an illustrative list of permanent establishments. These illustrations

are the same as those in the U.S. Model. They are a place of management, a branch, an office, a factory, a workshop, and a place of extraction of natural resources, such as a mine, well, or quarry.

Subparagraph 3(a) provides that a construction site, assembly or installation project, or supervisory activities in connection with such a site or project, constitutes a permanent establishment if the site, project, or activities continue for more than six months. In such a case, a permanent establishment exists from the first day when work physically begins within the territory of the other Contracting State, including preparatory work. Each site or project and each enterprise is considered separately. A series of contracts or projects which are interdependent both commercially and geographically are to be treated as a single project for the purpose of applying the six month test. For example, a "turn-key" project in which a facility is constructed and equipment installed in it would be a single project. However, it is possible that a project which constitutes a permanent establishment for the general contractor may not be a permanent establishment for a subcontractor if the latter performs services there for less than six months. For example, a subcontractor could install equipment at one site for four months and provide supervisory services at a separate site for an unrelated contractor for three months without itself having a permanent establishment.

Subparagraph 3(b) provides that an installation, drilling rig or ship used to explore for or exploit natural resources constitutes a permanent establishment if it continues for more than three months. A series of projects or contracts will be interpreted in the same manner as in the case of construction sites.

Subparagraph 3(c) provides that the furnishing of services by an enterprise through employees or other personnel will constitute a permanent establishment of the enterprise in that other State when the activities in the other Contracting State continue for more than six months within a twelve month period.

Paragraph 4 identifies activities which may be carried on in a Contracting State which will not constitute a permanent establishment even if conducted through a fixed place of business. The activities enumerated are the same as in the U.S. Model. The use of facilities solely to store, display, or deliver goods belonging to an enterprise does not constitute a permanent establishment. Nor does the maintenance of a stock of goods belonging to the enterprise solely for the purpose of storage, display, delivery, or processing by another enterprise. An enterprise may maintain a fixed place of business solely to purchase goods or collect information or to carry on any other preparatory or auxiliary activity for the enterprise without being considered to have a permanent establishment. Any combination of the enumerated activities also does not constitute a permanent establishment, subject to the condition that the combined activity is of a preparatory or auxiliary character for the enterprise.

Paragraphs 5 and 6 concern the use of agents. Under paragraph 5, which is the same as in the U.S. Model, a dependent agent who acts on behalf of an enterprise and habitually exercises an authority to conclude contracts in the name of that enterprise is deemed to be a permanent establishment of that enterprise (whether or not there is a fixed place of business) unless the activities of the agent are limited to activities which would not constitute a permanent

establishment under paragraph 4 if carried on directly by the enterprise. Paragraph 6 provides that an enterprise will not be considered to have a permanent establishment in the other State merely because it uses in that other State the services of an independent agent acting in the ordinary course of his business. However, an agent will not be considered independent if he acts wholly or almost wholly on behalf of that enterprise and it is shown that the transactions between the agent and the enterprise were not at arm's length.

Paragraph 7 states that control of one company by another does not, in and of itself, constitute either company a permanent establishment of the other. The determination whether a subsidiary is a permanent establishment of its parent corporation or conversely, or whether two or more subsidiaries of the same corporation are permanent establishments of the parent or of each other is made by reference to the tests set out in paragraphs 1 through 6.

ARTICLE 6
Income from Real Property

Paragraph 1 provides that income derived by a resident of a Contracting State from real property situated in the other Contracting State may be taxed in the State where the property is situated. The United States may also tax such income of its citizens and residents in accordance with paragraph 3 of Article 1 (General Scope) of the Protocol.

Paragraph 2 provides that "real property" is defined in accordance with the law of the Contracting State where the property is situated. It, in any case, includes property accessory to real property, such as livestock and equipment used in agriculture and forestry, and payments for the use of natural resource deposits. It does not include ships and aircraft.

Paragraph 3 elaborates that income from immovable property includes income from the direct use, letting, or use in any other form of such property.

Paragraph 4 further elaborates that real property of an enterprise and real property used for performing independent personal services are also covered by this article.

ARTICLE 7
Business Profits

This article provides rules governing the taxation by a Contracting State of income from business activity carried on in that State by a resident of the other Contracting State.

Paragraph 1 provides that business profits of an enterprise of one Contracting State shall be taxable only in that State except to the extent that such profits are attributable to a permanent establishment through which the enterprise carries on business activities in the other Contracting State.

Paragraph 2 provides that the profits to be attributed to a permanent establishment are those which it might be expected to make if it were an independent enterprise engaged in similar activities under similar conditions and dealing at arm's length with the enterprise of which it is a permanent establishment and all other related persons.

Paragraph 3 provides that deductions shall be allowed for expenses incurred for the purposes of the permanent establishment, including a reasonable allocation of executive and administrative expenses, without regard to where such expenses are incurred. However, the profits of the permanent establishment are not to be reduced by deductions for interest or royalties paid to the head office other than as reimbursements of costs incurred.

Paragraph 4 provides that, where the tax law of a Contracting State uses a deemed profit basis to determine the net income of a specific industry, the provisions of paragraph 2 do not preclude the use of that method provided that the results are consistent with the principles of this article. For example, for administrative reasons, China deems the profit of foreign shipping, airline, and oil drilling companies attributable to their Chinese operations to be a percentage of their gross receipts from China. Currently, the taxable income in such cases is deemed to be 10 percent of the gross income and that amount is subject to tax at the ordinary rates unless exempt under another provision of the Agreement. Such an approach is acceptable as long as its results are consistent with arm's length principles.

Paragraph 5 states that the mere purchase by a permanent establishment of goods or merchandise for the enterprise shall not result in profits being attributed to the permanent establishment.

Paragraph 6 provides that, unless there is good and sufficient reason to the contrary, the same method of determining profits attributable to the permanent establishment shall be used each year. In the United States, such a change may be a change in accounting method requiring the approval of the Internal Revenue Service.

Paragraph 7 provides, that, where business profits include items of income dealt within other articles of the Agreement, the provisions of those other articles govern. For example, the taxation of dividends, interest, and royalties is controlled by Articles 9, 10, and 11, respectively; however, the terms of those articles provide that where dividends, interest, or royalties derived by a resident of a Contracting State are effectively connected with (attributable to) a permanent establishment in the other State, the provisions of this article apply and the item of income is taxed as business profits.

ARTICLE 8
Related Enterprises

This article provides that, where related persons engage in transactions which are not at arm's length, the Contracting States may make appropriate adjustments to their taxable income and tax liability.

Paragraph 1 states the general rule that, where an enterprise of one Contracting State and an enterprise of the other State are related through management, control, or capital and their commercial or financial relations differ from those which would prevail between independent enterprises, the profits of the enterprises may be adjusted to reflect the profits which would have accrued if the two enterprises were independent.

Paragraph 2 provides that, where one of the Contracting States increases the profits of an enterprise of that State to the amount that would have accrued to the enterprise had it been independent of an enterprise of the other Contracting State, the second State shall, to the extent it agrees that the redetermination accurately reflects arm's length conditions, make a correlative adjustment, decreasing the amount of tax which it has already imposed on those profits. In determining such adjustments, due regard is to be paid to the other provisions of the convention. The competent authorities of the two States may consult each other in implementing this provision.

It is understood that each Contracting State may apply its internal law in determining liability for its tax. For example, although paragraphs 1 and 2 refer to allocations of "profits" and "taxes," it is understood that such terms also include the components of the tax base and of the tax liability, such as income, deductions, credits, and allowances. The United States will apply its rules and procedures under Code section 482.

ARTICLE 9
Dividends

This article limits the tax which a Contracting State may impose on dividends paid by a company which is a resident of that State to a resident of the other Contracting State.

Paragraph 1 confirms that such dividends may be taxed in the State of residence of the shareholder.

Paragraph 2 provides that the dividends may also be taxed in the Contracting State of which the paying company is a resident. However, the beneficial owner is a resident the other Contracting State, the tax may not exceed 10 percent of the gross dividend. Although the language used, which is taken from the OECD and U.N. Models, refers the recipient being the beneficial owner, it is understood (consistent with the OECD commentary) that the intended meaning is that the reduced rate will apply when the beneficial owner is a resident of the other Contracting State, even when the recipient of the dividend may be a nominee for such resident.

Paragraph 3 defines the term "dividends" for purposes of this article. The definition, which is the same as that in the U.S. Model, is relevant only for determining the appropriate taxation at source. It does not govern for purposes of the country of residence of the shareholder, which applies its own law to the extent that characterizing an item of income is relevant.

Paragraph 4 provides that, where a resident of a Contracting State derives dividends from

the other Contracting State and the holding is effectively connected with (the dividends are attributable to) a permanent establishment or fixed base through which the owner of the dividends carries on business in that other State, the dividends are taxable in accordance with the provisions of Article 7 or Article 13 rather than under this article. This paragraph does not automatically attribute dividends derived by a company having a permanent establishment in the source country to that permanent establishment (the "force of attraction" rule found in some early tax treaties).

Paragraph 5 provides that a Contracting State may not tax dividends paid by a company which is not a resident of that State except to the extent permitted under paragraph 2 or 4, of this article, *i.e.*, to the extent that the dividends are paid to a resident of that State (or, in the case of the United States, a U.S. citizen residing in a third State) or the dividends are attributable to a permanent establishment or fixed base in that State. Thus, the United States will not tax dividends which are considered to be from U.S. sources under Code section 861(a)(2)(B) if paid by a Chinese corporation. China does not impose a tax on distributions of a foreign corporation out of the profits of its Chinese permanent establishment or a supplementary tax on the profits of a Chinese branch of a foreign corporation.

In accordance with the "saving clause" of paragraph 2 of the Protocol, the United States may in any event tax dividends derived by U.S. citizens.

ARTICLE 10
Interest

This article limits the tax which a Contracting State may impose on interest arising in that State and paid to a resident of the other Contracting State.

Paragraph 1 confirms that such interest may be taxed in the State of residence of the recipient.

Paragraph 2 provides that such interest may also be taxed in the Contracting State in which it arises. However, if the beneficial owner is a resident of the other Contracting State, the tax may not exceed 10 percent of the gross interest. (See also the discussion of the corresponding provision in Article 9.)

Paragraph 3 provides, as an exception to paragraph 2, that interest arising in a Contracting State which is derived by the government of the other Contracting State, a political subdivision or local authority thereof, or the Central Bank or any financial institution wholly owned by the government of that other State or by any resident of that other State with respect to debt indirectly financed by any of the above (*e.g.*, loans indirectly financed by Eximbank) is exempt from tax in the State in which it arises.

Paragraph 4 defines "interest" for purposes of this article. It includes income from debt-claims of all kinds, including mortgage interest and original issue discount. The definition, which is relevant only for determining the appropriate taxation at source, permits the United States to

apply its rules regarding the distinction between interest and dividends pursuant to section 385 of the Code. It is understood that penalties for late payment are not interest.

Paragraph 5 provides that, where a resident of one Contracting State derives interest which arises in the other Contracting State and the debt claim is effectively connected with (*i.e.*, the interest is attributable to) a permanent establishment or fixed base through which the owner of the interest carries on business in that other State, that interest is taxable in accordance with the provisions of Article 7 or Article 13 rather than under this article. Thus, interest derived by a resident of China which arises in the United States and is attributable to a U.S. permanent establishment of that resident may be taxed by the United States in accordance with Article 7.

Paragraph 6 provides a source rule for interest payments. Generally, interest is deemed to arise in the state of residence of the payer. However, where the interest is attributable to debt incurred by or for a permanent establishment or fixed base in one of the Contracting States and is borne (deducted from taxable income) by that permanent establishment or fixed base, the interest is deemed to arise where the permanent establishment or fixed base is located.

Paragraph 7 states that this article does not apply to interest payments between related persons in excess of the amount which would have been agreed upon at arm's length. Such excess amount shall be taxable according to the laws of each Contracting State, with regard also to the other provisions of this Agreement. For example, if the excess amount is taxable as a dividend, the tax imposed will be subject to the provisions of Article 10 (Dividends).

In accordance with the "saving clause" of paragraph 2 of the Protocol, the United States may in any event tax interest derived by U.S. citizens.

ARTICLE 11
Royalties

This article limits the tax which a Contracting State may impose on royalties arising in that State and paid to a resident of the other Contracting State.

Paragraph 1 confirms that such royalties may be taxed in the State of residence of the recipient.

Paragraph 2 provides that such royalties may also be taxed in the Contracting State in which they arise. However, if the beneficial owner is a resident of the other Contracting State, the tax may not exceed 10 percent of the gross royalty. (See also the discussion of the corresponding provision in Article 9.) In recognition of the expenses associated with the leasing of industrial, commercial, and scientific equipment, paragraph 6 of the Protocol provides that in such cases the tax shall be imposed on 70 percent of the gross amount, *i.e.* the tax may not exceed 7 percent of the gross rental payment.

Paragraph 3 defines the term "royalties" for purposes of this article. The definition includes payments for the right to use a copyright, trademark, patent, design, models, secret

formula or process, know-how, or similar property or rights. Payments for film rentals and for the leasing of equipment are also included, and it is understood that the definition includes royalties contingent on the sale or use of the property or right.

Paragraph 4 provides that, where a resident of one Contracting State derives royalties which arise in the other Contracting State and the right or property is effectively connected with (*i.e.* the royalties are attributable to) a permanent establishment or fixed base through which the owner of the royalties carries on business in that other State, the royalties are taxable in accordance with the provisions of Article 7 or Article 13 rather than under this article.

Paragraph 5 provides a source of rule for royalty payments. In general, a royalty is considered to arise in a Contracting State if paid by the government or a resident of that State. However, if a permanent establishment or fixed base of the payor in one of the States incurs the liability to pay the royalties and bears the payment (deducts it in arriving at taxable income) the royalty is considered to arise in the State where the permanent establishment or fixed base is located. Moreover, if under these rules a royalty is not considered to arise in either State, but it relates to the use of, or the right to use, property in a State, the royalty is considered to arise in the State where the property is used (or where there is a right to use it). Thus, for example, if a resident of China were to license a patent to a third country company, which in turn sub-licensed it for use in the United States, the United States would tax the license payment by the third country company to the resident of China, subject to the limitation in paragraph 2. The sub-license payment by the U.S. user to the third country resident would not be covered by the Agreement and would be subject to U.S. tax under U.S. law or the provisions of a U.S. tax treaty with that third country, if applicable.

Paragraph 6 states that this article does not apply to royalties paid between related persons in excess of the amount which would have been agreed upon at arm's length. Such excess amount shall be taxable according to the law of each Contracting State, with regard also to the other provisions of this Agreement. For example, if the excess royalty is taxable as a dividend, it will be subject to the provisions of Article 9.

In accordance with the "saving clause" of paragraph 2 of the Protocol, the United States may in any event tax royalties derived by U.S. citizens.

ARTICLE 12
Gains

This article specifies the situations in which a Contracting State may tax gains derived by a resident of the other Contracting State. The term "gains" includes amounts treated as capital gains and as ordinary income.

Paragraph 1 provides that gains derived by a resident of a Contracting State from the alienation of real property situated in the other Contracting State may be taxed by the State where the property is located.

Paragraph 2 provides that gains derived by a resident of a Contracting State with respect to movable property forming part of a permanent establishment or a fixed base maintained by that resident in the other Contracting State and gains from the alienation of such a permanent establishment or fixed base may be taxed where the permanent establishment or fixed base is located.

Paragraph 3 reserves to the State of residence the exclusive right to tax gains of a resident of a Contracting State from the alienation of ships, aircraft, operated in international traffic, and related personal property, such as containers.

Paragraph 4 provides that gains derived from the alienation of shares of a company the assets of which directly or indirectly consist principally of real property situated in a Contracting State may be taxed in the State where the real property is situated.

Paragraph 5 provides that gains derived from the alienation of shares, other than those covered by paragraph 4, which represent a participating of 25 percent or more in a company which is a resident of a Contracting State may be taxed in that State. For example, China may tax the gain derived by a U.S. company from the alienation of its 25 percent or greater participation in a Chinese corporate joint venture.

Paragraph 6 provides that gains from the alienation of any property not referred to in paragraphs 1 through 5 may be taxed in the State in which they arise. Thus, gains on the disposition of a U.S. real property interest, to the extent not taxable under the preceding paragraphs, are taxable under this paragraph in accordance with the provisions of the Foreign Investment in Real Property Tax Act, as amended.

The gains covered in this article may also be taxed in the State of residence of the alienator, subject to the provisions of Article 22 concerning the avoidance of double taxation.
In accordance with paragraph 2 of the Protocol, the United States may also tax its citizens.

ARTICLE 13
Independent Personal Services

This article provides that income derived by an individual resident of a Contracting State from performing independent personal services may be taxed in the other Contracting State only if the individual is present in that other State for more than 183 days in the calendar year or has a fixed base regularly available to him in that other State. In such a case, that other State may tax the income attributable to the services performed there or to that fixed base, as the case may be.

The concept of a "fixed base" is analogous to that of a "permanent establishment" as defined in Article 5. Thus, a fixed base means a fixed place of business used with some continuity for performing independent services. It would not include a hotel room unless used as an office or work site on a continuing basis. The rules of Article 7 should also be applied in taxing the profits attributable to a fixed base, *e.g.*, taxation on a net basis using arm's-length

principles.

Independent personal services are in general, services performed by an individual for his own account where he receives the income and bears the losses arising from such services. They include services of professional persons, such as doctors and lawyers, but also other services performed by sole proprietors or partners.

In accordance with paragraph 2 of the Protocol, the United States may in any event tax its citizens.

ARTICLE 14
Dependent Personal Services

This article specifies when personal service income earned by an employee who is a resident of a Contracting State may be taxed by the other Contracting State.

Paragraph 1 provides the basic rule that such employment income may be taxed only in the employee's State of residence, unless the services are preformed in the other Contracting State.

Paragraph 2 provides that, even where the services are performed in the other Contracting State, the income derived may not be taxed by that other State if three conditions are met: (1) the recipient is present in that other State for not more than 183 days in the calendar year; (2) the remuneration is paid by or on behalf of an employer who is not a resident of that other State; and (3) the remuneration is not borne by (deducted from the taxable income of) a permanent establishment or a fixed base of that employer in that other State. If any one of the three conditions is not met, *e.g.*, if the remuneration is borne by a permanent establishment of the employer in the State where the services are performed, the income may be taxed by that State. In any such case, the right of the source State to tax is limited to the income attributable to services performed in that State.

In accordance with paragraph 2 of the Protocol, the United States may in any event tax its citizens.

ARTICLE 15
Directors' Fees

This article provides that a Contracting State may tax a resident of other Contracting State with respect to payments for his services as a director of a company which is a resident of the first-mentioned State. Payments for services as an officer or employee of such a company are covered under Article 13 or 14.

In accordance with paragraph 2 of the Protocol, the United States may in any event tax its citizens.

ARTICLE 16
Artistes and Athletes

This article specifies when a Contracting State may tax the remuneration of entertainers and athletes who are residents of the other Contracting State. It provides certain exceptions to the provisions of Articles 13 and 14. However, income from services rendered by producers, directors, technicians and others who are not artistes and athletes is taxable in accordance with Article 13 or 14, as the case may be.

Paragraph 1 provides that a Contracting State may tax income derived by a resident of the other Contracting State from the performance of services in the first State as an entertainer or athlete, unless the activities are exercised in accordance with a cultural exchange program agreed upon by the two Governments, in which case the host State agrees to exempt such income from tax. The exception for cultural exchange programs is expected to cover most, if not all, such exchanges at the present time.

Paragraph 2 provides that, where income for services performed by an entertainer or athlete accrues to another person, it may be taxed in the State where the activities are performed, without regard to the other provisions of the Agreement. Although this provision is drafted broadly, it is understood that it will be interpreted in accordance with the policy of the U.S. model and the commentary to the OECD model provision; *i.e.* the intent is to prevent abuse of the Convention by diverting income to a person, other than the individual performing the services (for example, by having the remuneration paid to a corporation which does not have a permanent establishment in the State where the services are performed). The paragraph is not intended to impose tax in cases where there is no tax avoidance motive, for example, when a payment is made to an orchestra on behalf of its members who performed in a concert.

In accordance with paragraph 2 of the Protocol, the United States may in any event tax its citizens.

ARTICLE 17
Pensions and Annuities

This article deals with the taxation of private pensions and social security benefits. Pensions in consideration of government employment are covered under Article 18. Paragraph 1 provides that pensions in respect of private employment derived by a resident of a Contracting State may be taxed only in that State. On the other hand, public payments, such as social security benefits or public welfare payments, paid by a Contracting State may be taxed only in the paying State. This provision is excepted from the “saving” clause of paragraph 2 of the Protocol, so the United States will not tax its residents on social security benefits paid to them by the People's Republic of China.

ARTICLE 18
Government Employees and Pensions

This article deals with the taxation of remuneration and pensions paid by the government of a Contracting State with respect to the performance of governmental functions for that State. It is based on the corresponding article in the OECD and UN model draft conventions.

Paragraph 1 provides that remuneration paid by the government of a Contracting State or a political subdivision or local authority thereof to an individual for services rendered may be taxed only in that State unless the services are performed in the other State and the individual is either a national of that other State or became a resident of that other State other than solely for the purpose of rendering such services. In the latter case, the remuneration may be taxed only in that other State. For example, the United States may tax the remuneration of an employee of the Embassy of the People's Republic of China if the individual is a U.S. citizen or was a U.S. resident prior to being hired by the Embassy, but it may not tax an employee who was a nonresident alien of the United States when assigned to work at the Embassy.

Paragraph 2 provides that a pension paid by or out of funds created by the government of a Contracting State or a political subdivision or local authority thereof to an individual for services rendered may be taxed only in that State unless the individual is both a resident and a national of the other Contracting State. Thus, the United States may tax such a pension paid by the People's Republic of China to a U.S. resident citizen but not to a resident alien. In the latter case, the exemption from U.S. tax is preserved by paragraph 3 of the Protocol.

The exemptions provided in this article are limited to remuneration and pensions with respect to services of a governmental nature. Paragraph 3 explains that services and pensions in government owned business are covered by Article 14, 15, 16, or 17 as the case may be. Whether functions are of a governmental nature is determined by reference to the concept of a governmental function in the State in which the income arises. For example, in the United States, employment by a government-owned airline does not constitute employment of a governmental nature.

ARTICLE 19
Teachers, Professors and Researchers

This article provides that a resident of a Contracting State who goes to the other Contracting State for the primary purpose of teaching, lecturing, or conducting research at an accredited educational institution or scientific research institution in that other State will be exempt from tax in that other State on the remuneration for such activities for a period of up to three years in the aggregate. Thus, for example, a resident of China who visits the United States to conduct research at the National Institute of Health (NIH) for two years, 1986 and 1987, returns to China for a year, and then comes back for another year of research at NIH in 1989 would be exempt from tax on his NIH remuneration for each of the three years. However, if he stayed at NIH in 1990 or returned at a later time the exemption would no longer be available. The exemption provided in this article is not available if the research is not undertaken in the

public interest, but for the private gain of a specific person or persons.

This article is excepted from the "saving clause" of paragraph 2 of the Protocol, so its benefits are available to persons who otherwise qualify even if they become U.S. residents.

ARTICLE 20
Students and Trainees

This article provides that a resident of a Contracting State who goes to the other Contracting State for the purpose of education, training or obtaining technical experience shall be exempt from tax in that other State on payments received from abroad for the purpose of his maintenance, education, or training, grants from a tax-exempt organization, and up to $5,000 per year of income for personal services performed in that other State. These exemptions may be claimed only for the period reasonably necessary to complete the education or training. In some cases, the course of study or training may last less than year. For most undergraduate college or university degrees the appropriate period will be four years. For some advanced degrees, such as in medicine, the required period may be longer, *e.g.*, seven years.

This article is excepted from the "saving clause" of paragraph 2 of the Protocol, so its benefits are available to persons who otherwise qualify even if they become U.S. residents.

ARTICLE 21
Other Income

Paragraph 1 provides that any income of a resident of a Contracting State which is not covered by other articles of the Agreement may be taxed only in that State. Prizes or winnings would be taxable under this article. (However, see also paragraph 3, which permits taxation at source.)

Paragraph 2 provides an exception for income (other than income from real property) which is attributable to a permanent establishment or fixed base which the resident maintains in the other Contracting State. Such income, which includes dividends, interest and royalties derived by a resident of a Contracting State from third States which are attributable to a permanent establishment or fixed base of that resident in the other Contracting State, is taxable under the provisions of the Article 7 and 13. The exception for income from real property means that income of a resident of a Contracting State from real property which is situated in a third State may not be taxed by the other Contracting State even if attributable to a permanent establishment of the resident in that other State.

Paragraph 3 overrides paragraphs 1 and 2 to permit a Contracting State to tax income derived by a resident of the other Contracting State and not dealt with in the preceding articles, if it arises in that first-mentioned State.

ARTICLE 22
Elimination of Double Taxation

This article describes the manner in which each country will undertake to avoid double taxation of its residents, and in the case of the United States, its citizens.

Paragraph 1 provides that China shall allow a foreign tax credit for income taxes paid to the United States up to the amount of Chinese tax on that income. A credit is also granted for U.S. income tax paid with respect to the profits of a U.S. company out of which dividends are paid to a Chinese company which owns at least 10 percent of the shares of the company paying the dividend.

Paragraph 2 provides that the United States, in accordance with its law, shall allow a foreign tax credit for income taxes paid to China by or on behalf of a U.S. resident or citizen and for Chinese income tax paid with respect to the profits of a Chinese company out of which dividends are paid to a U.S. company owning at least 10 percent of the voting rights of the company paying the dividends. For this purpose, the Chinese taxes referred to in Article 2 (paragraph 1(a) and 2) are considered income taxes. The guarantee of a foreign tax credit provided in this paragraph is independent of the statutory grant of a credit under sections 901-903 of the Code, but the amount of the credit to be allowed is determined in accordance with the limitations provided in the Code, (*e.g.*, section 904(g)).

For purposes of applying the foreign tax credit for Chinese taxes provided in this Article, paragraph 3 provides that income derived by a resident of a Contracting State will be deemed to arise in the other Contracting State if such income may be taxed in the other State in accordance with this Agreement. Thus, for example, dividends, interest and royalties which may be taxed by China in accordance with Articles 10, 11 or 12 will be considered Chinese source income.

This article is not affected by the "saving clause". Thus, the benefits may be claimed by a U.S. resident or citizen. Alternatively, a U.S. resident or citizen may rely on the rules of the Code. However, the taxpayer may not make inconsistent choices between the rules of the Code and Agreement.

ARTICLE 23
Nondiscrimination

This article prohibits discriminatory application of the taxes covered by the Agreement.

Paragraph 1 prohibits discrimination based solely on nationality. It provides that nationals of a Contracting State, wherever resident, shall not be taxed less favorably or subject to more burdensome requirements connected with taxation in the other Contracting State, the nationals of that other State who are in the same circumstances. U.S. citizens who are not residents of the United States are not in the same circumstances as citizens of China who are not residents of the United States, because nonresident U.S. citizens generally are subject to U.S. tax on their world-

wide income whereas nonresident aliens of the United States generally are subject to U.S. tax only on their U.S. income.

Paragraph 2 provides that a Contracting State may not impose more burdensome taxes or related requirements on a permanent establishment of an enterprise of the other Contracting State than it imposes on its own enterprises carrying on the same activities. However, when the permanent establishment is maintained by an individual resident of the other State, the State in which the permanent establishment is maintained is not obligated to grant to that individual the same personal allowances it grants to its own residents to reflect differing family responsibilities.

Paragraph 3 prohibits discrimination in the matter of deductions. interest, royalties, and other disbursements by a resident of a Contracting State to a resident of the other Contracting State must be deductible for determining taxable profits in that other State under the same conditions as if they had been paid to a resident of the first-mentioned State. The term “other disbursements" is understood to include a reasonable allocation of executive and administrative expenses incurred for the benefit of a group of related enterprises.

Paragraph 4 requires that a Contracting State not impose more burdensome taxation on a subsidiary corporation owned by residents of the other State than it imposes on similar corporations which are locally owned.

ARTICLE 24
Mutual Agreement

This Article provides for cooperation between the competent authorities to resolve problems of double taxation.

Paragraph 1 provides that a tax payer who considers that the actions of one or both of the Contracting States may result in taxation not in accordance with the Agreement may present his case to the competent authority of the Contracting State of which he is a resident or, in the case of claims concerning discrimination on the basis of nationality, to the competent authority of the Contracting State of which he is a national. In either case, the claim must be made within three years from the first notification of the action resulting in taxation not in accordance with the Agreement.

Paragraph 2 provides that the competent authority to which the case is presented, if it considers the objection to be justified and if it is not itself able to arrive at a solution, shall endeavor to resolve the case through consultation with the competent authority of the other Contracting State. Any agreement reached shall be implemented without regard to any statutory time limits of the Contracting States. Thus, if a Contracting State agrees that its tax was overstated, a refund of the excess tax paid will be made, even though the statute of limitations under domestic law may have expired. The waiver of the statute of limitations applies only for refunds and not for the imposition of additional taxes.

Paragraph 3 provides that the competent authorities shall endeavor to resolve by mutual

agreement any difficulties or doubts which may arise in the interpretation or application of the Agreement. For example, the competent authorities may agree on the same allocation of income, deductions, credits, or allowances, on the same characterization of items of income, and on a common meaning of terms used in the Agreement. The competent authorities also may consult together to eliminate double taxation in cases not provided for in the Agreement. The authority to consider cases not covered in the Agreement is not a broad grant of authority to expand the scope of the Agreement, but is intended to permit the competent authorities to apply the principles of the Agreement to settle specific cases of double taxation which are not expressly addressed.

Paragraph 4 provides that the competent authorities may communicate with each other directly for the purpose of reaching agreements in accordance with this article.

ARTICLE 25
Exchange of Information

This article provides for exchanges of information between the tax authorities of the two Contracting States to avoid double taxation and prevent fiscal evasion.

Paragraph 1 provides that the competent authorities shall exchange such information as is necessary for carrying out the provisions of the Agreement or of their domestic laws concerning taxes covered by the Agreement, in particular with the objective of preventing tax evasion. Such information may be provided whether or not the requested Contracting State has a tax interest in the case in question. It also provides assurances that information so exchanged will be protected in the same manner as information obtained under domestic laws with respect to secrecy and disclosure. Persons involved in the administration of taxes covered by the Agreement include legislative bodies involved in the administration of taxes and their agents such as, for example, the U.S. General Accounting Office. Information may be disclosed to such persons, subject to the limitations of this article and the domestic law of the respective Contracting State.

Paragraph 2 explains that the obligation undertaken in paragraph 1 to exchange information does not require a Contracting State to carry out measures contrary to the laws and administrative practice of either Contracting State, to supply information not obtainable under its laws or in the normal course of its administration, or to supply information which would disclose trade secrets or other information the disclosure of which would be contrary to public policy.

ARTICLE 26
Diplomats and Consular Officers

This article clarifies that the Agreement does not affect taxation privileges of diplomatic or consular officials under other special agreements or under international law.

ARTICLE 27
Entry into Force

The Agreement is subject to approval in each Contracting State according to its legal requirements. Each State will notify the other, in writing, through diplomatic channels when those requirements have been completed.

The Agreement enters into force on the thirtieth day after the date of the later of such notification. Once it enters into force, its provisions will take effect for income derived during taxable periods of the recipient beginning on or after January 1 of the year following the entry into force.

ARTICLE 28
Termination

The Agreement remains in force indefinitely unless terminated by one of the Contracting States. Either Contracting State may terminate the Agreement after five years from the date on which it enters into force by giving at least six months prior notice through diplomatic channels prior to June 30. In that event, the Agreement will cease to have effect with respect to income derived during taxable years of the recipient beginning on or after January 1 following the termination date.

PROTOCOL

A protocol accompanies and forms part of the Agreement.

The provisions of paragraphs 1 through 6 of the Protocol are discussed above in connection with Articles 1, 2, 3, 4 and 11 of the Agreement.

Paragraph 7 of the Protocol contains a protection against "treaty shopping." It provides that the competent authorities may through consultation deny the benefits of Articles 9, 10, and 11, concerning dividends, interest and royalties, to a company of a third country if that company becomes a resident of one of the Contracting States for the principal purpose of enjoying benefits under the Agreement. This consultation obligation is intended to benefit both governments. The denial of benefits requires consultation, but is not dependent on the prior agreement of the competent authorities.

This provision is stated in more general and limited terms than the corresponding provision in other recent U.S. tax treaties, not because of a lesser interest in the principle of limiting treaty benefits to residents of the other Contracting State, but because it is not anticipated that this Agreement will be used for treaty shopping purposes. In particular, Chinese currency and investment controls and their limited network of treaties make it unlikely that third country residents would use China as a conduit for investing in the United States.

Paragraph 8 confirms that the taxation of international transportation income is governed by the agreement of March 5, 1982 with respect to mutual exemption from taxation of transportation income of shipping and air transport enterprises.

EXCHANGE OF LETTERS

In letters signed at the same time as the rest of the Agreement, President Reagan and Premier Zhao confirm the understanding of the two governments with respect to the United States position on tax sparing credits. It is agreed that, if the United States amends its laws to authorize such credits or grants such a credit in a tax treaty with another country, the Agreement will be amended to incorporate such a credit. The amended Agreement would be subject to ratification.