Revenue Law Journal

Volume 16 | Issue 1 Article 6

January 2006

Tax Treaties' Interpretation and Application under the Challenges of the Digital Economy - Issues Raised by PANAMSAT v Beijing State Tax Bureau

Ge Tan

Tax Treaties' Interpretation and Application under the Challenges of the Digital Economy - Issues Raised by PANAMSAT v Beijing State Tax Bureau

Abstract
[Extract]Tax treaties are designed to deal with double taxation on income derived from crossborder transactions. If, however, the two contracting countries do not arrive at the same conclusion with regard to the tax rights under the treaty, judicial double taxation can occur today. This note analyses a case involving China and the US, which highlights this issue.

Keywords
digital economy, income tax, tax treaties

TAX TREATIES' INTERPRETATION AND APPLICATION UNDERTHE CHALLENGES OF THE DIGITAL ECONOMY - ISSUES RAISED IN *PANAMSAT V BEIJING STATE TAX BUREAU*

*Ge Tan**

Introduction

Tax treaties are designed to deal with double taxation on income derived from cross-border transactions. If, however, the two contracting countries do not arrive at the same conclusion with regard to the tax rights under the treaty, judicial double taxation can occur today. This note analyses a case involving China and the US, which highlights this issue.

Case Note

A The Facts

In May 1996, the appellant, PanAmSat International System Inc (PanAmSat), located in Delaware US, signed a contract with China Central Television (CCTV), which is the largest television company in China, for providing video distribution services. In January 1999, Beijing State Tax Bureau issued a notification (Jingguoshui no 001) to the CCTV regarding the collecting of a withholding tax of 7% on the rent paid by the CCTV to foreign satellite companies, including PanAmSat. In March 1999, PanAmSat paid US$1,546,632 to the Beijing State Tax Bureau, but applied for a reconsideration of this issue. In August, a reconsideration upheld the withholding tax of 7% on the rent income. Subsequently, PanAmSat sued the Beijing State Tax Bureau (Tax Bureau) at the Beijing Secondary Court of Appeal.

At the hearing in June 2000, the Tax Bureau withdrew the notification (Jingguoshui no 001). At the same time PanAmSat dropped their lawsuit. Four days after the withdrawal, the Tax Bureau issued another notification (Jingguoshui no 319) to impose the income tax of 7%. This was based on article 11 of China-US Double Taxation Agreement, article 19[1] of the *Foreign Entities Income Tax Law* in China (*Foreign*

* Ge Tan LLM(Bond).

1 Agreement between the Government of the People's Republic of China and the Government of the United States of America for the avoidance of Double taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income 1984.

Published by ePublications@bond, 2006

Tax Law), and the Decision on the Issue of Imposing Withholding tax on Foreign Satellite Companies issued by the State Administration of Taxation (the highest level tax authority in China). PanAmSat applied for another reconsideration. In November 2000, the reconsideration upheld the no 319 notification. PanAmSat filed a lawsuit in Beijing's First Court of Appeal seeking to reduce the extra tax burden.

During the court hearing the CCTV was required as a third party to testify. Again, in October 2001, the decision of the Court upheld the no 319 notification. PanAmSat refused to accept the decision and appealed to the Beijing High Court. Finally, on 26 December 2002, the appeal was overruled by the Beijing High Court, because the decision of Beijing First Court of Appeal was in accordance with the *Law of Tax Collection and Foreign Tax Law in China*.

The appellant submitted that the income derived from the contract between PanAmSat and the CCTV was business income from the service it provided to the CCTV. Under the China-US DTA, PanAmSat had not set up its 'Permanent Establishment'[2] in China; therefore, it is not liable to the tax on business profits in China. The service provided by PanAmSat was a business activity of the provider through the satellite they owned in space. The income should not be recognized as royalties under article 11 (3) of the DTA by classifying the payment as rent for the use of scientific equipment. The application and interpretation to the DTA in this case was not in accordance with the general interpretation of the OECD model tax treaty.

The respondent insisted that the video distribution service in the contract was provided by operating satellites and their accessory equipment; therefore it fell into article 11 of the DTA. Even though the CCTV did not operate the satellite and accessory equipment itself, it cannot alter the character of 'use' of the scientific equipment under the DTA.

Article 19: 'Any foreign enterprise which has no organization or establishment in China but has gained dividend, interest, rental, royalty and other income from sources in China, or though it has organizations or establishments in China, the said income is not actually connected with any of its organizations or establishments, shall pay an income tax of twenty percent on such income.' *Foreign Enterprise Income Tax Law of the People's Republic of China 1991*.

2 Article 7 of the Agreement between the Government of the People's Republic of China and the Government of the United States of America for the avoidance of Double taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income 1984.

In addition, the appellant argued that, under domestic law, the income derived from the use of the scientific equipment was not defined as one kind of royalties, but rather should fall into the category of rent. However, the contract in question was not a tenancy contract, therefore there was no domestic law to support the decision of imposing the withholding of tax on the business income made by PanAmSat in China.

The respondent also argued that, under article 28[3] of the *Foreign Tax Law*, when there is a difference between the domestic law and the DTA, the DTA provisions prevail. The DTA should be applied in preference to domestic laws. In this case, the application of the DTA and the *Foreign Tax Law* was in accordance with the laws in China.

B Three arguable issues raised in the case

Can a treaty itself impose a tax burden or higher tax burden than domestic law imposes? Both the Chinese judge and the tax authorities decided to impose a tax burden on business income based on the tax treaty between China and the US, rather than on domestic tax legislation. As it was argued by the respondent, under the domestic law, the income would not be recognized as royalties, therefore there would be no tax liabilities under the Foreign Tax Law to PanAmSat.

The basic question here is where the tax liability comes from. Tax treaties do not impose tax, they are designed primarily to relieve.[4] Whether an international tax agreement can be directly interpreted as tax legislation in a nation depends on that nation's Constitution; China's Constitution remains silent on this issue. However, the treaty authorising an overriding power by the structure can be understood as meaning that the lawmakers in China will not let the domestic law provisions override the treaty in order not to breach China's international obligations. It could not be interpreted that the treaty can directly become domestic law without the authorization by the Constitution. In a similar situation discussed by Philip,[5] in

3 Article 28: 'Where the provisions of the tax agreement concluded between the government of the People's Republic of China and foreign governments are different from the provisions of this Law, the provisions of the respective agreement shall apply.' The Foreign Enterprise Income Tax Law of the People Republic of China 1991.

4 Brian J Arnold and Michael J Mclntyre, *International Tax Primer* (2nd ed, 2004, Kluwer Law International, the Hague).

5 Philip B, Double Taxation Avoidance Conventions and international Tax Law (1st ed, 1994, Sweet & Maxwell, London) 7.

Germany, France, and the UK, judges agreed that a treaty does not impose a tax burden or higher tax burden than under domestic law.

The OECD model tax treaty, which is used by the Chinese government, serves not only to relieve from double taxation by two fiscal jurisdictions, but also to prevent tax evasion. As stated by the Council of the OECD, the main purpose of the model bilateral tax convention is to prevent international juridical double taxation.[6] The treaty describes the permissible boundaries of the tax system, not the actual tax system itself. Therefore, a provision like article 11 'may' permit a maximum withholding tax of 10% with no royalties: this does not mean that both states will actually decide to impose such a withholding tax under their domestic legislation.

China's current domestic laws do not recognise the income made by PanAmSat as royalties. Moreover, in China's domestic tax system, the income made by PanAmSat has not been regarded as China source income and liable to China's tax. From this perspective, the application and interpretation of the China-US treaty in this case is quite controversial.

Conflict of qualification under the China-US DTA

Different classification of the income between China and US

In this particular case, PanAmSat made income by providing a digital video distribution service to the CCTV. This service included up and down-linking satellites, converting frequencies, beaming signals, and transmitting digital signals. The work was mostly done by PanAmSat operating its satellites and other accessory equipment in space. Under Chinese domestic law the income could only be categorised as income derived from business activities. Meanwhile, under US domestic law, PanAmSat made income from the business activities in space, therefore, the source of the income would be domestic. There was no possibility of having foreign tax credit because PanAmSat is a resident of the US.[7] Under this hypothesis, the potential result would be PanAmSat paying the income tax only to the US government. This is clearly not fair to China's government.

China, as the state where income is sourced, takes advantage of the tax treaty by imposing tax on the income unilaterally. The result could be double taxation. The source state categorises the income so that both states share equally under the treaty;

6 Ibid 67.

7 Internal Revenue Service 26 CFR Part 1 (REG-106030-98) RIN 1545-AW50 2001.

but the resident state's internal law categorises the income as a different type, giving them the exclusive right to tax. This potential problem cannot be solved by the existing DTA. The idea that two treaty countries understand a given treaty rule differently is increased by the various difficulties that often surround the interpretation of tax treaties.

As technology develops and becomes more complex, the role of digital information goods becomes more prominent. As cross-border commercial digital flows become more commonplace, transactions increase in complexity and become more diverse. Goods and services can be delivered electronically in a digitised form, therefore a foreign enterprise does not need to be physically present in a country for trading purposes. Traditional income tax rules, which focus on traditional economic activities and geographic rules of source income, seek to slot digital transactions into specified boxes. Such rules are increasingly cumbersome to enforce.[8]

Interpretation to the distributive rules in the Treaty

If the US government does not apply the special internal rules to PanAmSat, the problem may continue to occur where two contracting countries interpret a treaty differently and apply different articles to the same income. In this case, China applied article 11 of China-US DTA,[9] (typical open distributive treaty rule[10]), to the income base. As a result of China's application of the treaty, PanAmSat's income, which was derived from its business in China, became a kind of royalty and was taxed 7% by China as the source state.

Using 'may be taxed' in the open distributive rules in the treaty does not determine if and how the income in question will be taxed. This is left to be determined by the corresponding articles in the treaty and the contracting states' domestic laws. As a result, both contracting states, each from its own unique perspective, may tax the income.

---

8 Arthur J C, 'The Law and Economics of Digital Taxation: Challenges to Traditional Tax Laws and Principles' (2002) *Bulletin* 606.

9 Above n 2, Article 11: 'However, such royalties may also be taxed in the Contracting State in which they arise and according to the law of the Contracting State, but if the recipient is the beneficial owner of the royalties, the tax so charged shall not exceed 10 percent of the gross amount of the royalties'.

10 Klaus Vogel, 'Conflicts of Qualification: the Discussion is not Finished' (2003) *Bulletin* 41.

The US government, however, would most likely interpret and apply the treaty differently. As a member of the OECD, according to the Commentary on Article 12 Concerning the Taxation of Royalties[11] issued by the Committee, the US would be very reluctant or it would find it impossible to recognize PanAmSat income as royalty.[12] The reason for this could be the difficulty of categorising the business activities performed by PanAmSat into the just 'for the use of, or the right to use, industrial, commercial or scientific equipment' category; alternatively, reluctance by the US may arise from the commentary stating that a better understanding of this issue is to remove this category from the application of article 11, ensuring that it would fall under the rules for the taxation of business profits. The problem here was caused by the ambiguous context in the treaty between countries.

Breach the duty of non-discrimination

Last, as the member of the WTO and many other international conventions, China has the duty to ensure non-discriminatory treatment to all member states in the WTO, regardless of the absence of a specific article in the China-US DTA on non-discrimination. Non-discrimination is a basic duty for a country willing to join the international trade and investment community. Non-discrimination in taxation issues means to provide national treatment to the non-resident taxpayers, ie, the resident taxpayers holding the other contracting state's nationality and the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other contracting state. More precisely, the national treatment shall be interpreted as equal tax burden and protection.

In this case, however, the US satellite company was required to pay its income tax based on the gross income of the royalties under the contracts with the Chinese company. This is different from the satellite company, which was incorporated in China and controlled directly or indirectly by China. Specifically, the satellite company incorporated in China paid income tax based on net income after the permissible deduction to the income derived from business activities, because Chinese domestic law does not characterise the satellite service fee as royalties. The decision issued by the State Administration of Taxation focused only on the foreign satellite company, rather than on the satellite service industry as a whole in China. Arguably, this decision, issued in 1999, came when China had not re-entered the WTO. In 2002, the final judgment was made after China's re-entrance to the WTO. This judgment

---

11 The 1963 Draft, the 1977 Model and the 1992 OECD Model were published with Commentaries to each Article prepared by the OECD Committee on Fiscal Affairs.

12 Paragraph 9.

applied the international treaty to impose the tax burden on the non-resident company, without giving consideration to the issue of non-discrimination; however, such a judgment cannot be easily pardoned from breaching international duty.

Problem solving

General rule for the interpretation and application of tax treaties

The fundamental issue in this case is how the contracting states interpret and apply the tax treaty. China's Constitution, which does not acknowledge international treaties, shall be amended in the near future to provide clear rules for the relevant authorities. This will allow courts to interpret and apply treaties properly and consistently. Considering China's internal legal system and their transitional economic situation, giving the treaties a position that is self-executing, similar to domestic legislation, would probably cause many problems. The indirect effect approach,[13] that is enacting treaty provisions into domestic law, should be given more consideration. Secondly, some international general rules for the interpretation of the treaties should be emphasised, especially when a court applies a tax treaty to some very complicated taxation issues.

Firstly, under the Vienna Convention,[14] article 31 says, 'A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.' As indicated earlier, the main purpose of tax treaties is to avoid judicial double taxation. Therefore, under China's current circumstance, the treaty may in a given case exempt a taxpayer from tax that he normally would have been subject to. However, it cannot make him subject to tax in China where he would not have been subject to that tax by virtue of an internal criterion regarding the territorial scope of the tax, unless there is an express and affirmed provision of the treaty which subjects him to it.[15]

Secondly, as a result of the technical complexity of international taxation, divergent interpretation and application of tax treaties by two given countries may often cause double taxation or double non-taxation. Many judicial authorities support using the OECD's commentaries to the model treaty as an aid to interpretation. [16] In some cases,

13 Roy Rohatgi, *Basic International Taxation* (1st ed, 2002, Kluwer Law International, the Netherlands) 15.

14 Vienna Convention on Law of Treaties 1980.

15 Philip B, *Double Taxation Avoidance Conventions and international Tax Law* (1st ed, 1994, Sweet & Maxwell, London) 8.

16 Ibid 28.

it is rather hard to see the commentaries as an agreement between states where one state is a non-OECD Member State. However, if the Commentaries are only persuasive and supplementary, there is no reason why reference should not be made to them.

Moreover, the creation of an advisory body made up of independent tax treaty experts is recommended by many scholars as a solution to help contracting states with the interpretation of tax treaties.[17] It is proposed that under an agreement between 'competent authorities' of contracting states, a panel of tax experts should be established to provide expert opinions at the request of courts and authorities.

Renegotiating the Treaty and amending the domestic legislation to apply a new classification of income to cope with the digital economy

The prevalent cause of divergences in the interpretation of the treaty is classifying income into the different categories described in the treaty provisions. This is especially true with the current digital economy, and traditional tax rules must be modified to cope with it. Moreover, compared to current income tax acts in many countries that are China's main trading partners, China's tax system seems too simple and unstructured, which leaves many loopholes for both the tax authority and taxpayers.

The method of classification of income is a significant factor in the determination of the applicable taxes in the source state, and of the foreign tax credit due in the residence state. General principles and rules for the physical world often do not apply to the electronic digital world.[18] Any unilateral approach could not work for this complex issue, because of the divergent interpretations of the treaty's provisions. Therefore, a better way to solve this problem for both China and the US is to renegotiate some of the provisions in the DTA, and subsequently amend each state's domestic tax law appropriately. Avoiding double taxation and sharing revenue fairly between developed and developing contracting states are issues that should be given equal weight in the renegotiation.

The suggestion, made by the US Treasury Paper, is to grant taxing rights over electronic transactions to the State of residence. This appears to be a simple solution.

---

17 Kees VR, 'International Coordination of Tax Treaty Interpretation and Application' (2001) INTERTAX Vol 29, 212-218.

18 Roy Rohatgi, *Basic International Taxation* (1st ed, 2002, Kluwer Law International, the Netherlands) 511.

But it may be neither equitable nor acceptable to source countries.[19] To avoid taxpayers carrying an extra tax burden, for example when PanAmSat paid double tax on one item of income, governments need to consider adopting some suggestions from the UN Model treaty, which gives certain additional taxing rights to source countries,[20] both bilaterally and domestically. From an economic point of view, by sharing tax revenue with developing countries, developed countries may become more competitive within the increasingly inter-dependent global economy.

Possible approach to qualifying conflicts under the existing Treaty

Renegotiation of a treaty is a time-intensive project for both contracting states. Instead of 'competent authorities' functioning to negotiate a solution on a particular case, with the possibility of acceptance by both governments according to the procedure under article 24 mutual agreements, the open distributive rules in the treaty leave space for contracting states to negotiate new issues.

Clearly, the service provided by PanAmSat could be recognized as a technical service, which is quite a controversial area in the classification of income by both countries. This could be the reason China insisted on characterising it as royalties, while the US regulated it as income derived from business activity. Whatever the income is, both competent tax regimes need to make decisions for income tax, basing them on the treaty as well as on each country's domestic law.

US domestic law, categorising income derived from China as US domestic income, is an unfair treatment of the issue, even though it is a possibility under the current diversity of tax systems. Increasingly, technical services are taxed similar to royalties, subject to a gross-basis withholding tax in Hong Kong, Japan, Korea, Malaysia, New Zealand, Portugal, South Africa, Spain and Uruguay.[21] Several countries grant relief to their residents for such foreign taxes, under the credit method.

Professor Klaus Vogel's work on a 'new approach' under the OECD model treaty, which has as its aim to settle the qualification conflicts caused by the distributive rules, suggests giving priority to the state of the non-resident. If the income may be taxed by the state of non-residents, in accordance with the treaty, the state of the

---

19 Ibid 517.

20 Ibid 516.

21 Ibid 528.

resident shall grant tax credit or exemption subject to progression, unless the state of the non-resident wrongly failed to levy tax.[22]

Nevertheless, the China-US DTA is an OECD model based tax treaty that does not consider a fee for technical services to be royalties. This causes complications with the above-mentioned approach to solving the problem. By learning from India's recent treaties, which give special treatment to fees for technical services, as source country income, China's tax office may consider taxing it on a reduced gross basis with the consent of its counterpart, in order to not make the taxpayer increase the price of the service to Chinese companies to offset the extra tax burden.

If China adopted India's recent approach to their tax treaties and provided special treatment to the fee for technical services, treating it as source country income, then, with the consent of the contracting state, China's tax office may consider taxing this income on a reduced gross basis. This would prevent the taxpayer from increasing the price of the service in order to offset the extra tax burden.

Conclusion

With the rapid development of the digital economy the instances in which tax treaties are being applied to remove double taxation is on the rise. The PanAmSat case, while making an effort, did not provide a good solution to the problems raised by this case. However, the result showed us the importance of properly applying and interpreting treaties. Ensuring the effectiveness and efficiency of treaties requires that contracting states to coordinate broadly and genuinely by renegotiating their existing treaties, amending domestic regulations, and establishing independent tax advisors. Close consideration should be given to the general rules of treaty interpretation and to widely accepted commentaries.

22 Above n 9, 44.