WANG JING & CO.
敬海律师事务所

Providing you with our continued insight and dedication

MARITIME LAW NEWSLETTER · DECEMBER 2012

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WJNCO NEWS

WJNCO named Chinese Shipping Law Firm of the Year 2012

Wang Jing & Co. was awarded Chinese Shipping Law Firm of the year by Acquisition International with record votes cast by the subscribers of this magazine and the international legal community. Acquisition International (AI) is a globally circulated monthly magazine registered in England and Wales that has reinvigorated corporate finance news and reporting. Wang Jing & Co. would like to thank AI for giving our firm this prestigious award. We will continue to strive for excellence and provide our clients with the highest quality of service.

2012 Chinese Lawyer International Conference on Maritime Law

On 24 November 2012, maritime law experts and professionals from all over China together with representatives from the shipping industry gathered in Lake Meilan's International Convention Centre for the "Chinese Lawyer International Conference on Maritime Law". Mr Wang Jing, managing partner of our firm, attended the conference and served as chairman and speaker, and also delivered the closing speech. Participants from different backgrounds shared ideas from their own perspectives. The understandings formed and disputes unsolved may both serve as sources, guiding thoughts and a realistic basis for the competent authorities to frame maritime laws and regulations and to issue judicial interpretation.

For more information and news please visit

CHARTER HIRE INCOME AND THE AVOIDANCE OF DOUBLE TAXATION

A recent arbitration being handled by the firm has led us to consider an important area of Chinese tax law which may directly affect foreign ship owners. The case considers the application of Chinese withholding tax to foreign ship owners in respect of charter hire. Below we will layout the basic fundamental principles of Chinese Withholding tax, and discuss its application to and impact on foreign ship owners, with a particular focus on charter hire income.

GENERAL PRINCIPLES

Charter hire is subject to Enterprise Income tax, Business tax and various other surtaxes. Withholding tax is the method by which tax levied on non-resident enterprises acquiring income from Chinese businesses is obtained. Non-resident enterprises that supply services to those companies based in China are effectively deriving China-sourced income, and should therefore be taxed accordingly under the relevant provisions. Tax due is obtained by the relevant authorities by way of withholding agents in China. The withholding agent is responsible for deducting the tax due from the gross invoice amount payable and for paying the tax deducted directly to the relevant authority.

Enterprise Income Tax

Pursuant to Article 3 of the Enterprise Income Tax Law (the "EIT Law"), a non-resident enterprise is liable to tax on its income sourced in China, which includes charter hire due from Chinese charterers. Article 37 of the EIT Law provides that the tax amount *"shall be withheld by the withholding agent during every payment, or when the payable amount is due from the payment due or payable amount"*. Further, according to Article 3 of the Provisional Regulations on the Withholding of the EIT of the Non Resident Enterprise From its Source, *"for EIT applicable on the income of interest, rental hire, royalties etc sourced from China, it shall be withheld from its origin and the unit or person that is directly responsible to pay to the non-resident enterprise shall be the withholder"*. As such, the charterer becomes the 'withholding agent', and is responsible for deducting the relevant amount from the gross hire invoice amount due to the ship owner.

Business Tax

Pursuant to Article 1 of the Business Tax Law (the "BT Law"), all enterprises and individuals engaged in the provision of "taxable services" within the territory of China shall be taxpayers of business tax. In addition, according to Article 4 of the Implementation Rules of the Provisional Regulations of Business Tax of China 2009 (the "Implementation Rules"), Business tax is now payable where either the service provider or the service recipient is located in China, without regard to where the service is actually rendered. As the rental of industrial and commercial equipment in the transportation industry qualifies as a taxable service, ship owners are liable to pay business tax on the hire they receive from charterers whose place of business is within the territory of China. According to Article 11(1) of the BT, if the non-resident enterprise has an agent in China, the agent shall be the withholder of the tax payable, otherwise, the assignee or buyer (i.e. Charterer) shall act as the withholding agent.

PROCEDURE

Withholding agents are required by both the EIT Law and BT Law to register the business transaction/contract with the relevant tax authority within a set time limit. Withholding agents are also required to establish account books for the withheld and remitted taxes, accept inspections from the relevant tax authorities, submit tax declarations to the relevant authorities if so required, and pay the tax withheld to the relevant authority within the prescribed time limits.

The PRC Law on Administration of Tax Collection and its Detailed Rules, the PRC Administrative Measures for Tax Registration, and the Provisional Measures for Administration of Source-based Withholding of Enterprise Income Tax on Non-resident Enterprises provide a detailed framework for the collection of tax and lay out the procedure by which withholding agents are to deduct tax from non-resident enterprises. Failure to comply with the relevant procedures may result in fines being imposed and/or … continued overleaf

potential criminal liability to the taxpayer and/or withholding agent. It is therefore important to fully understand your tax liabilities in China when contracting with a Chinese charterer.

AVOIDANCE OF DOUBLE-TAXATION

China is signatory to various avoidance of double-taxation agreements and maritime transportation agreements, which depending on the exact wording and content, may relinquish the taxpayer from liability to pay tax in China. From an international perspective, the classification of charter hire in reference to various tax agreements is an area of high debate. As each agreement/treaty contains its own definitions, terminology and methods of interpretation, each must be analyzed on its own merits to conclude whether or not double-taxation may be avoided in respect of charter hire.

The China-South Korea Agreement for Avoidance of Double Taxation

For example, a recent arbitration handled by the firm concerned the application of the China-South Korea Agreement for Avoidance of Double Taxation (the "China-South Korea Agreement"). The opponents argued that charter hire did not fall under the definition of "the operation of ships in international traffic", but did fall within the scope of 'royalties' under Article 12, so that they were thereby entitled to withhold the relevant tax amount from the charter hire due.

Charter hire as "the operation of ships in international traffic"

Internationally, the legal nature of charters for tax purposes is a topic of debate. During the arbitration, it was argued by the opponents that the income gained from the chartering of a vessel did not fall under the scope of Article 8 of the China-South Korea Agreement, and was merely a type of leasing falling under the scope of Article 12 of the China-South Korea Agreement, and thereby not entitled to tax relief. The opponents argued that the wording of Article 8 of the China-South Korea Agreement does not specifically encompass charter hire as tax exemptible.

Article 8 of the China-South Korea Agreement states, "*Profits from the operation of ships or aircraft in international traffic shall be taxable only in the Contracting State in which the place of head office or effective management of the enterprise is situated."* Article 3(i) defines the term "international traffic" as *"any transport by a ship or aircraft operated by an enterprise which has its place of head office or effective management in a Contracting State, except when the ship or aircraft is operated solely between places in the other Contracting State."* Accordingly, three elements must be examined when judging whether an enterprise of a Contracting State is engaged in the operation of international traffic as specified in Article 8:

i. The enterprise has set up their headquarters or a place of effective management in either Contracting State;

ii. The enterprise provides a transport service with vessels or aircrafts;

The transport service is not solely domestic in nature.

However, the definition of "transport service" is unclear and it can be said that in shipping practice, ocean-going transport with vessels covers 4 different modes i.e. liner services, voyage chartering, time chartering and bareboat chartering. The China-South Korea Agreement does not specifically clarify whether all of the abovementioned modes can be classed as "the operation of ships in international traffic". Therefore, arguably, the position must be dealt with as per Article 3(2) of the China-South Korea Agreement, which states "*As regards the application of this Agreement by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning which it has under the laws of that Contracting State concerning the taxes to which this Agreement applies*". In this instance however, Chinese law does not provide a definition in this respect either, nor has any supplementary agreement or protocol been concluded between China and South Korea to this effect, leaving this issue open for debate.

It was further argued by the opponents, in the alternative, that the chartering of a vessel may only gain relief under Article 8 of the China-South Korea Agreement if the income gained was ancillary to the international transportation business of an enterprise. So that if the rental income derived from the chartering of a vessel was the enterprise's main source of income, no tax relief can be obtained. Whereas, if the income obtained from the charter of a vessel was ancillary to the enterprise's other international transportation business (i.e. the transportation of passengers and/or cargo), tax relief may be obtained. The opponents' basis for this argument was founded in the State Tax Administration's Notice in relation to the construction of the China-Singapore Avoidance of Double Taxation Agreement (the "China-Singapore Notice"), which states that time charter income should be viewed as rental/lease income, not international transport income, except where such time charter income constitutes income ancillary to the transportation income of the enterprise. The China-Singapore Notice further provides that such ancillary income should not exceed 10% of the total income of the enterprise for the tax year concerned.

However, although such notice states on its face that it applies not only to the China-Singapore Avoidance of Double Taxation Agreement, but to all treaties with similar clauses, it cannot, without the express bilateral agreement of both China and South Korea, have any legally binding effect on the China-South Korea Agreement. Theoretically, the opponents' arguments in this respect may fail, and charter hire income may be entitled to the relief afforded by Article 8 of the China-South Korea Agreement as "profits from the operation of ships or aircraft in international traffic".

Charter hire as "royalties"

Article 12 of the China-South Korea Agreement states, *"Royalties arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other Contracting State … However, royalties may also be taxed in the Contracting State in which they arise"* and *"The term "royalties" as used in this Article means payments of any kind received as a consideration for the use of…or right to use, industrial, commercial or scientific equipment"* The opponents argued that Article 12 was sufficient to entitle the charterer to withhold tax from the gross invoice amount as charter hire fell under the definition of 'royalties' as payment for the use of industrial/commercial equipment. However, articles 31 of the Vienna Convention on the Law of Treaties states that *"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".* In its ordinary meaning, the term "royalties" refers to payment made for the use of property, especially a patent, copyrighted work, franchise, or natural resource. In its ordinary meaning, it does not relate to payments made for the use of a vessel. Although Article 12 of the China-South Korea Agreement has touched on the right to use industrial, commercial or scientific equipment, we argued that it cannot be inferred that an ordinary ocean-going vessel should fall within the intended meaning of "industrial, commercial or scientific equipment".

Further as per Article 31.4 of the Vienna Convention, a special meaning shall only be given to a term if it is established that the parties so intended. That is to say, if both China and South Korea intend to give a special meaning to the term "royalties" as referred to in the China-South Korea Agreement, there must be written

documentation to demonstrate such common expression of both countries. However, no such supplementary agreement currently exists, and so as per its ordinary meaning, arguably, the term 'royalties' should not bear any relevance to time charter hire.

As can be seen from the above discussion regarding the application of the China-South Korea Agreement to the taxation of charter hire income, this area of law remains arbitrary and each case must be analyzed on its own merits taking into consideration both Chinese Tax law and any relevant international treaties. Our firm is well versed in all areas of Chinese Tax law, with our experienced lawyers ready at hand to handle such complex matters. For more information regarding your specific circumstances, please do not hesitate to contact us at info@wjnco.com, or through your usual contact.

Chen Xiangyong & Jade Neame

THE UNSTABLE APPLICATION OF ARTICLE 55 OF THE CHINESE MARITIME CODE TO CHEMICAL CARGO DISPUTES

The Firm is currently handling two chemical cargo damage cases involving the application of Article 55 of the Chinese Maritime Code. Throughout these cases, the Chinese Courts have adopted different attitudes to the application of Article 55. Article 55 states, *inter alia, "…damage to the goods shall be calculated on the basis of the difference between the actual value of the goods before and after the damage, or on the basis of the expenses for repair…the actual value shall be the value of the goods at the time of shipment plus insurance and freight"*.

Case 1

The first cases involves the Firm defending the contractual carrier and the actual carrier against the cargo interests. The cargo interests bought the chemical cargo, phenol, at the price of USD 1,530/Ton (equal to RMB 10,477.746/ton). After the contractual carrier issued the B/L to the cargo interests, the vessel owned by the actual carrier shipped the phenol from Spain to China.

On arrival at the destination port, it was found that the colour of the phenol had changed from 5 hazen to 12 hazen, above the contractually agreed maximum of 10 hazen. In the meantime, the phenol market had been negatively influenced by the international economic crisis and the price of phenol fell sharply. Finally, the cargo interests sold the damaged phenol to its affiliated company at the price of RMB4,700/ton.

Given that the actual disposal price was unreliable, being sold to the cargo interests' affiliated company, we argued that under Article 55, the cargo damages should be measured on the basis of the expenses for repair. The Judge did not accept our expert's assessment of the expenses at RMB540/ton, and instead took the unit repair fees as shown in a Statement provided by the cargo interests.

Both sides appealed to the Higher People's Court against the judgement of the first instance court. The judgement of the second instance was also unexpected. Rightfully, the Judge adjusted the actual disposal price of the phenol from RMB4,700 to RMB5,000/ ton. However, the Judge then held the actual carrier and contractual carrier jointly and severally liable for the cargo damage, calculated by deducting the disposal price of the damaged phenol from the price at which the cargo interests bought them, i.e. RMB10,477.746/ ton less RMB5,000/ton, a difference of RMB5,477.746/ton.

During the course of the proceedings we argued that this method of calculation was legally unfounded for the following reasons;
1) When the damaged phenol was sold, the price of sound phenol was RMB5,850/ton, meaning that the carrier only caused an actual depreciation of around 15%, the remainder being caused by the falling market.
2) If the carriers were to pay the difference of RMB5,477.746, the cargo interests would, in effect, be benefiting from the cargo damage accident, by being able to purchase almost double the phenol ordered, due to the current market price, going directly against the principle of compensation under the Civil Law.

The case has now been referred to the Supreme People's court for retrial and is ongoing at this stage.

Case 2

In the second case, we represent the insurer, exercising their subrogated right against the Owners. The insured brought the chemical cargo MEG from Iran at the price of USD1,200/ton. Before shipment, the aldehyde content of the MEG was off-spec. When the MEG arrived at the destination port, the chloride content was also found to be off-spec.

The damaged MEG was sold at the price of RMB8,350/ton (the sound price of MEG being RMB8,950/ton), with a total depreciation rate of 6.7% or RMB600/ton. During the proceedings we argued that the slightly off-spec content of aldehyde would not influence the price of the MEG, and that even if such off-spec would have influenced the price of the MEG, such influence could not be separated from the influence caused by the severe off-spec of chloride, and that as a result, the entirety of the depreciation should be attributed to the Owners.

In their defence, the Owners provided a Survey Report which asserted that at the time the damaged MEG was sold, the depreciation rate of the damaged MEG was 5-6%, and the depreciation rate of MEG with only the content of aledhyde at the same level as the damaged MEG in question was 1-2%. The Judge held that the depreciation rates in the Owner's Survey Report were the figures to be relied upon and held the depreciation rate caused by the off-spec chloride to be 4% (6%-2%, or 5%-1%).

We are currently appealing this decision based on the above arguments, and *inter alia,* in addition to the following;
1) The depreciation rate of the damage cargo asserted by the Firm was calculated by comparing the actual sale price and the sound cargo price at the time the damaged MEG was sold, as such, our figures should have more evidential weight than those calculated by the Owners' surveyors.
2) Even if the off-spec aldehyde did affect the price of the MEG, since the Owners' surveyor also admitted that the influence of the off -spec aldehyde and the off-spec chloride cannot be separated, the judges reasoning for directly deducting 1-2% from the total depreciation rate was incorrect.

This case is also ongoing pending a second instance trial.

As is demonstrated by the two above active cases, the attitude of the Chinese courts in respect of chemical cargo damage disputes often differs and the area is full of uncertainty. Arguably, in no instance should a carrier be responsible to bear the cost of market fluctuations, this is a risk to be born by the cargo interests as part of their daily ongoing business practice, not one to be recouped by chance from a cargo damage dispute. As to whether, and under what circumstances, the parties can choose the method by which the cargo difference is calculated, we are awaiting the opinion of the Supreme Court and will keep our readers informed of any updates in this respect.

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