China issues clearer guidance for the determination of “Beneficial Ownership”

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In brief

The determination of “Beneficial Ownership” (BO) status for non-tax residents who derive dividends, interests and royalties from China for the purpose of enjoying tax treaty benefits has always been a hot topic. Since 2009, the State Administration of Taxation (SAT) has released several circulars including Guoshuihan [2009] No.601 (Circular 601) which listed seven unfavorable factors for the determination of BO and the SAT Public Notice [2012] No.30 (Public Notice 30) which provided a safe harbor rule for qualified non-tax residents to enjoy treaty benefit on dividends. Nevertheless, taxpayers and local-level tax authorities in China have encountered numerous technical and practical problems when dealing with BO related cases and have been expecting further guidance from the SAT.

On 3 February 2018, the SAT released the long-awaited SAT Public Notice [2018] No.9 (Public Notice 9). Public Notice 9 abolished Circular 601 and Public Notice 30 and comprehensively updates the assessment principles for the determination of BO. Compared with Circular 601 and Public Notice 30, Public Notice 9 has brought about two major breakthroughs for the claiming of tax treaty benefits on dividends: it has extended the scope of non-tax residents who are eligible for the safe harbor rule with respect to dividends; and, qualified treaty benefit applicants may apply a “same country/same treaty benefit rule” under multi-tier holding structures. These breakthroughs will increase non-resident taxpayers’ chance of enjoying treaty benefit on dividends and will be largely welcomed.

Meanwhile, Public Notice 9 has also tightened the first two unfavorable factors of Circular 601. This will be challenging for some non-resident taxpayers as their treaty benefits may be denied for the lack of BO status.

Public Notice 9 will take effect from 1 April 2018. Management of multi-national corporations (MNCs) are suggested to review whether the new changes brought by Public Notice 9 will increase their group companies’ chance of enjoying treaty benefits under the existing investment structure and business models. If needed, they may consider carrying out internal restructuring in order to leverage on the breakthroughs in Public Notice 9. If the extended safe harbor rule or the "same country / same treaty benefit rule” cannot be applied, management need to evaluate the impact of the amended unfavorable factors and establish strategies to deal with these changes. Meanwhile, they also need to prepare proper and sufficient documentation to prepare for the potential challenges from the tax authorities.

In detail

Background

In 2009, the SAT released Circular 601 to set forth seven unfavorable factors[1] in determining BO status. It subsequently issued Public Notice 30 in 2012 to provide further interpretation on Circular 601 and introduced a safe harbor rule[2] for listed companies to claim treaty benefit on dividend income. In order to address the uncertainties and key issues identified in the non-resident administration over the years, the SAT released Public Notice 9 to provide amendment and further interpretation and comprehensively update the assessment principles regarding BO.

Changes to the unfavorable factors

Public Notice 9 made some amendments to the unfavorable factors in Circular 601 by tightening the 1st and 2nd factors, deleting the 3rd and 4th factors and retaining the 5th to 7th factors. The 1st and 2nd factors are amended as follows:

1. The applicant has the obligation to pay more than

50% (note: the threshold was 60% in Circular 601) of the income within 12 months of receiving the income to a third jurisdiction tax resident. “Obligation” shall include both contractual obligation and any factual payment even though the applicant has no contractual obligation to pay;

2. The applicant does not carry out substantive business activities. Substantive business activities shall include substantive manufacturing, trading and management activities, etc. Whether an applicant’s business activities are “substantive” shall be assessed based on the functions performed and risks undertaken by the applicant. An applicant’s substantive investment and management activities may be construed as substantive business activities. Where an applicant carries out both non-substantive investment and management activities and other business activities, if the other business activities are insignificant, the applicant’s overall business activities cannot be considered as being substantive.

As is shown in the amendment to the 1st unfavorable factor, the SAT not only looks into the legal contractual payment obligations but also examines whether any factual payment exists. According to the explanatory notes of Public Notice 9, even if the applicant has not made any cash payment, certain intercompany transactions such as netting-off inter-company payable/receivable or other genuine commercial arrangements (e.g. extending loan to group companies by the applicant after receiving income from China) may be considered as a factual payment which may become unfavorable in determining the BO status.

Public Notice 9 sets out detailed guidance regarding the 2nd unfavorable factor on substantive business activities. Substantive business activities include manufacturing, trading and management activities as well as investment and management activities. The explanatory notes to Public Notice 9 have provided some guidance on what are investment and management activities: e.g. pre-investment research, project analysis, investment decision, execution, post-investment management, industry analysis, market research, regional headquarters function, treasury function, financing function, etc. The explanatory notes to Public Notice 9 also provide a few case studies. Based on SAT’s analysis of these cases, it appears that the SAT has a higher expectation of “substantive business activities” than before. For the situation where an applicant carries out both non-substantive investment and management activities and other business activities, the explanatory notes further gives an interpretation by way of an example: where the income generated from the other business activities by the applicant is less than 8% of its total income, the other business activities are insignificant.

The 3rd and 4th unfavorable factors in Circular 601 are deleted because their assessment criteria have already been incorporated into the 2nd unfavorable factor as amended by Public Notice 9.

Extended scope of non-tax residents eligible for the safe harbor rule with respect to dividends

Public Notice 9 extends the safe harbor rule with respect to dividends of listed companies to also include governments and individuals: i.e. if the applicant is the government, a listed company or an individual who are tax residents of a tax treaty jurisdiction, or a company 100% directly or indirectly owned by the above mentioned government, listed company or individual, the applicant can be directly considered as the BO of the dividends and there is no need to assess the case against the five unfavorable factors.

The explanatory notes to Public Notice 9 set out three diagrams for illustration purpose (please refer to Case 1, Case 2 and Case 3 of the Appendix). In Case 3, as long as the individuals, the listed company (who are Hong Kong tax residents) and Hong Kong government have a 100% collective shareholding in the applicant (i.e. Hong Kong tax resident D), the applicant is eligible to apply the safe harbor rule to the dividends.

The “same country/same treaty benefit rule” for a multi-tier holding structure with respect to dividends

Before the release of Public Notice 9, if the immediate dividend recipient is neither eligible for the safe harbor rule under Public Notice 30 nor qualified as a BO upon being assessed based on the unfavorable factors as stipulated in Circular 601, the dividends received by the applicant from China cannot enjoy the relevant treaty benefits. Public Notice 9 sets out a breakthrough so that, even if the immediate dividend recipient is not qualified as a BO, it can be deemed to be the BO of the dividend where certain conditions are satisfied. Specifically, the immediate shareholder of the Chinese TRE (i.e. the applicant) can be deemed as the BO of the dividend received from China and enjoy the relevant tax treaty benefit under either of the following two scenarios:

- Scenario 1: The shareholder directly or indirectly holding 100% equity interest of the applicant qualifies as a BO against the five unfavorable factors of Public Notice 9, and the above-mentioned shareholder and the applicant are tax residents of the same tax jurisdiction (“the same country rule”).

  The explanatory notes to Public Notice 9 set out examples as shown in Case 4 and Case 5 of the Appendix. In both cases, both Hong Kong tax resident F and Hong Kong tax resident E are tax residents of the same tax jurisdiction. Although E does not qualify as the BO of the dividend, it can be deemed to be the BO as long as F qualifies as a BO upon being assessed based on the five factors in Public Notice 9 (even if there are intermediate holding companies from other tax jurisdictions between them).

  We understand the underlying rationale of the same country rule is that: Since Hong Kong tax resident F (which can pass the five factors under Public Notice 9) could have enjoyed the tax treaty benefit in regards to the dividend if it had directly invested in the Chinese TRE, it can be seen that the intention of Hong Kong tax resident F of setting up Hong Kong tax resident E and BVI company is not to take advantage of the preferential treatment under the dividend article of the Mainland/Hong Kong double tax arrangement.

- Scenario 2: Although the applicant and the shareholder which directly or indirectly holds 100% equity interest of the applicant are tax residents of different tax jurisdictions, the applicant can be deemed to be the BO as long as the above-mentioned shareholder qualifies as a BO upon being assessed based on the five factors in Public Notice 9 and the above-mentioned shareholder and all the intermediate shareholders in between are tax residents from jurisdictions with the same or better treaty benefit with respect to dividends as compared with the applicant ("the same treaty benefit rule").

The explanatory notes to Public Notice 9 set out an example as shown in Case 6 of the Appendix. In that case, the Hong Kong tax resident G does not qualify as a BO but the Singapore tax resident I can qualify as a BO upon being assessed based on the five factors under Public Notice 9. Hong Kong tax resident G can be deemed to be the BO of the dividends because the dividends article under the China/Singapore tax treaty and the Mainland/Hong Kong double tax arrangement are the same. It is important to note that under Scenario 2, the real BO (i.e. Singapore tax resident I) and all the intermediate shareholders (i.e. Singapore tax resident H) have to be tax residents from tax treaty jurisdictions and can enjoy the same or better treaty benefit with respect to dividend as compared with the applicant. In addition, Public Notice 9 requires all the offshore shareholders along the investment chain to obtain a tax resident certificate from the tax authorities of their own jurisdiction.

We understand the underlying rationale of the same treaty benefit rule is that: Since Singapore tax resident I (which can pass the five factors under Public Notice 9) could have enjoyed the tax treaty benefit in regards to the dividends if it had directly invested in the Chinese TRE, it can be seen that the intention of Singapore tax resident I in setting up Singapore tax resident H and Hong Kong tax resident G is not to take advantage of the preferential treatment under the dividend article of the Mainland/Hong Kong double tax arrangement.

It is noteworthy that the "same country/same treaty benefit rule" is only applicable to situations where the direct or indirect shareholding percentage of the immediate holding company is 100%. In other words, it shall not apply to any case with less than 100% shareholding structure. It should also be noted that this "same country/same treaty benefit rule" is not applicable to interest article or royalty article under tax treaties.

Other major changes

Other major changes brought by Public Notice 9 in respect of BO determination include:

- As China has adopted the minimum standard, i.e. the principal purpose test ("PPT") with respect to Action 6 (Preventing the Granting of Treaty Benefits in Inappropriate Circumstances) of OECD's (Organization for Economic Co-operation and Development) BEPS (Base Erosion and Profit Shifting) project, Public Notice 9 no longer uses terms such as "conduit company" or "tax avoidance purposes" as originally used in Circular 601 and Public Notice 30. This provides an avenue for the Chinese tax authorities to use PPT to deny tax treaty benefits;
- Public Notice 9 also further clarifies the requirement of tax resident certificates for various circumstances for record filing purposes;
- It also clarifies that shareholders receiving dividends, creditors receiving interest, licensors receiving royalties shall not claim themselves as agents or designated recipients receiving income on behalf of others to let other parties to enjoy the tax treaty benefit.

The takeaway

The extension of the eligibility of the safe harbor rule and the adoption of the "same country / same treaty benefit rule" both reflect the SAT's implementation of the PPT mechanism. This signals a big step forward by the Chinese tax authorities in aligning its interpretation and implementation of tax treaties with international standards which will be greatly welcomed by non-resident taxpayers.

Generally speaking, the technical principles and administration guidance set out in Public Notice 9 will bring both joy and concerns to non-resident taxpayers. On the one hand, extending the eligibility of the safe harbor rule and adopting the "same country / same treaty benefit rule" for dividend income will increase the chance of non-resident taxpayers enjoying the tax treaty benefits. The clearer guidance will also reduce the difficulties faced by local level tax authorities in their post-filing administration. On the other hand, in order to prevent tax treaty abuse, the amended unfavorable factors are very stringent. The Chinese tax authorities will look into both the form and substance/fact of the arrangements and will pay more attention to the substantive business activities of an applicant. In addition, although the implementation of the PPT mechanism reflected in Public Notice 9 will bring benefits to taxpayers, the dropping of terms, such as, "tax avoidance purposes", so as to apply the PPT to deny treaty benefit will result in more challenges to taxpayers, i.e. an applicant that can successfully pass the BO test against the five factors in Public Notice 9 may still be denied of the treaty benefit if the tax authorities determine that the arrangement was carried out to take advantage of benefits available in certain tax treaties.

There are still some uncertainties which remain to be clarified. For example, regarding the 1st unfavorable factor, dispute may arise if the local level tax authorities treat certain genuine intra-group transaction as a factual payment. As to the 2nd unfavorable factor, the local level tax authorities and the applicants may have disputes on whether the applicant carries out substantive investment and management activities, whether the other business activities are significant. Moreover, the examples stated in the explanatory notes to Public Notice 9 for the "same country / same treaty benefit rule" are limited. In practice, there may be other investment structures that are not designed for treaty shopping purposes, and it remains to be seen whether these type of structures can also be eligible for the "same country / same treaty benefit rule".

MNCs should review their existing investment structure and business model against the extended safe harbor rule and the "same country / same treaty benefit rule" and assess whether it is possible to carry out internal restructuring in order to leverage on these benefits. In any case, proper and sufficient supporting documents (e.g. contracts, invoices, receipts, accounting entries, etc.) should be put in place in case of tax authorities' challenges.

Endnote

1. *The seven unfavorable factors for the determination of BO under Guoshuihan[2009]No.601 are as follows:*
   1) *The applicant is obligated to pay or distribute a portion (for example 60% or more) or all of its income within a prescribed timeframe (for example within 12 months of receiving the income) to a third jurisdiction resident;*
   2) *The applicant does not have or almost does not have any other business activities besides ownership of the assets or rights that generates the income;*
   3) *Where the applicant is a corporation, the assets, scale and employees of the applicant is relatively little and do not match the amount of income ;*
   4) *The applicant has no or almost no controlling rights or disposal rights on the income or the assets or rights that generate the income, and bears no or very little risk;*
   5) *The other treaty jurisdiction does not tax or exempts the income, or taxes the income at a very low effective tax rate;*
   6) *Besides the loan contract on which the interest arises, the lender has other loan or deposit contracts with a third person with very similar amount of principal, interest rate and time of conclusion;*
   7) *Besides the copyright, patent and technology licensing contract on which the royalty arises, the applicant has other licensing or transfer contracts with a third person with respect to the relevant copyright, patent and technology.*

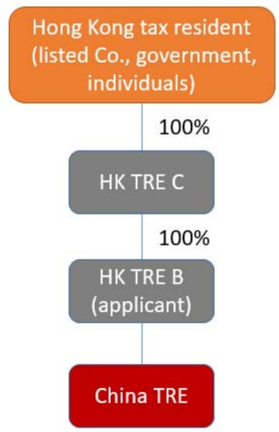
2. *The safe harbor rule under SAT Public Notice [2012] No.30 refers to the following scenario: if the dividend recipient (i.e. the applicant) is a listed company or is directly/indirectly held by a listed company, it is treated as the BO of the dividend income. The safe harbor rule under Public Notice 30 strictly requires that the immediate recipient of the dividend, the listed company and the intermediate holding companies (if any) have a 100% equity relationship and have to be tax residents of the same treaty jurisdiction. Qualified applicants under the safe harbor rule are directly considered as the BO of the dividend income and there is no need to go through the assessment against the seven unfavorable factors under Circular 601.*

3. *According to BEPS Action 6, in order to prevent the abusive usage of treaty benefits, treaty countries are suggested to include any of the following mechanisms in their tax treaties as a minimum standard:*
   - *Limitation on Benefits (LoB) plus Principal Purpose Test (PPT);*
   - *PPT alone, or*
   - *LoB plus a restricted PPT rule applicable to conduit financing arrangements, domestic anti-abuse rules or judicial doctrines that would achieve a similar result.*

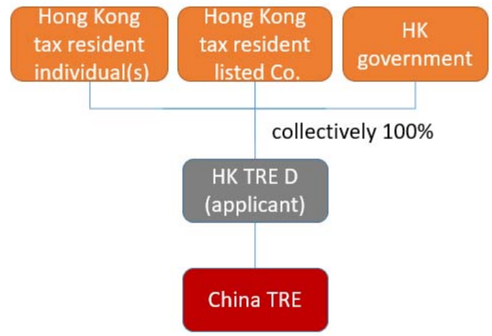
Appendix:

Case 1

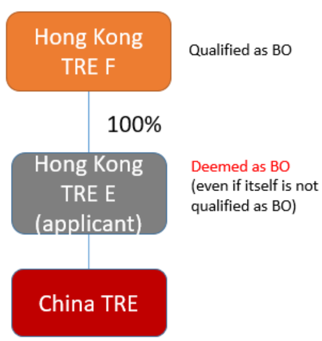
Case 2



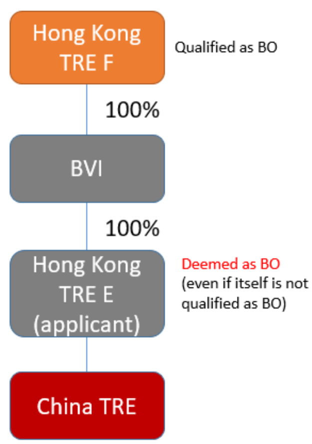
Case 3



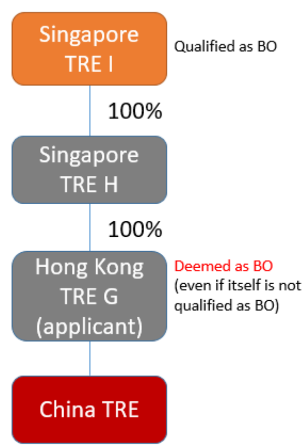
Case 4



Case 5



Case 6



Let's talk

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