Hong Kong companies will benefit from China's latest guidance on "beneficial ownership"

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Issue 2

In brief

The State Administration of Taxation of China (SAT) released the long-awaited Public Notice [2018] No.9 (Public Notice 9)[1] on 3 February 2018. Public Notice 9 provides additional guidance on assessing the beneficial ownership status for the purpose of enjoying the treaty benefits under China's tax treaties. Public Notice 9 will take effect from 1 April 2018.

The two favorable changes brought about by Public Notice 9 for claiming treaty benefits on dividends received from China are: (1) extending the scope of the "safe harbour rule" stipulated in the SAT Public Notice [2012] No.30 (Public Notice 30)[2] such that it now does not only apply in respect of listed companies but also governments and individuals and (2) introducing the new "same jurisdiction/same treaty benefit rule" in respect of multi-tier holding structures. On the other hand, Public Notice 9 has tightened two of the seven unfavorable factors set out in Guoshuihan [2009] No.601 (Circular 601)[3] for assessing the beneficial ownership status.

Business groups investing into China through a Hong Kong holding company should review whether the "extended safe harbour rule" or the "same jurisdiction/same treaty benefit rule" in Public Notice 9 can facilitate their Hong Kong holding companies to enjoy the treaty benefit under the dividends article of the China/Hong Kong double tax arrangement (China/HK DTA) based on their existing investment/ business structure. They may need to consider carrying out a group restructuring in order to leverage on the flexibilities offered by Public Notice 9 in fulfilling the beneficial ownership status. In cases where the "extended safe harbour rule" or the "same jurisdiction/same treaty benefit rule" cannot be applied, these groups need to evaluate the impact of the tightened unfavorable factors on them and establish strategies to deal with these changes.

In detail

Public Notice 9 repeals Circular 601 and Public Notice 30 and introduces new principles for assessing the beneficial ownership status for the purpose of claiming tax treaty benefits. This Hong Kong Tax News Flash highlights the three most major changes brought about by Public Notice 9 and their implications for Hong Kong companies. For the other changes and a more detailed discussion of Public Notice 9, please refer to our *China Tax & Business Advisory News Flash, February 2018, Issue 6*[4].

The "extended safe harbour rule"

Under the repealed Public Notice 30, the safe harbour rule only applied to treaty benefit applicants which are a listed company or a company directly/indirectly held by a listed company. As illustrated by examples 1 to 3 in the Appendix, Public Notice 9 extends the scope of the safe harbour rule in respect of dividend income such that the rule now applies to treaty benefit applicants which are (1) a listed company, a government or an individual who is a resident of a tax treaty jurisdiction (example 1 in the Appendix) or (2) a company **wholly owned** directly or indirectly by such listed company, government or individual (examples 2 and 3 in the Appendix).

The new "same jurisdiction/same treaty benefit rule"

Before the issuance of Public

Notice 9, if a Hong Kong company which is the immediate dividend recipient and the treaty benefit applicant (the HK applicant) is neither eligible for the safe harbour rule under Public Notice 30 nor qualified as a beneficial owner (BO) upon assessment based on the seven unfavorable factors set out in Circular 601, it cannot enjoy the treaty benefit for the dividends received from China under the China/HK DTA. Public Notice 9 introduces the "same jurisdiction/same treaty benefit rule" such that even if the HK applicant itself does not qualify as a BO, the HK applicant will be treated as the BO of the dividends.

- **The same jurisdiction rule**: If (1) the shareholder directly or indirectly holding **100% equity interest** of the HK applicant qualifies as a BO upon assessment based on the five unfavorable factors of Public Notice 9 and (2) both the shareholder and the HK applicant are a tax resident of Hong Kong, the HK applicant will be treated as the BO of the dividends. Under this rule, any intermediate shareholder(s) in a multi-tier holding structure need not to be a Hong Kong tax resident (examples 4 and 5 in the Appendix).
- **The same treaty benefit rule**: If (1) the shareholder directly or indirectly holding **100% equity interest** of the HK applicant qualifies as a BO upon assessment based on the five unfavorable factors in Public Notice 9 and (2) such shareholder and all the intermediate shareholder(s) (if any) in the multi-tier holding structure of the HK applicant are a resident of a tax treaty jurisdiction which enjoys the same or better treaty benefit with respect to the dividends received from China as compared to that is entitled by the HK applicant, the HK applicant will be treated as the BO of the dividends. (example 6 of the Appendix)

The rationale of the "same jurisdiction /same treaty benefit rule" seems to be if the 100% direct or indirect shareholder of the Hong Kong applicant could have enjoyed the same or even better treaty benefit on the dividends received from China if it had directly invested in the Chinese investee company, the purpose of setting up the intermediate Hong Kong holding company to hold the Chinese investment would not be to take advantage of the preferential treatment under the dividends article of the China/HK DTA.

This rationale is in line with China's adoption of the Principal Purposes Test as the minimum standard under Action 6 (Preventing treaty abuse) of the Organisation for Economic Co-operation and Development's Base Erosion and Profit Shifting project.

Changes to the unfavorable factors for BO assessment

Public Notice 9 makes some amendments to the seven unfavorable factors in Circular 601 by tightening the first and second factors, deleting the third and fourth factors (as these factors have been incorporated into the second unfavorable factor below) and retaining the fifth to seventh factors. The first and second factors are amended as follows:

1. The applicant has an obligation to pay more than 50% (instead of 60% as in Circular 601) of the income received to a third jurisdiction tax resident within 12 months of receiving the income. An "obligation to pay" includes a contractual obligation and any payment that is *in effect* made by the applicant based on the facts and circumstances even though there is not a contractual obligation to pay; and
2. The applicant does not carry out substantive business activities. Substantive business activities include substantive manufacturing, trading and management activities, etc. Whether the applicant's business activities are "substantive" will be assessed based on the functions performed and risks undertaken by it. The applicant's substantive investment and management activities can be construed as substantive business activities. If the applicant carries out both non-substantive investment/ management activities and other business activities which are insignificant, the applicant will not be regarded as carrying out substantive business activities.

The amendment to the first unfavorable factor indicates that the SAT will not only consider the legal or contractual payment obligation but also examine whether any payment is effected based on the factual circumstances. According to the interpretation notes of Public Notice 9, even if the applicant has not made any cash payment, certain intercompany transactions such as netting off of inter-company payable/receivable or other genuine commercial arrangements (e.g. providing a loan to a group company after receiving the income from China) may be considered as a payment made which may affect the BO status of the applicant.

As for the second unfavorable factor, the interpretation notes of Public Notice 9 provide (1) further guidance on what investment and management activities are and (2) a few examples to illustrate the SAT's views on "substantive business activities". For the situation where an applicant carries out both non-substantive investment/management activities and other business activities, the explanatory notes indicate that 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 regarded as insignificant.

Requirements on certificate of residence status

Public Notice 9 also specifies the requirements on certificate of residence status (CoR) for treaty benefit claims in the following circumstances:

1. Under the "extended safe harbour rule", the treaty benefit applicant (i.e. the HK applicant) as well as the ultimate and intermediate 100% shareholders of the HK applicant need to provide a Hong Kong CoR;
2. under the "same jurisdiction rule", both the treaty benefit applicant (i.e. the HK applicant) and the 100% shareholder of the Hong Kong applicant that qualifies as a BO need to obtain a Hong Kong CoR; and
3. under the "same treaty benefit rule", the treaty benefit applicant (i.e. the HK applicant), the 100% shareholder of the Hong Kong applicant that qualifies as a BO and all the intermediate 100% shareholders (if any) need to obtain a CoR of the relevant tax treaty jurisdictions.

It is worthwhile to note that the "same jurisdiction/same treaty benefit rule" under Public Notice 9 should made it easier for a Hong Kong company receiving dividends from China to enjoy the reduced Chinese withholding income tax rate of 5% under the China/HK DTA even though it may not have sufficient business substance in Hong Kong. However Pubic Notice 9 does not waive the requirement for such Hong Kong company to produce a Hong Kong CoR for claiming the treaty benefit.

Following the issuance of the Public Notice 9, we expect the Inland Revenue Department (IRD) to take a more flexible and pragmatic approach in assessing the Hong Kong CoR application submitted by a Hong Kong company that is deemed as a BO of the dividends under the "same jurisdiction /same treaty benefit rule" on the basis that: (1) the jurisdiction granting the treaty benefit (i.e. China) is willing to take a more flexible approach in assessing the BO status in those situations and (2) there is no treaty abuse motive of setting up such Hong Kong company in those situations.

In particular, in the situation where the Hong Kong applicant is part of a wider Hong Kong based group, we expect the IRD will consider the business substance of the whole group in Hong Kong instead of just the HK applicant in assessing its Hong Kong CoR application as well as the CoR applications of any Hong Kong companies within the group that require a HK CoR in cases where the "same jurisdiction/same treaty benefit rule" under Public Notice 9 is applicable.

The takeaway

Business groups investing into China through a Hong Kong holding company should review whether the "extended safe harbour rule" or the "same jurisdiction/same treaty benefit rule" in Public Notice 9 can facilitate their Hong Kong holding companies to enjoy the treaty benefit under the dividends article of the China/HK DTA based on their existing investment/business structure. They may need to consider carrying out a group restructuring in order to leverage on the flexibilities offered by Public Notice 9 in fulfilling the beneficial ownership status. In cases where the "extended safe harbour rule" or the "same jurisdiction/same treaty benefit rule" cannot be applied, these groups need to evaluate the impact of the tightened unfavorable factors on them and establish strategies to deal with these changes.

Endnotes

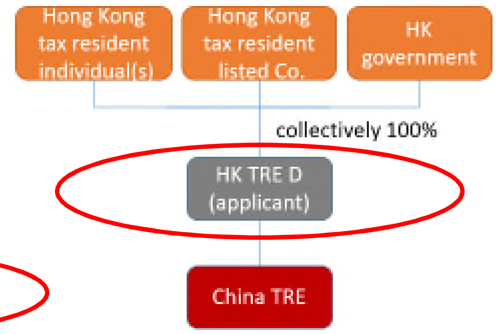
1. Public Notice 9 and its interpretation notes can be accessed via these links: http://www.chinatax.gov.cn/n810341/n810755/c3279059/content.html?from=singlemessage&isappinstalled=0#10006-weixin-1-52626-6b3bffd01fdde4900130bc5a2751b6d1 (Notice) http://www.chinatax.gov.cn/n810341/n810760/c3278984/content.html (Interpretation notes)
2. The safe harbour rule in Public Notice No.30 stipulates that: if the dividend recipient (i.e. the treaty benefit applicant) is a listed company or is directly/indirectly held by a listed company, it will be regarded as the BO of the dividends without the need to go through an assessment based on the seven unfavourable factors set out in Circular 601. The safe harbour rule strictly requires that the immediate recipient of the dividends, 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.
3. The seven unfavorable factors for BO assessment under Circular 601 are: (1) the applicant is obligated to pay or distribute a portion (e.g. ≥ 60%) or all of its income within a prescribed timeframe (e.g. within 12 months of receiving the income) to a third jurisdiction tax 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 number of employees of the applicant is relatively limited and do not match the amount of the income received; (4) the applicant has no or almost no controlling/disposal rights on the income or the assets/rights that generate the income, and bears no or very little risk; (5) the other tax 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 of which the interest arises, the lender has other loan or deposit contracts with a third party with very similar amount of principal, interest rate and time of conclusion; and (7) besides the copyright, patent and technology licensing contract of which the royalty arises, the applicant has other licensing or transfer contracts with a third party with respect to the relevant copyright, patent and technology.
4. *China Tax & Business Advisory News Flash, February 2018, Issue 6* can be accessed via this link: https://www.pwccn.com/en/services/tax/publications/chinatax-news-feb2018-6.html

Appendix

Example 1

Example 2

Example 3



Example 4

Example 5

Example 6

Let's talk

For a deeper discussion of how this issue might affect your business, please contact a member of **PwC's International Tax Advisory Team**:

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* These results are based on an independent survey of 100 primary buyers of tax services in Hong Kong, conducted by research agency Jigsaw Research (Q1-Q4 2016).

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