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NEW GUIDANCE FOR THE DETERMINATION OF "BENEFICIAL OWNER" IN THE CONTEXT OF PRC DOUBLE TAX AGREEMENTS

On 3 February 2018, the China State Administration of Taxation ('SAT') issued Public Notice [2018] No. 9 - "Issues Regarding "Beneficial Owner" in the Context of PRC Double Tax Agreements" ("PN 9") and the official interpretation. The Notice sets out the redefined adverse factors for the determination of "beneficial owner" and extends the eligibility of "safe harbour rule". PN 9 has taken effect from 1 April 2018 and replaces the following circulars:

- ***Circular Guoshuihan [2009] No. 601- "Interpretation and the Determination of "Beneficial Owner" in the Context of PRC Double Tax Agreements" ("Circular 601"); and***
- ***SAT Public Announcement [2012] No. 30 – "Determination of "Beneficial Owner" in the Context of PRC Double Tax Agreements" ("PN 30")***

In this Tax Flash, we will provide you the salient points of PN 9.

1. ADVERSE FACTORS FOR THE DETERMINATION OF "BENEFICIAL OWNER"

Most of the tax treaties have stipulated that only the "beneficial owner" who is a resident of the other treaty state can enjoy treaty relief in respect of dividends, interest, royalty and capital gains. According to Circular 601 issued by SAT in 2009, "beneficial owner" should be determined based on the facts and circumstances of each case and in accordance with the principle of "substance over form". The Circular sets out seven factors/arrangements that would adversely affect a tax relief applicant to be qualified as beneficial owner.

PN 9 now modifies and consolidates these seven adverse factors into five. Besides, it continues the related provisions of Circular 601 and states clearly that when determining whether beneficial ownership exists, all the relevant adverse factors should be analyzed and considered, i.e. determination should be based on a totality of factors.

The adverse factors/arrangements are summarized as follow:

	Circular 601 (repealed)	PN 9
(i)	➢ Within 12 months of receipt, the relief applicant is obligated to pay or distribute more than **60%** of the income to a resident of a third country	➢ Within 12 months of receipt, the relief applicant is obligated to pay[1] or distribute more than **50%** of the income to a resident of a third country
(ii)	➢ The relief applicant has almost no business activities other than ownership of assets or rights that generate the income	➢ The relief applicant does not carry out "substantive business activities"[2] ➢ "Substantive business activities" include substantive manufacturing, trading, management activities etc. ➢ Substantive investment management activities[3] may also be qualified as "substantive business activities"
(iii)	➢ For those relief applicants being a corporation, its assets, scale of operations and employees are relatively small and not commensurate with the amount of income received	Deleted as these 2 factors are covered under the definition of "substantive business activities" in the 2nd adverse factor above
(iv)	➢ The relief applicant has almost no right of control or disposal over the assets or rights from which it derives the income and bears little or no risks	
(v)	➢ The income earned is either exempt from tax or taxed at a low rate in the applicant's jurisdiction	Retained and became the 3rd, 4th and 5th adverse factor of PN 9
(vi) (vii)	➢ For interest/royalty relief, the relief applicant has entered into another loan/IP agreement with third party lender/ intellectual property provider of which the terms are similar to the one entered into between the relief applicant and the PRC party (i.e. "back-to-back" arrangement)	

[1] *PN 9 stipulated that "obligated to pay" includes (i) contractual obligation to pay; and (ii) factual payment but with no contractual obligation to pay. The official interpretation illustrated a case of "non arms-length finance arrangement to group companies after receiving the dividend" as an example of what is "factual payment but with no contractual obligation to pay".*

[2] *"Substantive business activities" should be assessed based on the functions performed and risks assumed by the relief applicant. If a relief applicant carries out both non-substantive investment management activities and other business activities, the scope and significance of the other business activities will have to be taken into account. In case the other business activities are insignificant, the relief applicant's overall business activities cannot be considered as being "substantive".*

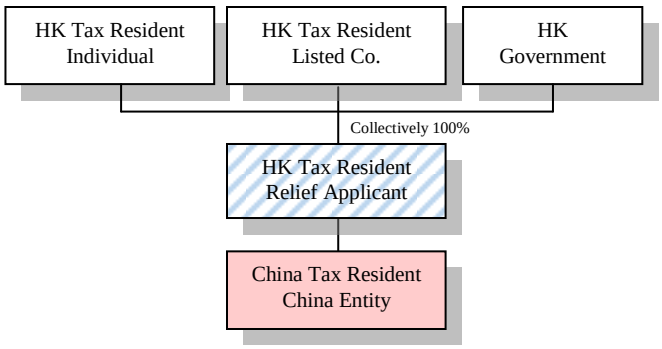
[3] *PN 9 and the official interpretation has set out examples of ""substantive" investment management activities: pre-investment research, project feasibility analysis, investment decision making, investment execution, post-investment management, industry analysis, market research, regional headquarters function, treasury function, financing function, etc.*

2. EXTENDS THE ELIGIBILITY OF "SAFE HARBOR RULE"

Under PN 30, a relief applicant would automatically be deemed as the beneficial owner of the PRC sourced dividend received if the applicant qualified for the "safe harbor rule". PN 9 now extends the eligibility of "safe harbor rule" to include individual and government:

"Safe harbour rule" under PN 30 (repealed)	**"Safe harbour rule" under PN 9**
➢ If the relief applicant is: (a) a listed company who is tax resident of DTA partner state; or (b) a company 100% directly or indirectly[4] owned by a listed company who is tax resident of DTA partner state; it will be directly deemed as the beneficial owner of the dividends received. ➢ There is no need to undergo the adverse factors assessment under Circular 601.	➢ Besides listed company, PN 9 extends the eligibility of safe harbour rule to include (i) individual who is tax resident of DTA partner state; and (ii) the government of DTA partner state

PN 9 also stipulated that if the structure involves more than 1 shareholder, the "safe harbor rule" will still apply as long as all the shareholders are tax residents (including government) of the same DTA partner state and they collectively own 100% shareholding in the relief applicant (who is tax resident of the same DTA partner state):



The above structure (assuming all the shareholders and the relief applicant are Hong Kong tax residents) was illustrated as Example 3 of the official interpretation.

[4] *The intermediate holding company must be a tax resident of the same DTA partner state, and the shareholding percentage in the safe harbor rules must be met at all times during the 12 consecutive months before dividends are received. Such requirements are retained by PN 9.*

3. DIVIDEND RECIPIENT NOT QUALIFIED FOR "SAFE HARBOUR RULE" AND "BENEFICIAL OWNER"

Before the release of PN 9, a non-China dividend recipient can enjoy tax treaty benefits only if it:

- qualified for the PN 30 "safe harbor rule"; or
- qualified as "beneficial owner" based on the "adverse factors" assessment under Circular 601

PN 9 now stipulates that even the non-China dividend recipient (i.e. the relief applicant) did not qualify for the "safe harbor rule" and the "adverse factors" assessment, it can still be deemed as beneficial owner and enjoy relevant tax treaty benefits under one of the following two cases[5,6]:

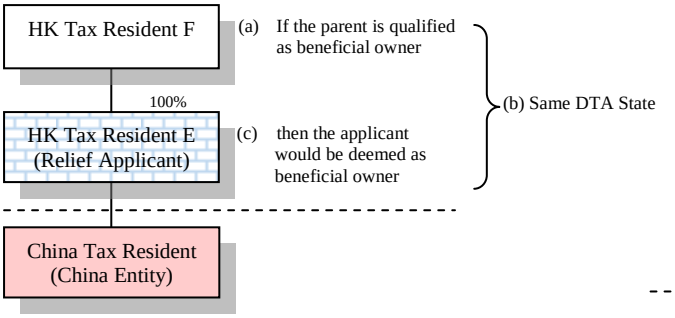
Case I - Same Tax Jurisdiction Structure

Condition:

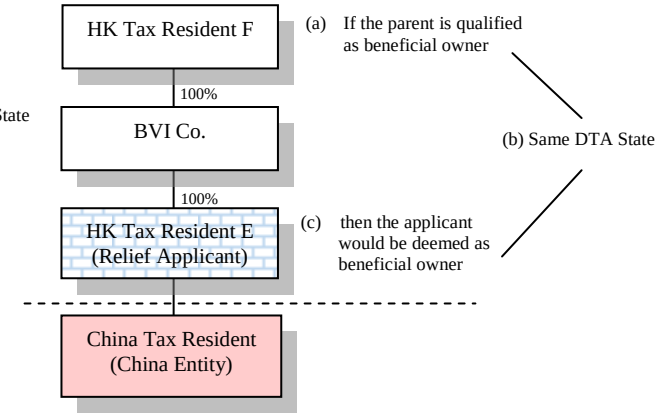
(i) The shareholder holding 100% equity interest of the relief applicant (directly or indirectly) qualified as beneficial owner under the PN 9 "adverse factors" assessment; and
(ii) the relief applicant and the abovementioned shareholder are tax resident of the same tax jurisdiction.

For illustration, the official interpretation sets out the following structures as Example 4 and 5 (assuming "Tax Resident E" and "Tax Resident F" are Hong Kong tax residents):

Example 4



Example 5



In both cases, both "Tax Resident E" and "Tax Resident F" are tax residents of the same tax jurisdiction (in the above examples, Hong Kong). Although the relief applicant (i.e. "Tax Resident E") itself does not qualify as the beneficial owner of the dividend received under the PN 9 "adverse factors" assessment, it would still be deemed as the beneficial owner if "Tax Resident F" is qualified as beneficial owner under the PN 9 "adverse factors" assessment.

As illustrated in Example 5, the application of the "same tax jurisdiction structure" will not be affected by the existence of intermediate shareholder in the investment structure, even it is from a different tax jurisdiction (in this example, BVI).

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[5] *The shareholding percentage of the immediate holding company (direct or indirect) must be 100%. It will not apply to any case with less than 100% shareholding structure.*

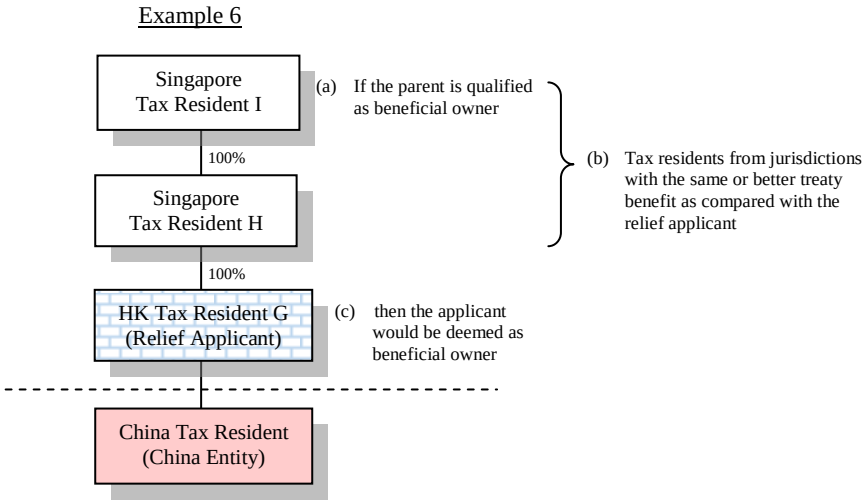
[6] *Not applicable to interest and royalty articles under tax treaties.*

Scenario II - Same Tax Treaty Benefit Structure

Condition:

(i) The shareholder holding 100% equity interest of the relief applicant (directly or indirectly) qualified as beneficial owner under the PN 9 "adverse factors" assessment;
(ii) the above-mentioned shareholder and all the intermediate shareholders in between are tax residents of jurisdictions with the same or better treaty benefit on dividend as compared with the relief applicant; and
(iii) all the shareholders have to obtain tax resident certificate from the tax authorities of their own jurisdiction.

The official interpretation sets out the following structure as Example 6:



In this example, the "Tax Resident G" (Hong Kong) itself does not qualify as the beneficial owner of the dividend received under the PN 9 "adverse factors" assessment. However, "Tax Resident I" (Singapore) does. Since "Tax resident I" (Singapore) and all the intermediate shareholders (in this example, "Tax Resident H" (Singapore)) are tax resident of jurisdictions that can enjoy the same treaty benefit with respect to dividend (under the China/Singapore tax treaty) as compared with the relief applicant (under the China/Hong Kong tax treaty), "Tax Resident G" (Hong Kong) would be deemed to be the beneficial owner of the dividends received.

4. OTHERS

- Using an agent to collect income will not affect the recognition of beneficial owner status. However, "agents or designated recipients receiving income on behalf of others" do not include:

  - shareholders receiving dividends;
  - creditors receiving interest; and
  - licensors receiving royalties

- Tax residence certificates must certify the residence status for the year in which the income was received or for the previous year.

5. POINTS TO NOTE

In response to BEPS Action Point 6 (Preventing the Granting of Treaty Benefits in Inappropriate Circumstances), SAT has set out very stringent redefined "adverse factors" assessment (in particular the "substantive business activities" test) in PN 9 for the determination of beneficial owner. In addition, the Notice also stipulated explicitly that the tax authority can still invoke the main purpose test under a tax treaty or the general anti-avoidance rule (GAAR) in domestic tax law to deny those relief applicant who has successfully passed the "adverse factors" assessment to enjoy the treaty benefits if the authority considers the structure/arrangement was carried out to take advantage of benefits available in certain tax treaties.

For many years, beneficial ownership has been a very challenging area for non-resident taxpayers in China. Foreign investors setting up intermediate holding companies to hold investments in the PRC should study the implications of PN 9, review their existing investment structure and take appropriate actions if necessary (e.g. group restructuring).

RSM Tax Advisory (Hong Kong) Limited

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- Advise on tax efficient holding and operational structures for new cross-border investment, including the formation of Hong Kong and Chinese business entities
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- Assist clients to discuss and clarify matters with tax officials, including transfer pricing and advance rulings
- Act as client representative in tax audits and tax investigations
- Provide transaction support services on mergers and acquisitions, including tax due diligence, deal structure advice, tax health checks, related human resources arrangements and other tax compliance and consultation services
- Advise on human resources and structuring employment arrangements in a tax-efficient manner
- Advise on tax equalization schemes
- Provide tax compliance services for individual and corporate clients in Hong Kong and China

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