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SAT issues guidance on beneficial ownership of dividends under tax arrangement with Hong Kong

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China's State Administration of Taxation (SAT) issued guidance on 12 April 2013 (*Shuizonghan* [2013] No. 165 (Circular No. 165)) in response to enquiries from various provincial and city SAT offices as to whether certain Hong Kong companies should be regarded as beneficial owners of dividends received for purposes of the tax arrangement between Mainland China and Hong Kong. Although Circular No. 165 is addressed to the relevant local SAT offices, the guidance is expected to be followed generally by all tax authorities in China with respect to the application of similarly worded dividends articles in China's other tax treaties.

Circular No. 165 clarifies rules issued in 2009 and 2012 which provided guidance on whether a resident of a contracting state should be considered the beneficial owner of particular items of income under the dividend, interest and royalties articles of China's tax treaties (Circular No. 601 and Bulletin No. 30, respectively). Circular No. 165, which provides guidance on the application and interpretation of the relevant provisions of the previous guidance in relation to dividends, was formulated on the basis of internal SAT studies and consultation with the Hong Kong Inland Revenue Department.

Interpretation of Circular No. 601

For a nonresident to benefit from reduced withholding tax rates on dividends, interest and royalties under Chinese tax treaties, the nonresident must be considered the "beneficial owner" of the income. Circular No. 601 defines the term beneficial owner and sets out a number of "negative factors" that could affect a nonresident's status as a beneficial owner. Circular No. 165 addresses the following negative factors set out in Circular No. 601, in relation to dividends:

1) *Article 2(1): The applicant is obliged to distribute or pay the entire or most (such as above 60%) of the income within the prescribed time period (such as within 12 months of the date of receipt of income) to a resident of a third country (or area).*

   Circular No. 165 focuses on the words "*obliged to distribute … to a resident of a third country*" and the relationship between the nonresident applicant and its immediate parent company. According to Circular No. 165, consideration of the Circular No. 601 factor is irrelevant if the applicant does not distribute its "profits" to a non-Hong Kong resident enterprise. However, if it does distribute profits to a non-Hong Kong immediate parent company,

the applicant must submit documentary evidence about its obligation to make such distributions, including any contractual obligations. The responsible tax authorities should formulate their conclusions on this adverse factor based on the evidence provided.

Circular No. 165 may be read to imply that this Circular No. 601 negative factor is irrelevant in determining the beneficial owner status of a Hong Kong resident enterprise which distributes its profits only to other Hong Kong resident enterprises, e.g., a Hong Kong company which is wholly-owned by another Hong Kong company.

2) *Article 2(2): Other than the rights or property from which the item of income is derived, the applicant has no, or hardly has any, other business activities.*

Circular No. 165 clearly states that the existence of this single negative factor should, in and of itself, not disqualify an applicant from being regarded as the beneficial owner of dividends. Circular No. 165 clarifies that the phrase "*business activities*" includes "*investing in the shares in respect of which the dividends are received*," and the phrase "*has no, or hardly has any, other business activities*" is intended to catch companies whose only investment and business operations relates to the shares in respect of which the dividends received.

3) *Article 2(3): In the case where the applicant is an entity such as a corporation, its assets, scale of business, and personnel deployment are comparatively small (or small), and not commensurate with its income.*

Circular No. 165 specifies that the tax authorities should not merely focus on the single factors enumerated, e.g., the number of employees employed by the applicant or whether the applicant pays those individuals; and should not equate the applicant's "assets" with its registered capital. All relevant facts are to be considered, including:

- How the applicant is funded, as well as the level of risk it bears in relation to its investments; and
- The nature of the work performed by, and the role and responsibilities of, the employees of the applicant.

4) *Article 2(4): With respect to the item of income, or the property or right from which that item of income is derived, the applicant has no or minimum right to control or dispose of, nor does it bear any risks.*

Circular No. 165 focuses on the words: "*has no or minimum right to control or dispose of, nor does it bear any risks.*" The tax authorities should not conclude that the applicant does not possess the right to control or dispose of its investments merely because the applicant is wholly owned by its immediate parent company.

In deciding whether the applicant possesses the right to control or dispose of its investments, the tax authorities should focus on the following factors:

- Whether the provisions of relevant legal documents grant the applicant such rights;
- Whether the applicant has exercised such rights; and
- Whether the exercise of such rights was at the discretion of the applicant.

5) *Article 2(5): The relevant income is non-taxable or exempted by the other contracting state (or area); or, if being taxable, the effective tax rate is extremely low.*

The fact that Hong Kong does not tax offshore source income should not be the "key factor" in deciding that the applicant is not the beneficial owner of the dividends received.

Interpretation of Bulletin No. 30

Bulletin No. 30 clarifies the determination of beneficial owner under China's tax treaties and introduces a listed company safe harbor, which simplifies the definition of beneficial owner to the extent recipients of dividends are qualifying listed companies or group companies. Circular No. 165 provides guidance on the application and interpretation of the listed company safe harbor. Article 3 of Bulletin No. 30 provides as follows:

> "*If a resident of the other contracting state ("the applicant") applies for preferential tax treatments of China-sourced dividends under a DTA, it can be recognized directly as a beneficial owner, provided that it is a company listed in the other contracting state or is 100% owned directly or indirectly by a company listed in the other contracting state which is also a resident of the other contracting state (excluding cases where the shares of the applicant are indirectly held by the listed company through a resident company of a third state which is a resident of neither China nor the other contracting state)…*"

Circular No. 165 clarifies that this safe harbor rule is meant to provide preferential treatment in relation to listed company groups located in relevant treaty jurisdictions, in this case, Hong Kong. The safe harbor is not meant to be applied to disqualify applicants that do not satisfy the conditions of the safe harbor from being regarded as beneficial owners of dividends received; in particular:

- An applicant that is directly or indirectly wholly owned by an unlisted Hong Kong resident company; and
- An applicant that, although ultimately controlled by a Hong Kong company, is immediately owned by an intermediate holding company that is located in a third jurisdiction.

Other

Circular No. 165 also stipulates that the treatment accorded an applicant for treaty benefits should be consistent among the relevant tax authorities responsible for the companies from which dividends are received by the applicant.

Taxpayers may apply for its beneficial ownership status to be reassessed in the event of substantial changes in its business.

Comments

The additional guidance and clarification provided by Circular No. 165 are welcome. The circular addresses many, although not all, of the issues and questions that have been encountered by taxpayers applying for treaty benefits. The comments in Circular No. 165 that all relevant facts and circumstances should be considered, and no one negative factor, of itself, should disqualify the applicant from being regarded as beneficial owner, as well as the stipulation the treatment of a taxpayer should be consistent across different tax bureaus, are especially welcome.

The guidance may be regarded as part of the SAT's efforts to respond to the need for more certainty and improve consistency in taxpayer treatment. It is hoped that such efforts on the part of the SAT will continue.

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