

Tax

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Tax Analysis

SAT Published New Rules on Beneficial Owners

On 3 February 2018, China's State Administration of Taxation (SAT) published new rules on the concept of a beneficial owner (BO) of income under China's tax treaties: *Bulletin of the SAT on Matters Concerning "Beneficial Owners" in Tax Treaties* (Bulletin [2018] No. 9 (Bulletin 9)). Bulletin 9 will apply to tax payment or withholding obligations that arise on or after 1 April 2018, and provides welcome clarifications on various aspects of the rules regulating BO status.

For a non-resident to benefit from reduced withholding tax rates on dividends, interest and royalties under China's tax treaties, the non-resident must be considered the BO of the income. Since 2009, the SAT has issued several sets of guidance that address the concept of BO and the requirements to qualify for BO status. Circular 601, *Circular of the SAT on the Interpretation and the Determination of "Beneficial Owners" in Tax Treaties* (Guo Shui Han [2009] No. 601), issued in 2009, defined the term BO and set out seven "negative factors" that could affect a nonresident's status as a BO. Bulletin 30, *Bulletin of the SAT on the Determination of "Beneficial Owners" in Tax Treaties* (Bulletin of the SAT [2012] No. 30), issued in 2012, clarified the determination of BO status and introduced a listed company safe harbor, which allowed automatic qualification as a BO where the recipient of dividends is a qualifying listed company or is wholly owned by a qualifying listed company.

Bulletin 9 repeals Circular 601 and Bulletin 30 in their entirety while retaining certain provisions unchanged and amending the rules on the determination of BO status, the safe harbor and the requirement to produce a tax residence certificate. Bulletin 9 expands the ways in which a non-resident can achieve BO status, but it also revises the negative factors in ways that will make it more difficult for non-residents to obtain tax treaty benefits. The official interpretation notes accompanying Bulletin 9 contain practical examples that provide detailed and clarifying guidance for both taxpayers and the Chinese local tax authorities on how to understand and implement the rules in the bulletin.

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Question 1: What changes does Bulletin 9 make to the seven negative factors in Circular 601 that are used to determine a non-resident's status as a BO?

Answer 1: Circular 601 contains seven factors that are taken into account by the tax authorities in determining whether a "recipient" of China-source income is a BO under a tax treaty (the term "recipient" as used in this article does not include situations where the recipient is acting as an agent). Bulletin 9 modifies the first and second factors, which will make it more difficult for a non-resident to obtain BO status. Bulletin 9 deletes the third and fourth factors in Circular 601 because, as explained in the interpretation notes, the analysis that must be made on factors three and four is incorporated into the factor two assessment. Bulletin 9 does not make any changes to the fifth, sixth and seventh negative factors in Circular 601, so there will be only five negative factors after 1 April 2018.

Table 1 compares the negative factors in Circular 601 and Bulletin 9:

Table 1

Circular 601	Bulletin 9
<p>1. The recipient is obligated to distribute or pay all or most of the income (e.g. more than 60%) to a resident(s) of a third jurisdiction within a prescribed period of time (e.g. within 12 months after it receives the income).</p>	<p>1. The recipient is obligated to pay more than 50% of the income to a resident(s) of a third jurisdiction within 12 months after it receives the income. "Obligated to pay" for this purpose means that the recipient of the income has a contractual obligation to pay or if there is no contractual obligation to pay, the recipient actually has made a payment(s).</p>
<p>2. Other than holding the rights or property from which the income is derived, the recipient conducts no or very few other business activities.</p>	<p>2. The business activities carried out by the recipient of the income do not qualify as substantive business activities; substantive business activities include substantive manufacturing, trading and management activities, etc.</p> <p>The determination of whether the recipient has carried out substantive business activities will be made based on the functions performed and risks assumed by the recipient.</p> <p>Substantive investment management activities can qualify as substantive business activities. Where a recipient carries out both non-substantive investment management activities and other business activities, it will not be considered as being engaged in substantive business activities if the other business activities are insignificant.</p>

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3. Where the recipient is an entity, such as a corporation, its assets, the size of its business and the number of its personnel are comparatively small (or insufficient), and not commensurate with its income.	Deleted
4. With respect to the income or the property or rights from which the income is derived, the recipient has little or no right to control or dispose of the relevant income/property, and bears few or no related risks.	Deleted
5. The recipient is exempt from tax on the relevant income or the income is not taxable in the residence jurisdiction, and if the income is taxable, the effective tax rate is extremely low.	Unchanged, now factor 3
6. In addition to a loan agreement under which interest arises and is paid, the creditor has concluded another loan agreement or deposit agreement with a third party and that agreement contains similar terms, such as the amount, interest rate and signing date, etc. to the first mentioned loan agreement.	Unchanged, now factor 4
7. A license or transfer agreement exists between the non-resident and a third party relating to the right to use, or the transfer of the ownership of, the copyright, patent or technology covered by the license agreement, based on which a royalty is derived and paid.	Unchanged, now factor 5

Question 2: What changes does Bulletin 9 make to the first negative factor stipulated in Circular 601?

Answer 2: Bulletin 9 makes the following main changes to the first factor:

- Specifies that "12 months from the date the income is received" is the measuring period for determining whether the recipient is obligated to distribute the income to a resident in a third jurisdiction;
- Lowers the payment ratio threshold from 60% to 50%; and
- Specifies that an obligation to pay includes an actual payment in cases where there is no contractual obligation to make a payment.

To illustrate the last bullet point, the interpretation notes contain an example of a financing arrangement. Under the arrangement, each time the non-resident received dividends from its Chinese subsidiaries, it used at least 80% of the income to make loans to its parent entity within a month of the date the dividends were received. In this example, the loan arrangement was not found to comply with the arm's length principle because it did not specify the loan repayment period and the interest rate was lower than the benchmark bank loan interest rate in the country where the recipient was located. Therefore, the first negative factor in this situation would be considered to be present.

Despite the example in the interpretation notes, we do not believe that using income received from China to make a related party loan *automatically* would be deemed to result in the presence of the first negative factor. Instead, we believe it would be necessary to examine the business purpose for the loan and whether the transaction complies with the arm's length principle. Further, as stipulated in both Bulletin 9 and Bulletin 30, *all* of the negative factors—not merely one factor—must be analysed in their totality in determining BO status.

Question 3: What changes does Bulletin 9 make to the second negative factor stipulated in Circular 601?

Answer 3: Bulletin 9 makes the following main changes to the second factor:

- Bolsters the requirement relating to business activities carried out by the recipient by changing the standard "*recipient conducts no or very few other business activities*" to the "*business activities carried out by the recipient are not substantive business activities*";
- Clarifies that "substantive business activities" include "substantive investment management activities" and provides further guidance through examples in the interpretation notes; and
- Provides that where a recipient 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 practice, the tax authorities and taxpayers have not always been able to agree on how to demonstrate that an investment holding company engages in substantive business activities. The interpretation notes contain some guidance by stating that "generally, the recipient should carry out activities such as pre-investment research, evaluation and analysis, making investment decisions, execution of investment, post-investment management, etc."

Table 2 summarizes three examples relating to the meaning of substantive business activities in the official interpretation notes:

Table 2

	Case I	Case II	Case III
Functions	The recipient claims it carried out investment management activities, but it did not actually perform any industry research or market analysis or actually manage its Chinese subsidiaries.	The recipient did not perform any industry research or market analysis in relation to China, but it did perform functions such as evaluating and analysing investment plans, making investment decisions and acting as the regional treasury center for its Asian subsidiaries.	The recipient's main function is to select and acquire target companies in the IT industry. It performs tasks such as industry research, conducting surveys on the regional market, evaluating investment projects, carrying out investment risk analyses, target screening and selecting, making investment decisions, carrying out post-investment management, etc. The recipient also actively manages the subsidiaries it acquired.
Assets and personnel	The recipient claims to have five employees, but all of these individuals actually work for the parent entity of the recipient, and the recipient does not have any personnel engaged in the management of the Chinese subsidiaries.	Other than its Chinese subsidiaries, the recipient has investments in about 50 companies in more than 10 countries (including Japan, Korea, Vietnam, and Singapore). It has eight employees.	Sixty percent of the recipient's subsidiaries are based in China, with the remaining subsidiaries based in neighboring countries. The recipient has more than 50 employees, who perform the functions described above.
Risks	The recipient has no investment plan for the dividends received from its Chinese subsidiaries and did not assume any risks in relation to the dividends.	No information is provided.	The recipient did not distribute profits to its parent entity; instead, it used the profits to acquire new targets or help expand the business of its existing subsidiaries.
Conclusion	The recipient does not carry out substantive business activities.	The recipient is, to some extent, engaged in substantive investment management activities since it is the regional headquarters, but it only has eight employees and, therefore, lacks the resources to perform all the relevant functions, some of which were performed by the recipient's parent entity. Therefore, the recipient cannot be considered as being engaged in sufficient substantive business activities.	The tax authorities would tend to accept the recipient as having BO status.

The interpretation notes also contain an example under which the recipient of China-source income carried out both non-substantive investment management activities and other business activities (e.g. procurement services and trading activities). Because the profits earned from the other business activities account for only 8% of the recipient's total profits (including profits derived from China), the other business activities are considered insignificant and, thus, the recipient is not treated as being engaged in substantive business activities.

Question 4: How does Bulletin 9 amend the safe harbor rule provided in Bulletin 30 under which an applicant automatically can be recognized as the BO of its China-source dividends?

Answer 4: Bulletin 9 expands the scope of the safe harbor rule.

As noted above, Bulletin 30 introduced a safe harbor for listed companies that derive China-source dividend income. Bulletin 9 expands the scope of the safe harbor to include dividends received by (i) listed companies resident in the other state, individuals resident in the other state and the government of the other state, and (ii) recipients that are wholly held by such persons and resident in the other state. In these cases, the recipient of the dividends will be deemed to be the BO of the dividends and it will not be necessary to make an assessment of the five negative factors mentioned above.

Table 3 compares the rules in Bulletin 30 with the new rules introduced in Bulletin 9.

Table 3

Bulletin 30	Bulletin 9
<p>If a resident of the other contracting state applies for preferential tax treatment of China-source dividends under a tax treaty, it automatically will be recognized as a BO, provided it is a company listed in the other contracting state or is wholly owned directly or indirectly by a company listed in the other contracting state that also is a resident of that other contracting state (except for cases where the shares of the recipient are held indirectly through a company resident in a jurisdiction other than China and the other contracting state) and the dividends are derived from the shares held by the listed company.</p>	<p>The following recipients of China-source dividends automatically will be recognized as BOs and will not be required to undergo a comprehensive assessment of the five negative factors:</p> <ol style="list-style-type: none"> 1) Government of the other contracting state; 2) Company that is a resident of and listed in the other contracting state; 3) Individual who is a resident of the other contracting state; and 4) Recipient that is wholly owned, directly or indirectly, by one or more persons described in bullets 1) to 3), and any intermediary shareholders are residents of China or the other contracting state in situations where the shares are held indirectly.

An example in the interpretation notes shows a shareholding structure under which the shares of the China-source income recipient are held by multiple parties that qualify for the safe harbor (see Diagram 1 below). In this case, HK Resident Company D invests in PRC Resident Company and derives dividends therefrom. HK Resident Company D is wholly owned by a HK resident individual, the HK government and a HK resident company that is listed in HK. HK Resident Company D can be automatically recognized as a BO.

Diagram 1



Bulletin 9 also requires that the shareholding percentage in the safe harbor rules be met at all times during the 12 consecutive months before dividends are received, which reflects the requirement for shareholding continuity. A similar requirement can be found in other SAT guidance: (i) Circular 81 (Guoshuihan [2009] No. 81), where "preferential tax treatment can be granted provided the non-resident company owns directly at least 25% of the shares of a Chinese resident company at all times during the 12 consecutive months before receiving the dividends;" and (ii) article 10 (relating to dividends) of Circular 75 (Guoshuifa [2010] No. 75), where "if a Singapore resident company owns directly at least 25% of a Chinese resident company at all times during the 12 consecutive months before receiving the dividends, the Singapore resident company may be entitled to benefits under the China-Singapore tax treaty."

Question 5: Circular 601 and Bulletin 30 provide that a non-resident may not enjoy treaty benefits if it does not fall within the scope of the safe harbor or qualify as a BO on its own after a comprehensive assessment of the negative factors. Does Bulletin 9 make any changes to this rule?

Answer 5: Yes, Bulletin 9 allows a path for a recipient of dividends to qualify for tax treaty benefits even when the recipient does not qualify for the safe harbor or as a BO on its own. Bulletin 9 provides that the recipient will be recognized as a BO if its shareholder that wholly owns, directly or indirectly, the equity of the recipient can meet the BO requirements after an overall assessment of the five negative factors is made, and the conditions in one of the two scenarios below are satisfied. This new provision will significantly increase the chances for a recipient to enjoy treaty benefits.

Scenario 1

The person who can meet the BO requirements is a tax resident of the same jurisdiction as the recipient of the dividends.

If the shareholder of the recipient of dividends meeting the BO requirements is resident in the same jurisdiction as the recipient, it is irrelevant whether there are any intermediary shareholders between this shareholder and the recipient or what the status is of the intermediary shareholders (e.g. where the intermediary shareholder is a tax resident, etc.).

The interpretation notes include an example as shown in Diagram 2: HK Resident E invests in a Chinese Resident Company and receives dividends. Although HK Resident E itself does not meet the BO requirement, it can be recognized as the BO by virtue of being wholly owned by its indirect shareholder F, also a HK resident, which can meet the BO requirements. The presence of the shareholder in an intermediary jurisdiction, BVI (which does not have a tax treaty with China), is irrelevant.

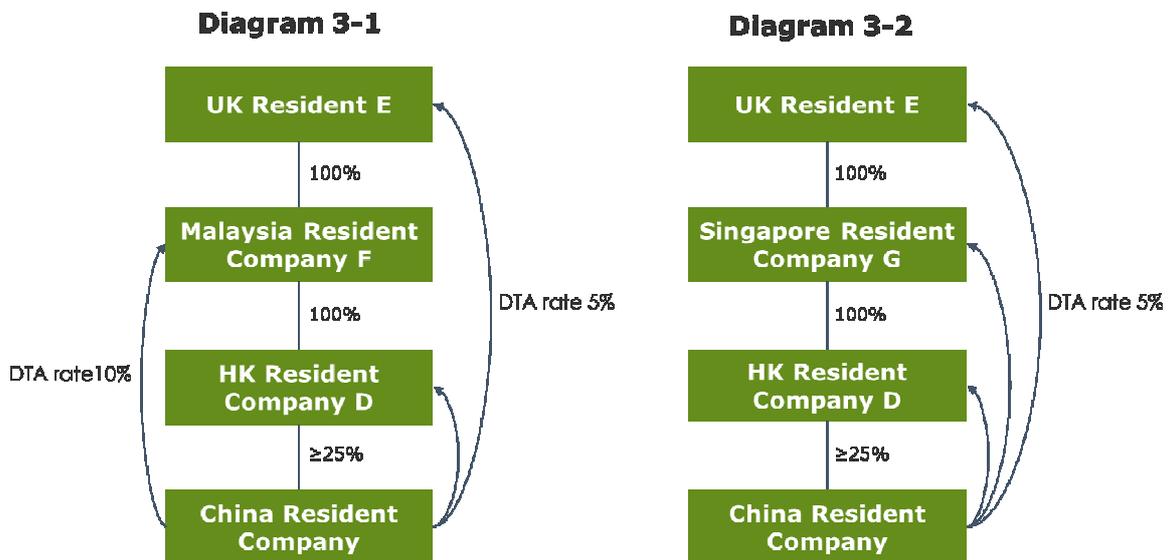


Scenario 2

The person that can meet the BO requirements is not a tax resident of the same jurisdiction as the recipient. However, it and any intermediary shareholders all are "qualified persons." As defined in Bulletin 9, a "qualified person" is a person that is resident in a tax treaty jurisdiction and is entitled to treaty benefits pursuant to the relevant treaty (or arrangement) between China and the person's country of residence on China-source dividends that are the same as or better than those to which the recipient would be entitled.

In Diagram 3-1 and 3-2, HK Resident D invests in a Chinese Resident Company and receives dividends income. HK Resident D cannot meet the BO requirements, but its 100% indirect shareholder, UK Resident E, can meet the requirements. In Diagram 3-1, since the intermediary shareholder, Malaysia Resident Company F, only is entitled to a 10% withholding tax rate on dividends (under the China-Malaysia tax treaty), which is higher than the 5% rate to which HK Resident D would be entitled (under the mainland China-HK tax arrangement), Malaysia Resident Company F is not a qualified person. Therefore, HK Resident D cannot be recognized as a BO by virtue of its shareholder, UK Resident E.

In Diagram 3-2, since the intermediary shareholder, Singapore Resident Company G, can enjoy a 5% withholding tax rate (under the China-Singapore tax treaty), which is the same as the rate to which HK Resident D would be entitled (under the mainland China-HK tax arrangement), G is a qualified person. Similarly, UK Resident E also is a qualified person (because of the China-UK treaty rate on dividends). As a result, HK Resident D can be recognized as a BO by virtue of its shareholder UK Resident E.



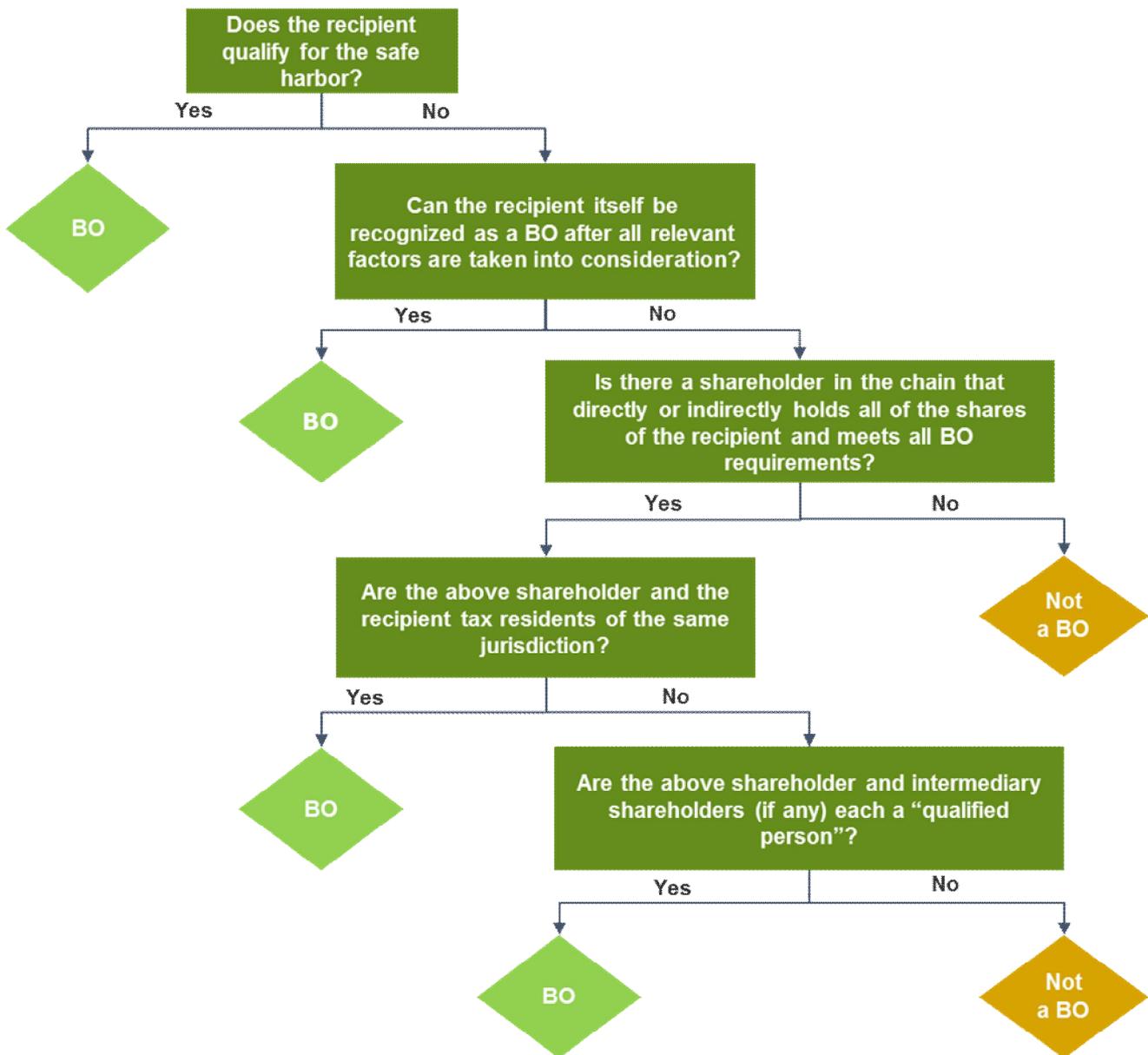
It is clear from Diagram 2, 3-1 and 3-2 that where a recipient can obtain BO status only by virtue of its 100% indirect shareholder that meets the BO requirements, the criteria for the intermediary shareholder is more stringent in cases where the recipient and the shareholder meeting the BO requirements are not residents in the same jurisdiction.

In line with the shareholding period under the safe harbor rules, in scenario 1 and scenario 2, Bulletin 9 requires the shareholding percentages be met at all times during the 12 consecutive months before dividends are received.

Summary of considerations for recognition of BO status

The following decision tree sets out the requirements for obtaining BO status for China's tax treaty purposes:

Diagram 4



Question 6: What are the new documentation requirements to claim treaty benefits?

Answer 6: Bulletin 9 introduces new requirements relating to the period covered by the tax residence certificate and the persons whose certificates must be submitted.

Bulletin 9 requires that tax residence certificates must certify the residence status for the year in which the income was received or for the previous year. For example, if a taxpayer applies for treaty benefits in 2018 with respect to income derived in 2016 and claims a tax refund for the tax withheld, the tax residence certificate must show the residence status for 2016 or 2015.

Table 4 contains a list of the persons whose tax residence certificates must be submitted and summarizes the requirements relating to the intermediary shareholders in a multi-tier structure.

Table 4

	Safe harbor rule	Scenario 1	Scenario 2
Is an intermediary shareholder allowed?	Yes	Yes	Yes
Can the intermediary shareholder be a resident of a third jurisdiction?	No	Yes	Yes
Are there any additional requirements relating to intermediary shareholders?	No	No	Must be a "qualified person"
Whose tax residence certificate must be submitted?	(i) the recipient, (ii) the person that wholly owns, directly or indirectly, the shares of the recipient and that is a resident listed company, a resident individual or the government in the other contracting jurisdiction, and (iii) intermediary shareholders (if any)	(i) the recipient, and (ii) the person that meets the BO requirements and that wholly owns, directly or indirectly, the shares of the recipient	(i) the recipient, and (ii) the person that meets the BO requirements and that wholly owns, directly or indirectly, the shares of the recipient and (iii) intermediary shareholders (if any)

Question 7: Are treaty benefits available in all cases where BO status is obtained?

Answer 7: No, according to Bulletin 9, even if a recipient of China-source income is considered the BO, the tax authorities still can invoke the main purpose test under a tax treaty or the general anti-avoidance rule (GAAR) in domestic tax law to deny treaty benefits.

Some of China's recent tax treaties include a main purpose test. One type of a main purpose test applies to the treaty as a whole. For example, article 29(1) (miscellaneous rules) of the China-Germany treaty provides that "the benefits of this Agreement shall not be available where the main purpose for entering into certain transactions or arrangements was to secure these benefits and obtaining those benefits would be contrary to the object and purpose of the relevant provisions of this Agreement."

Another type of a main purpose test applies to specific provisions, such as dividends, interest, royalties and other income articles. For instance, article 10(7) (dividends) of the China-UK treaty stipulates that "the provisions of this Article shall not apply if it was the main purpose or one of the main purposes of any person concerned with the creation or assignment of the shares or other rights in respect of which the dividend is paid to take advantage of this Article by means of that creation or assignment."

In addition, on 7 June 2017, China signed *OECD Multilateral Convention to Implement Tax Treaty Related Measure to Prevent Base Erosion and Profit Shifting*, which introduced the "Principal Purpose Test" (PPT) into China's tax treaty network, which is similar to the first type of the main purpose test, so that once the relevant provisions enter into force with respect to China's covered tax agreements, the impact of the PPT will be much broader.

Some controversy has arisen about the power of the Chinese tax authorities to invoke the domestic GAAR to deny treaty benefits. Bulletin 9 makes clear that, even if a recipient is a BO, the tax authorities still can initiate a GAAR investigation. In practice, disputes about the application of the GAAR often relate to capital gains, and we understand that since the domestic GAAR can override BO status, the authorities should be able to deny treaty benefits relating to capital gains.

Question 8: Does Bulletin 9 contain new rules on the use of an agent?

Answer 8: Bulletin 9 further clarifies the concept of an agent and sets out the situations that do not fall within the scope of the phrase "receiving the income on behalf of the applicant" under Bulletin 30.

Consistent with Bulletin 30, Bulletin 9 confirms that using an agent to collect income will not affect the recognition of BO status of a non-resident. Bulletin 9 also clarifies that the concept of "receiving the income on behalf of the applicant" by an agent does not include situations where shareholders receive dividends based on the holding of shares, creditors receive interest based on a debt claim and licensors receive royalties based on licensing arrangements.

Comments

BO status has been an area of focus for both the Chinese tax authorities and taxpayers. The publication of Bulletin 9 makes the BO rules in China more comprehensive. On the one hand, Bulletin 9 increases the opportunities for recipients to enjoy treaty benefits and provides clearer guidance to the tax authorities and taxpayers on many issues. On the other hand, Bulletin 9 signals that the PRC tax authorities aim to prevent treaty abuse. Potentially affected parties should study the implications of Bulletin 9 and take appropriate steps for their existing or future cross-border structures.

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