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China Alert

China Issued Supplementary Rule for Determination of Beneficial Ownership for Treaty Benefits Claim

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On 29 June 2012, the State Administration of Taxation (“SAT”) in China issued the long awaited supplementary rule i.e. Bulletin [2012] No.30 (“Bulletin 30”) to Guoshuihan [2009] No.601 (“Circular 601”) to provide clarification on determining beneficial ownership for the enjoyment of PRC Double Tax Treaty (“DTA”) Benefits in respect of dividend, interest and royalty etc (“Passive Income”) derived from China. Bulletin 30 took effect from 29 June 2012. It addresses a number of technical and practical issues for implementation that were not previously covered in Circular 601. Subsequent to the release of Bulletin 30, the SAT further elaborated its position in a policy explanatory note published on its official website on 16 July 2012.

Background

The concept of “beneficial owner” has been used in the OECD¹ model treaties and is generally applied to assess qualification of prescribed passive income recipients for the claim of treaty benefits. Although the OECD issued a Discussion Draft on Clarification of the Meaning of “Beneficial Owner” in the OECD Model Tax Convention for public consultation in 2011, it has not yet pinned down a clear definition of the beneficial ownership concept as of 1 August 2012. While the OECD and some foreign jurisdictions were still reviewing and updating their interpretations of beneficial ownership concepts and rules, the China SAT made a decisive move and issued its first domestic rule, i.e. Circular 601 in October 2009 to set out basic parameters in determining beneficial ownership status for the purpose of DTA benefits claim. Circular 601 expressly stipulates seven factors that would lead to unfavourable results in determining beneficial ownership, and has been enacted with a view to combating the abuse or misuse of double tax treaties by foreign investors to obtain tax benefits.

Since the release of Circular 601, there were observations that the guidelines laid down by the circular might not have been applied consistently by the Chinese tax authorities in different locations. Issues that have not been clearly addressed in Circular 601 were also susceptible to variations in interpretations and implementation across different tax bureaus. In response to calls from taxpayers, industry participants and professional organisations for further guidance on the beneficial ownership assessment process, the SAT released the much-awaited supplementary rule Bulletin 30.



Comprehensive Assessment based on a Totality of Factors

Pursuant to Bulletin 30, the SAT confirmed that the determination of whether beneficial ownership exists should depend on a collective assessment of a totality of factors set out in Circular 601. In this regard, no single or specific negative factor could override or outweigh other factors. The lack of tax avoidance motive (e.g. to escape or reduce tax, transfer or accumulate profits etc) cannot be used as an argument to refute or deny the application of the totality of factors assessment. Bulletin 30 emphasizes the importance of reviewing various financial and legal documentations for conducting a comprehensive analysis of factors in determining beneficial ownership status. The company documentation to be analyzed and recognized would generally include articles of association, financial statements, movement of cashflow, minutes and resolutions of the board of directors, human and other resources arrangements, relevant costs and expenses, functions undertaken and risks assumed, loan agreements, license agreements for use or transfer of intellectual properties, patent registration certificates, copyright ownership evidences, agency agreements or designated fee collection contracts. The explanatory note of Bulletin 30 also reiterated the application of the “substance over form” principle in the beneficial ownership assessment, taking into account of the applicant’s ownership right, control right and disposal right of the relevant income. In this regard, an applicant who does not have any tax-avoidance or tax-mitigating motive may still be denied entitlement to the treaty benefits due to the absence of the above-said right(s).

Safe harbour provision for dividends distributed to listed companies

In relation to relief for dividend repatriation, Bulletin 30 introduces a new safe harbour provision for dividends distributed to listed companies, thereby permitting qualified listed companies having direct or indirect equity interest in PRC subsidiaries to be granted beneficial ownership status directly for treaty tax relief claims for dividends. According to Bulletin 30, an applicant from a treaty jurisdiction could be directly recognised as a beneficial owner if it is a tax resident and listed company from that treaty jurisdiction or is 100% directly or indirectly held by a listed company located in that treaty jurisdiction (provided that no intermediate holding company from a resident of a third jurisdiction is interposed between the listed company and the PRC subsidiary).

Declaration by agents

Where a treaty resident company derives China-sourced passive income through an agent or a designated person for collection (collectively called “Agent”), Bulletin 30 also provides measures that allow a self-declaration (per sample attached to Bulletin 30) being made by the Agent that the relevant treaty benefits could be granted to the true beneficial owner. In this connection, the qualification of the true beneficial owner and its entitlement to treaty benefits are recognised by the China tax authorities provided that the genuine Agent follows the declaration procedures to disclaim its beneficial ownership. Pursuant to the explanatory policy note, the Agent should also provide agency contract or contract for the collection of income in support of such declaration. Where an improper declaration being made by an Agent is uncovered through information exchange mechanisms under the relevant DTA, the China tax authorities may reassess the qualification of the beneficial owner, levy tax under-collected on the true beneficial owner and impose late payment surcharge.



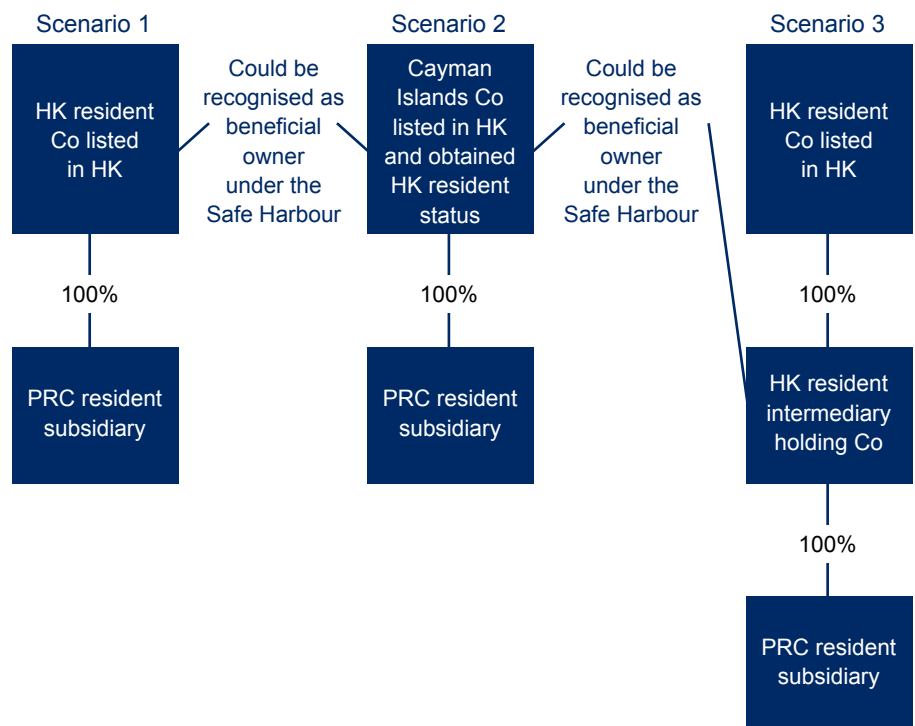
Administrative procedures

If the local China tax authorities encounter difficulties in determining the beneficial ownership status of the applicant before the expiry of the relevant review period per Guoshuihan [2009] No.124, the China tax authorities can temporarily ignore the treaty benefits application and impose tax accordingly. However, the applicant may obtain a refund upon confirmation of its beneficial ownership status. Bulletin 30 also emphasizes that only the provincial level tax authorities have the rights to deny beneficial ownership status. In cases where different local tax authorities cannot reach a unanimous decision on a beneficial ownership application that involves joint assessment covering their in-charge locations, they should refer to a higher level tax authority for determination.

Our Observations

The issuance of Bulletin 30 demonstrates the China tax authorities' continuous efforts in refining the beneficial ownership assessment process to combat improper claims for DTA benefits and to facilitate the granting of benefits to the true qualified beneficial owners. We set out below our observations on key issues:

- It is worthy to note that various documentation may be examined by the China tax authorities under the totality of factors assessment according to Bulletin 30 specification. In this regard, applicants should have well-prepared documentation in place to support their DTA relief applications.
- Since the power to reject DTA benefits claim is vested with the provincial level tax bureau, local level tax authorities that have resource constraints or encounter administrative and technical issues may have tendencies to refer doubtful /complicated DTA relief claims to the provincial authorities for guidance and approval. This may prolong the processing time.
- Listed companies may benefit from the new safe harbor rule that enables them to be recognized as beneficial owners directly for treaty tax relief claims for dividends. The scenarios below illustrate several possible examples:



- The agency declaration procedure may facilitate DTA benefits claim by true beneficial owners who set up intermediary holding companies in other jurisdictions for commercial purposes under genuine agency arrangement recognized and accepted by the China tax authorities. For the “conduit companies” which are not legally and genuine agents or nominees, Bulletin 30 does not provide clear guidelines on the relevant applicability.

We welcome the guidance and clarifications on beneficial ownership assessment provided by the SAT through the release of Bulletin 30. In view of the complexity of the beneficial ownership concept, it is hoped that additional guidelines will be released by the SAT in future to clarify the uncertain areas or open issues that are not yet addressed in the Bulletin.

For more information about Bulletin 30, please contact our China tax team of Crowe Horwath Hong Kong.

For details of Circular 601, please refer to our Tax Alert Issue No.2 on our website <http://www.crowehorwath.net/uploadedFiles/HK/services/tax/TaxAlert2.pdf>

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