



Issue 7 | 09 July 2013

China Alert

Further Clarifications provided by China's SAT on the Recognition of Beneficial Ownership of Dividends under PRC-HK Double Tax Arrangement

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In response to issues brought up by several provincial and state tax bureaus regarding how to enforce the dividend provisions in relation to Beneficial Ownership cases under the Double Tax Arrangement between Mainland China and Hong Kong ("PRC-HK DTA"), China's State Administration of Taxation ("SAT") issued Shuizonghan [2013] No.165 ("Circular 165") on 12 April 2013. Circular 165 serves to supplement two important notices previously issued by the SAT, i.e. Guoshuihan [2009] No.601 ("Circular 601") and Bulletin [2012] No.30 ("Bulletin 30")¹ that address the beneficial ownership concept and assessment factors in the context of double tax treaties / arrangements concluded by China.

In light of the cross-border nature of the issues involved, the SAT has liaised with the Hong Kong Inland Revenue Department before issuing Circular 165. Circular 165 provides more practical guidelines to Chinese local tax bureaus for assessment of applications for the enjoyment of benefits on dividends under the PRC-HK DTA. It is expected that the spirit of the guidelines set out under Circular 165 would be applicable to other China's double tax treaties with similar terms on dividends.

The salient clarifications and interpretations provided by Circular 165 are summarized below:

Distribution of dividends within a prescribed time limit

According to Article 2.1 of Circular 601, the fact that an applicant is obliged to distribute or pay the entire or most (e.g. above 60%) of the income within a prescribed time limit (e.g. within 12 months after date of receipt of income) to a resident of a third jurisdiction would be considered as one of the negative factors for beneficial ownership assessment.

In assessing the applicant's situation based on the above Article, Circular 165 stipulates that the applicant should provide information that reflects its profit distribution status, and the rights and obligations of the applicant and the holding company, including legally binding articles of association of the enterprise, relevant contracts and agreements with the holding company and company resolution. Based on such information, the tax authority in charge should analyze whether the applicant's application for the enjoyment of DTA benefits in relation to dividends would satisfy the conditions set out in Article 2.1 of Circular 601.

¹ For details of Circular 601 and Bulletin 30, please refer to our Tax Alert Issue No.2 and China Alert Issue No.6.



If the applicant does not distribute profits to a non-Hong Kong resident enterprise, this would not constitute a negative factor as stipulated in the above-mentioned article.

Examination of business activities

Pursuant to Circular 601, the fact that an applicant has no, or hardly has any, other business activities would constitute an unfavourable factor for beneficial ownership determination.

With the issue of Circular 165, the SAT clarifies that the applicant's investment activities involving the holding of properties or rights from which the income is derived should be considered as business activities. The phrase "has no, or hardly has any, other business activities" refers to the situation under which an applicant has neither other investment projects nor other different types of business activities other than a single investment project.

Investment companies that are set up for a single project should not be denied beneficial ownership solely based on this single unfavourable factor, as the SAT considers that it is necessary to make a consolidated assessment based on other factors.

Assets and staff

In determining whether an applicant's assets commensurate with its income, Circular 165 confirms that a consolidated assessment should be made to analyse the applicant's assets, which is not simply equal to its registered capital. For an assessment of the applicant that possesses comparatively low registered capital, other factors including the source of funds, and the level of investments risks it borne should be considered in determining whether its assets commensurate with its income earned.

When analyzing whether the staff deployed by an applicant commensurate with its income earned, the focus should be placed on the responsibilities of the staff and substance of their work performed, instead of merely on the number of staff and the payment for staff costs.

Rights to control or dispose of assets

In deciding whether an applicant possesses the rights to control or dispose of the assets or rights that generate the income, takes what level of risks, an analysis should be conducted by the tax authority in charge based on three factors:

- i) Whether the company's articles of association or related legal documents contain relevant provisions that grant the applicant the rights to control or dispose;
- ii) Whether the applicant has exercised such rights of control or disposal, e.g. whether being an investment company, the applicant has used the dividends received to conduct capital transaction activities such as project investment, share subscription, increase of share capital, enterprise merger and acquisition, as well as venture investment;
- iii) Whether the applicant could make its own decision in conducting such relevant transaction

The applicant's rights of control or disposal should not be disregarded simply based on the fact that the applicant's shares are controlled by its immediate holding company.



Issues arising from the characteristics of the Hong Kong tax regime

Having considered the practical circumstances of Mainland China and Hong Kong, the fact that Hong Kong adopts a territorial tax system which does not tax offshore dividends should not be considered a key factor in making an unfavourable assessment of the beneficial ownership status. When making an assessment, the SAT clarifies that considerations should be given to the applicant's Hong Kong tax filing status and the actual application of Hong Kong tax laws in order to conduct a detailed analysis.

Safe harbor rule

Bulletin 30 provides a safe harbor provision for dividends distributed to listed companies. According to Article 3 of Bulletin 30, an applicant from a treaty jurisdiction could be directly recognized 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.

Circular 165 clarifies that the above provision under Bulletin 30 should not be interpreted to deny an applicant's beneficial ownership status under the following situations:

- An applicant is 100% directly or indirectly owned by a non-listed Hong Kong resident company
- An overseas registered company is interposed between the applicant and its ultimate Hong Kong holding company.

Our comments

1. Circular 165 aims at providing approval guidelines to the Chinese local tax authorities for examining applications for the enjoyment of benefits under the PRC-HK DTA. However, as it was issued in form of a public notice and not an internal document available to local tax authorities only, it could be considered as guidelines for taxpayers who intend to apply for the enjoyment of DTA benefits.
2. Circular 165 provides guidelines to local tax authorities on the examination of the business activities and other economic substance of an applicant. It will bring a positive impact to foreign companies that set up a Hong Kong company as an intermediary holding company ("IHC") to hold investments in China. If the economic substance of the IHC meets the examination criteria, the IHC could get the approval for the enjoyment of benefits under the PRC-HK DTA.
3. Circular 165 requests the tax officers to examine a series of company documents, including the incorporation documents of the applicant in order to determine the economic substance and whether the applicant has a tax-driven motive. It is very important for an applicant to ensure sufficient documentation be kept in place to substantiate its reasonable and commercial purpose for DTA benefits application.
4. In view of the more vigorous approach applied by the SAT to the review of treaty benefit claims, investors from Hong Kong and worldwide that intend to apply for the enjoyment of DTA benefits should read the guidelines carefully, analyse their current status and maintain adequate documentation in order to secure entitlement to the DTA relief.

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