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Tax Alert

China issued a tax notice on the interpretation and recognition of “Beneficial Owner” of tax treaties

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The State Administration of Taxation (“SAT”) in China issued a very important notice, Guo Shui Han [2009] No. 601 (“Notice 601”) on 27 October 2009 providing guidance on the interpretation of the Beneficial Owner when a resident of a contracting country or region applies for the enjoyment of treaty treatment for income including dividends, interest and royalties under the China’s tax treaties or arrangements.

The background

In 2008, a Barbados company was denied the treaty benefits under the China-Barbados tax treaty by the Chinese tax authorities, after the latter went through the tax information exchange mechanics under the China-Barbados tax treaty, on the grounds that it failed to establish its substance in Barbados and was not regarded as a Barbados resident, and thus the tax exemption¹ from capital gains tax in China on disposal of investments in China was not allowed.

The Notice 601

Following the above case, the SAT issued the Notice 601 with an aim at limiting the extent of treaty shopping.

Under the Notice 601, a beneficial owner refers to a person who has the ownership rights and control rights on the income, or the right or property from which the income is derived. A beneficial owner includes any individual, corporation or other organization carrying on substantive business activities, and do not include agents and conduit companies.

Conduit companies are those companies set up for the purpose of tax avoidance or minimization, or shifting or accumulating profits. They were set up in those treaty countries or regions only to take advantage of the treat benefit available. They comply with the legal requirements but do not carry out any substantive activities of manufacturing, trading or management.

In determining beneficial owners for this purpose, the substance over form principle will be applied and taking into account the spirit of the law in respect of the anti-avoidance of taxation. A totality of fact would be considered and not purely from the technical meaning or from domestic tax point of view. In general, the following factors are considered disadvantageous in determining beneficial owner status :

- The company is obliged to distribute within a stipulated period (for example within 12 months from receipt of income) all or the majority (for example over 60%) of the income to a resident of a third country / region.

- Apart from investment holding or patent holding, the company does not or nearly does not have other business activities.
- The business scale, assets and human resources are out of line with that of the income.
- The company has no or practically no control or disposal right over the income-producing assets, and bears little or no risk.
- The treaty country or region in which the company is a resident does not impose tax on such income, or such income is exempt from tax there or subject to very low rate of tax.
- Besides the interest-bearing loan agreement with the PRC borrower, the company that receives interests has another back to back loan arrangement(s) with approximately the same repayment terms with a third party.
- Besides the licensing agreement with royalty payments on copyright, patent right and technology, the company that receives royalty payments has a licensing agreement on the said copyright, patent right and technology with a third party.

Applicants for treaty treatments should at the time of application submit evidence to substantiate their beneficial owner status as set out above.

All local tax offices should follow the above regulations to approve the beneficial owner status when the non-residents applying for treaty treatments. In case of need, they should make use of the tax information exchange system to confirm the information received, and in case of doubt they may refer the case to SAT.

Comments

In light of the Notice 601 mentioned above and other relevant anti-avoidance provisions, the mere submission of a tax residence certificate for applying treaty benefits in China is no longer sufficient.

Investors should review their current investment structure or corporate structure to ensure that the intended treaty benefit / treatment is not affected by the new anti treaty shopping regulation. In addition, substance of an effective management and operating activities plus relevant documentation of substantiation for complying with other relevant requirements should be in place.

¹ Under the China-Barbados tax treaty, the right of tax on the gains derived from the disposal of an equity interest in a PRC entity by a Barbados tax resident is conceded to Barbados.

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