China Takes Step to Prevent Tax Shopping by Issuing Guidelines on Determining “Beneficial Owners” under Tax Treaties

On October 27, 2009, China’s State Administration of Taxation (the “SAT”) issued a *Circular on How to Understand and Determine “Beneficial Owners” under Tax Treaties* (“Circular 601”),[1] providing technical guidance for China’s tax authorities to assess non-residents’ claims of treaty benefits with respect to China-sourced dividends, royalties and interest income. This Memorandum summarizes this Circular.

I. REASON FOR THE ISSUANCE OF THE CIRCULAR

Passive income derived by a non-resident enterprise from China, such as dividends, royalties, interest and capital gains, are generally subject to Chinese withholding tax at a rate of 10 percent, unless a reduced treaty rate applies. Under the tax treaties or arrangements between China and some of its treaty partners (including Hong Kong and Macau), a reduced tax rate (*e.g.*, 5 percent or 7 percent) may apply with respect to income of dividends, royalties or interest, as applicable, if the recipient is a “beneficial owner” of such income. The term “beneficial owner” is usually not a defined term in these tax treaties or arrangements and there has been no consistent view as to when a recipient constitutes a “beneficial owner.” In the absence of a treaty definition, Circular 601 provides detailed guidance to China’s tax authorities to determine the question of “beneficial ownership” as it relates to a non-resident’s claim for treaty benefits with respect to dividends, royalties and interest income.

II. KEY PROVISIONS

According to Circular 601, a “beneficial owner” is a person who has the ownership and control over the income or the rights or property that generates such income. A “beneficial owner” can be an individual, a corporation or any other type of organization and must generally engage in substantive business activities. The Circular excludes “agents” or “conduit companies” from being treated as “beneficial owners”. A “conduit company” is defined as a company that is established for the purpose of avoiding or reducing tax, or shifting or sheltering profits. Such a company may be registered in the country of its formation in compliance with the formal requirements of law in that country, but it does not carry out substantive business activities (such as manufacturing, trading and management).

[1] Guoshuihan [2009] No. 601.

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When determining whether a non-resident claiming treaty benefits is the "beneficial owner" of the passive income, China's tax authorities must consider the specific facts and circumstances of each case, taking into consideration the purposes of the tax treaties (*i.e.*, avoiding double taxation as well as preventing fiscal evasion), and follow the "substance over form" principle. Most importantly, the Circular enumerates the following seven factors that would very likely lead China's tax authorities to deny the applicant's "beneficial owner" status:

- The applicant shall pay or distribute to a resident of a third country (or region) all or a substantial majority of the income (*e.g.*, 60% or more) within a prescribed timeframe (*e.g.*, within 12 months of receipt of the income);
- The applicant has no or almost no business activities other than ownership of the property or rights generating the income;
- Where the applicant is a corporation, its assets, scale of operations and number of employees are small in size and do not match the amount of income;
- With respect to the income or the property or rights generating the income, the applicant has no or almost no control or disposal rights, and bears no or very little risk.
- The other treaty country (or region) exempts or does not tax the income, or taxes the income at a very low effective tax rate;
- There exist loan or deposit agreements between the applicant and a third party which, in terms of principal amount, interest rate and signing date, are similar to the loan agreements that generate the interest income; and
- In parallel with the copyright, patent or know-how license agreements that generate the royalty income, the applicant has back-to-back arrangements with a third party.

When applying to China's local tax authorities for tax treaty benefits, the applicant must submit supporting documents relative to the above factors proving that it is the "beneficial owner" of the relevant income.[2] The Circular does not specify though what type of supporting documents the applicant needs to submit in order to prove that it qualifies for the "beneficial owner" status. In the event that the local tax authorities have difficulty in determining the applicant's status, they may seek confirmation from the other treaty country (or region) through information exchange channels. They can also report to the SAT for solution if the case is complicated.

[2] Procedurally, for a non-resident to claim treaty benefits with respect to dividends, royalties or interest, it must file an application, together with supporting documents, to China's relevant tax authority for approval. *See Administrative Rules on Nonresidents Enjoying Tax Treaty Treatments,* issued by the SAT on August 24, 2009, Guoshuifa [2009] No. 124. Without such an approval certifying that a treaty tax exemption or reduction applies, the payor shall withhold a 10 percent tax on any dividend, royalty or interest it pays to a non-resident enterprise.

III. IMPLICATIONS

Circular 601 does not by its terms address taxation of capital gains, in particular capital gains from a non-resident's sale of its investments in China.[3] One may not exclude the possibility, however, that China's tax authorities would in practice follow a reasoning similar to the one underlying this Circular, or that the SAT may promulgate similar rules for claims of treaty benefits with respect to capital gains.[4]

Although it remains to be seen how China's tax authorities will enforce this Circular and how China's treaty partners will respond to China's new interpretation of the "beneficial ownership," this Circular may make it very difficult for the intermediary holding companies set up by multinational corporations or offshore private equity funds in treaty countries (or regions) to hold their investment in China, to claim treaty benefits in the future. The Circular may also affect investors that have made their investment through special purpose companies set up for non-tax commercial reasons, although this will depend on the practical interpretation of the Circular by the Chinese authorities. Investors using holding structures to invest into China are recommended to review their existing holding structures and assess the potential risks in the light of Circular 601.

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Please feel free to contact any of your regular contacts at the firm or any of our partners and counsel listed under China Practice or Tax under the "Practices" section of our website (http://www.clearygottlieb.com) if you have any questions.

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[3] Unlike treaty provisions relating to dividends, interest and royalties, treaty provisions relating to capital gains do not have a "beneficial ownership" requirement. In general, subject to certain other restrictions that may apply under each tax treaty or arrangement, in order to be eligible for the treaty benefits relating to capital gains, the recipient must be a tax "resident" in the other treaty country (or region).

[4] Even without similar rules for claims of treaty benefits with respect to capital gains, it is still possible for China's tax authorities to disapprove such claims pursuant to the general anti-abuse rules under the Enterprise Income Tax Law, if the arrangement at issue is one without "reasonable commercial purpose," *i.e.*, an arrangement whose main purpose is that of tax reduction, exemption or deferral.

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