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Significant relaxation of the beneficial ownership criteria under the Hong Kong – Mainland double taxation arrangement

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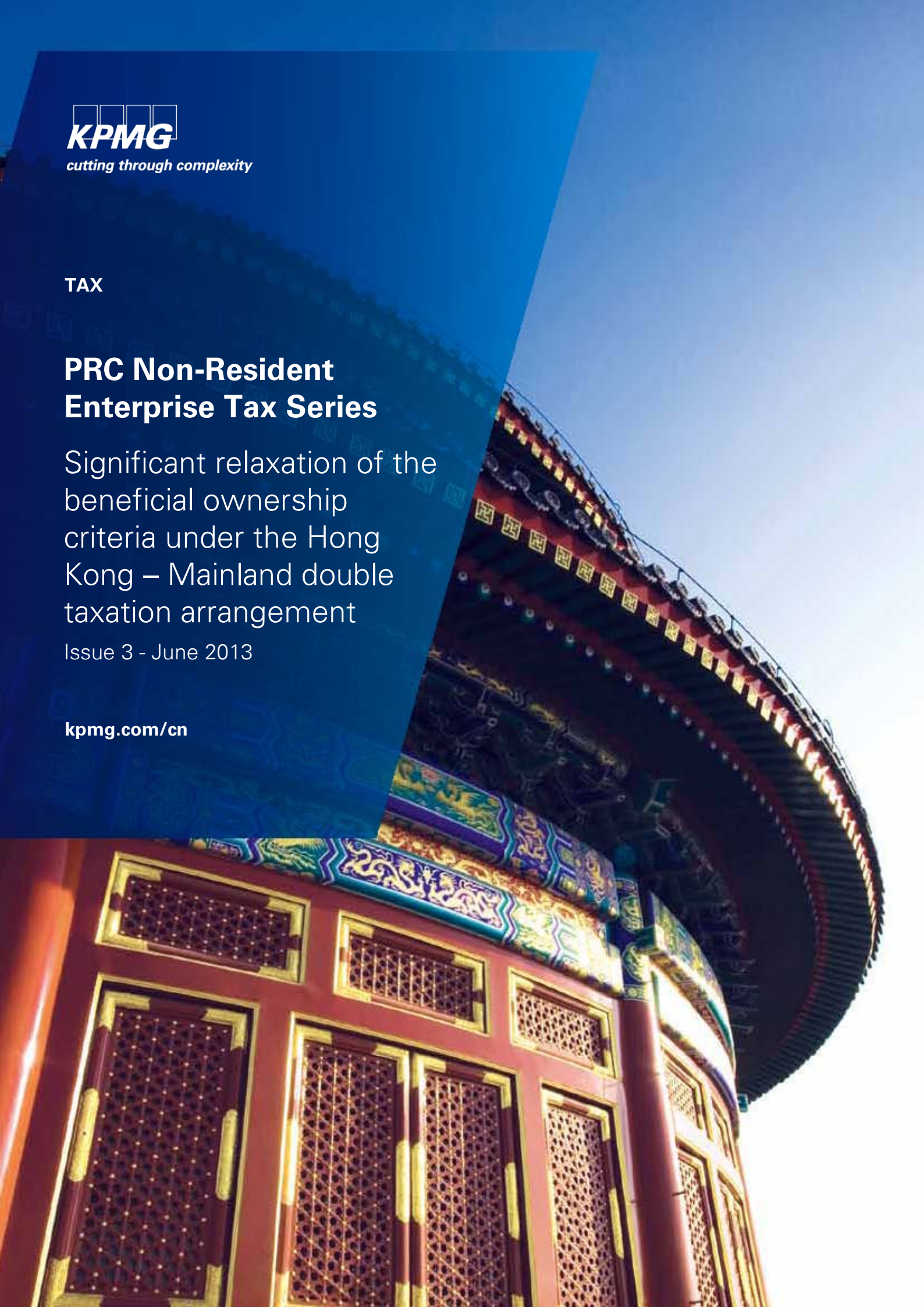

Introduction

This publication follows on from the previous two articles in this series, 'Beneficial Ownership and Indirect Disposals' published in March 2010, and 'Indirect offshore, direct offshore and onshore disposals in an M&A context' issued in April 2012. These two articles focussed on the increased rigor of the Chinese tax regime for taxing non-residents on a withholding tax basis, which has been a major area of concern in recent years for foreign businesses investing and operating in China. These developments consisted of essentially two main strands. A system was put in place, through State Administration of Taxation (SAT) Circular 698 (2009) and SAT Announcement 24 (2011), for identifying indirect offshore disposals of Chinese equity and taxing the gains where the arrangement is determined to be directed at avoiding Chinese tax. In addition, the access to and use of preferential withholding tax (WHT) reductions under a Chinese double tax arrangement (DTA) on investment income derived directly from China were effectively limited by the clarification of a strict definition of the 'beneficial ownership' DTA relief qualification criterion in SAT Circular 601 (2009) and SAT Announcement 30 (2012).

These two regulatory developments and their subsequent rigorous enforcement by the Chinese tax authorities have prompted serious reconsideration by foreign enterprises of the structures they use for their business and investment activities in China. However, restructuring and recalibration of existing investment structures has been complicated by a lack of clarity in the regulations and variance in the enforcement approach of the local tax authorities. SAT Announcements 24 and 30 were released, in large part, to try to achieve a greater consistency of approach by local authorities in their implementation of Circulars 698 and 601, respectively. However, many matters of interpretation remain to be clarified and supplementary circulars to both Circular 698 and 601 are eagerly awaited by the foreign business community.

Recently, in April 2013, an important new circular, Circular 165 (2013), was issued which, depending on the manner in which it is ultimately implemented by local tax authorities, may radically improve access to DTA dividend WHT reductions where the DTA relief claimant is a Hong Kong (HK) tax resident enterprise. The clarifications contained in the circular potentially make HK the jurisdiction of choice when establishing holding structures for investment into China and may prompt foreign enterprises to consider restructuring their China holding arrangements. The details of this promising new development and what it means for foreign enterprises with business and investment operations in China is the focus of this edition of KPMG's PRC Non-Resident Enterprise Tax Series.

The basic contents of Circular 165 are set out in KPMG China Tax Alert 2013 Issue 10. The Circular is addressed by the SAT to several provincial state tax bureaus[1] to clarify specific questions raised by them in relation to the determination of whether a DTA benefits claimant, tax resident in HK, should be considered to be beneficial owner of dividend income in respect of which DTA WHT reductions are claimed, and so qualify for the DTA relief under the PRC-HK DTA. It also reiterates the message that local tax authorities must take a "totality of facts" approach on a case-by-case basis to the determination of the beneficial owner.

Senior officials at the SAT have subsequently elaborated on the intention and policy behind Circular 165, and this permits a high-level examination on practically how the Circular's clarifications will impact on how foreign enterprises may modify and enhance their approach to supporting their beneficial ownership positions. Firstly though, it is necessary to consider the status quo under Circular 601 and existing practice to fully appreciate the effect of Circular 165.

[1] The provinces of Liaoning, Shandong, Henan, Jiangsu, Hubei and Hainan, as well as the city of Xiamen

Existing approaches to supporting a beneficial ownership position

Under the PRC Corporate Income Tax (CIT) Law (2008), to the extent that a foreign enterprise has neither PRC tax residence nor a PRC permanent establishment (PE)[2], it should not be taxed on an assessment basis, but rather, PRC WHT should be imposed on any PRC sourced income arising at a rate of 10 percent. China's better DTAs, such as that with HK, allow for this rate to be reduced to five percent where the shareholding held by a foreign enterprise, which is tax resident in the jurisdiction of the DTA counterparty, in the dividend-paying company is at least 25 percent of its total equity.

A 'beneficial ownership' requirement is usually included in the dividend article of these DTAs. The Circular 601 guidance on the meaning of beneficial ownership to be applied by the PRC tax authorities sets out a series of 'adverse factors' which are to be taken into account in evaluating whether the foreign enterprise qualifies as beneficial owner of the dividend income. While there is no fixed, internationally agreed approach to the determination of beneficial ownership, with the OECD currently revising and updating its guidance on the meaning of the term for application of DTAs following the OECD Model Convention, the Chinese approach has been widely recognised as much more demanding and difficult to satisfy. Furthermore, Circular 124 (2009) sets out an application procedure which must be gone through in advance of securing DTA relief, with extensive documentation required to be supplied by the applicant. Therefore, each and every DTA claim in China will fall under scrutiny.

Adverse Factor assessment of beneficial ownership

Circular 601 lists out seven factors that are considered to be unfavourable to a beneficial ownership determination by the PRC tax authorities.

1. The DTA resident has the obligation to pay or distribute all or a substantive part of its income (e.g., 60 percent or more) to a resident of a third country within a prescribed timeframe (e.g. within 12 months)

2. The DTA resident has no or almost has no other business activities other than holding the assets or interests that generate the income in respect of which the DTA claim is made

3. The DTA resident is an entity, and its assets, size and personnel is relatively small and not commensurate with the income it derives

4. The DTA resident has no or almost no controlling rights or disposal rights on the income or the assets or rights that generate the income, and bears no or very little risk

5. The other DTA country does not tax or exempts the income, or taxes the income at a very low effective tax rate

These first five factors are relevant in making the beneficial ownership assessment for DTA claims in respect of any of dividend, interest or royalty income. The last two criteria are relevant just for interest and royalties, respectively.

[2] The domestic PE concept is formally referred to as an 'establishment or place of business' but a higher threshold for identifying a PE is provided for where the foreign enterprise is tax resident in a jurisdiction with a DTA with the PRC

6. In addition to the loan agreement giving rise to the interest income on which DTA relief is claimed there are other loan agreements between the DTA claimant and a third person with similar terms (directed at back-to-back loan arrangements)

7. In addition to the licensing contract giving rise to the royalty income on which DTA relief is claimed there are other licensing or transfer agreements between the DTA claimant and a third person with respect to the copyright, patent or technology underlying the first contract (directed broadly at back-to-back royalty arrangements)

For dividend DTA claims attention is focused on the first five criteria. The tax authorities are instructed to perform a 'totality of facts' assessment for the beneficial ownership determination, and are cautioned against giving undue weight to any one particular factor. Approaches vary across China but some tax authorities are known to take the position that if three of the five relevant adverse factors are in point then the beneficial ownership assertion is usually rejected. This approach is overlaid with a 'substance over form' evaluation, so that claims that satisfy three criteria, but are still in substance considered to be abusive conduit arrangements, do not get approved.

Current recommendations and existing challenges

The general recommendations which have been made to foreign enterprises on the basis of these criteria, and on the basis of how they have been known to have been applied in practice, are:

- The 'income retention test' should be satisfied to ensure that the claimant does not have legal commitments which automatically sweep out the bulk of its revenue

- It should be ensured that the legal documents into which the claimant has executed do not appear to limit their controlling rights over their assets and income, beyond what can be shown to be reasonable and standard commercial limitations (e.g., standard loan covenants, standard limitations of use of a franchise, etc)

- The claimant should have a properly constituted board of directors comprising predominantly non-PRC tax residents which is documented through the minutes of (preferably physical) board meetings to have exercised real control over the deployment of the assets and use or distribution of the income and of the claimant. The claimant should be in a position to show that the directors have the experience and competence to direct the business that the claimant is asserted to conduct

- The claimant should maintain a level of equity balance that is significant in size compared with the income received from Chinese company in which the claimant invests

- The claimant, where possible, should look to directly lease a business premises in its tax residence jurisdiction, conduct 'other business activities' beyond solely the investment/rights holding function, and be able to evidence a level of business assets and staffing commensurate with its level of income

Naturally enough, factors 2 and 3 have been the most difficult to address. The nature of the business models, used by many foreign enterprises with business and investment operations in China, frequently do not call for there to be substantial numbers of staff employed in conventional business operations at the level of the holding company with the investment in the PRC company

from which dividends are drawn, as these personnel and operations may for commercial and legal reasons be housed in different group entities. The problems consequently created for the satisfaction of the Circular 601 criteria exist both for multinational enterprises (MNEs) with active business operations in China and for financial investors such as private equity funds, but may be even more accentuated for the latter. Specifically, there has been a lack of clarity as to the level and nature of 'other business activities' which would be seen by the tax authorities to suffice, as well as an absence of benchmarks for the adequacy of asset holdings and staffing levels. There has been uncertainty as to whether local tax authorities will have regard to different business models, and their differing requirements for commercial substance at the level of holding companies, when making the assessment.

Consequently, many foreign enterprises have been adopting a 'wait-and-see' attitude if they are not making imminent DTA relief claims, in advance of clarifications emerging from regulatory or practice developments. Foreign enterprises have also been liaising with local tax authorities to see what particular interpretation they are putting on the criteria. Clearly the situation has been far from satisfactory. Circular 165 now significantly narrows the uncertainty where the holding company is in HK and concrete action by foreign enterprises to secure their beneficial ownership positions can consequently be taken.

Circular 165 clarifications and their impact

Senior officials in the SAT have elaborated that the intent of Circular 165 is to extend a preferential approach to assessing beneficial ownership to DTA relief claims by HK companies, when compared with claimants elsewhere. Crucially, the clarifications would appear to limit the degree to which local PRC tax authorities could demand to see very substantive other business activities and assets, at the level of the holding company, before being willing to grant the DTA relief.

Practical significance of the Circular 165 clarifications

The circular clarifies that 'investment activities' will be considered to be 'business activities' for the purposes of adverse factor 2 and that the tax authorities may not deny DTA relief solely on the basis that the claimant only holds one investment. This effectively lessens the need for extensive 'other business activities' to be conducted by the claimant, as long as the analysis under the other adverse factors is supportive of the claimant's position. This also effectively clarifies that there is no need for the claimant to have extensive operational business assets, such as direct leasehold interests in premises.

There is no lessening of the requirement to have staffing commensurate with the income earned. However, in this regard the circular is also helpful as it provides that the local PRC tax authorities should not solely consider the number of staff and the size of staff costs of the applicant in assessing whether its staffing level is commensurate with its income. The authorities should also take into account the responsibilities and nature of the work of the staff. This would appear to open the way to agreeing with the approving tax authorities that a small number of experienced and competent staff, sufficient to servicing the needs of the investment business or other business of the claimant, suffice to meet adverse factor 3.

It is also clarified that, for the purposes of adverse factor 3, the tax authorities are not to draw negative inference from the fact that the claimant funds itself to a limited extent through equity. This effectively removes the negative implications of having the claimant thinly capitalized, so long

as this is commercially justifiable and the interest payments on the claimant's debt do not result in a failure of the income retention test in adverse factor 1.

Further, it is confirmed that no negative implication will be drawn from the fact that dividend income of a HK resident applicant falls outside the scope of HK Profits Tax (HKPT). As a further point, where the HK company does not make any distributions out of HK, adverse factor 1 can be ignored in its entirety.

A consequence of paring back the limits of what the tax authorities can demand to see, before they agree that the claimant has satisfied the adverse factors analysis, is that attention is focused even more on the 'corporate governance' focused adverse factor 4. In this regard Circular 165 requires examination of the applicant's legal capacity and rights to control and dispose of investments, as supplemented by information on the actual exercise of those rights. It specifically directs regard to be had to the claimant company's articles of association, as well as other documents setting out and limiting the claimant's freedom of action in relation to its disposition and use of its investments.

Clearly the minutes of board meetings will be key to evidencing how the board has exercised its powers of control to use dividend income to make investments, declare dividends, convert reserves to share capital, etc. In this regard, Circular 165 emphasizes the need for the board to be able to exercise its rights voluntarily. While the Circular precludes local tax authorities from disregarding the claimant company's control and risk attributes on account of it being wholly owned by a parent company, the direction and management of the claimant company directly by the parent, without the board of the claimant company going through its own deliberations and making its own decisions, will be regarded negatively for the beneficial ownership determination.

Updated recommendations for supporting beneficial ownership assertion

The upshot of Circular 165 for HK holding companies is thus quite positive. The following modifications, to the recommendations made above to securing a HK holding company's beneficial ownership position, might be suggested:

- It is often found to be commercially preferable to fund holding companies with shareholder loans rather than entirely with equity. So long as the use of shareholder loans rather than equity financing can be commercially justified, Circular 165 would appear to remove the negative connotations of a holding company being thinly capitalised, thus facilitating this. It should be noted though that the 'Income Retention Test' means that care would have to be taken if these loans are interest-bearing

- Pursuant to Circular 165, adverse factor 1 may be set aside where the holding company does not pay dividends or interest abroad. Where commercially acceptable it may be considered instead to use the dividend income of the HK company for investment or loans to other group entities

- The Circular 165 clarification that the tax authorities must take into account the responsibilities and nature of the work of the staff, and not be overly fixated on staff number and cost, is quite helpful as it means that even a small number of staff, where shown to be sufficient to the management of the investment in the Chinese enterprise, should be acceptable to the authorities.

However, it still makes sense, where commercially feasible in the context of a MNE, to house other business functions within a holding company (e.g. procurement) as, even following Circular 165, the assessment of beneficial ownership remains a 'substance over form' evaluation and the presence of real activity in the company is helpful in this regard. Only a small number of staff may be required in this regard, as the claimant can point to the special skills and competencies of the staff used, and the staff need not necessarily be in HK.

- Adherence to corporate governance formalities, with properly constituted and fully documented board meetings is now more key than ever. Regard should be had to the documents, such as articles of association, and ensure that nothing is stated in these that would appear to limit the freedom of the holding company's board to deal with company assets. Sufficiently competent and experienced people should be chosen to serve on the board and their deliberation and conclusion on matters of relevance to the managing of the Chinese enterprise investment and other functions should be fully documented.

  Board meetings should ideally always take place physically and it may be preferable that some of these take place in HK. However, this has to be balanced against a claim that any income / gains from the holding / disposal of the PRC investment is offshore sourced and non-taxable for HKPT purposes. This is a normal objective of HK holding structures and requires that board meetings, to discuss and decide on certain key actions, such as the purchase and sale of shares, take place outside HK. It is considered that this should be reconcilable with establishing, to the satisfaction of the PRC tax authorities, that the HK holding company has a robust board in control of the affairs and assets of the company.

It should be noted that the actual implementation of Circular 165 remains to be observed. The circular is formally only addressed to certain provincial tax bureaus, though it is considered that other provinces will likely have regard to it as guidance. It is also the case that some of the understandings set out above come from the explanations provided by senior SAT officials as to the policy intent behind Circular 165, rather than being necessarily evident from the language of the circular itself. The extent to which the senior SAT officials communicate this policy intent to lower level tax authorities would thus be crucial to its effectiveness. As the practice of the tax authorities is to examine the documentation of the claimant for the year in which relief is being claimed, as well as potentially the three years prior, to the extent that foreign enterprises have some time before dividend income needs to be drawn up from China, they can wait to see how these uncertainties are dealt with. Nonetheless, Circular 165 is a very welcome development for foreign enterprises and a very important development for HK as the holding jurisdiction of choice for China investments.

HK as a preferred holding company location

HK has long been the preferred holding company location for foreign enterprises with Chinese subsidiaries and joint ventures. Operationally, HK was for a long time the starting point for foreign enterprises making their initial entry into the China market with the senior staff co-ordinating China operations being centred in HK. HK's well developed market for financial and business services and trusted legal system were key attractions as well, with financing and contracting for Chinese operations conducted by regional headquarters staff based in HK. For financial investors, such as private equity funds, deal teams were often based in HK from where they would venture into the Mainland. The use of HK holding companies mapped these operational arrangements, and this was further encouraged by HK's domestic law tax provisions excluding foreign income from HKPT, as well as the HK-PRC DTA allowing for generous reductions in PRC WHT.

However, recent years have seen operational activity of foreign enterprises become much more embedded in the Mainland itself; consequently, HK is no longer the necessary focal point for the China operations of foreign multinationals and investment groups. In parallel, the development of China's DTA network and improvements to the holding company tax regimes of jurisdictions such as Singapore, Luxembourg and Ireland has given rise to competitors to HK as the choice of holding company location. HK has also been somewhat hampered by a unique and somewhat unusual requirement that, in order to obtain the HK tax residence certificate which is necessary to support the PRC-HK DTA relief claim, the PRC local tax authority which would grant the relief would first need to be approached to issue a 'referral letter' thus making the DTA relief claim process even more cumbersome for HK holding companies than for companies based in other jurisdictions. The release of Circular 601 caused some consternation in HK that HK's position as the holding company and co-ordination centre of choice for China might be further eroded.

Circular 165, if implemented as anticipated in the outline above, could contribute to stabilising and improving HK's position and allows it to reassert itself as the holding jurisdiction of choice for China investments. Foreign enterprises might consider restructuring their holding arrangements so as to place their China equity holdings under a HK company, where they do not already do so.

One matter on which greater clarity would be useful though pertains to the DTA relief for WHT on interest. The PRC-HK DTA is one of few PRC DTA's which allow for a reduction in interest WHT, from 10 percent to seven percent, but as Circular 165 solely relates to dividend WHT it is not clear whether a HK claimant might qualify as beneficial owner for dividends but not for interest. While Circular 165 eliminates the difficulties with thin capitalisation for dividend WHT relief, it might still be problematic for interest. Further, adverse factor 6 specifically views back to back lending as a negative factor. The financing arrangements for a HK holding company may, depending on the practical approach taken by the tax authorities, ultimately come to be determined by whether it is dividend or interest WHT relief that will be sought.

Circular 165 promises greater certainty to foreign enterprises with business and investment operations in China and allows for concrete action to be taken to secure DTA relief on dividends. It opens the door for HK to reassert itself as the premier holding location for China operations. Much remains to be clarified though and we will keep you informed on these exciting new developments.

How can KPMG assist?

The release of Circular 165 marks a crucial time for MNEs to reconsider their investment holding structures for China and think about potential restructuring opportunities to take advantage of the now relaxed beneficial ownership standard for Hong Kong, to the extent that a holding company in Hong Kong is not currently utilized within the group. For MNEs already utilizing a Hong Kong holding vehicle to channel investment into China, it is also important to re-examine the asset, people and operation arrangements in Hong Kong based on the clarified standards in Circular 165. Documentation should be refined and remedied when relevant to strengthen the claim of the holding company in Hong Kong as the beneficial owner of China-sourced dividends.

In these regard, KPMG can offer assistance in the following areas:

1. Develop a detailed strategy to migrate the regional holding company location of a MNE into Hong Kong.

    a. Advising on how to qualify the migration for special tax treatment under the Chinese corporate reorganization rules, to the extent that the migration is ordinarily a taxable transaction under Chinese tax law.
    b. Providing guidance on the regulatory process of implementing the migration.

2. Review the legal documents of the Hong Kong holding company, such as the incorporation memorandum, Articles of Association, board resolutions, and intercompany agreements, and provide comments to improve robustness and rectify weaknesses.

3. Assist a MNE to develop a set of working protocols to guide the corporate governance processes for its Hong Kong holding company. The protocols will specify the roles and responsibilities of personnel in Hong Kong and outline the decision making process of the holding company in detail.

4. Assist a MNE to prepare and file various application packages and seek the preferential five percent dividend withholding rate under the China-HK DTA, including:

    a. Obtaining a referral letter from the local Chinese tax authorities to request a Hong Kong tax resident certificate from the Inland Revenue Department (IRD) of Hong Kong.
    b. Filing an application to the IRD to seek a Hong Kong tax resident certificate.
    c. Filing an application to the Chinese local state tax bureau in charge of the Chinese subsidiary remitting the dividend to support that the Hong Kong Holding company meets the beneficial ownership requirement under Circular 165.
    d. Conducting various meetings with the Chinese tax officials to negotiate the qualification of the Hong Kong holding company for the five percent WHT, and involve the SAT and IRD in the discussions when necessary.

Authors

Khoonming Ho
Tel. +86 (10) 8508 7082
khoonming.ho@kpmg.com

Abe Zhao
Tel. +86 (10) 8508 7096
abe.zhao@kpmg.com

Conrad Turley
Tel. +86 (10) 8508 7513
conrad.turley@kpmg.com

Contact us

Khoonming Ho
Partner in Charge, Tax
China and Hong Kong SAR
Tel. +86 (10) 8508 7082
khoonming.ho@kpmg.com

Beijing/Shenyang
David Ling
Partner in Charge, Tax
Northern China
Tel. +86 (10) 8508 7083
david.ling@kpmg.com

Qingdao
Vincent Pang
Tel. +86 (532) 8907 1728
vincent.pang@kpmg.com

Shanghai/Nanjing
Lewis Lu
Partner in Charge, Tax
Central China
Tel. +86 (21) 2212 3421
lewis.lu@kpmg.com

Hangzhou
Martin Ng
Tel. +86 (571) 2803 8081
martin.ng@kpmg.com

Chengdu
Anthony Chau
Tel. +86 (28) 8673 3916
anthony.chau@kpmg.com

Guangzhou
Lilly Li
Tel. +86 (20) 3813 8999
lilly.li@kpmg.com

Fuzhou/Xiamen
Jean Jin Li
Tel. +86 (592) 2150 888
jean.j.li@kpmg.com

Shenzhen
Eileen Sun
Partner in Charge, Tax
Southern China
Tel. +86 (755) 2547 1188
eileen.gh.sun@kpmg.com

Hong Kong
Ayesha M. Lau
Partner in Charge, Tax
Hong Kong SAR
Tel: +852 2826 7165
ayesha.lau@kpmg.com

Karmen Yeung
Tel. +852 2143 8753
karmen.yeung@kpmg.com

kpmg.com/cn