

# China Tax Alert

Issue 4, February 2018

## China clarifies beneficial ownership tax treaty requirements

### Regulations discussed in this issue:

- Announcement on Clarification of Beneficial Ownership in DTAs (SAT Announcement [2018] No. 9, "Announcement 9"), issued by the SAT on 6 February 2018.
- SAT Interpretative Guidance on Announcement 9 ("interpretative guidance"), issued on 6 February 2018.
- Circular on Understanding and Recognizing the "Beneficial Owner" in DTAs (Guo Shui Han [2009] No. 601, "Circular 601"), issued by SAT on 27 October 2009.
- Announcement on Determining Beneficial Ownership to qualify for China DTA Benefits (SAT Announcement [2012] No. 30, "Announcement 30"), issued by SAT on 29 June 2012.

On February 6 the State Administration of Taxation (SAT) issued Announcement 9. This refines the interpretation of the beneficial ownership requirement in the dividends, interest and royalty articles of Chinese double tax agreements (DTAs) and takes effect from April 2018.

Announcement 9 retains the commercial substance-focused approach to beneficial ownership, originally set out in Circular 601 in 2009. At the same time, it provides much more clarity on the substance requirements, with numerous detailed examples. It also expands the 'safe harbour' and introduces a form of 'derivative benefits' test. The changes should be of assistance to multinational enterprises (MNEs). For investment funds, the recognition that investment management activity may constitute a substantial business activity is welcome, but challenges are likely to remain.

### Announcement 9 background and main changes

Beneficial ownership has been, for many years, a very challenging area in China tax practice. Whereas the general international tax understanding of beneficial ownership focuses primarily on a DTA relief claimant's degree of control over the income for which relief is sought (and the related assets), the Chinese approach has been to look at the commercial substance at the level of the DTA relief claimant (in addition to the control aspects). The evaluation is conducted with reference to a series of 'negative factors'.

There have been calls by taxpayers for many years for the SAT to disentangle the commercial substance test from the control test, and integrate the former with anti-abuse rules. However, with Announcement 9, the SAT has now conclusively decided to stay with a commercial substance driven concept of beneficial ownership.

This being said, a number of aspects of the new guidance may help to improve access to DTA relief:

- The SAT interpretative guidance accompanying Announcement 9 sets out numerous detailed examples, which give a much better sense of the level of commercial substance that the SAT considers acceptable.

## Regulations discussed in this issue:

- Administrative Measures on Entitlement of Non-Resident Enterprises to DTA Benefits (SAT Announcement [2015] No. 60, "Announcement 60"), issued by SAT on 27 August 2015.
- SAT Opinions on Beneficial Ownership for the dividend articles in Mainland-Hong Kong tax arrangement (Shui Zong Han [2013] No. 65, "Circular 65"), issued on 12 April 2013.
- Announcement on Recognition of Beneficial Owner for Entrusted Investments (SAT Announcement [2014] No. 24, "Announcement 24"), issued by SAT on 21 April 2014.

- Announcement 30, issued in 2012, had provided a 'safe harbour' under which listed foreign companies, and their local subsidiaries tax resident in the same jurisdiction, would not need to satisfy the 'negative factor' analysis to qualify as beneficial owners. Announcement 9 now extends this to companies, held 100% by individuals resident in, and government bodies of, the company's jurisdiction. Intermediate entities must be located in the company's jurisdiction or in China.
- There is now a type of 'derivative benefits' test, under which regard can be had to the 100% direct and indirect parents of a DTA relief claimant company, in making the beneficial ownership assessment for dividends. If the parent company is either tax resident in the same jurisdiction as the DTA relief claimant, or in a jurisdiction whose DTA with China offers equivalent benefits, and it satisfies the 'negative factors' test, then DTA relief will be available to the DTA relief claimant. Intermediate entities must be located in jurisdictions with equivalent China DTA benefits.

There are other minor changes, including consolidation and tweaking of some of the 'negative factors'. The Circular 601 base erosion test threshold is reduced from 60%, of income received, to 50%, and equity holding is now explicitly recognized as a potential substantial business activity; the other factors are not substantively changed. Circular 601 and Announcement 30 are abolished.

## KPMG's observation

One of the main issues with the existing beneficial ownership concept is the great diversity in local tax authority interpretations on the appropriate level of 'substance'. As such, the detailed examples in the interpretative guidance will be useful in justifying taxpayer positions before the local authorities. This being said, in particular for investment funds, the substance expectations in the guidance could be viewed as quite challenging to meet.

The 'derivative benefits' test is useful for MNEs, as they will have commercial substance at the level of the parent entity or significant subsidiaries, and there will often be 100% holding relationships with treaty claimant subsidiaries. For investment funds, it would likely be challenging for fund SPVs to 'derive' substance from the fund's investment management activities, as these are typically separate in ownership and holding.

It should be noted that, even with these beneficial ownership clarifications, accessing DTA relief in China remains challenging due to the great diversity and inconsistency in the administrative procedures followed by local tax authorities. This is despite the issuance of detailed DTA administrative guidance in Announcement 60 in 2015. This is coupled with the increased challenges of obtaining tax residence certificates in some of the key holding company jurisdictions for China (e.g. Hong Kong and Singapore), which further complicate DTA access.

It might further be noted that, while Announcement 9 sets out procedures for use the general anti-avoidance rule, or DTA principal purposes tests, to deal with DTA abuse cases, the continued inclusion of commercial substance tests in the beneficial ownership definition mean that the former are less likely to be used.

In addition, while there are some clarifications on the residence documentation required of Hong Kong persons, the status of Circular 165, which in 2013 set out a nuanced interpretation of beneficial ownership for Hong Kong residents, remains to be clarified.

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