KPMG
cutting through complexity

China alert

Issue 15 – July 2012

Tax treaty beneficial ownership clarifications issued

Regulations discussed in this issue:

- *Circular on how to understand and recognise the "Beneficial Owner" in DTAs*, Guoshuihan [2009] No.601, issued by the State Administration of Taxation (SAT) on 27 October 2009.
- *Announcement on Determining Beneficial Ownership in the context of Qualifying for PRC DTA Benefits,* SAT Announcement [2012] No. 30, issued on 29 June 2012

Background

In October 2009, the State Administration of Taxation (SAT) of the People's Republic of China (PRC) issued Guoshuihan [2009] No.601 (Circular 601) to address the beneficial ownership issue in the context of PRC income tax treaties (double taxation agreements (DTAs)). Circular 601 emphasises that a non-resident recipient of certain China sourced passive income must be the beneficial owner of such income before it can enjoy treaty benefits under the relevant DTA with China. This is in addition to the usual requirement that the non-resident recipient must be a tax resident of the DTA partner state. Circular 601 then sets out a series of 'adverse factors' that will be considered by the PRC tax authorities in determining whether the non-resident recipient is the beneficial owner or not. The factors require, inter alia, that sufficient 'substance' (in terms of staff, premises and business operations) be in evidence at the level of the DTA benefits claimant.

Uncertainties have arisen in practice concerning the manner in which the adverse factors are to be applied in the tax authority review. In particular, it has been unclear whether the status and substance of group companies may be taken into account in supporting an assertion of beneficial ownership by the treaty benefits claimant. Furthermore, where the registered owner of equity interests in a PRC company is merely an agent, acting on behalf of the true beneficial owner, it was unclear whether the true beneficial owner could make the DTA relief claim itself. Finally, administrative complications had arisen due to variance in the DTA claims approval approach adopted by local tax authorities and the need in certain cases to obtain approval from multiple tax authorities in China.

To address these concerns, the SAT has released several versions of a draft supplemental notice to tax analysts since August 2011, seeking to clarify the application of the adverse criteria in Circular 601 and setting out clearer

administrative guidelines. KPMG has actively participated in various SAT roundtables to provide comment, including the most recent SAT seminar held in Xiamen on 4 May 2012. On 12 July 2012, several authoritative PRC tax websites, including the government homepages of the tax bureaus in Jiangsu and Tangshan, released SAT Announcement [2012] No. 30 (Announcement 30), dated 29 June 2012. Although the SAT has not issued an official pronouncement on the publication of Announcement 30 at the time of this alert, it appears that in all likelihood, the version of Announcement 30 that is circulated on the web is authentic and represents the culmination of multiple rounds of revisions on the draft versions of the supplemental notice to Circular 601.

In this alert, we discuss the content of Announcement 30, its significance for multinational companies applying for PRC tax treaty benefits, and other issues to be explored further.

Announcement 30

Announcement 30 confirmed in written form what we have previously communicated to our clients on the application of the negative factors. The determination of whether beneficial ownership exists should be made based on a totality of factors. No super factor exists that outweighs other factors. However, taxpayers cannot use a lack of tax avoidance motive as an argument to escape from applying the factors. In reviewing the factors, Announcement 30 stresses the importance of reviewing various legal and financial documents, including articles of association, financial statements, board minutes and resolutions, functional analyses, legal contracts, asset ownership certificates and invoice registers.

In relation to relief from PRC dividend withholding tax (WHT), Announcement 30 explicitly states that a company that is a tax resident of a DTA partner state and is listed in that jurisdiction (Listed Parent) will automatically satisfy the beneficial ownership criteria in respect of PRC dividends received. It appears that this treatment will apply regardless of the outcome of an assessment under the Circular 601 adverse factors and therefore represents a safe harbour provision. Furthermore, subsidiaries that are wholly owned by the Listed Parent, directly and/or indirectly, and are tax residents of the same DTA partner state, may also be automatically regarded as the beneficial owners of any PRC dividends they receive. However, if the subsidiary is indirectly held by the Listed Parent through an intermediate holding company that is not a tax resident of the DTA partner state, this safe harbour will not be available.

In addition, Announcement 30 clarifies that where an 'agent or designated payee' receives income, in an agency or nominee capacity for another party (the principal), this should not affect the identification of the true beneficial owner. Rather the Chinese tax authorities should look at the principal in making the beneficial ownership assessment, regardless of whether the agent itself is a tax resident of the DTA partner state. For the principal to claim beneficial owner status, the agent in question is required to disclaim its beneficial ownership of the China-sourced income. However, if through DTA information exchange the PRC tax authorities discover that the agent has improperly made the disclaimer and should have been considered as the true beneficial owner of the income in question, the PRC tax authorities will make a tax reassessment on the 'false' principal and levy penalties.

Furthermore, Announcement 30 provides some explanations on administrative procedures. Circular 601 mandates that, subsequent to the submission of a DTA relief claim pursuant to Guoshuifa [2009] No. 124 ('Circular 124'), a decision on the granting of relief is to be communicated by the tax authorities within specified timelines. Under Announcement 30, if the tax authority review proves difficult and requires more time to complete, the tax authority is allowed to suspend granting DTA relief temporarily. In this case, the withholding agent must withhold the full amount of WHT as if no treaty

benefits are available. Subsequently, when it is proved that the treaty benefits claim is justified, the DTA relief claimant may obtain a refund of the overpaid WHT.

Finally, if an in-charge tax bureau rejects DTA relief claims on the grounds of lack of beneficial ownership, it needs to report to and obtain approval from the provincial level tax bureau. After the provincial level tax bureau makes a decision on the case, it should report the case to the international tax division of the SAT for record. Where approval for a DTA relief claim needs to be given by several tax bureaus, these tax bureaus shall team up to reach a unanimous decision. If a consensus cannot be reached, the case should be escalated to the next Chinese tax authority level that is in charge of all these tax bureaus involved in the decision.

KPMG observations

The supplemental notice is a welcome development, particularly in relation to the clarifications on agent-principal treatment and the refinements to the sometimes cumbersome and inconsistently applied DTA relief application process. Announcement 30 suggests that a determination of beneficial ownership must be performed based on an overall factual analysis and no taxpayer can avoid the factor-by-factor assessment as specified in Circular 601.

The statement on the types of documents that the tax authorities refer to in making the beneficial ownership assessment highlights the importance of maintaining sufficient documentation as support. These days, the Chinese tax authorities are less likely to accept theoretical arguments alone and are more inclined to trust corporate documents as indication that the desired substance level is met. Therefore, taxpayers are strongly encouraged to establish a set of internal control procedures and ensure that the relevant legal, tax and financial documents are prepared and maintained from day one in preparation for future reviews by the tax authorities.

The requirement for local authorities, where intending to reject a relief claim, to refer this to the provincial level authority for approval, should limit the number of DTA relief rejections by local authorities who may not fully understand the issues involved and enhance consistency in local enforcement practice. The requirement for a unanimous decision for relief claims, which entails the coordination and sign-off of more than one authority, should diminish inconsistencies, and reduce situations where the same non-resident recipient receives different rulings on its beneficial ownership status from different local tax authorities when deriving similar types of passive incomes from multiple investments in China.

The clarifications made in Announcement 30 are helpful to listed foreign companies and their same-country 100% direct or indirectly held subsidiaries in obtaining DTA relief. However, difficulties in availing of the benefits of the provision may be encountered in practice where the jurisdiction of listing and the jurisdiction of incorporation for the Listed Parent differ. Historically, the PRC tax authorities were reluctant to accept companies incorporated in tax haven jurisdictions as residents of a treaty partner jurisdiction by reason of effective management. For example, many Hong Kong listed companies with PRC subsidiaries are actually Cayman Islands incorporated for legal and HK stamp duty considerations. If these companies could not get recognition in China that they are tax residents of Hong Kong, they would have a hard time arguing that they are entitled to the benefits of this safe harbour provision for listed companies.

In a previous draft, a non-resident company that applies for PRC DTA relief on dividend, but lacks the necessary substance, was allowed to affirmatively disclaim its beneficial ownership status so that its parent company can step in as the DTA applicant. Announcement 30 removes this provision, and implies that for the parent to claim beneficial ownership on China sourced dividend

income received by its subsidiary, the parent needs to demonstrate that its subsidiary is only acting as its agent. Nevertheless, Announcement 30 does not elaborate what kinds of documents need to be submitted to support the principal-agency relationship being claimed.

The clarifications concerning agents will be of particular interest to Qualified Foreign Institutional Investor license holders (QFIIs) and their clients. Under current PRC laws, foreign investors are generally only permitted to directly acquire and own A-shares if they qualify as QFIIs (Qualified Foreign Institutional Investors) and possess sufficient investment quota. As the QFIIs themselves must hold the securities as registered owners (ultimate beneficial ownership by the clients being recognised under the agency agreement between the QFII and the clients), it has long been unclear whether the QFII holders or their clients can make the treaty claim. For tax technical reasons, a difficulty exists for a DTA claim to be made directly by the QFIIs, and it was unclear whether their clients would be permitted to make the claim instead. Announcement 30 provides greater certainty to the tax treatment of QFII arrangements in this aspect, although it does create a host of complex practical issues regarding the tracing of China-sourced incomes to potentially numerous clients, for which better information systems may need to be developed.

Further, and contrary to expectations based on earlier drafts of the Announcement, Announcement 30 makes no mention of the tax authorities being able to evaluate the substance of parent and sister companies of a DTA benefits claimant when making the beneficial ownership assessment. As such, the degree to which such substance can be taken into account remains uncertain. In practice, to-date, local tax authorities are varied in their approach to substance attribution for assessing a DTA relief claim. Some local authorities have taken a very strict approach, by only considering the characteristics and status of the WHT relief claimant itself. Other authorities have been willing to consider arrangements within the claimant's broader corporate group, including the substance at the claimant's parent company or even sister companies that are tax residents of the same DTA partner jurisdiction. In some extreme cases, when the DTA claimant has affiliates that are tax residents of another jurisdiction and such a jurisdiction has a DTA with China offering equivalent DTA benefits as the DTA in question, taxpayers have contended that the substance of such out-of-country affiliates should also be taken into account under arguments similar to the 'derivative benefit test' in the U.S. treaty network.

Given that substance attribution was not addressed in Announcement 30, some local tax authorities may conclude that, in the absence of explicit direction by the SAT to consider such substance, parent/sister substance is to be disregarded, despite the fact that there may be sound commercial reasons for the arrangements in place (e.g., aircraft leasing businesses typically hold the aircraft through separate SPVs with the management staff and premises in a parent/sister service company). The agent-principal clarifications in Announcement 30 do not appear to assist in such cases. Unless arrangements are in place between the direct recipient and its parent/sister to pass on the income in question (an approach which may be commercially undesirable), substance at parent/sister level does not seem to bear on the beneficial ownership analysis.

Finally, although Announcement 30 specifies an effective date of 29 June 2012, it does not say to what extent the provisions can be applied retroactively to cases that remained open as of 29 June 2012. Taxpayers should communicate with the tax authorities in charge to understand the local interpretations and practices. It is hoped that future notices supplementing Circular 601 will build on the helpful clarifications made in Announcement 30 and further amplify on open issues listed in this alert, such as substance attribution from parent/sister companies within the jurisdiction of the direct income recipient or jurisdictions with equivalent DTA benefits.

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

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

Vaughn Barber
Tel. +86 (10) 8508 7071
vaughn.barber@kpmg.com

Roger Di
Tel. +86 (10) 8508 7512
roger.di@kpmg.com

John Gu
Tel. +86 (10) 8508 7095
john.gu@kpmg.com

Jonathan Jia
Tel. +86 (10) 8508 7517
jonathan.jia@kpmg.com

Paul Ma
Tel. +86 (10) 8508 7076
paul.ma@kpmg.com

Vincent Pang
Tel. +86 (10) 8508 7516
+86 (532) 8907 1728
vincent.pang@kpmg.com

Michael Wong
Tel. +86 (10) 8508 7085
michael.wong@kpmg.com

Irene Yan
Tel. +86 (10) 8508 7508
irene.yan@kpmg.com

Leonard Zhang
Tel. +86 (10) 8508 7511
leonard.zhang@kpmg.com

Tracy Zhang
Tel. +86 (10) 8508 7509
tracy.h.zhang@kpmg.com

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

Catherine Zhao
Tel. +86 (10) 8508 7515
catherine.zhao@kpmg.com

David Chamberlain
Tel. +86 (10) 8508 7056
david.chamberlain@kpmg.com

Kevin Lee
Tel. +86 (10) 8508 7536
kevin.lee@kpmg.com

Eric Zhou
Tel. +86 (10) 8508 7610
ec.zhou@kpmg.com

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

Anthony Chau
Tel. +86 (21) 2212 3206
+86 (28) 8673 3916
anthony.chau@kpmg.com

Cheng Chi
Tel. +86 (21) 2212 3433
cheng.chi@kpmg.com

Chris Ho
Tel. +86 (21) 2212 3406
chris.ho@kpmg.com

Lily Kang
Tel. +86 (21) 2212 3359
lily.kang@kpmg.com

Sunny Leung
Tel. +86 (21) 2212 3488
sunny.leung@kpmg.com

Martin Ng
Tel. +86 (21) 2212 2881
+86 (571) 2803 8081
martin.ng@kpmg.com

Yasuhiko Otani
Tel. +86 (21) 2212 3360
yasuhiko.otani@kpmg.com

John Wang
Tel. +86 (21) 2212 3438
john.wang@kpmg.com

Jennifer Weng
Tel. +86 (21) 2212 3431
jennifer.weng@kpmg.com

Lachlan Wolfers
Tel. +86 (21) 2212 3515
lachlan.wolfers@kpmg.com

Grace Xie
Tel. +86 (21) 2212 3422
grace.xie@kpmg.com

Zichong Xu
Tel. +86 (21) 2212 3404
zichong.xu@kpmg.com

William Zhang
Tel. +86 (21) 2212 3415
william.zhang@kpmg.com

Cheng Dong
Tel. +86 (21) 2212 3410
cheng.dong@kpmg.com

David Huang
Tel. +86 (21) 2212 3605
david.huang@kpmg.com

Dylan Jeng
Tel. +86 (21) 2212 3080
dylan.jeng@kpmg.com

Amy Rao
Tel. +86 (21) 2212 3208
amy.rao@kpmg.com

Michelle B. Zhou
Tel. +86 (21) 2212 3458
michelle.b.zhou@kpmg.com

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

Angie Ho
Tel. +86 (755) 2547 1276
angie.ho@kpmg.com

Jean Jin Li
Tel. +86 (755) 2547 1128
+86 (592) 2150 888
jean.j.li@kpmg.com

Jean Ngan Li
Tel. +86 (755) 2547 1198
jean.li@kpmg.com

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

Kelly Liao
Tel. +86 (20) 3813 8668
kelly.liao@kpmg.com

Bin Yang
Tel. +86 (20) 3813 8605
bin.yang@kpmg.com

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

Chris Abbiss
Tel. +852 2826 7226
chris.abbiss@kpmg.com

Darren Bowdern
Tel. +852 2826 7166
darren.bowdern@kpmg.com

Alex Capri
Tel. +852 2826 7223
alex.capri@kpmg.com

Barbara Forrest
Tel. +852 2978 8941
barbara.forrest@kpmg.com

Charles Kinsley
Tel. +852 2826 8070
charles.kinsley@kpmg.com

John Kondos
Tel. +852 2685 7457
john.kondos@kpmg.com

Alice Leung
Tel. +852 2143 8711
alice.leung@kpmg.com

Curtis Ng
Tel. +852 2143 8709
curtis.ng@kpmg.com

Kari Pahlman
Tel. +852 2143 8777
kari.pahlman@kpmg.com

John Timpany
Tel. +852 2143 8790
john.timpany@kpmg.com

Wade Wagatsuma
Tel. +852 2685 7806
wade.wagatsuma@kpmg.com

Jennifer Wong
Tel. +852 2978 8288
jennifer.wong@kpmg.com

Christopher Xing
Tel. +852 2978 8965
christopher.xing@kpmg.com

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

kpmg.com/cn