"Totality of Facts" approach confirmed for grant of tax treaty benefits for dividends

Regulations discussed in this issue:

- *Opinion Letter on the determination of beneficial ownership cases under the dividend article of the PRC-HK double tax arrangement,* Shuizonghan [2013] No. 165 (Circular 165), issued by the State Administration of Taxation (SAT) on 12 April 2013
- *Circular on how to understand and recognise the "Beneficial Owner" in DTAs*, Guoshuihan [2009] No.601 (Circular 601), issued by the SAT on 27 October 2009
- *Announcement on Determining Beneficial Ownership in the context of Qualifying for PRC DTA Benefits,* SAT Announcement [2012] No. 30 (Announcement 30), issued on 29 June 2012

A circular issued by the State Administration of Taxation (SAT) provides some guidance on the assessment of beneficial ownership of dividends under the PRC-HK double tax arrangement (PRC-HK DTA) for the purposes of withholding tax relief. This circular has confirmed the position put forward in Circular 601 and Announcement 30 that a "totality of facts" approach be adopted in assessing the beneficial owner status of a non-resident enterprise in relation to dividends derived from China.

While the contents of Circular 165 were worked out by the SAT in consultation with the Hong Kong Inland Revenue Department, part of the circular can be of more general application in practice. It is encouraging to see that the SAT suggest to the local tax authorities that they should not narrowly focus on certain individual factors in determining the beneficial ownership of dividends; instead they should take a "totality of facts" approach on a case-by-case basis, which necessarily involves a dialogue with the taxpayer and a thorough understanding of the taxpayer's position.

Key points of Circular 165

The DTAs that China has entered into with other jurisdictions generally require that, where withholding tax reduction on dividends is sought, the applicant must qualify as the beneficial owner of the dividends. Circular 601 has set out a number of adverse factors that should be considered in determining whether the non-resident recipient is the beneficial owner or not. Announcement 30 has provided further guidance, notably introducing a safe harbour for applicants that are listed companies or controlled by listed companies in the other contracting jurisdiction. Circular 165 sheds some light on how these rules should be applied under the PRC-HK DTA. The key points of this circular are summarized in the table below:

Questions on "adverse factors"	Guidance in Circular165
Factor 1 – Income retention Does the applicant have an obligation to distribute 60 percent or more of the income to the resident of a third jurisdiction (i.e. not the applicant's jurisdiction or China) within a specified time limit?	Under the PRC-HK DTA, the beneficial owner status of the applicant should not be adversely affected where the applicant does not make any distributions to a non-HK resident enterprise. .
Factor 2 – Business activities Does the applicant have any business activities other than the holding of the investments in China which generate the dividends concerned?	A single-project holding company should not be denied any DTA benefits simply based on the fact that it has only one investment. The other factors should be taken into account as well.
Factor 3 – Assets Are the assets, scale of business and personnel of the applicant small such that they are not commensurate with the applicant's income?	The tax authorities should not equate "assets" with the registered capital of the applicant. They should consider other sources of funding and risks of the applicant. The 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.
Factor 4 - Rights of control and disposal Does the applicant have the rights of control and disposal and bear the risks in relation to the income on which the DTA relief is claimed and the related assets?	There are three aspects to consider: 1. Do the articles of associations etc of the applicant grant such rights of control and disposal? 2. Has the applicant exercised such rights before? 3. Is the exercise of such rights voluntary, as evidenced by the resolutions of the general meetings or board meetings etc? The mere fact that the applicant's shares are controlled by a higher-level corporation should not negate the existence of rights of control or disposal of the applicant.
Factor 5 - Local taxation Does the applicant enjoy non-taxation or exemption status in its own jurisdiction?	The fact that the offshore dividend income of a HK resident applicant falls outside the scope of HK Profits Tax under the territorial tax system should not have a negative implication for determining the beneficial ownership of the income. The actual tax filing situations should be taken into account.

Circular 165 also provides a more common-sense interpretation of the safe harbour rules contained in Announcement 30 in situations where the applicant is held by a non-listed Hong Kong resident company and where there is a third jurisdiction entity between the applicant and the ultimate Hong Kong holding company.

Lastly, Circular 165 provides that where different local tax authorities are considering the granting of DTA relief in respect of the same sort of investment activities, they should apply a consistent treatment.

KPMG observations

Circular 165 reiterates the need for the local tax authorities to exercise professional judgment in applying the rules set out in Circular 601 and Announcement 30 in assessing the beneficial ownership of the dividend income of non-resident enterprises, rather than applying the adverse factors mechanically. The local tax authorities are required to apply a totality of facts approach, with substance taking precedence over form. This means that each application case will have to be decided based on its own merits, and a dialogue between the taxpayers and the tax authorities will be essential.

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