

China tightens the requirements for Non-Tax Residents to enjoy tax benefits on income under Double Tax Treaties



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Background

This newsletter is to give the readers an update on some recent developments in China regarding the administrations and requirements for Non-Tax Residents (“Treaty Residents”) to enjoy tax benefits on income under Double Tax Treaties (“DTAs”).

On 24 August 2009, the State Administration of Taxation (“SAT”) issued the circular *GuoShuiFa [2009] No.124* (“Circular 124”) which gave detailed and comprehensive administrative measures for Treaty Residents to enjoy treaty benefits under DTAs. Further to Circular 124, the SAT issued *GuoShuiHan [2009] No.601* (“Circular 601”) on 27 October 2009 to tighten the conditions for Treaty Residents to enjoy treaty benefits.

Circular 601 stipulates that only a “Beneficial Owner” can enjoy the beneficial tax treatments under DTA. Treaty Residents could be denied from being recognized as beneficial owners if they cannot fulfill the conditions as set out in Circular 601.

Definition of Beneficial Owner

The concept of “Beneficial Owner” was brought up in an early circular of reference, *GuoShuiHan [2009] No.81* (“Circular 81”) issued on 20 February 2009. Circular 81 states that, in order to enjoy treaty benefits on dividends, the Treaty Resident has to be the beneficial owner of the dividends. The circular does not explain under what circumstances that a Treaty Resident will be regarded as a beneficial owner. Circular 81 elaborates further in Circular 601 as follows:

1. It extends the concept of “Beneficial Owner”. Unlike Circular 81 which only addresses dividends, Circular 601 indicates that when a Treaty Resident applies for treaty benefits in respect of dividends, interests, royalties etc, “Beneficial Owner” has to be considered.
2. The circular defines a “Beneficial Owner” as individual, company or other organization that has the ownership and control over the relevant income in question (e.g. dividends, interests, royalties etc), or has the ownership and control over the assets or rights employed for generating the relevant income. Circular 601 states that a “Beneficial Owner” generally will conduct genuine business operations. Agents or Conduit Companies are not regarded as a “Beneficial Owner”.

Conduit companies refer to companies being established for the purpose of tax avoidance, tax reduction, transfer profits or accumulate profits. Conduit Companies are only established in the corresponding jurisdictions to fulfill the legal requirements in formality but they are not conducting business operations

such as manufacturing, sales, management, etc. It seems that conduit companies stated in Circular 601 resembles what commonly known as “intermediate holding companies” that are established for pure investment holding purposes.

Factors that may jeopardize the recognition of Treaty Resident as Beneficial Owner

Circular 601 stipulates that in judging whether or not a Treaty Resident is a beneficial owner, one should not only consider from the technical and domestic law aspects, but should be based on the DTA and the principle of “substance over form”. Circular 601 lists out the following factors that may jeopardize the Treaty Resident from being recognized as a beneficial owner:

1. The Treaty Resident applying for treaty benefits (“the applicant”) is obligated to remit most of the relevant income (say, above 60% of the income) to the third country / jurisdiction residents within an agreed time frame (for example, within 12 months of the receipt of a particular income).
2. Apart from owning and controlling over the assets or rights employed to generate China sourced income, the applicant does not conduct or almost not conducting other business operations.
3. In case the applicant is an entity (such as a company), the entity only has limited amount of assets, operating scale and number of employees, and the above do not match with the income generated.
4. The applicant does not have control over the assets or rights employed to generate the relevant income, and it bears no or almost no risks associated with the assets or rights.
5. The relevant income from China received by the applicant is either exempt from tax in the jurisdiction where it is located, or the effective tax rate is very low.
6. In case the China sourced income is interest income generated from a loan agreement, the applicant (as a lender) has entered into other loan agreements or deposit agreements with another party with similar amount, interest rate and signing date.
7. In case the China sourced income is a royalty income generated from a contract granting a Chinese entity to use the copyright, patent, technology etc, the applicant (as the granting party) has entered into other contracts with another party for acquiring the ownership or the right to use the relevant intangible assets.

Our observation

Circular 601 is introduced to challenge Foreign Enterprises (“FEs”) that are regarded as Conduit Companies (e.g. pure investment holdings, shell companies, special purpose vehicles, etc) and restricting them from enjoying treaty benefits under DTAs.

Furthermore, as stipulated in Circular 601, the China tax authorities may also adopt the “substance over form” principle in judging whether or not a Treaty Resident is a beneficial owner. As a result, some FEs that are not regarded as conduit companies may nevertheless be rejected from their applications to enjoy treaty benefits and the China sourced incomes will then be subject to China withholding tax at 10%.

However, the factors listed in Circular 601 are not conclusive to determine whether or not a Treaty Resident is a beneficial owner, and some conditions listed are very vague and subject to further clarifications from the SAT.

Multinationals and FEs earning China sourced income and enjoying treaty benefits are advised to:

- review the current holding structure to identify if they fall into the definition of Conduit Company and whether there are any factors that jeopardize them from being recognized as a beneficial owner
- if possible, strengthen the current / future holding structure by adding business substance to the companies that hold investments in China

You are advised to contact our colleagues in Hong Kong and /or China offices for further advice should the above have impact on your business.

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