

Further clarification of the “totality of facts” approach regarding beneficial ownership

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Key points

- » Further confirmation of “totality of facts” approach for beneficial owner determination
- » Tax authorities shall not focus on single adverse factors
- » Communication with tax authorities becomes more important

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1) Background

In 2009, the State Administration of Taxation (“SAT”) issued Circular 601¹, stipulating the criteria how to understand and recognize the “beneficial owner” under China’s tax treaties. The approach of “totality of facts” has then been further clarified in Circular 30² with regard to the determination of the “beneficial owner” under China’s tax treaties for the claiming/granting of tax treaty benefits in respect of dividends, interest and royalties. Further to the above mentioned Circulars, the SAT issued Circular 165³ in response to enquiries from various provincial and City tax bureaus as to whether Hong Kong companies should be regarded as beneficial owners of dividends received from China. In general, Circular 165 provides further guidance on the regulations issued in previous years (Circular 601 and Circular 30) and further explains how the criteria shall be applied by tax authorities. The recognition of Hong Kong companies as beneficial owners of dividends received from Chinese entities is of special importance, since the withholding tax rate of originally 10% according to national Chinese law can be lowered to 5% under the Double Tax Agreement (“DTA”) between China and Hong Kong.

2) Salient Points of Circular 165

- » For the application of the preferential withholding tax rate of 5% on dividends derived from Chinese entities, the nonresident tax payer must be regarded as the “beneficial owner” of the related income. Circular 601 defines the term beneficial owner and sets out certain “negative factors” that could affect a nonresident’s status as the beneficial owner. Circular 165 provides further clarification with regard to these “negative factors” as stipulated in Circular 601.

Negative factors in Circular 601	Clarification in Circular 165
<p>Item 1 Income retention The applicant is obliged to distribute or pay the entire or most (more than 60%) of the income within the prescribed time period (e.g. within 12 months after receiving the income) to a resident of a third country.</p>	<p>The fact that the applicant has to distribute the received income to another company resident in Hong Kong has no unfavorable effect.</p>
<p>Item 2 Business activities Other than the investment from which the income is derived, the applicant has no, or hardly any, other business activities.</p>	<p>The existence of this single negative factor should, in and of itself, not disqualify an applicant from being regarded as the beneficial owner of dividends.</p>
<p>Item 3 Assets The assets, scale of business, and personnel deployment of the applicant are comparatively small (or few), and not commensurate with its income.</p>	<p>The tax authorities should not only focus on the single factors enumerated, i.e. on the number of employees or the staff costs; further, the applicant’s “assets” should not be equated with its registered capital. All relevant factors are to be considered, including:</p>

¹ Guoshuihan [2009] No.601
² Announcement [2012] No. 30
³ Shuizonghan [2013] No. 165

	<ul style="list-style-type: none"> • How the applicant is funded, as well as the level of risk he bears in relation to its investments; and • The nature of the work performed by, and the role and responsibilities of, the employees of the applicant.
<p>Item 4 Rights of control and disposal With respect to the income received or to the assets from which the income is derived, the applicant has no or minimum rights of control or disposal, nor does he bear any risks.</p>	<p>Tax authorities should not conclude that the applicant does not possess the right to control or dispose its investments merely because the applicant is controlled by its immediate parent company. Rather, 3 aspects shall be considered:</p> <ul style="list-style-type: none"> • Whether relevant documents grant the applicant such control or disposal rights; • Whether the applicant has exercised such rights before; and • Whether the exercise of such rights was at the discretion of the applicant.
<p>Item 5 Local taxation The relevant income is non-taxable or exempt by the other contracting state (or area); or, if being taxable, the effective tax rate is extremely low.</p>	<p>The fact that Hong Kong does not tax offshore income should not be the “key factor” in deciding whether the applicant is the beneficial owner of the dividends received.</p>

- » Circular 30 introduced a listed company safe harbor, which simplifies the definition of beneficial owner to the extent recipients of dividends are qualified listed companies or qualified group companies. Circular 165 now provides guidance on the application and interpretation of the listed company safe harbor.

“Listed company safe harbor” in Circular 30	Clarification in Circular 165
<p>If the immediate recipient of the dividends is a resident company of a DTA contracting state and is a listed company, it will automatically be treated as the beneficial owner of the dividends distributed from the Chinese company. The same treatment shall be applied, if the subsidiary, which receives the dividends, is 100% directly or indirectly owned by the listed parent company and is located in the same jurisdiction as the listed company (provided the subsidiary is not indirectly held through a third jurisdiction).</p>	<p>The safe harbor is not meant to be applied to disqualify applicants that do not satisfy the conditions of the safe harbor; as such, failing to meet the safe harbor does not change the regular beneficial owner assessment process.</p>

In addition, Circular 165 stipulates that an applicant shall be treated consistently across locations with regard to the beneficial owner status.

Further, a taxpayer may apply for the beneficial owner status to be reassessed in the event of substantial changes in its business.

3) Conclusion

Circular 165 provides important clarification and guidelines for Chinese tax authorities but also for taxpayers to assess the beneficial owner status on dividends. The stipulation that all relevant facts and circumstances shall be considered, and that not one negative factor by itself should disqualify the applicant from being regarded as beneficial owner, are especially welcome. The requirement for tax authorities to treat the same determination in a consistent manner across regions is a further positive development, as it provides a higher degree of certainty for taxpayers.

Circular 165 emphasizes that the local tax authorities shall 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. Therefore, communication with the tax authorities will be crucial.

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