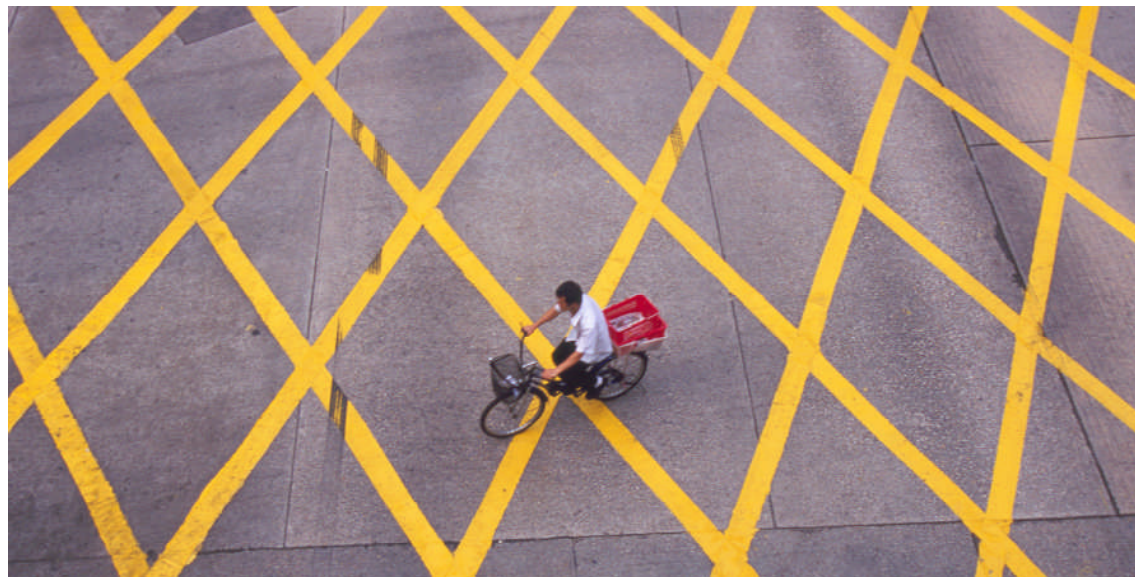


Financial Services

Foreign FS investors in China: Important developments on treaty access and beneficial ownership



Background

There are significant developments affecting foreign financial institutions with operations, or joint ventures in China, as well as affecting asset managers with investments in China.

From 1 October 2009, the claim of double taxation agreement (DTA) benefits by treaty residents in respect of passive income derived from China is subject to approval of the authorised Chinese tax authorities. On 27 October 2009 the Chinese State Administration of Taxation (SAT) released guidance for the determination of "beneficial ownership" for the purpose of claiming DTA benefits by treaty residents.

The salient points are as follows:

Definition of Beneficial Owner

Beneficial owner has been defined under China's domestic tax law as follows:

- Beneficial owner is a person that has the ownership and control over the income or the rights or assets that generates such income

- Beneficial owner can be an individual, corporation or other organization
- A beneficial owner shall generally engage in "substantive business activities" which is further referred to as manufacturing, trading and management activities, etc.

Unfavourable factors when determining beneficial owner

Beneficial owner shall not be interpreted only from a technical perspective, rather it should be analysed and determined based on the facts and circumstances of each case, and in accordance with the principle of "substance over form".

The following seven factors provide circumstances in which generally the treaty resident is not the beneficial owner of the DTA passive income:

1. The treaty resident is obligated to pay or distribute a portion or all of the income within a prescribed timeframe

2. The treaty resident has little or no other business activities besides ownership of the assets or rights
3. The treaty resident is a corporation and its assets, scale of operations and employees are not commensurate with the amount of the income
4. The treaty resident has little or no controlling rights or disposal rights on the income or assets, bears little or no risk
5. The other treaty country exempts or does not tax the income, or taxes the income at a very low effective tax rate
6. Besides the loan contract on which the interest arises, the lender has another loan with a third person with very similar amount of principal, interest rate and time of conclusion
7. Besides the copyright, patent and technology licensing contract on which the royalty arises, the owner has another licensing or transfer contract with a third person with respect to the relevant copyright, patent and technology

Entities excluded from being beneficial owners

Agents and conduit companies shall not be regarded as "beneficial owners". A conduit company is further elaborated as a company that is

- established for the purposes of avoiding or reducing tax, or shifting or parking profits,
- such a company is registered in a country with the mere intention of putting in place the necessary legal form but it does not carry on substantive business activities such as manufacturing, trading or management, etc.

PwC observations

Most existing DTAs (including those entered into by China) do not contain a clear definition of "beneficial ownership". Article 3 of the OECD Model Convention (and Article 3 in most of China's DTAs) provides that, in the absence of a treaty definition, the relevant domestic law shall apply. The SAT now provides the legal basis and detailed guidance for determining whether the treaty resident is a beneficial owner of the DTA Passive Incomes or not, and hence whether to grant DTA benefits.

What is good?

- Beneficial ownership should be assessed based on totality of facts of each case with reference to the seven factors
- "Substantive business activities" is defined to include, not only manufacturing and trading, but also management activities.
- Treaty residents now have clearer guidance when self-assessing their China tax liabilities in relation to the DTA Passive Incomes derived from China.

What is challenging?

- Circular 601 makes it clear that "conduit companies" shall not be regarded as "beneficial owners", but the Commentary to Article 10 (Dividends) of the OECD Model Convention suggests that there could be cases where a conduit company is the "beneficial owner".
- The SAT has delegated the assessment and determination of whether the treaty resident is a "beneficial owner" to the local level tax bureaus.
- Circular 601 does not provide sufficient guidelines as to what types of documentation the treaty residents should put forward to prove their beneficial ownership.

Suggested Actions

As the SAT emphasizes "substance and control" it is imperative for treaty residents to establish strategies in order to withstand potential challenges from the Chinese tax authorities. Take action to assess the substance in the treaty resident, and where insufficient, build more substance. As always, relevant and proper documentation is the key.

The 6th and 7th unfavourable factors are targeting back-to-back loans and licensing arrangements. Treaty residents have to revisit their current financing and licensing arrangements with China and estimate the potential China tax exposure, and where necessary to restructure these.

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