Asia Pacific Tax Newsalert

A Washington National Tax Services (WNTS) Publication

July 24, 2012

China clarifies beneficial ownership guidance

Circular 601, which China issued in 2009, provided taxpayers and Chinese local-level tax authorities with high-level guidance for assessing beneficial ownership (BO) status when claiming treaty benefits on passive income such as dividends, interests and royalties.

While following the guidance in Circular 601, the taxpayers and tax authorities encountered many technical and practical issues. This led to disputes in assessing BO status. Therefore, both groups encouraged the State Administration of Taxation (SAT) to address the issues.

The SAT responded, on June 29, 2012, with Public Notice [2012] No. 30. The notice, effective on the issuance date, is intended to clarify how to assess BO status.

This newsalert summarizes the notice along with our observations.

Highlights of Public Notice No. 30

- **Principles for applying the seven factors in Circular 601**: Circular 601 provides seven factors for assessing BO status with respect to China-sourced passive income. The notice emphasizes that taxpayers and authorities should thoroughly consider all relevant factors and determine whether they are favorable or unfavorable to the taxpayer. Beneficial ownership status should not be denied simply because one of the seven factors is unfavorable. On the other hand, BO status should not be allowed merely because there is no motivation for avoiding or reducing tax;

- **Documents and evidence**: The notice lists a range of crucial documents and evidence to consider when analyzing the Circular 601 factors;
- **Safe-harbor rule**: For dividend income, the notice provides a safe-harbor rule allowing qualified listed companies which directly or indirectly hold Chinese subsidiaries to receive BO status without needing the vetting process. Under the safe-harbor rule, the immediate recipient of the China-sourced dividend, the listed company and any intermediate holding companies must be 100 percent related and must be tax-resident in the same treaty jurisdiction;
- **Treatment for 'agency' arrangement**: A treaty resident that receives China-sourced passive income through an agent (or a designated person) may be deemed to have BO provided that the agent declares to the Chinese tax authority that it does not have BO status. This applies regardless of whether the agent is in a treaty jurisdiction. Furthermore, safeguard measures ensure that the agent's self-declaration aligns with the facts;
- **Tentative denial**: If a Chinese tax authority cannot accurately determine an applicant's BO status within the prescribed timeframe, it may tentatively deny the treaty benefit application and collect the full Chinese tax. However, if the applicant's BO status is eventually approved, thus entitling it to the treaty benefit, the Chinese tax authority should refund any overpaid tax;
- **Authority to deny the BO status**: Only the provincial-level tax authorities have the authority to deny BO status;
- **Collaboration among tax authorities**: Relevant tax authorities should collaborate, through their common superior tax authority, to consistently assess BO status for a treaty resident who applies for treaty benefits on the same type of passive income in different locations.

PwC observations

Since the issuance of Circular 601, some local-level tax authorities have denied the BO status to treaty residents due to one or two unfavorable factors under Circular 601. This generally occurred where the treaty resident enterprise did not have employees or substantial operations. Now, the notice emphasizes that all the relevant factors under Circular 601 should be thoroughly considered. In addition, the notice lists certain documents and evidence that should be examined when assessing BO status. The notice also grants the provincial-level tax authorities the right to deny BO status in order to provide a check and balance over the local-level tax authorities' assessment. These clarifications confirm that the SAT has no intent to deny a treaty resident's BO status only because a few unfavorable factor(s) exists. Furthermore, the SAT is keen to help the local-level tax authorities make more objective assessments of treaty residents' BO status. This should assist treaty residents assess their BO status. On the other hand, the requirements to examine a wide range of documents and evidence may create more taxpayer compliance burdens.

The notice introduces a safe-harbor rule to grant BO status to qualified listed companies under certain conditions. However, these conditions are not easy to fulfill in the prevailing group structure of most listed companies. Thus, the applicability of the safe-harbor rule may be quite narrow.

Thankfully, the notice allows a treaty resident with real BO to apply for treaty benefit even if it receives China-sourced passive income via an agent (or a designated party). As a prerequisite, the agent must submit both a non-BO declaration and an agency agreement supporting its relationship with the real BO treaty resident. However, the notice does not clearly define 'agent'. The notice mentions that one of the documents required is an 'agency agreement' (or designated income recipient agreement). So in

theory, the real BO treaty resident and the agent should have signed such agreement. Apart from documentary evidence, it is also necessary to consider various issues in substantiating the agency relationship. For example, the relevant accounting treatment of the real BO treaty resident should reflect the agency relationship properly. Also, the real BO treaty resident should consider other possible commercial and tax impacts when disposing of the agent in the future.

The notice stipulates that tax authorities in different locations should collaborate to agree on the BO status of the same treaty resident applicant with respect to the same type of income. If those tax authorities cannot reach a consistent position, they must report to their common superior tax authority. Generally, this is good news for treaty residents, and, in particular, for those that hold investments in different Chinese locations. However, the notice does not specify which in-charge tax authority must initiate the reporting. Therefore, if the tax authorities cannot agree, it is possible that no tax authority would initiate a report it to its superior tax authority. This could delay the treaty benefit approval.

Conclusion

The notice helps by further clarifying certain technical and practical issues when assessing BO status. However, the notice should not be seen as a new tax incentive. As the BO concept is complex, the SAT is cautiously addressing certain controversial issues regarding the BO assessment. Those involved should not expect the notice to resolve all existing issues. Indeed, there are still various issues and controversies with respect to BO assessment. Nevertheless, in drafting the notice, the SAT has demonstrated that it is open-minded and willing to consider feedback and concerns.

We believe that the Chinese tax authorities will continue to explore the proper way(s) to better assess BO status under the Sino-foreign double tax agreements. PwC will continue to monitor developments and issue newsalerts as appropriate.

For more information, please contact:

Your tax contacts in the United States:

Rebecca Lei Wang	*(646) 471 7384*	*rebecca.l.wang@us.pwc.com*

Your tax contacts in China:

National	*Cassie Wong*	*(8610) 6533 2222*	*cassie.wong@cn.pwc.com*
South	*Charles Lee*	*(86755) 8261 8899*	*charles.lee@cn.pwc.com*
North	*Edward Shum*	*(8610) 6533 2866*	*edward.shum@cn.pwc.com*
Central	*Peter Ng*	*(8621) 2323 8888*	*peter.ng@cn.pwc.com*