

China clarifies beneficial ownership assessment under Hong Kong treaty; US MNCs should review their Asian investment structures

June 4, 2013

In brief

The Chinese State Administration of Taxation (SAT) issued Circular Shuizonghan [2013] No.165 (Circular 165) on April 12 to clarify how local-level tax bureaus should assess beneficial ownership (BO) with respect to dividends under China's tax treaty with Hong Kong.

A Hong Kong company whose BO status is accepted would be eligible for a reduced withholding tax rate of five percent on dividends derived from its Chinese investments. Circular 165 further explains how to apply the 'unfavorable factor' tests provided in Circular Guoshuihan [2009] No.601 (Circular 601), as well as interpretations of Public Notice [2012] No.30 (Public Notice 30) with respect to BO assessments.

The principles and guidelines presented in Circular 165 provide a useful reference guide for taxpayers in other jurisdictions that have similar tax treaties with China.

In detail

Although the SAT provided interpretation and guidelines in Circular 601 and Public Notice 30, Chinese local-level tax authorities still have faced practical difficulties when assessing the BO status of Hong Kong companies. As a result, some of these authorities sought rulings from the SAT.

According to Circular 165, the SAT picked five cases from different provinces for detailed examination. All five involved Hong Kong companies that had applied for treaty benefits with

respect to dividends received from Chinese investments. In particular, the cases involved the BO status of the Hong Kong applicants.

Clarification of unfavorable factors in Circular 601

Circular 165 provides guidance on five of the seven unfavorable factors listed in Circular 601 related to dividends. These five factors are discussed below.

Additional distribution of dividend income

The fact that dividend income is distributed to another Hong

Kong tax resident shortly after the Hong Kong applicant receives such income from the Chinese entity should not be an unfavorable factor when assessing the applicant's BO status.

Business activities

Investing and holding shares in a Chinese company should be treated as a valid business activity.

Observation: Hong Kong applicants that are investment holding companies and do not carry on other business

activities should welcome this guidance. However, if the applicant has only one investment and no other business, this could be an unfavorable factor when assessing BO status unless the wider fact pattern suggests otherwise.

Assets and staffing

When determining whether a Hong Kong applicant's assets and staffing are commensurate with its income, analysis of the applicant's circumstances should consider all relevant facts. In particular:

- Assets should not simply equal registered capital. The examination should consider the source of funds and the investment risks borne.
- For staffing, the analysis should look beyond the number of, and expenditure for, staff to the individual staff responsibilities and the nature of their work. For example, an applicant with only a few staff members should not be viewed unfavorably as long as the staff is qualified for, and normally engaged in, formulating investment strategies and making decisions for the applicant.

Power of control and disposal over dividend income or the assets from which the dividend income derives

A Hong Kong applicant's right of control or disposal should not be disregarded simply because its shares are controlled by the applicant's immediate holding company. Instead, the following factors should be considered:

- whether the articles of association or other legal documents allow the applicant to exercise the power of control and disposal

- whether the applicant has exercised such power to use the dividends other than for additional distributions, e.g., to invest in projects, or engage in merger and acquisition activity; and
- whether the decision to pay dividends is made by the applicant through board of director or shareholder resolutions.

Tax regime

The fact that Hong Kong has a territorial tax system that does not tax offshore dividends should not be treated as a key factor in the determination of BO status.

Other principles affecting BO assessment

Circular 165 clarifies that failure to meet the safe harbor rule in Public Notice 30 does not necessarily result in denial of BO status. (The safe harbor allows a qualified listed company with a direct or indirect investment in a Chinese company to be accepted as a beneficial owner without going through the assessment process.) In other words, a Hong Kong applicant that fails the safe harbor rule should be allowed to go through the normal process for BO assessment.

Circular 165 also sets out further administrative guidelines, including consistent treatment of the same applicant in different jurisdictions, and how to deal with a change of circumstances related to BO status.

Applicability of Circular 165

For Hong Kong applicants other than those named in Circular 165, the principles and guidelines in Circular 165 should apply to both current and future applications for BO status with respect to dividends.

While Circular 165 cannot apply automatically to applicants from treaty jurisdictions other than Hong Kong, the principles in Circular 165 may provide a useful reference point.

The takeaway

Circular 165 provides important principles and guidelines for the Chinese tax authorities to assess BO status on dividends under the China-Hong Kong tax treaty.

Because most US multinationals have Hong Kong holding companies in their Asia holding structures, they should review these principles and guidelines. In conjunction, they should adjust, if necessary, their current investment structure and documentation efforts in order to fully support their BO applications.

For those whose investment structures do not include Hong Kong holding companies, Circular 165 may provide a good reference for assessing BO status in similar situations.

Let's talk

For a deeper discussion, please contact:

International Tax Services, United States

Rebecca Lei Wang
+1 646 471 7384
rebecca.l.wang@us.pwc.com

International Tax Services, China

Cassie Wong, *National*
+86 10 6533 2222
cassie.wong@cn.pwc.com

Charles Lee, *South*
+86 755 8261 8899
charles.lee@cn.pwc.com

Edward Shum, *North*
+86 10 6533 2866
edward.shum@cn.pwc.com

Peter Ng, *Central*
+86 21 2323 8888
peter.ng@cn.pwc.com

© 2013 PricewaterhouseCoopers LLP. All rights reserved. In this document, PwC refers to PricewaterhouseCoopers (a Delaware limited liability partnership), which is a member firm of PricewaterhouseCoopers International Limited, each member firm of which is a separate legal entity.

SOLICITATION

This content is for general information purposes only, and should not be used as a substitute for consultation with professional advisors.