China Tax Treaty Preference: Burden of Proof and Documentation

By Neal Stender, Peter Connors & Forrest Ye
(Orrick, Herrington & Sutcliffe LLP, Hong kong, New York & Beijing)

A foreign resident receiving investment or transaction income from China, and seeking to enjoy preferential rates of China withholding tax, now must prove its status as a "beneficial owner", which is not acting on behalf of a resident of a different jurisdiction. Otherwise, the recipient will be deemed to be a "conduit company", which is not eligible for preferences under the tax treaty or arrangement between China and the recipient's jurisdiction of residence. A new element of China's increasingly complex environment for tax planning and compliance, this burden of proof, is detailed in an October 27, 2009 circular by the China State Administration of Taxation (SAT), entitled *How to Understand and Determine "Beneficial Owners" under Tax Treaties*, and numbered Guo Shui Han [2009] No. 601 ("Circular 601").

Background

Until recently, preferential treatment of dividends, interest, and royalties had been granted to residents of tax treaty jurisdictions by China local tax officials without a consistent level of scrutiny, or an express burden of proof, as to whether an applicant qualified as a beneficial owner.

Counterparties to tax treaties with China include major trading partners such as the United States, most European countries, Japan, South Korea and Russia, where companies are rarely suspected of locating solely for the purpose of tax planning. Counterparties also include certain 'tax haven' jurisdictions where such suspicions are common, such as Luxembourg, Cyprus, Malta, Mauritius and Barbados.

Most notably, China has negotiated highly favorable tax preferences in its treaty with Singapore and even more favorable tax preferences in its treaty-type "arrangement" with Hong Kong (7% on interest and intellectual property royalties, and 5% on dividends from substantial direct investments). These two jurisdictions both are major trading partners with China, and have domestic conditions that enable and encourage affiliates of multi-national groups to engage in the type of business operations that support the status of beneficial owners. This is particularly true of Hong Kong, which continues to play a very large role both in China transshipments and re-exports, and in multinational groups' Greater China regional distribution and management activities.

Definition & Factors

"Beneficial owners" are defined in Circular 601 as persons who possess ownership and right of control over China-source income, or over rights or properties from which such income is generated, and who routinely engage in substantive business operations. "Conduit companies", a concept which has not been used in previous China laws or official circulars but which is well-known to U.S. taxpayers, are specifically excluded from being treated as beneficial owners. Conduit companies are further described in Circular 601 as entities that (i) engage in no, or nearly no, substantive operational activities such as manufacturing, trading, or provision of management services or other services, and (ii) have established residence in a particular jurisdiction for the purposes of evading tax, reducing tax, or transferring or sheltering profits.

A foreign resident receiving investment or transaction income from China, and seeking to enjoy preferential rates of China withholding tax, now must prove its status as a "beneficial owner", which is not acting on behalf of a resident of a different jurisdiction.

The Chinese tax authorities will determine beneficial owner status case-by-case in line with the principle of "substance over form." An applicant's chance of being deemed a beneficial owner will be reduced if it falls under any of the following factors (all of which are intended to be considered and balanced, without any particular weighting having been indicated in Circular 601 or other promulgated sources):

See Tax Treaty, page 4

Tax Treaty, from page 3

- The applicant is obliged to pay or distribute all or a major portion (e.g., above 60%) of the China-source income within a specified time limit (e.g., within 12 months after receipt) to residents of another jurisdiction;
- The applicant has no or nearly no operational activities except holding the properties or rights from which China-source income is generated;
- The applicant has assets and staff that are disproportionately small in comparison with its China-source income;
- The applicant has no or few rights to control or dispose of, or assumes little or no risk in connection with, its China-source income;
- The applicant is registered in a county (region) that does not levy tax, or grants tax exemption, or levies tax at an extremely low rate, on its China-source income;
- In respect of China-source income that is loan interest, the applicant has loan or deposit agreements with another person specifying similar amounts, interest rates, and creation date; or
- In respect of China-source income that is generated by a transfer or license agreement for usage or ownership of copyright, patent, or technology, the applicant has transfer or license agreements with another person providing for similar royalties.

The Chinese tax authorities will determine beneficial owner status case-by-case in line with the principle of "substance over form."

Procedures & Timing

Urgent filing, of its first application for a particular remittance to qualify under Circular 601, now appears to be the most attractive approach for a foreign company, as soon as it is able to specify the amount of the remittance. Such an application must contain a variety of commercial and legal information about the applicant, including its assets, its shareholders located in a third jurisdiction, and its related-party transactions, along with "other relevant documents." These requirements are detailed in an earlier circular, effective from 1 October 2009, by the SAT, entitled Guo Shui Fa [2009] No. 124, ("Circular 124"). Any remittance that is made before approval of this application will be subject to standard (non-treaty) withholding tax, although a refund can be obtained through a successful application that is submitted any time up to three years after the withholding or payment of such tax.

Each subsequent remittance must be covered by a separate application (except that approval of one remittance can be used, during a three-year period, to make additional remittances under the same category of income, enjoying the same treaty preference, and within the jurisdiction of the same local tax authority).

Different types of remittances to the same recipient will face different risks, notably depending on how closely connected they are to the recipient's substantive assets and activities. However, even if an applicant's first application under the above circulars is for a relatively non-controversial remittance, the resulting first impression made on tax authorities is likely to have ongoing importance when they examine later applications.Circular 601 complements, and Circular 124 reinforces, China's recent trend towards broadening, and more actively enforcing, tax liabilities arising from various domestic and cross-border activities, while narrowing tax and other incentives. These circulars also fit into larger trends, such as the increasing scrutiny by investment destination countries, including the United States, of the role of offshore holding companies, and the increasing complexity of China-related tax planning and financial structuring.

Neal Stender is a partner in the Hong Kong office in Orrick. Mr. Stender focuses his practice on cross-border investments, transactions and operations in China and Hong Kong. He advises on tax planning and other aspects of joint ventures, mergers & acquisitions, intellectual property licensing and protection, customs and trade. He can be reached by e-mail at nstender@orrick.com or by phone at +852 2218 9199. Peter J. Connors is a partner in the New York office of Orrick. Mr. Connors' practice focuses on cross-border financial transactions, particularly those involving banks and insurance companies. He also has extensive experience in related areas of tax law, including asset securitization, financial transactions, corporate reorganizations and cross-border transactions. Mr. Connors is Vice Chair of the New York Chapter of the International Fiscal Association. He can be reached by email at pconnors@orrick.com or by phone at +1 (212) 506-5120. Forrest Ye is a tax and corporate practice associate in the Beijing office of Orrick and can be reached via e-mail at flye@orrick.com or by phone at +86 10 8595 5655.

