Mainland China issues guidance for determining beneficial owner status under dividend clause of the tax arrangement with Hong Kong

On 12 April 2013, China’s State Administration of Taxation (SAT), after undergoing consultation with the Inland Revenue Department of Hong Kong, released Shuizonghan [2013] No. 165 (Circular 165) to provide guidance to and respond to requests raised by five local tax authorities for the determination of Beneficial Owner (BO) status of five Hong Kong companies under the dividend clause of the mainland China–Hong Kong tax arrangement. Circular 165 provides clarification and interpretation of certain determining factors for the assessment of BO status set out in Guoshuihan [2009] No. 601 (Circular 601, i.e., notice regarding the interpretation and determination of the term “BO” under tax treaties)¹ and State Administration of Taxation Announcement [2012] No. 30 (Announcement 30, i.e., notice regarding the determination of the term “BO” in tax treaties)².

Key features of Circular 165 are laid out in the table below:
<table>
<thead>
<tr>
<th>No.</th>
<th>Determining factors for BO assessment stipulated in Circular 601/Announcement 30</th>
<th>Provisions in Circular 165</th>
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</thead>
<tbody>
<tr>
<td>1</td>
<td>Pursuant to Circular 601, it will be disadvantageous to sustaining a determination of BO status if the recipient is under an obligation to distribute all or majority (e.g., more than 60%) of the mainland China-sourced income to a resident of a third jurisdiction within a specified period (e.g., 12 months).</td>
<td>In determining whether an applicant has distributed dividends within a specified period of time, tax authorities should require the applicant to submit relevant documents to substantiate its profit distribution status and the rights and obligations between the applicant and its holding companies. Such documents may include the articles of associations, board resolutions, related contracts, and agreements with holding companies. If the applicant does not distribute dividends to a non-Hong Kong resident company, this will not constitute a negative factor for purposes of BO determination.</td>
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<td>2</td>
<td>Pursuant to Circular 601, it will be disadvantageous to sustaining a determination of BO status if other than holding the properties or rights that generate the income received, the recipient conducts little or no business activities.</td>
<td>Investment activities conducted by an applicant related to the holding of properties or rights shall be regarded as business operations. The fact that the applicant has no other investment projects or other types of business operations except for holding a single investment project shall constitute a negative factor for BO determination purposes. However, BO status shall not be denied solely due to a single factor that an investment company is established to invest in a single project.</td>
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<td>3</td>
<td>Pursuant to Circular 601, it will be disadvantageous to sustaining a determination of BO status if the recipient is a corporation or another type of business entity, and the assets, the size of operations, and the human resources of the recipient are disproportionately small compared to the income received from mainland China.</td>
<td>To determine whether the assets of an applicant are proportionate to its income received, a comprehensive analysis should be conducted on the asset status of the applicant. “Assets” of the applicant should not be considered as equal to its registered capital. For an applicant with disproportionately small registered capital, the source of its funding, the investment risk it bears, etc. should be analyzed to determine whether its assets are commensurate with its income received. To determine whether the human resources of an applicant are commensurate with its income received, special emphasis should be placed on the responsibilities of its staff and the substance of their work activities and should not be solely determined by the quantity of personnel and whether staff expenses are paid by the applicant.</td>
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| 4   | Pursuant to Circular 601, it will be disadvantageous to sustaining a determination of BO status if the recipient does not, or usually does not, have rights to control or dispose of the income or properties or rights giving rise to the income, and bears little or no risks. | Tax authorities should analyze the following three aspects:  
- Whether relevant legal documents such as articles of association have granted the applicant relevant rights to control or dispose of the assets or income;  
- Whether the applicant has exercised its control or disposal rights;  
- Whether the applicant has executed such rights upon its own discretion. The rights of an applicant to control or dispose shall not be denied solely based on the fact that the applicant's shares are controlled by a higher tier company. |
Pursuant to Circular 601, it will be disadvantageous to sustaining a determination of BO status if the recipient is exempt from a tax or is not subject to a tax in the resident jurisdiction with respect to income received from mainland China, or the recipient pays tax in the resident jurisdiction but at an extremely low effective tax rate.

The principle that income derived outside of Hong Kong is generally exempt from Hong Kong tax shall not constitute a key negative factor when assessing BO status.

In assessing BO status, a comprehensive analysis should be made taking into consideration the applicant's tax filing status in Hong Kong along with Hong Kong tax law.

Pursuant to Announcement 30, if an applicant is a listed company or 100% directly or indirectly owned by a listed company located in the same country/jurisdiction, the mainland Chinese tax authorities can directly grant a determination of BO status with respect to dividends.

BO status of the following applicants shall be determined according to prevailing regulations and Circular 165. BO status shall not be denied solely based on the existence of the following fact patterns:

- The applicant is 100% directly or indirectly owned by a non-listed Hong Kong resident company;
- There are non-Hong Kong intermediate holding companies between the applicant and the ultimate Hong Kong holding company.

Circular 165 also indicates that the tax treatment of tax authorities at different locations on similar investment income received by the same taxpayer should be consistent.

As Circular 165 is case specific, it is not clear whether it has general applicability. However, at the very least it provides insight into various principles that the SAT may apply when seeking to determine BO status. Taxpayers are encouraged to comprehensively consider Circular 601, Announcement 30 and Circular 165 before distributing dividends to a Hong Kong holding company.

Endnotes

1. For additional information, please see Ernst & Young Global Tax Desk Alert, *China's new definition of “beneficial owner” makes structures lacking substance and business purpose come under further challenge*, dated 20 November 2009.

2. For additional information, please see Ernst & Young Global Tax Desk Alert, *China releases supplemental guidance to Circular 601 to further provide clarification of beneficial ownership for income tax treaty purposes*, dated 20 July 2012.
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