

Client Alert

February 2018

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China's Latest Anti-Treaty Shopping Rules Create New Tax Saving Opportunities for MNCs

On 6 February 2018, the State Administration of Taxation (SAT) released the *Bulletin on Issues Relating to Beneficial Owner in Tax Treaties* ("**Bulletin 9**")¹. Bulletin 9 takes effect on 1 April 2018, and replaces China's existing anti-treaty shopping rules in Circular 601² and Bulletin 30³.

1. Background

China's efforts to combat treaty shopping precede the OECD's BEPS action plans. In 2009, the SAT issued Circular 601, which was a unilateral interpretation of the beneficial ownership concept in China's bilateral income tax treaties. Circular 601 has posed a major challenge to non-Chinese multinational companies (MNCs) deriving dividend, interest or royalty income from China and seeking to benefit from lower withholding tax rates under China's income tax treaties. To enjoy these preferential withholding tax rates, the income recipient must perform substantial business activities in its country of tax residence and cannot be viewed as a conduit with respect to the China-sourced income. In later years, the SAT issued additional guidance on beneficial ownership in Bulletin 30, Circular 165⁴ and Bulletin 24⁵. Although these subsequent notices clarified certain specific issues under Circular 601, they did not materially improve the situation for MNCs.

In 2017, the State Council issued two bulletins calling on lower-level government authorities, including the SAT, to identify and adopt concrete measures to enhance the investment environment for MNCs doing business in China. The objective was to encourage MNCs to put more capital into China to help drive China's economic growth. One example of such a measure in the tax area is the dividend reinvestment incentive under Notice 88⁶, which is intended to incentivize MNCs to reinvest earnings in China rather than to repatriate them. We discussed this new incentive in our last client alert⁷.

¹ State Administration of Taxation's Bulletin on Issues Relating to "Beneficial Owner" under Tax Treaties, SAT Bulletin [2018] No. 9, dated 3 February 2018, effective from 1 April 2018.

² The Circular of the State Administration of Taxation on the Interpretation and Determination of "Beneficial Owner" Under Tax Treaties, Guo Shui Han [2009] No. 601, dated 27 October 2009.

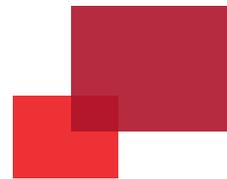
³ The *State Administration of Taxation's Bulletin on the Determination of "Beneficial Owner"* Under Tax Treaties, SAT Bulletin [2012] No. 30, dated 29 June 2012, effective as of the same date.

⁴ *The State Administration of Taxation's Opinions on Handling Beneficial Owner Cases Involved in the Implementation of the Dividends Provision under the Taxation Arrangement between Mainland China and Hong Kong by the Provincial and Municipal State Tax Bureaus in Places such as Hubei*, Shui Zong Han [2013] No. 165, dated 12 April 2013.

⁵ *The State Administration of Taxation's Bulletin on Issues Relating to the Determination of Beneficial Owner in Entrusted Investment*, SAT Bulletin [2014] No. 24, dated 21 April 2014, effective as of 1 June 2014.

⁶ *Notice of the Ministry of Finance, the State Administration of Taxation, the National Development and Reform Commission and the Ministry of Commerce Concerning the Deferral of Withholding Tax on Dividends Directly Invested by Foreign Investors*, Cai Shui [2017] No. 88, dated 21 December 2017, retroactively effective from 1 January 2017.

⁷ <https://www.bakermckenzie.com/en/insight/publications/2018/01/china-revives-tax-incentive>.



Bulletin 9 may be seen as the latest tax notice aimed at enhancing the competitiveness of China's investment environment. Although Bulletin 9 does not fundamentally change the underlying principles of beneficial ownership determination in Circular 601, it provides greater certainty to foreign investors by prescribing more detailed guidance on how the beneficial ownership test should be applied in practice. Most notably, it expands the beneficial ownership safe harbor rule in Bulletin 30 and introduces a new "derivative benefits test" that will create more opportunities for MNCs to meet the beneficial ownership test and thereby to access lower withholding tax rates under China's tax treaties.

2. Summary of Key Provisions

2.1 *Clarified Beneficial Ownership Test*

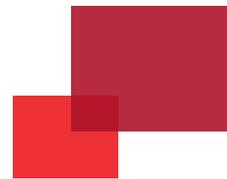
Circular 601 lists seven negative factors that help determine whether the income recipient meets the beneficial ownership test. These seven factors are consolidated into five factors under Bulletin 9. One key change is the tightening of the anti-conduit factor. Under Circular 601, the income recipient could be viewed as a conduit if it was obligated to pay 60% or more of the China-sourced income to a tax resident of a third jurisdiction within 12 months after receipt. The 60% test is reduced to 50% in Bulletin 9, and both an obligation to pay and an actual payment will be taken into account. For example, using more than 50% of the China-sourced income to make a loan to a tax resident of a third jurisdiction could be viewed as a negative factor under Bulletin 9.

With respect to income recipients that conduct investment activities, Circular 165 provided that investment activities may constitute economic substance that can support beneficial ownership. Bulletin 9 refines this principle in a way favorable to MNCs by stating that substantive investment management activities alone may meet the beneficial ownership test. However, whether investment activity is substantive must be evaluated based on whether the income recipient possesses enough assets and personnel to perform the investment functions, to bear the corresponding risks and to own the economic rights over the investment income.

If an income recipient conducts only passive investment activities, it must also carry out an additional active trade or business to meet the beneficial ownership test. An official interpretation that the SAT released together with Bulletin 9 indicates that the migration of an active trade or business into an entity that otherwise conducts only passive investment activities may not satisfy the beneficial ownership test if the migration was not driven by commercial necessity and represents only a small part of the income recipient's overall business.

2.2 *Expansion of Beneficial Ownership Safe Harbor*

Bulletin 30 contains a beneficial ownership safe harbor with respect to dividend income from a Chinese subsidiary. An income recipient that is both a tax resident and publicly listed in the treaty partner jurisdiction is treated as a per se beneficial owner. Bulletin 9 significantly expands the scope of per se beneficial owners of dividend income to include government bodies and individuals who are tax resident in the treaty partner jurisdiction. Furthermore, this safe harbor treatment will be extended to a dividend income recipient that is not a per se beneficial owner if it is directly or indirectly 100% owned by



one or more per se beneficial owners and all the intermediate entities, if any, between the income recipient and the per se beneficial owner(s) are tax residents of either China or the treaty partner jurisdiction.

It should be noted, however, that Bulletin 9 contains an anti-abuse provision, stating that the new beneficial ownership rules will not apply in a situation where they would conflict with the principal purpose test in an income tax treaty or with China's domestic general anti-tax avoidance rules.

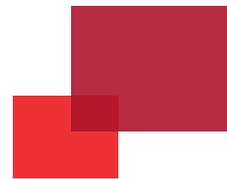
2.3 *Attribution of Beneficial Ownership*

Another important development under Bulletin 9 is a beneficial ownership attribution test. This new rule will increase access to treaty-based dividend withholding tax rates for MNCs where the income recipient itself does not qualify for the safe harbor and does not possess enough local commercial substance to pass the more general beneficial ownership test. The beneficial ownership attribution test applies only to dividend withholding tax and contains both a same-country scenario and a non-same country scenario.

In the same-country scenario, Company A-1 directly owns 100% of Company A-2, and both companies are tax residents of Country A, which has a bilateral tax treaty with China. Company A-2 owns an equity interest in a Chinese subsidiary and receives dividend income from the subsidiary. Company A-2 is not a beneficial ownership due to a lack of local substance in Country A. However, Company A-1 would have qualified for beneficial ownership if it had directly invested in the Chinese subsidiary and received the dividend income. In this case, Company A-2 will be granted beneficial ownership status and will qualify for the treaty withholding tax rate on the dividend income. This result remains the same if Company A-1 indirectly holds 100% of Company A-2 through one or more intermediate entities, regardless of whether these intermediate entities are tax residents of Country A or other countries (including tax haven countries).

In the non-same country scenario, Company A is a tax resident of Country A and owns a Chinese subsidiary, while Company B is a tax resident of Country B and directly owns 100% of Company A. If Company A receives dividend income from the Chinese subsidiary but fails the beneficial ownership test based on its own merits, Company A can still be treated as a beneficial owner if Company B meets the beneficial ownership test and is a "qualified person". To constitute a "qualified person", Company B must be a tax resident in a jurisdiction that has a tax treaty with China and must be eligible to enjoy the same or a lower withholding tax rate under the treaty between its jurisdiction and China as Company A would obtain under the treaty between Country A and China. If Company B indirectly owns 100% of Company A through intermediate entities, each of these intermediate entities must also be a qualified person in order of Company A to be treated as a beneficial owner.

With respect to both the beneficial ownership safe harbor and the beneficial ownership attribution test, the 100% ownership requirement must be satisfied not only at the time of the application for the treaty benefit, but also continuously during the preceding 12 months.



2.4 Supporting Documents

Bulletin 9 prescribes in detail the supporting documents that must be presented to the tax authority in connection with an application for beneficial ownership status based on the general test, the beneficial ownership safe harbor or the beneficial ownership attribution test. These documents may include, among other things, financial statements, contracts, functional analysis, intellectual property ownership certificates, corporate governance documents and tax residency certificates. Where the application is based on the beneficial ownership safe harbor or the beneficial ownership attribution test, a tax residency certificate is required for the income recipient and for each of the upstream affiliates that are relevant to the safe harbor or to the attribution.

Bulletin 9 further clarified that all such tax residency certificates should relate to the year of the application for the treaty benefit or to the immediately preceding year.

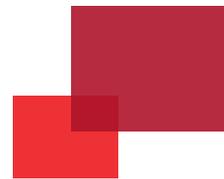
2.5 Tax Administration

Since the 2015 issuance of Bulletin 60⁸, an applicant for treaty benefits needs to provide the supporting documents only to the Chinese withholding agent, which will review the information received and, upon being satisfied with the treaty benefit claim, will make a recordal filing with the in-charge tax authority indicating the treaty position taken by the treaty applicant. The in-charge tax authority is authorized to conduct a post-filing examination of the treaty position and to make an adjustment when necessary. Bulletin 9 adds an additional requirement that an in-charge tax bureau (usually at the district level) that wishes to deny beneficial ownership status for a treaty applicant must seek the approval of the provincial-level tax authority. This requirement likely reflects the fact that the beneficial ownership determination is technically complex and the involvement of provincial tax authorities will help ensure a level of consistency in enforcement.

2.6 Agency

Bulletin 30 introduced an agency principle with respect to beneficial ownership for tax treaty purposes. For example, if non-resident A from Country A receives China-sourced passive income in the capacity of an agent of non-resident B from Country B, the treaty between China and Country B should apply and non-resident B should be the applicant under the beneficial ownership test. Bulletin 9, however, provides that the legal owner of the equity interest, loan or intellectual property that underlies the dividend, interest or royalty income received from China should be the applicant under the beneficial ownership test. The legal owner cannot claim that another party should be the treaty applicant under the agency principle. This provision in Bulletin 9 leads to uncertainty with respect to nominee structures in which legal title rests with the nominee, while the economic owner exercises control, derives the benefits and bears the risks over the underlying equity interest or intellectual property based on contractual agreements. It would appear that the nominee with legal title will be treated as the income recipient and treaty applicant for purposes of the beneficial ownership analysis under Bulletin 9.

⁸ State Administration of Taxation's Bulletin on the Administrative Measures for the Non-resident Taxpayer to Claim Tax Treaty Benefits, SAT Bulletin [2015] No. 60, dated 11 August 2015, effective from 1 November 2015.



3. Analysis and Recommendations

Bulletin 9 reflects efforts by the SAT to increase the competitiveness of the Chinese tax environment and to move closer to international best practices. These efforts include not only exemptions or reductions in tax rates and other types of domestic tax incentives, but also measures such as those found in Bulletin 9 which seek to lower the barriers that currently prevent MNCs from enjoying preferential tax rates under tax treaties.

The most significant development in Bulletin 9 is the beneficial ownership attribution test, which resembles a simplified version of the derivative benefits test in OECD BEPS Action 6, and which is likely to deliver the most tangible benefits to MNCs in the near term. At the same time, it is noteworthy that the attribution of beneficial ownership is limited to substance in the direct or indirect parent(s) of the income recipient, while it seems that substance in brother-sister companies in the same jurisdiction as the income recipient will not be taken into account. In this respect, beneficial ownership attribution under Bulletin 9 is narrower than in some other jurisdictions with broadly similar rules.

In other respects, Bulletin 9 preserves the beneficial ownership requirements under Circular 601 related to substantive business activity, which will remain the most critical factor for most applicants seeking beneficial ownership status under China's tax treaties. It will be more important than ever for MNCs seeking to benefit from lower withholding tax rates under China's tax treaties to have sufficient business substance in the ownership chain above China, to maintain detailed supporting documentation, and to ensure that the necessary tax residency certificates are available to the relevant companies in the chain.

On balance, we see Bulletin 9 as a major improvement on the existing rules in Circular 601 and its offspring. We would encourage MNCs to analyze the impact of the new rules in the context of their existing holding structures for China, as well as to explore new structures that can fully take advantage of the planning opportunities provided by Bulletin 9.

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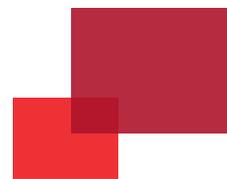
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Appendix

Unofficial Translation Prepared by Baker McKenzie

State Administration of Taxation's Bulletin on Issues Relating to "Beneficial Owner" under Tax Treaties

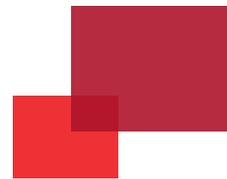
(Document ref. SAT Bulletin [2018] No. 9

Dated 3 February 2018.)

In order to implement treaties for the avoidance of double taxation signed by the Government of People's Republic of China (hereinafter "**Tax Treaty**"), hereby announces in relation to the determination of "beneficial owner" status as used in the dividends, interest and royalties provisions under the Tax Treaties:

1. A "beneficial owner" refers to a person who possesses ownership over and the right to control income, or the rights or properties that generate such income.
2. In order to determine the "beneficial owner" status of a resident from a treaty partner jurisdiction who claims for Tax Treaty treatment (hereinafter "**Applicant**"), a comprehensive analysis of the specific circumstances should be conducted in accordance with the factors listed in this article. The following are generally considered negative factors for determining an Applicant is a "beneficial owner":
 - (1) The Applicant is obliged to pay more than 50% of the income within 12 months from receipt of the income to a resident from a third country or region. The term "obliged" includes situations where the Applicant bears a contractual obligation to make the payment and situations where the Applicant does not bear a contractual obligation but has actually made the payment.
 - (2) The business activities carried out by the Applicant do not constitute substantial business activities. Substantial business activities include substantial activities such as manufacturing, distribution and management. Whether the business activities carried out by the Applicant are substantial shall be determined based on the actual functions performed and risks assumed by the Applicant.

Substantial investment-holding and management activities carried out by the Applicant may constitute substantial business activities. If the Applicant engages in investment-holding and management activities that do not constitute substantial business activities and also engages in other business activities, the Applicant shall not be regarded as engaging in substantial business activities if the other business activities are not significant.
 - (3) The treaty partner country or region does not levy tax or grants tax exemption on the income, or levies tax at an extremely low rate.
 - (4) Besides the loan agreement under which interest accrues and is paid, the creditor has another loan or deposit agreement with a third party



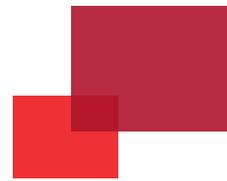
that contain similar amount, interest rate and execution date with the aforementioned loan agreement.

- (5) Besides the agreement to license copyright, patent or technology, etc. based on which royalties are generated or paid, the Applicant has another agreement with a third party to transfer the ownership over or the right to use the respective copyright, patent or technology, etc.
3. An Applicant who derives dividends from China but does not satisfy the conditions for "beneficial owner" shall still be regarded as having "beneficial owner" status if a person that directly or indirectly holds 100% shares of the Applicant satisfies the conditions for "beneficial owner" and is either:
 - (1) a resident of the Applicant's country or region of residence; or
 - (2) a qualified person (in the case of an indirect shareholding, all intermediate entities must also be qualified persons).

"Satisfying the conditions for 'beneficial owner'" refers to a situation where a comprehensive analysis in accordance with Article 2 of this bulletin indicates that a person possesses "beneficial owner" status.

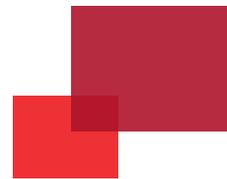
A "qualified person" refers to a person who, in accordance with the Tax Treaty signed between China and that person's country or region of residence, may claim a Tax Treaty benefit that is the same with or more favorable than the benefit that the Applicant can enjoy.

4. When deriving dividends from China, the following Applicants shall be automatically considered as having "beneficial owner" status without undergoing a comprehensive analysis in accordance with the factors provided under Article 2 of this bulletin:
 - (1) A government body of a treaty partner jurisdiction;
 - (2) A listed company that is a resident of a treaty partner jurisdiction;
 - (3) An individual who is a resident of a treaty partner jurisdiction;
 - (4) An Applicant directly or indirectly 100% held by one or more persons who fit into Items (1) to (3) above and are from the Applicant's country or region of residence (in the case of an indirect shareholding, all intermediate entities shall be residents of China or the Applicant's country or region of residence).
5. The shareholding percentages as provided in Article 3 and Article 4 shall be satisfied at any time within 12 months preceding the receipt of the dividends.
6. An agent or a designated recipient, etc. (collectively "**Agent**") does not belong to a "beneficial owner". If the Applicant derives income through an Agent, the Agent's residency status in the treaty partner jurisdiction shall not affect the determination of the Applicant's "beneficial owner" status.



"Deriving income through an Agent" as used in this article does not include situations where: a shareholder derives dividends based on shareholding, a creditor derives interest based on debt-claims or a licensor derives royalties based on a license.

7. When determining the "beneficial owner" status in accordance with all the factors as provided under Article 2, documents relevant to the specific category of the income shall be comprehensively analyzed. These documents include articles of association; corporate financial statements; capital flow records; board meeting minutes; board resolutions; information relating to the disposition of human and material resources, relevant expenses, and functions performed and risks assumed; loan agreements; license or transfer agreements; patent registration certificates; and copyright certificates. When determining whether income was derived through an Agent within the meaning of Article 6, documents such as the agency agreement or recipient-designation agreement shall be analyzed.
8. In order to establish "beneficial owner" status, the Applicant shall submit relevant supporting documents in accordance with Article 7 of the *State Administration of Taxation's Bulletin on Promulgating the Administrative Measures for the Non-resident Taxpayer to Claim Tax Treaty Benefits* (ref. SAT Bulletin [2015] No. 60). Whereby, if the Applicant has "beneficial owner" status in accordance with Article 3 of this bulletin, the Applicant shall submit, in addition to the Applicant's own tax residency certificate, tax residency certificates for the person who satisfies the conditions for "beneficial owner" and for the qualified person(s). The tax residency certificates must be issued by the competent tax authority of such person's country or region or residence. If the Applicant has "beneficial owner" status in accordance with Article 4(4), the Applicant shall submit, in addition to the Applicant's own tax residency certificate, tax residency certificates for the person who directly or indirectly holds 100% shares of the Applicant and for any intermediate entities. The tax residency certificates must be issued by the competent tax authority of such person's or intermediate entity's country or region of residence. The tax residency certificates must prove the person's or intermediate entity's tax residency in the current year or the year preceding the receipt of the relevant income.
9. If, during the subsequent administration by the in-charge tax authority, an Applicant voluntarily pays the taxes owed because of lack of "beneficial owner" status, the in-charge tax authority shall file the relevant case with the provincial-level tax authority. If the in-charge tax authority opines that the Applicant's "beneficial owner" status should be denied, it shall report the case to the provincial-level tax authority for approval before implementing its opinion.
10. If an Applicant has "beneficial owner" status but the in-charge tax authority finds it necessary to apply the principal purpose test under a Tax Treaty or the general anti-avoidance rules in domestic PRC tax law, the relevant general anti-avoidance rules shall apply.
11. This bulletin applies to the determination of "beneficial owner" status under the dividends, interest and royalties provisions in the *Arrangement Between Mainland and Hong Kong Special Administrative Region for the*



Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and the Arrangement Between Mainland and Macau Special Administrative Region for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income.

The provisions under the *State Administration of Taxation's Bulletin on Issues Relating to the Use of Hong Kong Residency Certificates in the Mainland* (Ref. SAT Bulletin [2016] No. 35) shall apply to the provision of tax residency certificates by Hong Kong residents.

12. This bulletin applies to the claim of Tax Treaty benefits where the tax liability or tax withholding obligation arises on or after April 1, 2018. The *Circular of the State Administration of Taxation on the Interpretation and Determination of "Beneficial Owner" Under Tax Treaties* (ref. Guo Shui Han [2009] No. 601) and the *State Administration of Taxation's Bulletin on the Determination of "Beneficial Owner" Under Tax Treaties* (Ref. SAT Bulletin [2012] No. 30) are simultaneously repealed.

It is hereby announced.

The State Administration of Taxation
3 February 2018