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AN ALERT FROM THE BDO INTERNATIONAL TAX PRACTICE

BDO KNOWS: INTERNATIONAL TAXATION

SUBJECT

CHINA DENIES REDUCED WITHHOLDING BY CHALLENGING "BENEFICIAL OWNER" STATUS

The Guangdong Provincial Local Taxation Bureau, a provincial-level tax bureau office of China's State Administration of Taxation ("SAT"), recently denied beneficial owner status to a Hong Kong company and two Mauritius entities after they requested treaty-reduced withholding tax rates for their Chinese-source income.

BACKGROUND

China's foreign tax treaties generally require a nonresident recipient of certain China-sourced passive income to be approved as the "beneficial owner" of such income before it can enjoy the benefits of reduced taxation under the treaty. In October 2009, the SAT issued Guoshuihan [2009] No. 601 ("Circular 601") which provided a series of adverse factors (discussed further below) to be considered in determining beneficial owner status.

Subsequent to the issuance of Circular 601 and in response to issues encountered in practice, in June 2012, SAT issued Announcement [2012] No. 30 ("Announcement 30") entitled "Announcement on Determining Beneficial Ownership in Tax Treaties" to provide further clarifications on the implementation of Circular 601.

Thereafter, on April 12, 2013, after consultation with the Inland Revenue Department of Hong Kong, SAT released Shuizonghan [2013] No. 165 ("Circular 165") in response to requests raised by local tax authorities for the determination of beneficial owner 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

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factors for the assessment of beneficial owner status set out in Circular 601 and Announcement 30. The principles and guidelines presented in Circular 165 also provide a useful reference guide for taxpayers in other jurisdictions that have similar tax treaties with China.

Key factors which tend to cast doubt on beneficial owner status, as first set forth under Circular 601, include the following:

1. Recipient of income has an obligation to distribute all or majority of the mainland-China sourced income;
2. Recipient conducts little or no business activities other than holding the properties or rights that generate the income received;
3. Assets, size of operations, and human resources are disproportionately small compared to the income received from mainland China;
4. Recipient does not, or usually does not, have rights to control or dispose of income or properties, and bears little or no risks; or
5. Recipient is exempt from tax or subject to tax at an extremely low effective tax rate in its resident jurisdiction with respect to income received from mainland China.

RECENT DEVELOPMENTS

The Guangdong Provincial Local Taxation Bureau recently denied beneficial owner status to a Hong Kong company and two Mauritius entities after they requested treaty-reduced withholding tax rates for their Chinese-source income.

Private Opportunities (Mauritius) II Ltd., an entity incorporated under the laws of Mauritius, was denied beneficial owner status and consequently was held ineligible for a five-percent preferential treaty-reduced withholding tax rate for its Chinese-source dividend income, according to Yue Guoshuihan [2014] 152, issued by the Guangdong tax bureau on March 24, 2014. The applicant was not recognized as the beneficial owner of the dividend income because it did not carry out any substantial business activity (other than its Chinese investment) and also because its operations and number of personnel were not consistent with its income levels.

On the same day, the Guangdong tax bureau also refused to recognize another Mauritius entity -- GS Investment Partners (Mauritius) V Ltd. -- as the beneficial owner of Chinese-source dividend income for the same reasons (Yue Guoshuihan [2014] 153).

Previously, on January 8, 2014, the Guangdong tax bureau determined that a Hong Kong company was not entitled to a seven-percent treaty-reduced tax rate for its Chinese-source interest income for the same reasons as the two Mauritius entities were denied beneficial owner status (Yue Guoshuihan [2014] 15).[1]

BDO OBSERVATION

The Chinese tax authorities are continuing to closely scrutinize and in some cases challenge taxpayers on their applications for treaty benefits. Therefore, nonresident taxpayers should prepare detailed documentation to demonstrate their beneficial owner status and entitlement to treaty benefits when applying for treaty benefits and maintain relevant documentation[2] for future review by the tax authorities.

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[1] 2014 WTD 72-7.

[2] The income recipient should prepare and maintain documents supporting their substance, *e.g.*, financial statements, board of directors meeting minutes, loan agreements, patent registration, licensing agreements, etc.

Inasmuch as there are still some uncertainties, taxpayers should actively communicate with the relevant tax authority to pursue a favorable interpretation and enforcement of the law.

HOW BDO CAN HELP

BDO China and BDO United States China Desk have the knowledge and expertise to help clients in all matters related to beneficial ownership applications and documentation.

BDO can also assist multinational organizations seeking reduced taxation on China-sourced income pursuant to an applicable tax treaty or agreement in reviewing these principles and guidelines.