



JONES DAY
COMMENTARY

SPECIAL PURPOSE COMPANIES HOLDING INVESTMENTS IN CHINA MAY NOT BE PROTECTED BY TAX TREATIES

Many multinational corporations set up holding companies in favorable jurisdictions to hold equity investments in China. One of the popular locations is Hong Kong. According to the “Agreement between the Mainland of China and the Hong Kong Special Administration Region for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income,” China withholding tax on the dividends paid by a company in the Mainland of China to a resident company of Hong Kong is limited to five percent of the gross amount of the dividends. This limitation occurs when the Hong Kong company is the beneficial owner of the dividends and directly holds at least 25 percent of the shares of the Chinese company. The China-Hong Kong tax arrangement also provides reduced tax rates for royalties and interest paid to the beneficial owners in a contracting state. On October 27, 2009, the State Administration of Taxation issued the Notice on Interpretation and Determination of “Beneficial Owner” under Tax Treaties, Guo Shui Han [2009] No. 601 (the “Notice”). The Notice provides guidance for

determination of a “beneficial owner” in the application of tax treaty provisions such as dividends, interest, and royalties.

A CONDUIT COMPANY IS NOT A BENEFICIAL OWNER

According to the Notice, a “beneficial owner” is a person who has ownership of and control over an income or the rights and assets generating the income. A beneficial owner, which can be an individual, a company, or any other group, is generally engaged in substantial business activities. An agent or a conduit company is not a beneficial owner. The Notice defines a “conduit company” as a company that is set up for the purpose of the avoidance or reduction of tax, or the transfer or accumulation of profits. This type of company merely registers in a country in order to satisfy a legally required organization form; it does not conduct substantial business activities such as production, trading, and

management. According to the above definition, many holding companies set up in Hong Kong as well as other favorable tax jurisdictions solely for holding equity in Chinese entities most likely will be considered as conduit companies and would not be eligible for relevant treaty relief.

DETERMINATION OF A BENEFICIAL OWNER

According to the Notice, in determining the status of a “beneficial owner,” the term should not be understood merely from the perspectives of technical sense or domestic law; rather, the status should be determined in its context and in light of the object and purposes of the tax treaty (*i.e.*, avoiding double taxation and the prevention of fiscal evasion and avoidance) and based on the principle of substance over form and the analysis of actual facts and circumstances. The Notice lists the following factors, which are not in favor of positive determination of a “beneficial owner”:

1. The applicant is obligated to pay or distribute the income in full or a majority portion thereof (*e.g.*, 60 percent or more) to residents of a third country or region within a prescribed time period (*e.g.*, within 12 months after receiving the income).
2. The applicant has no or almost no business activities other than holding the rights or assets that generate the income.
3. If the applicant is a company, the assets, operation scale, and personnel of the applicant are small in size or amount, which does not match the amount of income.
4. The applicant has no or almost no right to control or dispose of the income or the rights or assets generating the income and assumes no or little risk.
5. The contracting country (region) does not tax the income, or the effective tax rate is very low.
6. The lender to a loan agreement that generates interest income has another loan agreement or deposit contract with a third party; the amount, interest rate, and the time of conclusion with respect to the third-party contract is similar to those of the first loan agreement.

7. The licensor to an agreement on copyright, patent, and technology licensing or transfer has a contract to license or transfer those from a third party.

When a taxpayer applies for tax relief under a treaty, it should provide the information relevant to the factors listed above that proves that it is a beneficial owner. The tax authorities should determine whether the applicant is a beneficial owner by analyzing the above factors relevant to the income. If necessary, they may confirm the information relevant to the identification of a beneficial owner through information exchange with a treaty country.

CONCLUSION

The Notice is a significant step for China to crack down on treaty shopping by nonresident enterprises. The enforcement of the Notice, together with other anti-avoidance provisions in various tax circulars issued recently, will make it very difficult for multinational companies to enjoy the China treaty benefit merely by setting up a holding company in a favorable treaty country or region. However, it is not clear whether treaty partners will agree with China’s interpretation of the treaty provisions. It is also not clear how the Chinese tax authorities will actually enforce the rule with respect to existing overseas holding companies.

LAWYER CONTACT

For further information, please contact your principal Firm representative or the lawyer listed below. General email messages may be sent using our “Contact Us” form, which can be found at www.jonesday.com.

Fuli Cao
+86 10 5866 1223
fcao@jonesday.com

Jones Day publications should not be construed as legal advice on any specific facts or circumstances. The contents are intended for general information purposes only and may not be quoted or referred to in any other publication or proceeding without the prior written consent of the Firm, to be given or withheld at our discretion. To request reprint permission for any of our publications, please use our “Contact Us” form, which can be found on our web site at www.jonesday.com. The mailing of this publication is not intended to create, and receipt of it does not constitute, an attorney-client relationship. The views set forth herein are the personal views of the authors and do not necessarily reflect those of the Firm.