

## The Concept of Beneficial Ownership In China's Treaties

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# PRACTITIONERS' CORNER

## The Concept of Beneficial Ownership in China's Treaties

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On October 27, 2009, China's State Administration of Taxation (SAT) issued a circular that defined the concept of "beneficial ownership" for the purpose of China's income tax treaties.<sup>1</sup> Beneficial ownership is used in treaties to assist with determining whether a taxpayer is entitled to the benefit of a particular double tax agreement regarding some types of income — namely, dividends, royalties, and interest. China's treaties are largely modeled on the OECD model treaty. The problem is that the concept of "beneficial ownership" was imported into Chinese law, via the income tax treaties, that did not otherwise exist under Chinese law. As a result, the beneficial ownership concept was, up until October 27, basically ignored for the purpose of interpreting China's treaties — strict legal ownership was sufficient. Similarly, the Chinese tax officials took a soft approach to the concept of permanent establishment, which establishes China's taxing rights to income sourced in China by an enterprise that is a resident of a different jurisdiction.

As a result of this favorable environment, it became very popular in China to establish offshore investment vehicles (special purpose vehicles, or SPVs), to act as the direct shareholder for the company established in China. There are several benefits in interposing an SPV for China investments, including the limitation of liability and the ability of the SPV to be used to quickly sell the China business without all the regulatory red tape on the mainland. There were also ancillary tax benefits to such an arrangement — the SPV

could be established in a jurisdiction whose domestic tax law and treaty with China would lead to a favorable tax result.

Often the tax benefits of interposing an SPV were overstated; using SPVs was advocated by nontax lawyers who did not truly understand that the tax laws of the ultimate owner's home jurisdiction may still subject any income held by the SPV to tax, such as via a controlled foreign company and similar antideferral provisions. However, there were legitimate tax benefits in the right circumstances via the withholding tax clauses in some of China's treaties. For example, withholding tax is charged at 5 percent on dividends when the recipient is a Hong Kong resident company as opposed to the general rate of 10 percent for such income. Similarly, royalties and interest were a concessional tax treatment under the China-Hong Kong double tax agreement.<sup>2</sup> When the income of the China operations was high, there could be significant savings, particularly when the home jurisdictions did not give tax credits for withholding tax payments.

However, things have been different since the introduction of the Enterprise Income Tax Law<sup>3</sup> (EITL) in

<sup>1</sup>"Notice on how to understand 'beneficial owners' in tax agreements," Guo Shui Han [2009] 601.

<sup>2</sup>Arrangement Between the Mainland of China and the Hong Kong Special Administrative Region of Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income.

<sup>3</sup>Enterprise Income Tax Law (promulgated by the Standing Committee of the National People's Congress, Mar. 16, 2007, effective Jan. 1, 2008), 2007 *Standing Comm. National People's Congress Gazette* No. 63 (P.R.C.).

2008. Tax officials have started taking a more aggressive approach to tax avoidance, and in particular have started disregarding SPVs for tax purposes. In late 2008 the Chongqing Yuzhong tax bureau and the Xinjiang tax bureau, in unrelated cases, relied on China's new general antiavoidance rule and issued tax determinations that disregarded SPVs in Singapore and Barbados, respectively. Similarly, the SAT has issued a circular on the transfer pricing rules (Circular 363) that indicates their intention to aggressively investigate any enterprise that runs up losses in China to determine whether they are shifting profits offshore.<sup>4</sup> The SAT has issued Circular 601 in which it suggests that it will, in many circumstances, look through interposed companies to see who receives the true benefits of the income for purposes of determining which treaty, and tax rate, is applicable.

### Beneficial Ownership in China's Treaties

In examining the concept of beneficial ownership, this article will examine the Australia-China income tax treaty as an example. Beneficial ownership is used in three articles of the Australia-China treaty:

- article 10 — outlines the rights of a country (the nonresident country) to impose tax on dividend income paid by an enterprise resident of that country to a shareholder resident of the other country (the resident country);
- article 11 — operates similarly for interest as article 10 does with dividends; and
- article 12 — again, operates similarly for royalties as article 10 does with dividends.

For example, article 10(1) of the Australia-China treaty states that “[d]ividends which are paid by a company which is a resident of a Contracting State and which are beneficially owned by a resident of the other Contracting State may be taxed in that other State.” Beneficial ownership operates in those articles to establish whether the shareholder is entitled to access the benefits of the treaty. When an SPV does not satisfy the definition of beneficial owner, the authorities will look to the treaty (if one exists) of the taxpayer that satisfies the SAT's definition of beneficial ownership. Accordingly, the concept of beneficial ownership is critical for determining whether a treaty is applicable.

### The SAT's Interpretation

Circular 601<sup>5</sup> provides that the following will be indicators of beneficial ownership:

- Beneficial owners will have the right to own and dispose of the assets. They will usually conduct substantial business work. Individuals, enterprises, and organizations are qualified. However, agent companies and companies that are set for transferring profits and conduct no business work are not qualified.
- In determining the beneficial owner, the objective of tax treaties should be weighed. Usually, the following elements will not be favorable indications of a beneficial owner:
  - Applicants transfer most (more than 60 percent) of their income within 12 months to residents of a third country.
  - Applicants have no business except the assets and rights they hold.
  - As companies, the applicants' operations are so small-scale that the level of income is inappropriate.
  - Applicants have no control or cannot dispose of their assets or rights derived from the income.
  - Countries to which the agreements are signed levy no taxes or apply a lower tax rate.
  - A further loan contract exists between the creditor and a third party of a similar amount, rate, and date.
  - A further transfer contract for copyright, patent, or technology exists between the applicant and a third party.

Circular 601 also states that taxpayers should provide proof of qualifying as beneficial owners in accordance with the circular when applying for tax benefits under the relevant treaty.

Note that article 4 of the Australia-China treaty contains an anti-treaty-shopping provision. Paragraph 5 states:

If a company has become a resident of a Contracting State for the principal purpose of enjoying benefits under this Agreement, that company shall not be entitled to any of the benefits of Articles 10, 11 and 12.

Article 4(5) only applies to determine whether a taxpayer should be entitled to the benefit of the Australia-China treaty; it does not operate on the interposed entity. No such provision can be found, for example, in the Hong Kong-China double tax agreement. A further difference between article 4(5) and Circular 601 is that the practical onus regarding article 4(5) is on the tax authorities to establish that the arrangement is one of treaty shopping. In contrast, Circular 601 explicitly places the onus on the taxpayer to establish that it is entitled to the benefits of the treaty. In a country of 1.3 billion people, where the tax authorities struggle to keep track of offshore funds, such a difference is significant.

<sup>4</sup>“Notice on strengthening the monitoring and investigation on cross-border related-party transactions,” Guoshuihan [2009] No. 363.

<sup>5</sup>There is no official English translation of Circular 601 at the time of writing this article.

## 'Beneficial Ownership' in Australia

A question that arises is whether Circular 601 creates an asymmetry in the meaning of the term "beneficial owner" in the Australia-China treaty. Is the meaning of the term as used in the treaty different under Australian and Chinese law? To this writer's knowledge, there is no Australian case that directly considers the meaning of beneficial owner in Australia's treaties. Beneficial ownership does have an established meaning under Australian law. However, *Commissioner of Taxation v. Lamesa Holdings BV*<sup>6</sup> (*Lamesa*) establishes that the starting point for interpreting a treaty is the text of the treaty itself. *Thiel v. Commissioner of Taxation*<sup>7</sup> is authority for the proposition that it is appropriate to consider the commentaries to the OECD model treaty when construing Australia's treaties. Accordingly, the treaty should not necessarily be interpreted consistently with the general legal notion of beneficial ownership.

The commentaries to article 10 of the OECD model treaty discuss the meaning of beneficial owner. First, they state that beneficial owner is not "used in a narrow, technical sense" but rather should be interpreted in light of the objectives of treaties in preventing double taxation and reducing fiscal evasion.<sup>8</sup> The commentaries further state that:

[a] conduit company will not normally be regarded as the beneficial owner if, though the formal owner, it has, as a practical matter, very narrow powers which render it in relation to the income concerned, a mere fiduciary or administrator acting on account of the interested parties.<sup>9</sup>

The problem is that while advocating a broad construction, the commentaries still limit the holding of the income to trust or quasi-trust-like relationships. Very few interposed entities would have legal limitations placed on how they can use dividends that they

receive, although in a practical sense they may always be held for the benefit of the ultimate owner. It would not be difficult to arrange the affairs of the interposed entity so that it could not be said that it only has narrow powers. In *Prévost Car Inc. v. The Queen*,<sup>10</sup> the Tax Court of Canada held that the term "beneficial owner" could not be used to pierce the corporate veil, except when the interposed entity is without discretion in how to apply the funds received.<sup>11</sup> Note that in *Lamesa*, the Federal Court indicated that interpretations of treaties in foreign judgments could be used as part of the material that an Australian court may refer to in arriving at its own construction.

If such a construction is correct, it suggests that the notion of beneficial ownership in Circular 601 is more restricted than that found in the commentaries to the OECD model, and therefore the interpretation that would be utilized under Australian law.

## Conclusion

Are the days of SPVs numbered in China? The answer depends on whether you believe that SPVs merely exist to obtain tax benefits. The writer believes that tax benefits have rarely been the principal motivation for investing in China via an SPV. Rather, the most significant reason for using an SPV not located in mainland China is to avoid the burdensome regulatory requirements on the sale of an enterprise. The sale of equity interests in a foreign invested enterprise in China needs to be approved by the relevant government departments, usually the Administration for Industry and Commerce and the Ministry of Commerce. This process can take between four weeks to three months (even longer in some circumstances). Therefore, SPVs will still be useful in the right circumstances, although there may no longer be any incentive in locating them in jurisdictions with a favorable treaty. As such, it may just be that the days of treaty shopping are numbered. ♦

<sup>6</sup>(1999) 157 ALR 290.

<sup>7</sup>(1990) 171 CLR 338.

<sup>8</sup>OECD Model Tax Convention on Income and on Capital, 151.

<sup>9</sup>*Id.* at 152.

<sup>10</sup>2008 TCC 231 (Apr. 22, 2008).

<sup>11</sup>*Id.* at 100.