# HONG KONG TAX ALERT

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## China clarifies beneficial ownership requirements – a look from a Hong Kong tax perspective


### Summary

Effective from 1 April 2018, Announcement 9 replaces both Circular 601 and Announcement 30. Announcement 9 clarifies the rules for foreign investors to claim tax treaty benefits on their China-sourced dividends, interest and royalties.

Foreign investors investing into China via Hong Kong should revisit their current holding structure to determine whether the extended "safe harbor" rules and same jurisdiction rules for treaty benefits under Announcement 9 apply so that the Hong Kong holding companies can obtain tax treaty benefits under the China – Hong Kong double tax arrangement.

Given the Hong Kong Inland Revenue Department's ("IRD") approach in issuing tax residency certificates, it remains to be seen whether the IRD will adopt a pragmatic approach in issuing Hong Kong tax residency certificates for the purposes of Announcement 9.


The long awaited Announcement 9 has been released by the State Administration of Taxation of China (SAT). Effective from 1 April 2018, Announcement 9 replaces Circular 601 and Announcement 30, both of which are key circulars setting out the rules for foreign investors claiming tax treaty benefits on their Chinese-sourced dividends, interest and royalties ("passive income").

Announcement 9 provides additional guidance for taxpayers to determine their beneficial ownership ("BO") status for the purpose of obtaining tax treaty benefits under China's double tax agreements ("DTA"). The issue of Announcement 9 demonstrates the SAT's commitment to prevent tax treaty abuse by implementing Base Erosion and Profit Shifting (BEPS) Action Plan 6 recommendations.

The key changes to the BO analysis are:

(i) Extended "safe harbor" rules (Announcement 30)
(ii) Same jurisdiction rules for treaty benefits
(iii) Changes to the existing negative factors (Circular 601)

The extended "safe harbor" rules and "same jurisdiction rules for treaty benefits" applies only to dividend whilst the negative factors in determining the BO status apply to passive income.

### Extended "safe harbor" rules (Announcement 30)

Announcement 9 extends the scope of the existing BO safe harbor rules in respect of dividend income to include government bodies, listed companies and individuals who are direct recipients of Chinese-sourced dividends.

Where there is an indirect shareholding, all of the intermediate holding companies must be residents of the DTA country (region) where such government body, listed company or individual is resident.

There is also a requirement that the recipient must have owned the shares of the Chinese enterprise for at least 12 months before receiving the dividend income.

## New "same jurisdiction rule for treaty benefits"

Announcement 9 also introduces the "same jurisdiction rule for treaty benefits". If the immediate recipient of the Chinese-sourced dividend income does not qualify as a BO, it could still qualify for treaty benefits provided that it meets either of the following two conditions:

(i) The investor who directly or indirectly holds 100% of the equity interest in the immediate recipient of the dividend is itself a qualified BO; or
(ii) That investor is tax resident in either the same jurisdiction as the immediate recipient of the dividend or in another jurisdiction that has a DTA with China that provides the same or more favourable treatment.

## Changes to the negative factors (Circular 601)

Announcement 9 also makes some amendments to the 'seven negative factors' under Circular 601.

- The first negative factor has been amended to consider whether the investor (i.e., the DTA relief claimant) has an obligation to pay or distribute more than 50% of the dividend to a person who is resident in a third country (region) within 12 months after receiving the Chinese-sourced dividend. Announcement 9 defines "obligation to pay" to include both agreed obligations and situations where there are no agreed obligations but the income is actually paid by the DTA relief claimant to its shareholders or other parties resident in a third country (region).
- The second negative factor has been amended to refine the concept of whether the business activities undertaken by the applicant are "substantive activities". Substantive business activities include substantive manufacturing, trading and management activities as well as the functions and risks assumed by the DTA relief claimant in carrying out these activities.

  Where an applicant carries out both investment holding and management activities, the substance requirements for carrying on such activities will generally include preliminary study, assessment and analysis, investment decisions, implementation and post-investment management activities. Where the DTA relief claimant's investment holding, management and other business activities are considered insignificant, the DTA relief claimant would be regarded as not carrying on substantial business activities.

## Tax residency certificate ("TRC") requirements – Hong Kong DTA relief claim

Specific requirements for TRCs for claiming tax treaty benefits have been amended as follows:

- Under the extended safe harbor rules, the Hong Kong DTA relief claimant, the ultimate and intermediate shareholders of the Hong Kong DTA relief claimant will each need to provide a Hong Kong TRC;
- Under the "same jurisdiction rule", the Hong Kong DTA relief claimant and the shareholder that qualifies as the BO both need to provide a Hong Kong TRC;
- Under the "same treaty benefit rule", the Hong Kong DTA relief claimant, the 100% shareholder of the Hong Kong DTA relief claimant that qualifies as a BO and all of the 100% intermediate holding companies all need to obtain a TRC from the relevant tax treaty jurisdictions.

## KPMG observations

Announcement 9 is a highly anticipated and welcome enhancement to China's BO rules. From a Hong Kong tax perspective, these changes provide foreign investors who hold investments in China via Hong Kong with more flexibility in obtaining tax treaty benefits on their Chinese-sourced dividend income.

Foreign investors (such as multinational groups) should ensure that any Hong Kong holding companies are not established for the primary or sole purpose of claiming tax treaty benefits under the China – Hong Kong DTA as there is a risk that general anti-avoidance rules (GAAR) or the DTA principal purpose test (PPT) could be invoked to prevent treaty abuse.

Given the Hong Kong Inland Revenue Department's ("IRD") approach in issuing TRCs, it is unclear whether the IRD will adopt a pragmatic approach in issuing Hong Kong TRCs to comply with Announcement 9. Announcement 9 focuses on a commercial substance driven concept of BO. It remains to be seen whether the IRD will issue Hong Kong TRCs to the immediate DTA relief claimant where the commercial and operating substance of other group companies can now be considered under the same jurisdiction / same treaty benefit rule (provided that certain conditions are met).

For investment funds, investment management activities may constitute a substantial business activity. This is beneficial to the funds industry; however, we expect challenges are likely to remain.

For more information and assistance, please contact your usual tax advisor or one of our tax advisors below.

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