



China Tax Bulletin

Welcome to White & Case's monthly China Tax Bulletin. This client bulletin includes updates and analyses on recent tax regulations, ensuring you stay up to date on tax developments important to your business.

Treaty Benefits Only Available to "Beneficial Owners": What about Offshore Holding Companies?

As the domestic tax incentives have been gradually phased out, foreign investors are increasingly looking to tax treaties for any relief. Apparently, the State Administration of Taxation ("SAT") has been fully aware of the situation and set its sights on anti-avoidance rules designed to prevent foreign investors from abusing the treaty benefits.

In 2009, the SAT made several decisive moves to redefine how certain tax treaty benefits are applicable to foreign investors. As previously discussed, the SAT issued the following rules (please refer to our China Tax Bulletin March 2009, September 2009 and October 2009 respectively):

- Guoshuihan [2009] No. 81: treaty-based dividend withholding tax reduction;
- Guoshuifa [2009] No. 124: comprehensive guidance on claiming treaty benefits;
- Guoshuihan [2009] No. 507: tax treatment of treaty-based royalties.

On October 27, 2009, the SAT released Guoshuihan [2009] No. 601 ("Circular 601") to define the term "beneficial owner" with respect to the tax treaty treatment of dividends, interest and royalties. Only beneficial owners can claim the treaty benefits with respect to dividends, interest and royalties. Circular 601 basically draws a line on who are eligible for the reduced or zero withholding tax rate and who are not. The SAT intended to target offshore holding companies with minimum substance in jurisdictions that have tax treaties with China. Below is a summary of the main points of Circular 601.

Definition of Beneficial Owner

Under Circular 601, an individual, a company or any other organization can be a beneficial owner if the following requirements are met:

- The person owns or controls the income, or the assets or rights from which the income is generated;
- The person is engaged in substantive operational activities, such as manufacturing, distribution, or management; and
- The person is neither an agent nor a conduit company.

The requirement of substantive operational activities could be a challenge for some offshore holding companies, which virtually have no or very few business activities, other than merely holding and administering lower-tier subsidiaries. These offshore holding companies in current form are unlikely to qualify as beneficial owners under Circular 601.

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Neither an agent nor a conduit company is considered a beneficial owner. According to Circular 601, a conduit company has the following elements:

- The company is set up for the purpose of evading or reducing tax liabilities, or transferring or accumulating profits, or both;
- The company is registered in a jurisdiction other than China and merely meets the minimum legal requirements on organizational form; and
- The company is not engaged in substantive operational activities with respect to manufacturing, distribution or management.

Principle and Factors in Determining Beneficial Owner

To claim the treaty benefits, a non-resident taxpayer must submit an application to the local tax authorities. Circular 601 specifies that the determination of beneficial owners be made on a case-by-case basis through analysis of specific facts and circumstances involved, in accordance with the "substance over form" principle. Such determination needs to consider both the technical or domestic rules and the underlying purposes of tax treaties, which are to eliminate double taxation and prevent tax evasion.

In addition, Circular 601 expressly lists the following seven factors, which generally lead to unfavorable results, in determining beneficial owners:

- The applicant is obligated to pay or distribute all or substantially all the income (e.g., more than 60 percent) to a resident of a third jurisdiction within a prescribed time limit (e.g., 12 months following the receipt of the income);
- The applicant has no or few business activities, other than holding the assets or rights from which the income is generated;
- Where the applicant is a company or other entity, its size in terms of assets, scale and number of employees is disproportionately small relative to the amount of income;
- The applicant has no or few rights to control or dispose of the assets or rights from which the income is generated and bears no or few risks;
- The treaty partner does not tax the income, exempts the income from tax, or imposes tax on the income at a very low effective rate;
- In addition to a loan contract from which the interest is generated and paid, the creditor and a third party enter into a back-to-back loan or deposit contract with similar principal amount, interest rate and signing date;

- In addition to a copyright, patent or technology licensing contract from which the royalty is generated and paid, the applicant and a third party enter into a back-to-back copyright, patent, or technology licensing or transfer contract.

Documentation

An application to claim the treaty benefits is subject to the examination and approval by the local tax authorities. In determining the beneficial owner status, a non-resident taxpayer must provide supporting documents, including documents relevant to the above seven factors. The local tax authorities must follow the rules specified in Circular 601 and verify submitted documents through the informational exchange mechanism if necessary. Difficult applications should be reported to the SAT for final resolution.

Comments and Suggestions

Circular 601 is a significant development of China's anti-treaty shopping rules. The rules specified in Circular 601 are useful for both non-resident taxpayers and the local tax authorities. Nevertheless, it is a challenge for some offshore holding companies, which have expected to enjoy the treaty benefits by establishing minimum presence in jurisdictions entering into favorable tax treaties with China. As China now focuses on substantive operational activities, these offshore holding companies should carefully review their current structures. Merely being a holding company with no or little substance is not enough to claim the treaty benefits going forward. The bottom line is that to claim the treaty benefits, foreign investors must build up business substance in terms of activities, assets and employees in China's tax treaty partners beyond the minimum level.

It is unclear how tax treaty counterparties will react to Circular 601, arguably a unilateral position adopted by China without negotiations. Coincidentally, on November 5, 2009, the Indonesian Directorate General of Taxation issued procedural rules on how non-residents claim the tax treaty benefits and similarly focused on the classification of beneficial owners. Obviously, Circular 601 sheds some light on the same topic in China. Given the evolving nature of anti-avoidance rules, it remains to be seen how things will play out between China and its tax treaty partners on these interesting issues. We will closely monitor the development and provide updates in our monthly tax bulletin.

Foreign-Invested R&D Centers Eligible for Tax Exemption on Equipment Purchase

Research and development (“R&D”) are generally encouraged by various tax incentives. Under Orders 44 and 45 jointly issued by the Ministry of Finance (“MOF”), the General Administration of Customs (“GAC”) and the SAT in 2007, qualified R&D institutions are exempt from import tariffs, import value-added tax (“VAT”) and import consumption tax on import of certain equipment and goods, for a period from February 1, 2007 until December 31, 2010. In addition, Article 15(4) of the Provisional VAT Regulations, which were amended on November 10, 2008, similarly grants a VAT exemption on equipment imported and directly used in R&D activities.

On October 10, 2009, the MOF, the GAC and the SAT again jointly released Caishui [2009] No. 115 (“Circular 115”) to clarify preferential tax treatment to qualified R&D institutions on equipment purchase. For qualified foreign-invested R&D centers, Circular 115 allows an exemption of VAT and customs duty on import of equipment, and a VAT rebate on purchase of domestically-manufactured equipment.

Qualified Foreign-Invested R&D Centers

- A foreign-invested R&D center established no later than September 30, 2009 will be qualified if it meets all of the following requirements:
 - > R&D Expenses
 - For a R&D center which has been established for less than two years, with a legal person status or as a division or branch, the total amount of R&D investment shall be no less than US\$5 million;
 - For a R&D center which has been established for no less than two years, the annual R&D investment shall be no less than RMB 10 million;
 - > R&D Personnel
 - The number of R&D personnel shall be no less than 90;
 - > Accumulation of Value
 - The accumulated original value of equipment purchased since its establishment shall be no less than RMB 10 million.

- A foreign-invested R&D center established no earlier than October 1, 2009 will be qualified if it meets all of the following requirements:

- > R&D Expenses
 - For a R&D center with a legal person status or as a division or branch, the total amount of R&D investment shall be no less than US\$8 million;
- > R&D Personnel
 - The number of R&D personnel shall be no less than 150;
- > Accumulation of Value
 - The accumulated original value of equipment purchased since its establishment shall be no less than RMB 20 million.

Effective Period

Circular 115 is effective from July 1, 2009 until December 31, 2010.

Qualified Equipment

Circular 115 provides a list of equipment, to which tax preferential treatment may be granted.

Further implementation rules regarding the classification of qualified foreign-invested R&D centers will be promulgated by the Ministry of Commerce jointly with the MOF, the GAC and the SAT.

No Hong Kong Depreciation for Leased Machinery or Plant in Pearl Delta

The Hong Kong government has confirmed that a Hong Kong enterprise cannot claim Hong Kong depreciation allowances for machinery or plant leased to, or used for free by, a mainland China enterprise outside Hong Kong under an import-processing arrangement. The government also does not intend to extend depreciation allowances to such arrangements, according to replies on October 21 and November 4, 2009, in the Legislative Council by Hong Kong Secretary for Financial Services and the Treasury, Professor K.C. Chan, to questions raised by Dr. the Hon. Lam Tai-fai.

Professor Chan explained that section 39E of the Inland Revenue Ordinance is aimed at limiting tax-avoidance opportunities under various forms of machinery or plant leasing arrangements. As many tax-avoidance arrangements involve machinery or plant owned by a Hong Kong enterprise and used by an enterprise outside Hong Kong for a long period of time, section 39E provides that a Hong Kong enterprise will not be granted depreciation allowances for leased machinery or plant, if it is used wholly or principally outside Hong Kong by another person. Therefore, the Hong Kong enterprise will not be able to claim depreciation allowances, even if the machinery or plant is used to manufacture goods for sale by the Hong Kong enterprise and the profits of the Hong Kong enterprise are subject to Hong Kong tax.

Section 39E is not intended to have any impact on normal commercial leasing transactions. If a Hong Kong enterprise leases its machinery or plant to another enterprise outside Hong Kong under a normal leasing arrangement, the Hong Kong enterprise will not be granted depreciation allowances for the machinery or plant, but its rental income derived from outside of Hong Kong also will not be subject to Hong Kong tax. Therefore, section 39E should not have any impact on such transactions.

As a result of the restructuring of the operations of Hong Kong enterprises in the Pearl River Delta in recent years, Hong Kong enterprises may make their machinery or plant (mainly moulds) available for use by mainland China enterprises free of charge under import-processing arrangements. Professor Chan clarified that the Hong Kong enterprises would neither receive any rental income nor enjoy depreciation allowances because of section 39E.

Despite calls from the industry, the government has decided not to extend depreciation allowances to such arrangements, because of practical difficulties in relaxing the restriction under section 39E. For example, it would be difficult for the Hong Kong Inland Revenue Department to check the actual usage of the relevant machinery or plant, because the machinery or plant is used by another enterprise outside Hong Kong and the enterprise usually is a separate legal entity. Moreover, the Inland Revenue Department does not have the statutory power to request an overseas entity to provide supporting documents. Therefore, if the restriction is relaxed, the anti-avoidance provision can easily be exploited, resulting in tax deferral or loss and a large number of cases in dispute.

Hong Kong Treaty Update

Ethiopia and Maldives

The Hong Kong government on November 20, 2009, gazetted two orders to give effect to the double taxation agreements relating to income from aircraft operations agreed between Hong Kong and Ethiopia and between Hong Kong and the Maldives, respectively.

Under the double taxation agreements, tax exemption for income and profits derived from the operation of aircraft in international traffic will be provided for the airlines of Hong Kong, Ethiopia and the Maldives. Subject to negative vetting at the Legislative Council, the orders will take effect on January 18, 2010.

Negotiations

In October 2009, Hong Kong conducted negotiations concerning double taxation agreements with the following countries:

Country	Negotiations Scheduled	Negotiations Completed
Ireland	October 7 - 9, 2009 (1st round)	October 9, 2009
France	October 13 - 14, 2009 (3rd round)	October 14, 2009

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- Tier One for China Tax (Foreign Firms)—*Asia Pacific Legal 500*, 2009
- Tier One China Tax Practice (Foreign Firms)—*Chambers Asia*, 2008
- A leading law firm for China and Hong Kong tax—*International Tax Review*, 2008
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Our Tax practice in China and across the globe works with clients to meet international tax challenges. We help clients execute international tax-planning strategies and resolve the tax controversies that often accompany cross-border investments and transactions. Our tax controversy experience helps clients resolve tax audits, domestic appeals and government-to-government negotiations.

Our team in China is comprised of preeminent lawyers based in Shanghai, Beijing and Hong Kong, who are recognized for their accomplishments in transfer pricing, as well as for the tax aspects of corporate mergers, acquisitions, reorganizations and joint ventures. Additionally, they provide counsel on inbound and outbound syndicated investment structures involving real property, distressed debt and other assets, financial products and global trading, mutual funds and other domestic and cross-border taxation advisory matters.

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