

# China Law Update

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## **China Clarifies Concept of "Beneficial Owner" in Tax Agreements**

On October 27, 2009, the Chinese State Administration of Taxation (“SAT”) issued a Notice, "How to Understand and Determine the 'Beneficial Owner' in Tax Agreements" (Circular No. 601, hereinafter referred as to the “Notice”). This Notice clarifies the definition of beneficial ownership for purposes of avoiding double-taxation and appropriately reducing tax burdens.

### **Background**

China has signed a number of tax arrangements with foreign countries or regions, including Hong Kong and Macau Special Administrative Regions. The Notice states that the definition of the “Beneficial Owner” will be applied to determine whether a taxpayer qualifies for certain benefits of double taxation regarding dividends, royalties and interests specified by relevant tax arrangements.

### **Major Points**

The term “Beneficial Owner” under the Notice refers to a person who has the right to own and dispose of the income and rights or properties generated from the aforesaid income. The Notice further highlights that the “Beneficial Owner” may be an individual, a company or any other organization which is engaged in substantial business operations. An agent or conduit company[\*] is not a “Beneficial Owner”.

The Notice adopts a rationale of “Substance over Form” that focuses on the purpose of tax treaties, namely avoiding double taxation and preventing evasion of taxes. Moreover, the Notice enumerates seven situations that are unfavorable to determining “Beneficial Owner” status for applicants:

1. Where the applicant pays or distributes to residents of a third country (region) the total or majority of the income (for example, 60% or more) within a fixed period (for example, within twelve months after the income is received);

2. Where the applicant never or rarely performs other business operations except for the holding of properties or rights generated from the income;
3. Where the applicant is an enterprise, but has less assets and personnel, and is smaller in scale than would proportionately match its income;
4. Where the applicant rarely has or does not have a right to control or dispose of the income or the properties or rights generated from the income, nor bears little or no risk;
5. Where the other party (country or region) to the tax treaty either 1) imposes no taxes on, 2) exempts tax from, or 3) imposes extremely low taxes over the relevant income.
6. Where except for the loan contract from which interests originate and are paid, there exists another loan or deposit contract between the creditor and a third party, which entails similar amounts, interest rates and dates of commencement as the loan contract itself;
7. Where there exists another contract between the applicant and a third party on the right to use or own a copyright, patent or technology apart from the contract, from which the royalty is generated and under which it is paid.

Therefore, SAT will make a comprehensive analysis of the aforementioned factors to determine whether the applicant will be regarded as a “Beneficial Owner”.

### **Conclusion**

The Notice demonstrates SAT's serious attitude on recognition of a “Beneficial Owner”. Since more and more offshore special purpose vehicles (“SPVs”, offshore investment vehicles) have been set up in jurisdictions whose tax treaties with China would lead to a preferential policy regarding avoidance of double taxation, SAT promulgates the Notice to facilitate avoidance of double taxation for multi-national taxpayers on the one hand, and to prevent “tax treaty shopping” on the another hand.

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2[\*] In Article 1 of the Notice, SAT specifies and emphasizes that the term “conduit company” refers to a company which is usually established to dodge or reduce taxes, and transfer or accumulate profits. Such

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a company is only registered in the country of domicile to satisfy the organizational form as required by law, but does not engage in substantial business operations such as manufacturing, distribution or management.