



The End of SPVs in China?

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Introduction

On 27 October 2009 China's State Administration of Taxation (SAT) issued a circular defining the concept of "beneficial ownership" for the purpose of China's Double Taxation Agreements (DTAs).¹ Beneficial ownership is used in DTAs to assist with demarcating the allocation of tax on certain types of income – namely, dividends, royalties and interest. China's DTAs are largely modeled on the OECD standard. The problem with this is that a term was imported into Chinese law, via the treaty, that did not otherwise exist under Chinese law. As a result, the term was, up until 27 October 2009, basically ignored for the purpose of interpreting China's DTAs – strict legal ownership was sufficient. Similarly, the Chinese tax officials took a very soft approach to the concept of permanent establishment – a concept that operates to establish China's taxing rights to income sourced in China by an enterprise resident of a different jurisdiction.

As a result of this favourable environment, it became very popular in China to establish off-shore investment vehicles, or Special Purpose Vehicles (SPV), 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 needing to go through 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 DTA with China would lead to a favourable tax result.

Often the tax benefits of interposing an SPV were overstated as it was advocated by non-tax 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 controlled foreign company and similar anti-deferral provisions. However, there were legitimate tax benefits in the right circumstances arising out of the withholding tax clauses in some of China DTAs. For example, withholding tax is charged at 5% on dividends where the recipient is a Hong Kong resident company as opposed to the general rate of 10% for such income. Similarly, royalties and interest were concessional tax treatment under the *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* ("Hong Kong-China DTA"). Where the income of the China operations was significantly high this could result in significant savings, particularly where the home jurisdictions did not give tax credits for withholding tax payments.

However, since the introduction of the *Enterprise Income Tax Law*² ("EITL") in 2008 the tides have been turning in respect of Chinese tax law. The tax officials have started taking a far more aggressive approach to tax avoidance, and in particular have started disregarding SPVs for tax purposes. In late

¹ 'Notice on how to understand "beneficial owners" in tax agreements' Guo Shui Han [2009] 601

² Enterprise Income Tax Law (promulgated by the Standing Comm. Nat'l People's Cong., Mar. 16, 2007, effective Jan. 1, 2008) 2007 *Standing Comm. National People's Congress Gaz No. 63* (PRC) (hereinafter "Enterprise Income Tax Law")



2008 Chongqing Yuzhong Tax Bureau and the Xinjiang Tax Bureau, in unrelated cases, relying upon China's new general anti-avoidance rule issued tax determinations that disregarded SPVs in Singapore and Barbados respectively. Similarly, the SAT has issued a circular in respect of the transfer pricing rules ("**Circular 363**"), which indicates their intention to aggressively investigate any enterprise that runs up losses in China to determine whether they are shifting profits off-shore³ Now the SAT has issued Circular 601 in which it is suggested that it will, in many circumstances, look-through interposed companies to see who receives the true benefits of the income for purpose of determining which DTA, and tax rate, is applicable.

The Operation of Beneficial Ownership in China's DTAs

In examining the operation of the concept of "beneficial ownership" this article will examine the *Agreement Between the Government of Australia and the Government of the People's Republic of China for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income* ("**Australia-China DTA**") as an example. Beneficial ownership is used in three articles of Australia-China DTA:

1. Article 10 – which outlines the rights of a countries (the non-resident 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);
2. Article 11 – which operates similarly with respect to interest as article 10 does with dividends; and
3. Article 12 – which once again does the same in respect of royalties.

For example Article 10(1) of the Australia-China DTA provides 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.' Accordingly, "beneficial ownership" operates in those Article to establish if the shareholder is entitled to access the benefits of the particular DTA. Where a SPV does not satisfy the definition of "beneficial owner", the authorities will look to the DTA (if one exists) of the taxpayer that satisfies the SATs definition of "beneficial ownership". Accordingly, the concept of beneficial ownership is critical for determining if a DTA is applicable.

The SAT's Interpretation of Beneficial Ownership

Circular 601 provides that the following will be indicators of beneficial ownership (note there is no official English translation at the time of writing this article):

1. 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 which are set for transferring profits and conduct no business work are not*

³ 'Notice on strengthening the monitoring and investigation on cross-border related party transactions' Guoshuihan [2009] No.363



qualified.

2. In determining the beneficial owner, the objective of tax agreements should be weighed. Usually the following elements will not be favorable indications of a beneficial owner:

- a) Applicants transfer most (more than 60%) of its income within 12 months to residents of a third country.
- b) Applicants have no business except the assets and rights they hold.
- c) As companies, the applicants are so small-scaled that the incomes can not match.
- d) Applicants has no control or can not dispose of his assets or right derived from the income.
- e) Countries to which the agreements are signed levy no taxes or apply a lower tax rate.
- f) A further loan contract exists between the creditor and a third party, of a similar amount, rate and date.
- g) A further transfer contract for copyright, patent or technology exist between the applicant and a third party.

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

It should be noted that Article 4 of the Australia-China DTA contains an anti “treaty shopping” provision. Paragraph 5 provides that

“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.”

The first thing to note is that Article 4(5) only applies to determine if a taxpayer should be entitled to the benefit of the Australia-China DTA; it does not operate in respect of the interposed entity. No such provision can be found, for example, in the Hong Kong-China DTA. A further difference between Article 4(5) and Circular 601 is that the practical onus in respect of Article 4(5) is on the taxation 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 DTA. In a country of 1.3 billion people, where the tax authorities struggle to keep track of off-shore funds, such a difference is significant.

The meaning of “beneficial ownership” in DTAs under Australian law

A question that arises is whether Circular 601 creates an asymmetry in meaning for the term “beneficial owner” in the Australia-China DTA. That is, 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 DTAs. Beneficial ownership does have an established meaning under Australian law. However, *Commissioner of Taxation v Lamesa Holdings BV*⁴ (“**Lamesa**”) establishes that the starting point for interpreting a DTA is the text of the

⁴ (1999) 157 ALR 290.



DTA itself, and *Thiel v Commissioner of Taxation*⁵ is authority for the proposition that it is appropriate to consider the commentaries to the OECD's *Model Tax Convention on Income and on Capital* ("Model Tax Convention") when construing Australia's DTAs. Accordingly, it is submitted that the treaty should not necessarily be interpreted consistently with the general law notion of "beneficial ownership".

The commentaries to Article 10 of the Model Tax Convention discusses the meaning of beneficial owner. Firstly, it states that beneficial owner is not 'used in a narrow, technical sense' but rather it should be interpreted in light of the objectives of DTAs in preventing double taxation and reducing fiscal evasion.⁶ 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'⁷

The problem with this is that, whilst advocating a broad construction, it still limits 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 utilise 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*⁸, a Canadian case, it was held that the term "beneficial owner" could not be used to pierce the corporate veil, except where the interposed entity is without discretion in how to apply the funds received.⁹ It should be kept in mind that in *Lamesa*, the Federal Court indicated that interpretations of DTAs in foreign judgments could be utilised 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 Model Tax Convention, and therefore that which would be the case for Australian law.

Conclusion - Are the days of SPVs numbered in China?

The answer to this question depends upon whether you hold the view that SPVs merely exist to obtain tax benefits. The writer holds the view, as indicated above, 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 upon 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 ("AIC") and the Ministry of Commerce ("MOFCOM"). This process can take anywhere between 4 weeks to 3 months (even longer in some circumstances). Accordingly, SPVs will still be

⁵ (1990) 171 CLR 338.

⁶ OECD, *Model Tax Convention on Income and on Capital*, 151.

⁷ *Ibid* at 152.

⁸ 2008 TCC 231 Date: April 22, 2008.

⁹ *Ibid* at [100].



useful in the right circumstances, although there may no longer be any incentive in locating them in jurisdictions with a favourable DTA. As such, it may just be that the days of treaty shopping are numbered.

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