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Definition of Beneficial Owner under Entrusted Investments

The State Administration of Taxation of China issued the *Announcement* on *the Definition of Beneficial Owner Under Entrusted Investments* [2014] No. 24 on 21 April, 2014, which will be enforced from 1 June 2014 and also be effective to those unsettled tax cases before 1 June 2014.

Background

In October 2009, the SAT issued Guoshuihan [2009] No.601 ("Circular 601") that provides guidance for determining the "beneficial owner" in a double taxation treaty ("DTT"). In light of the many practical issues encountered by local tax authorities when adopting Circular 601 guidance, in 2012, SAT issued Announcement [2012] No.30 ("Announcement 30") to standardize and align local tax authorities in their interpretation of "beneficial owner" when implementing Circular 601.

On 21 April 2014, the State Administration of Taxation (the "SAT") released Announcement [2014] No.24 to clarify the definition of beneficial owner under "entrusted investments". As a supplementary regulation to Guoshuihan [2009] No.601 and Announcement [2012] No.30 issued by the SAT in 2009 and 2012 respectively, the issuance of the new circular provides more detailed guidance to local tax authorities on how to determine the beneficial owner when non-residents invest in the PRC via entrustment with single- or multiple-layer collective investment structure. However, given that Announcement 24 does not provide clear guidance on which collective investment scheme will be in scope while sets very strict requirements on documentation submission requirements, it is likely to cause many practical issues during the implementation of this circular.

Main contents

Announcement 24 aims to provide further clarification on the determination of beneficial owner under an entrusted investment, which is defined in the Announcement as equity or debt investments made by a non-resident with its own capitals through an overseas professional institution. "Overseas professional institution" further refers to a financial institution approved by the home jurisdiction to conduct business in securities brokerage, asset management, capital and securities trust, etc.

According to Announcement 24, the overseas professional institution must maintain separate accounts for their own funding and the entrustment funding during the entrustment period, and collect service fees or commissions under the entrustment agreement. As the investor, the non-resident will obtain investment income and bear relevant investment risks. This shows that Announcement 24 aims to regulate the taxation of collective investment schemes in areas such as investment fund, trust investments, etc.

Documentation Requirements

According to Announcement 24, the non-resident investor must submit the following documents in order to enjoy treaty benefits on the investment income from such entrusted investment:-

Documents Required
All the relevant contracts or agreements signed by various parties in the investment chain[1]; other documents explaining the investment business, including supporting documents on the sources and composition of investment capital for the entrusted investment and charges or income obtained by each party;
Any information or supporting documents regarding the investment income and other gains distributed to the non-resident at each level, as well as term sheets on the determination and allocation of different types of income;
Other information requested by the tax authorities to determine the beneficial owner.

Tax Treatment

Announcement 24 also stipulates that after reviewing the documents submitted by the non-resident, the tax authority should adopt the following treatments depending on the type of income:-

Type of the Investment Income	Treatments
Dividend or interest	If there has not been any change to the nature of the income during each stage of distribution to the non-residents, and there are evidence showing that such income has actually been distributed to the non-resident, the non-resident shall be recognized as beneficial owner of such income and enjoy treaty benefits
Charges or remunerations received by all other parties (except the non-resident) in the investment chain	If such charges or remunerations are related to dividends or interests, the non-resident should not be treated as the beneficial owner on such portion of charges or remunerations, and the treaty benefits on dividends or interests shall not be applicable on such portion
Gains on property or other types of income not subject to beneficial owner test	Relevant clauses in the DTTs should apply

Announcement 24 further specifies that if the non-resident or its agent refuses to provide the documents, or the information provided fails to separate the investment income of the non-resident from the remunerations of other parties in the investment chain, the tax authorities shall not grant such treaty benefits.

In the case that the non-resident and some other parties in the investment chain are related parties, documents should be provided to prove that the related-party transaction is of arm's length. Failing to do so may result in the tax authorities refusing to grant relevant treaty benefits.

[1] Including the PRC non-residents, the investment manager, the custodian, the securities company, etc.

Follow-up Administration

According to Announcement 24, once recognised as beneficial owner, a non-resident investor can be waived from the application of beneficial owner status with the same tax authorities within three calendar years from the date of granting the initial treaty benefits on dividend or interest. In such case, the tax authorities only reviews the types of investment income as long as the investment income received by the PRC non-resident under the entrusted investment meets all of the following conditions:-

(1) The investment structure remains the same for the entrusted investment;

(2) All parties in the investment chain except the investee enterprise remain the same; and

(3) The contracts or agreements related to the investment signed by all parties in the investment chain except the investee enterprise remain the same.

The non-resident should report to the tax authorities in charge in case of any change in the information related to the determination of beneficial owner. If the non-resident cannot continue to enjoy treaty benefits due to a change in circumstances, the eligibility for treaty benefits shall be terminated from the date of such change and relevant taxes should be filed pursuant to PRC tax regulations.

In addition, in the case that the documents provided by the non-resident or its agent are not consistent with those obtained by the tax authorities through information exchange with tax authorities in other countries, the in-charge tax authorities could revoke the previous approval even when the treaty benefits have been granted, and relevant regulations in the PRC Tax Collection and Administration Law and Guoshuifa [2009] No.124 shall apply instead.

KPMG Observation

The release of Announcement 24 further defines "beneficial owner" under collective investment schemes, while giving definitions of "entrusted investment" and "overseas professional institution" for the first time, and setting out the detailed documentation requirements for non-residents to apply for treaty benefits under an entrusted investment arrangement. In addition, Announcement 24 clarifies different tax treatments on the income and gain derived from investments of non-residents. To a certain extent, it provides more detailed guidance to local tax authorities on how to determine the beneficial owner when non-residents invest in the PRC via entrustment with single- or multiple-layer investment structure. It would appear that identifying the actual (ultimate) beneficial owner of an entrusted investment will be the key to receiving tax treaty benefits. Nevertheless, the following practical issues may still cause uncertainties during the implementation of Announcement 24:

Firstly, as "overseas professional institution" in Announcement 24 refers to a financial institution approved by its home jurisdiction to conduct business in securities brokerage, asset management, capital and securities trust, etc. Thus Announcement 24 may also be relevant when determining the beneficial owners of investments through certain investment schemes/arrangements (e.g. Real Estate Investment Trust, QFII/RQFII, Exchange Traded Fund). On the other hand, the SAT did not clarify whether some investment vehicles (e.g. private equity funds) used by foreign investors to invest in PRC resident enterprises, which could be established without having necessarily gone through approval by regulatory bodies in their home jurisdictions, are included as "overseas professional institution" in the Announcement. The scope of institutions as well as types of investment schemes/arrangements affected by this Announcement remains debatable.

Secondly, it is a common practice for overseas professional institutions to use intermediate holding companies in countries or regions that have tax treaty with the PRC (e.g. Hong Kong, Singapore) to hold shares of PRC resident enterprises. It is unclear whether the tax authorities will cut through these intermediate holding companies and determine the beneficial owner based on the ultimate beneficial owner of the investment.

Thirdly, there are stringent documentation requirements under Announcement 24 for applying for treaty benefits under entrusted investment. The investors are required to reveal all the relevant contracts and agreements (including the sources and composition of investment capital in the entrusted investment and charges or income obtained by all parties) signed by all parties in the investment chain. In addition, they are also required to provide information or supporting documents regarding the investment income and other gains distributed to the non-residents at each level of the investment structure, as well as proof of income category and explanation on income allocation. Many investors may be reluctant to reveal such highly detailed and confidential information, rendering it difficult to obtain approvals from various parties in the investment chain for submitting to the tax authorities. It is even more difficult to collect such information from some overseas investment funds where a large number of non-resident investors or multiple-layer investment structure (like fund-on-fund structure) are involved. It is therefore probable that non-residents are prevented from enjoying treaty benefits because they fail to meet the stringent documentation requirements.

Fourthly, Announcement 24 clarifies that if the charges or payments received by other parties (except the PRC non-residents) are related to dividend or interest (e.g. management fees, custodian fees, fund administration charges, carried interest etc), such charges or payments may not be included for enjoying treaty benefits under dividend or interest clause. Yet, the Announcement does not provide guidance on determining such charges or payments and relevant tax treatments, leaving local tax authorities the power to interpret at their own discretion.

Finally, although Circular 601 clearly states that the recognition of "beneficial owner" only applies to the cases for enjoying treaty benefits on dividend, interest and royalty, we understand that some local tax authorities also refer to Circular 601 when reviewing the treaty relief on the gains on transfer of property. Announcement 24 has further clarified that capital gain should not be referred to the recognition of "beneficial owner" but should be subject to the treatment under the applicable tax treaty[2]. But there is a possibility that the documentation requirements set out in Announcement 24 may be referred to by some tax authorities in reviewing capital gain cases, thus increasing the difficulty for non-residents to apply for treaty benefits.

[2] According to a typical double taxation treaty, the capital gain article only refers to whether the "tax resident" of a contracting state is the "alienator" who obtains the capital gain.

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