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Taxation on indirect equity transfers of a PRC company

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The State Administration of Taxation (“SAT”) of the People’s Republic of China released the Notice on Strengthening the Administration of Corporate Income Tax Concerning Equity Transfers by Non-resident Enterprises (Guoshuihan [2009] No. 698) (“Circular 698”) on December 10, 2009, with retroactive effect from January 1, 2008, which requires foreign investors to report indirect transfers of equity of a Chinese company under certain circumstances. It was anticipated that there would be issues and difficulties that may impede the implementation of Circular 698, and many taxpayers adopted a “wait and see” strategy.

Six months later, after the release of Circular 698, a case involving the taxation of an indirect equity transfer was posted on the official website of the Jiangdu State Tax Bureau (“JSTB”), Jiangsu Province (the “Jiangdu Case”). The “Jiangdu Case” has attracted widespread attention and is a reflection of the strong determination of Chinese tax authorities to combat anti-tax avoidance arrangements.

The Case

The Jiangdu Case is the first reported case in the area of indirect equity transfers since Circular 698 was issued. The Jiangdu Case sets an important precedent to foreign investors with investment in China, and brings taxpayers’ attention to crucial aspects of Chinese tax rulings.

- A well-known multinational foreign investment group, (the “Seller”) held a 49% interest in a joint venture (“JV”) in Jiangdu, Jiangsu Province, which was acquired in 2007 through its wholly owned Hong Kong holding company (“Holdco”).

- In January 2010, the Seller transferred its 100% interest in the Holdco to a U.S. company (“Buyer”), and then the Buyer in turn holds 49% interest in the JV through the Holdco.

1 Please see our China Alert published in March 2010 concerning the issuance of Circular 698 at http://www.nixonpeabody.com/services_pubdetail.asp?ID=3172&SID=554
2 The website address of JSTB: http://jd.yzgs.gov.cn/
Since neither the Buyer, the Seller, nor the Holdco was a Chinese resident enterprise, it was anticipated that the capital gain derived from the transaction should not be subject to Chinese Enterprise Income Tax (“EIT”).

The Jiangdu State Tax Bureau disagreed. The State Administration of Taxation (“SAT”) and the JSTB noticed that this was an indirect transfer while performing normal review procedures of the transaction. Based on the information collected, the JSTB noticed that the Holdco had no employees, no assets, no liabilities, no investment and no business other than the investment of the JV, and thus the Holdco did not have any “economic substance.” The JSTB disregarded the Holdco and collected a tax payment of RMB173 million on the gain realized by the Seller on the disposal.

The holding structures before and after the transfer are depicted below:

Circular 698 Revisited

It is therefore advisable to revisit Circular 698 in order to assess the associated tax risks and get prepared for potential challenges from Chinese tax authorities. It is common practice for foreign investors to invest in Chinese companies through an interposed foreign holding or operating company, such as a Cayman Island or Hong Kong-based company for both tax and business purposes. In doing so, foreign investors are able to avoid the lengthy approval and registration processes required for a direct transfer (i.e., without a foreign holding or operating company) of an equity interest in a foreign invested Chinese company.

Under Circular 698, when a foreign investor (actual controlling party) indirectly transfers the equity of a Chinese resident enterprise, if the actual tax burden in the country (region) where the overseas holding company being transferred is located is less than 12.5%, or the aforesaid country (region) does not levy income tax on its resident’s overseas income, it shall, within 30 days from the date when the equity transfer contract is concluded, provide the relevant materials and information to the competent taxation authority where the Chinese resident enterprise whose equity is transferred is located. Based on the information disclosed by the foreign investor and collected by the Chinese tax authorities, the Chinese tax authorities will determine whether the transaction lacks “commercial
purpose,” resulting in the avoidance of the Chinese Enterprise Income Tax. If this is the case, the foreign investor would be treated as having income from the direct transfer of an equity interest in a Chinese company, thereby generating Chinese income subject to Chinese EIT.

The rationale behind the Circular 698 is the application of the general anti-avoidance rule (“GAAR”) introduced by the new PRC Enterprise Income Tax Law, which came into effect on January 1, 2008. The Implementation Measures for Special Tax Adjustments (Trial) [Guoshuifa (2009) No.2] (“Circular 2”) issued by the SAT on January 9, 2009, sets out the detailed implementing rules for the anti-avoidance principles and introduces the “substance over form” principle that permits the tax authorities to disregard the existence of an offshore holding or operating company that lacks adequate business substance, particularly one established in a tax-free country. According to Article 47 of the new PRC Enterprise Income Tax Law, if an enterprise implements another arrangement that does not have a reasonable commercial purpose and that reduces its taxable revenue or income, the tax authority has the right to adjust such taxable revenue or income. The “main purpose” or “reasonable commercial purpose” approach has been introduced to verify the nature of the transfer.

Conclusion

The Jiangdu Case shows that Chinese tax authorities are taking a proactive approach to detect indirect equity transfers, rather than merely relying on investors’ voluntary reports. In the Jiangdu Case, the Chinese tax authorities learned of the transaction when JSTB carried out its normal administrative procedures for the Chinese JV. This illustrates that even if foreign investors do not report indirect share transfers, the Chinese tax authorities may still detect it and invoke GAAR where applicable. Circular 698 imposes a reporting obligation on ultimate sellers under certain circumstances. Based on the information available to the public, however, there weren’t any fines or penalties imposed on the Seller who did not voluntarily report to the local tax authority. Circular 698 is also silent on the application of penalties where the reporting obligations are not fulfilled.

In the assessment of the Jiangdu Case, “commercial purpose” and “substance” are two key factors considered by SAT and JSTB. It is therefore advisable for foreign investors, especially those with investment in China, to review their existing holding structures and documentation to determine how best to reinforce their “reasonable commercial purpose” and “economic substance.”

Moreover, the Jiangdu Case may be considered as a strong signal that the Chinese tax authorities are aggressive on the enforcement of Circular 698; it is therefore necessary for foreign investors to re-evaluate tax planning techniques to see whether they are still workable under Circular 698, and make appropriate adjustments where necessary.

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