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China Alert

Tax Bulletin 24 for Clarification on Tax Circular 698 regarding Indirect Equities Transfer by Non-resident Companies

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The State Administration of Taxation ("SAT") issued the Guoshuihan [2009] No.698 ("Circular 698") "Strengthening the Administration of Enterprises Income Tax for Equities Transfer by Non-resident Enterprises" on 10 December 2009 which specifies that a foreign investor that transfers its shares in a foreign intermediate holding company ("FIHC") which holds equities in a Chinese resident enterprise may trigger off capital gains tax in China.

On 28 March 2011, the SAT further issued a bulletin [2011] No.24 ("Bulletin 24") with an aim at clarifying the uncertainties in Circular 698 and other non-resident income tax matters. Bulletin 24 is effective from 1 April, 2011 and will apply to the cases which occurred prior to 1 April, 2011 but have not yet been resolved or settled.

In this alert, we briefly discuss the focal points stated in Bulletin 24 in respect of the clarifications on Circular 698.

Recognition of income from equities transfer

Where a non-resident enterprise transfers directly the equities in a Chinese resident enterprise ("CRE") and it is specified in the equities transfer contract or agreement that payment shall be made by installments, then income from the transfer shall be recognized at the time when the transfer contract or agreement takes effect AND upon completion of procedures for change of registration of the relevant equities.

Exclusion of the transfer of stocks of CREs traded in a public securities market

Where a non-resident enterprise transfers the equities in a CRE, Circular 698 states that it will not apply to "stock of CREs purchased and/or sold in a public securities market". Bulletin 24 clarifies that the above refers to purchases and sales of the stocks where the trading parties, quantities and prices in respect of the transactions are not pre-determined, but are determined based on normal trading rules of a public securities market.



Foreign investor (actual controlling party) and reporting criteria

Circular 698 states that, if a foreign investor (actual controlling party) transfers the equities in a FIHC, and the reporting criteria stated in the Circular 698 are met, the foreign investor will be required to report the information relating to the transfer of equities to the Chinese tax bureau in charge in the location where the CRE is located.

Bulletin 24 clarifies that the term "actual controlling party" stated in Circular 698 refers to ALL investors who have indirectly transferred shares of a CRE. Based on the above clarification, it appears that even if an investor only holds a minor percentage of the total issued shares in a FIHC and transfers the said shares, the investor will still have a reporting obligation under Circular 698 regardless whether it is an actual controlling party or not.

Regarding the criteria for reporting obligation of an indirect transfer, Bulletin 24 clarifies that if a foreign investor transfers the shares through a FIHC which holds equities in a CRE, and

- The actual tax burden on the income generated from the share transfer is less than 12.5% in the intermediary holding jurisdiction ("IHJ"), or
- The IHJ does not tax foreign-sourced income of its residents generated from the share transfer for enterprise income tax ("EIT") purpose,

the foreign investor is required to report the tax information in respect of the indirect equities transfer to the tax bureau in charge where the CRE is located.



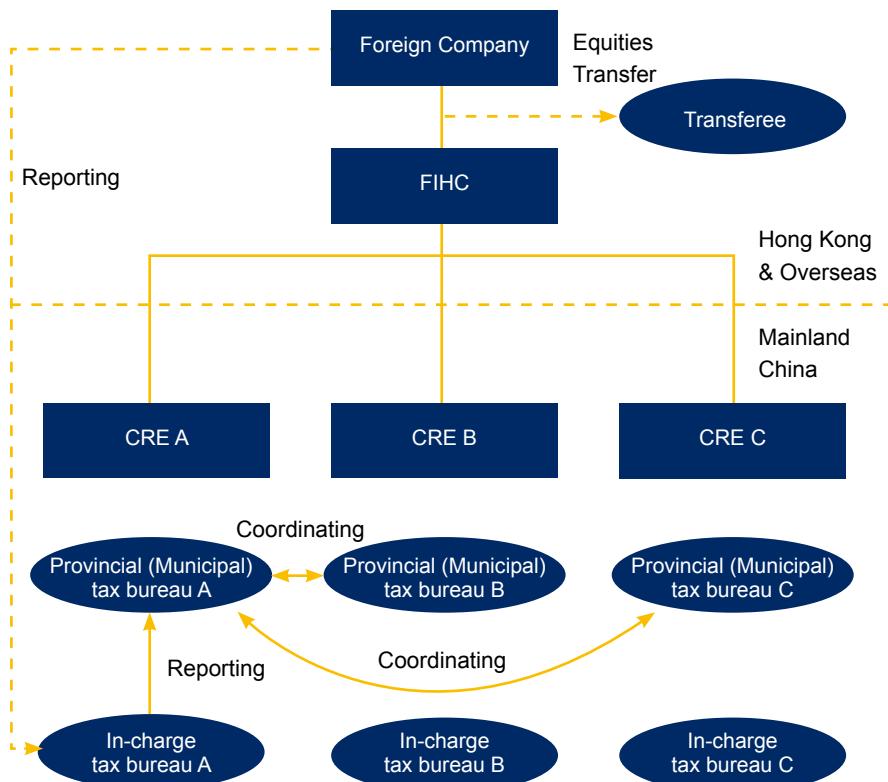


Procedures for reporting of indirect equities transfer

The following reporting procedures are specified in Bulletin 24:

If two or more foreign investors undertake transfers of equities in a CRE simultaneously, any one of them can, pursuant to article 5 of Circular 698, report to Chinese tax bureau where the CRE is located.

Where a foreign investor transfers indirectly the equities of two or more CREs that are located in different provinces (municipalities), the foreign investor may choose to report to any one ("Reported Bureau") of the Chinese tax bureaus in-charge where the CREs are located. The provincial or municipal tax bureau that is in-charge of the Reported Bureau shall coordinate and discuss with other relevant tax bureaus at provincial or municipal level to determine whether income tax would be imposed on the indirect transfer. The provincial or municipal tax bureau where the Reported Bureau is located is also responsible for reporting the information to the SAT. Please see the diagram below regarding the reporting procedures for indirect equities transfer if two or more CREs located in different provinces (municipalities) are involved:



(In-charge tax bureau A has been selected as the Reported Bureau)

Upon tax chargeability being determinated, the foreign investor shall pay tax to the respective tax bureaus in charge accordingly.

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Observation and comments

One of the purposes of Bulletin 24 is to clarify the uncertainties contained in Circular 698. However, some uncertainties remain. For example:

Bulletin 24 clarifies that the "foreign investor (actual controlling party)" means all investors that have indirectly transferred equities in a CRE. It implies that a minor foreign investor (say only holds a minor percentage of shares in a FIHC) transferring its shares may still be caught under Circular 698. In addition, Bulletin 24 reiterates that Circular 698 will not apply to foreign investors who transfer the shares in a CRE traded in a public securities market. It is unclear, if a foreign company only holds a minor percentage of shares in a listed FIHC which is not a CRE but holds shares in a CRE and sells the shares in a public securities market, whether Circular 698 would apply?

It seems that some issues in connection with Circular 698 are still open for clarification. It may be necessary for the SAT to issue further notices for clarification. It is important that foreign investors review their respective PRC investment structures and consult with their tax advisors before making decisions on the share transfers which may have Circular 698 impacts. For certain special situations, direct clarifications with the Chinese tax bureaus in charge or even the SAT may be necessary.

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