



Issue 3 | 30 June 2010

Tax Alert

New China Tax Rule on Equity Rights Transfer by Non-resident Companies

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Reprinted from Crowe Horwath Asia Pacific Tax News (June 2010)

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The Chinese State Administration of Taxation ("SAT") issued a tax circular Guoshuihan [2009] No.698 on 10 December 2009 named "Strengthening the Administration of Enterprises Income Tax for Shares Transfer by Non-resident Enterprises" ("Circular 698"). Under Circular 698, a foreign investor transfers its shares in a foreign intermediary holding company ("FIHC") which holds investments in China may trigger capital gain tax in China. Circular 698 is effective retroactively from 1 January 2008.

This article addresses the relevant income tax laws in China regarding the capital gains arising from shares / equity rights transfers by non-resident companies and analyzes their impacts on foreign companies for transfer of investments in China.

Tax laws and regulations

According to the Chinese Enterprise Income Tax Law ("EIT Law") and its implementation rules, a non-resident company transferring its equity rights or shares in a resident enterprise in China is subject to EIT, in form of withholding tax, at a reducing tax rate of 10% on any gains derived from the transfer if it has no establishment in China or if it has an establishment, such gain is not effectively connected with the establishment.

How to determine the gains

Circular 698 defines the gains derived from equity rights transfer as follows :

Gains (losses) = Transfer price of equity rights - cost of equity rights

"Transfer price of equity rights" refers to the proceeds including cash, non-monetary assets or valuable rights received by a transferor of the equity rights. If the resident enterprise of which the equity rights are transferred has undistributed profits or after-tax funds ("Other Investor's Equities") AND the transferor also transfers the Other Investor's Equities together with the equity rights, the Other Investor's Equities should not be deducted from the transfer price of equity rights.

"Cost of equity rights" refers to actual capital paid in the resident enterprise in China or the purchase price of the equity rights in the case of an acquisition.

Direct transfer of equity rights of a Chinese resident enterprise

If a non-resident company transfers the equity rights in a resident enterprise in China, the gains derived from the transfer will be subject to PRC withholding tax. If the withholding agent has not withheld or fails to fulfill its withholding obligation on the capital gain tax according to the prescribed regulations, the non-resident company should file and pay EIT within 7 days after the date of the transfer as stated in the equity rights transfer agreement or the date on which the transferor obtains the proceeds of the equity rights transferred, whenever is earlier.

Indirect transfer of equity rights of a Chinese resident enterprise

Circular 698 states that, if a foreign investor (actual controlling party) transfers the shares in a FIHC, the jurisdiction in which the FIHC is located has an actual tax burden of less than 12.5%, or provides an tax exemption on the offshore income of its residents, the foreign investor will be required to provide the relevant documents on the transfer of equity rights to the Chinese tax authorities in charge in the location where the Chinese resident enterprise is located within 30 days after the date of signing the equity rights transfer agreement.

If the foreign investor (actual controlling party) transfers the equity rights in a Chinese resident enterprise by an arrangement (“Arrangement for Tax Avoidance”) which is considered as abuse of organization form and has no reasonable commercial purpose (i.e. for the purpose of avoiding EIT payment obligation in China), the SAT could use the principle of “substance over form” to disregard the existence of the FIHC.

Rights to make adjustments on transfer price

Under the circumstance that a non-resident company transfers its equity rights in a Chinese resident enterprise to its related party and the transfer price is considered as not complying with the arm’s length principle resulting in a reduction of taxable income, the tax authorities in China have rights to make adjustments on the transfer price by using reasonable methods.

Circular 698 will not apply to purchases and sales of the shares in Chinese resident enterprises in an open securities market.

Observation and comments*Reasonable commercial purpose*

Circular 698 provides that a transaction being considered as an Arrangement for Tax Avoidance would meet two criteria simultaneously : one is abuse of organization form AND the other is no reasonable commercial purpose (i.e. for the purpose of avoiding EIT payment obligation). However, Circular 698 does not provide clear guidelines on the interpretation in respect of the “abuse of organization form” and “no reasonable commercial purpose”. For example, if a Hong Kong resident sets up an investment holding company in Hong Kong to hold the investments in China for legal and commercial reasons, will it be regarded as having a reasonable commercial purpose ?

Reporting requirements for indirect transfer

The reporting requirement for indirect transfer is compulsory if the reporting criteria laid down in Circular 698 for the indirect transfer are met. The reporting burden is on the original foreign investor (in case of an acquisition of shares, the reporting party should be the seller of the shares transferred). Whether the capital gains (if any) derived from an indirect transfer will be taxed for EIT purpose in China is uncertain. Consequently, it will bring a great challenge, due to this reporting requirement, to the multinational companies and listed companies which have significant merger and acquisition activities for acquiring or selling investments in China through indirect transfers.

Conclusion

The issuance of Circular 698 indicates a notable move that Chinese tax authorities are further tightening their anti-avoidance enforcement. Foreign investors should comply with the requirements of Circular 698, properly plan their holding structures for investments in China and make sure that the structures are commercially justifiable and supported with proper documentation and business activities.

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