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PRC Tax Update

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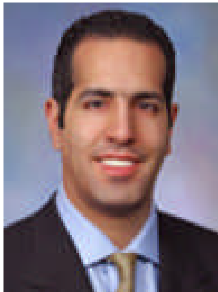

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Topics

- Determination of “beneficial ownership” in claiming tax treaty benefits for passive income.
- Deemed PRC Tax Resident Enterprises.
- Tax on the sale of a foreign company owning investment in China - Circular 698.
- New tax rules for representative offices of foreign enterprises in China.
- Higher tax costs for foreign companies and foreign-invested companies doing business in China or with Chinese companies.
- A new form of investment for foreign investors—Foreign-invested partnership.
- Typical investment structures of a US company and a European company.

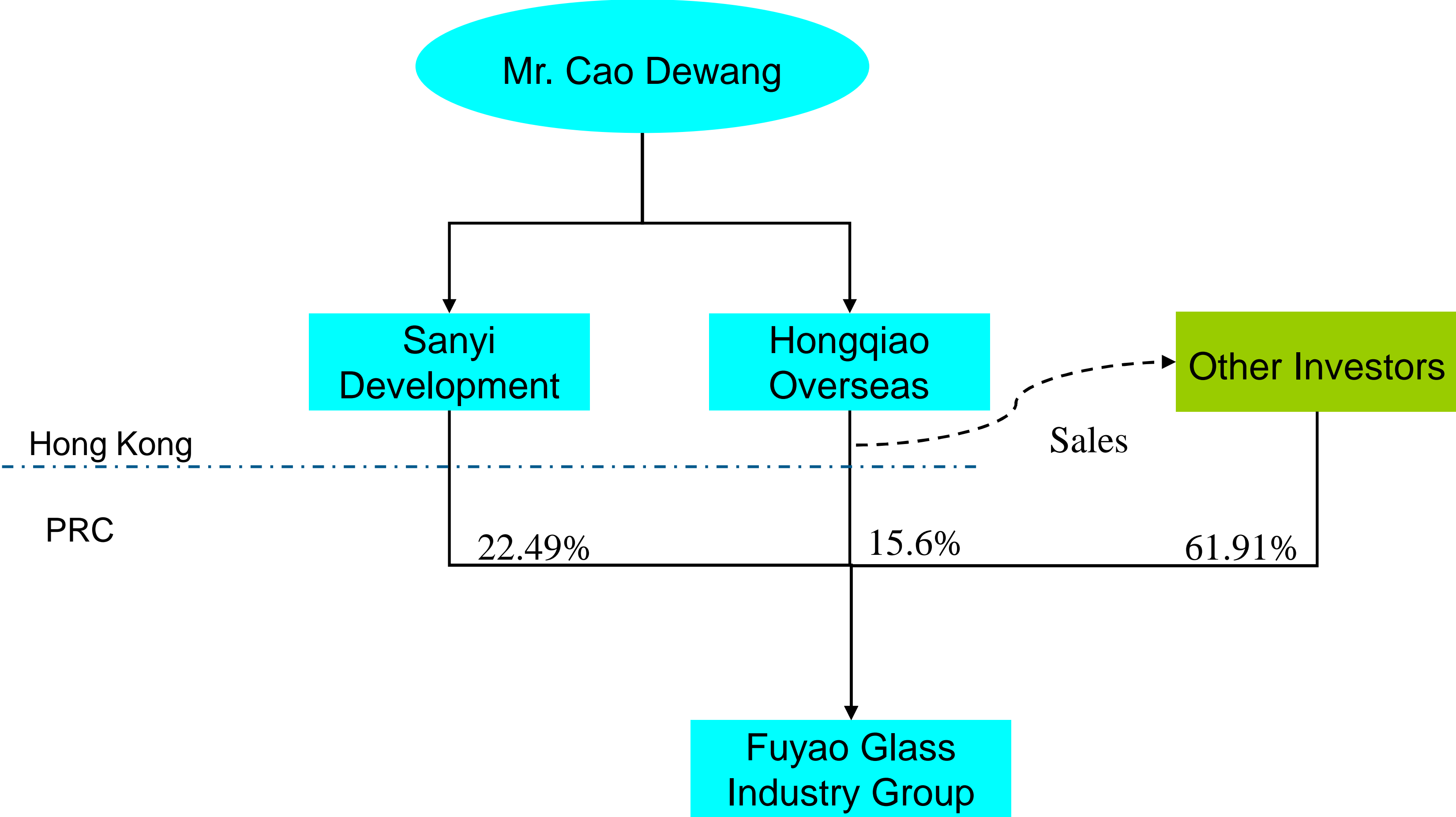
Beneficial Owner – Circular 601

- Guoshuihan [2009] No. 601 ("Circular 601"), issued on October 27, 2009
  - Eligibility for treaty benefit
  - Applies to dividends, interest, royalties (and capital gains?)
- A beneficial owner is a person that has ownership of, and control over the income or the rights or assets that generated the income.
  - A beneficial owner can be an individual, a company or another form of organization.
- A conduit entity is an entity established to avoid or reduce taxes, or to shift or accumulate profits.
  - A conduit entity or an agent is not a beneficial owner.
  - A conduit entity does not engage in substantive business operations, such as manufacturing, distribution or management.

Beneficial Owner – Circular 601

- Determination of beneficial owner is based on the principle of substance-over-form
- The following factors would send up a red flag to the tax authority:
  - The company must pay or distribute all or a substantial portion (such as 60%) of its income to a resident in a third country.
  - The company does not have any business operations, other than holding the assets or rights that generate the income.
  - The income received by the company is not commensurate with the size of the company, considering the company's assets, personnel, etc.
  - The company does not have control over, or the right to dispose of, the income or the assets, or the rights that generated the income, and bears little risks.
  - The company is in a country that imposes little or no tax on the company's income.
  - The company has back-to back contracts with a third party (such as loan agreements or licensing agreements).

The Fuzhou Case – Beneficial Ownership



The Fuzhou Case – Beneficial Ownership

- Facts
  - Mr. Cao was born in mainland China but is now a Hong Kong resident.
  - Mr. Cao indirectly held 38.09% of the shares in a listed Chinese company, Fuyao Glass Industry Group Co., Limited, located in Fujian Province, through two wholly owned Hong Kong subsidiaries, Hongqiao Overseas and Sanyi Development, which respectively owned 15.6% and 22.49% of Fuyao's shares.
  - Beginning in October 2009, Mr. Cao gradually disposed of shares of Fuyao held by Hongqiao Overseas and realised a gain of over RMB3 billion.
  - Hongqiao Overseas claimed an exemption from capital gains under the PRC / Hong Kong tax arrangement.

The Fuzhou Case – Beneficial Ownership

- Challenges raised by the Tax Authority
  - The two direct owners are non-operating, holding companies (or conduit companies).
  - The ultimate beneficial owner is one individual.
- Consequences
  - Hongqiao Overseas settled a tax liability of RMB379 million with the competent tax authority in Fujian, where the target company is located.
  - The target company was designated as an agent of Hongqiao Overseas.

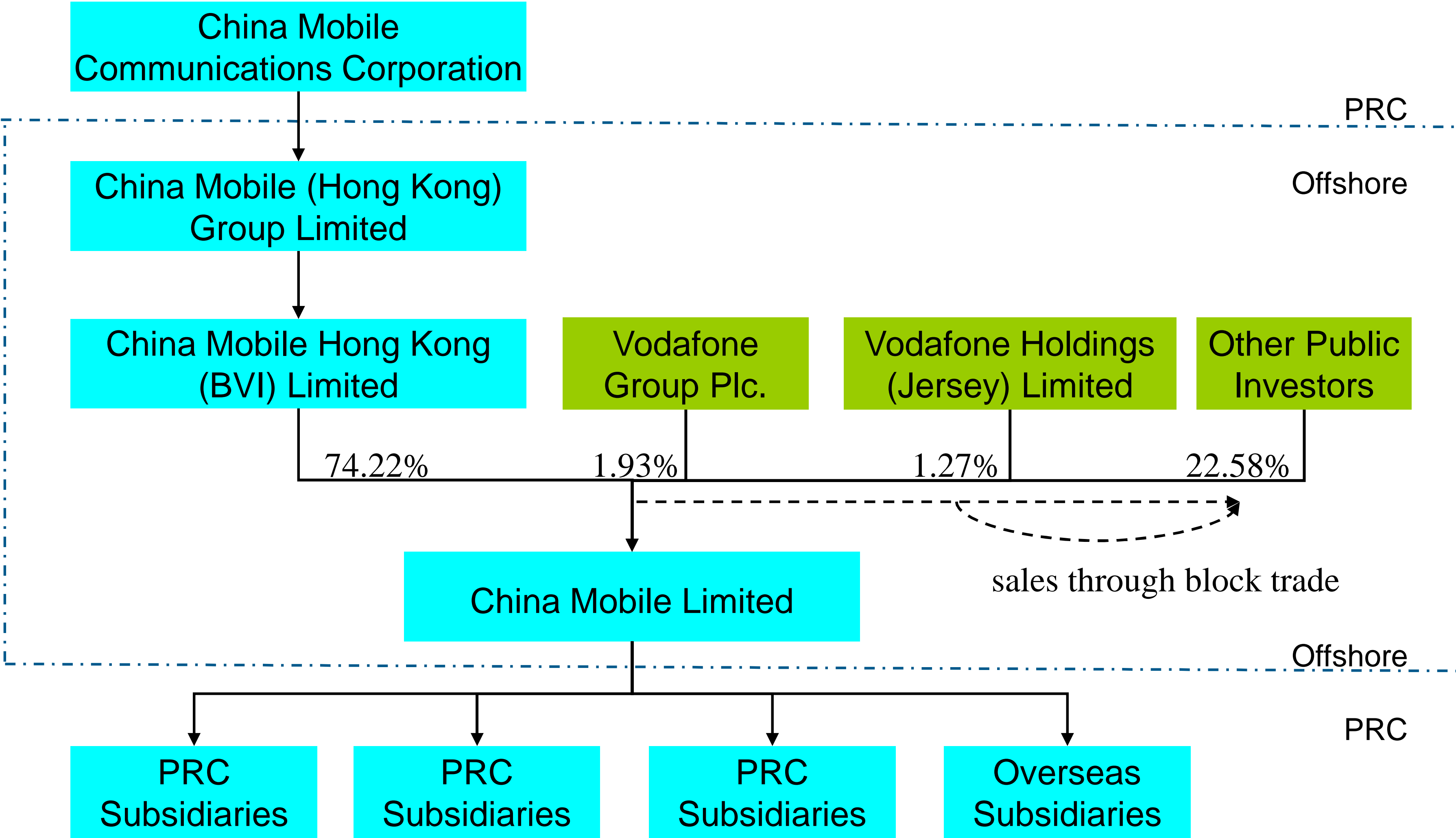
QFIIs

- Beneficial Owner
  - Who is the taxpayer, the investment manager or the fund?
  - Which tax treaty applies?
- Dividends: 10%
  - Guoshuihan [2009] No. 47
- Business tax: exempted
  - Caishui [2005] No. 155
- Gains from disposal of A shares: taxable?
  - Is it trading income or capital gains?
  - Can gains be used to offset losses?

Treaty Rates on Dividends and Capital Gains

- UK and Japan
  - Dividends: 10%
  - Capital Gains: no exemption
- Singapore and Hong Kong
  - Dividends: 5% if at least 25% of the equity in the PRC company
  - Capital Gains: exemption if less than 25% (not immovable property)
- Ireland
  - Dividends: 5% if at least 25% of the equity in the PRC company
  - Capital Gains: exemption (not immovable property)
- Mauritius
  - Dividends: 5%
  - Capital Gains: exemption if less than 25% (not immovable property)

Vodafone Case



Vodafone Case

- Facts
  - China Mobile Limited (China Mobile), a Hong Kong-registered company, was listed on the NYSE and HKEx on October 22 and 23 1997, respectively.
  - On October 4, 2000, China Mobile and Vodafone entered into a strategic investor subscription agreement, whereby Vodafone Group Plc. acquired new shares of China Mobile for US$2.5 billion.
  - On May 18, 2002, Vodafone Holdings (Jersey) Limited purchased 236,634,212 ordinary (new) shares of China Mobile for HK$5.85 billion under a Subscription Agreement.
  - On September 18, 2010, Vodafone sold its entire 3.2% stake in China Mobile in a block trade arranged by several leading investment banks for US$6.5 billion.

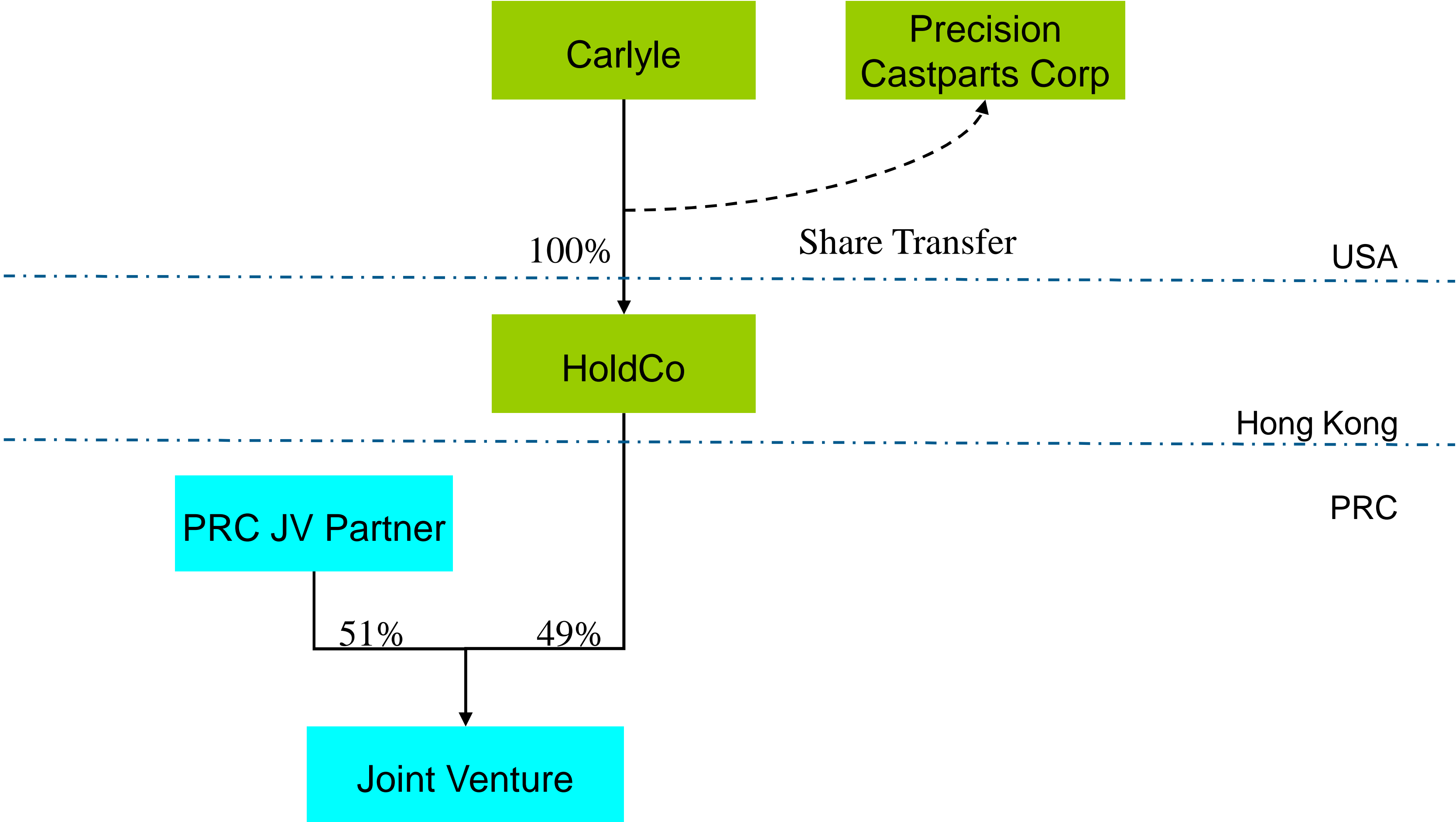
Vodafone Case

- Comments
  - China Mobile was treated as a deemed tax resident enterprise ("TRE") by the State Administration of Taxation (the "SAT") in accordance with Circular 82.
  - First published case in which Chinese tax was imposed on a foreign investor for the disposal of a deemed TRE.
  - First published case in which Chinese tax was imposed on the sale of a minority interest (less than 25%) in a company listed on an overseas stock exchange.
  - Unlucky Vodafone – no treaty protection.

Deemed Tax Resident Enterprise

- Guoshuifa [2009] No. 82 ("Circular 82"), issued on April 22, 2009, effective from January 1, 2008
  - Registered outside China but effectively managed and controlled in China
- Factors
  - The senior management responsible for the daily operations of the enterprise are located in China and they exercise their power in China.
  - Decisions over the finance and personnel of the company are made by people or entities in China or are subject to the approval of such people or entities.
  - The company's main assets, accounting records, chops, minutes of board meetings and shareholder meetings, etc. are located in China.
  - Half or more of the board of directors or senior management who have veto power reside in China.

The Jiangdu Case: Carlyle



The Jiangdu Case: Carlyle

- Facts
  - Carlyle owned a subsidiary in Hong Kong (HoldCo), which in turn owned a 49% interest in a joint venture, Yangzhou Chengde Steel Tube Co., Ltd., in Jiangdu, Jiangsu Province (as a result of a US$80 million private equity investment made in 2007).
  - In January 2010, Carlyle exited from the joint venture by transferring the HoldCo to a subsidiary of a US company (Precision Castparts Corp) for US$350 million.
- Challenges raised by the Tax Authority
  - HoldCo had no employees, no assets, no liabilities, no other investments, and no business operations.
  - The Jiangdu Tax Authority asserted that the transfer of HoldCo was in substance a transfer of the joint venture company and should be subject to Chinese withholding tax.

General Anti-Avoidance Rule (GAAR)

- GAAR was first introduced into the Enterprise Income Tax (EIT) Law of China in 2008.
  - If an enterprise engages in a business arrangement that does not have a bona fide commercial purpose and that results in reducing the taxable revenue or taxable income of the enterprise, the tax bureau has the right to make adjustments based on a reasonable method.
- The Implementing Measures for Special Tax Adjustments, issued on January 8, 2009
  - Article 94 allows the tax authority to ignore the existence of an enterprise that does not have any economic substance, especially an enterprise that is located in a tax haven and that contributes to tax avoidance by a related party or an unrelated party.
  - An investigation and a special adjustment under the GAAP must be approved by the SAT

Circular 698

- Guoshuihan[2009] No. 698, dated July 27, 2009, effective from January 1, 2008.
  - Applies to a non-resident enterprise that transfers an offshore holding company with underlying PRC companies
  - Does not apply to shares that are purchased and sold through a stock exchange
- Circular 698 imposes a filing obligation on the non-resident seller if one of the following two conditions is met:
  - the jurisdiction of the offshore holding company has an effective tax rate (on capital gains) lower than 12.5%; or
  - the jurisdiction of the offshore holding company does not tax its residents on overseas capital gains income.

Circular 698

- Timing and place of the filing
  - Within 30 days after the share transfer agreement is signed.
  - With the competent tax authority at the place where the underlying Chinese resident enterprise is located.
- Documentation
  - The share purchase agreement.
  - Relationship between the transferor and the offshore holding company in relation to cash flow, operations, purchase and sales activities.
  - Business operations, personnel, financial accounts and properties of the offshore holding company.
  - Relationship between the offshore holding company and the Chinese target enterprise in relation to cash flow, operations, purchase and sales activities, and so on.
  - Explanation of the reasonable business purpose of setting up the offshore holding company by the transferor.

Circular 698

- Taxation under Circular 698
  - The tax authority may treat the offshore transfer as a direct transfer of the underlying PRC company and thus levy PRC withholding tax on capital gains if all of the following three conditions are met:
    - There is an abuse of organizational form;
    - There is no reasonable commercial purpose; and
    - The purpose is to avoid PRC enterprise income tax.
- Outstanding Issues
  - Application to non-resident individuals?
    - A case in Shenzhen: taxing a Hong Kong resident on the indirect disposal of logistics companies in China in 2010.
  - Will rules on tax-free re-organization apply?
  - How will the look-through treatment be applied?
  - Will treaty benefits be available?
  - Will the foreign investor be able to obtain a foreign tax credit in its own jurisdiction?

Representative Offices

- Guoshuifa [2010] No. 18 (“Circular 18”), issued on February 20, 2010, effective from January 1, 2010
- Changes
  - Old exemptions are repealed, and new exemptions are based on treaties.
    - Examples of old exemptions: market research, liaison and similar activities for products manufactured by the head office.
  - Still three taxation methods, but more emphasis on keeping books and records and being taxed on an actual basis.
    - Three taxation methods: on an actual basis, cost-plus method, and method of actual revenue and deemed profit.
    - Old regime: most ROs were taxed under a cost-plus method.
    - Current regime: an RO is required to maintain books and records; profits must reflect the functions performed by the RO and the risks borne by the RO.
  - The deemed profit rate has been increased from 10% to no less than 15%
    - Old regime: enterprise income tax and business tax (5%) as a percentage of total expenses: 8.82%.
    - Current regime: 10.94% as a percentage of total expenses.

Additional Tax Costs for Foreign Investors

- Guo Fa [2010] No. 35 (“Circular 35”), issued on October 18, 2010, effective from December 1, 2010.
  - Exemption from city maintenance and construction tax and education surcharge was repealed.
  - Affects foreign enterprises, foreign-invested enterprises and foreign individuals.
- Education surcharge is 3% of VAT, business tax (“BT”) and consumption tax (“CT”).
- City maintenance and construction tax is also a percentage of VAT, BT and CT.
  - 7% for taxpayers located in a city.
  - 5% for taxpayers located in a county and town area.
  - 1% for taxpayers located in other regions.
- Effectively, 10% of VAT, BT and CT.

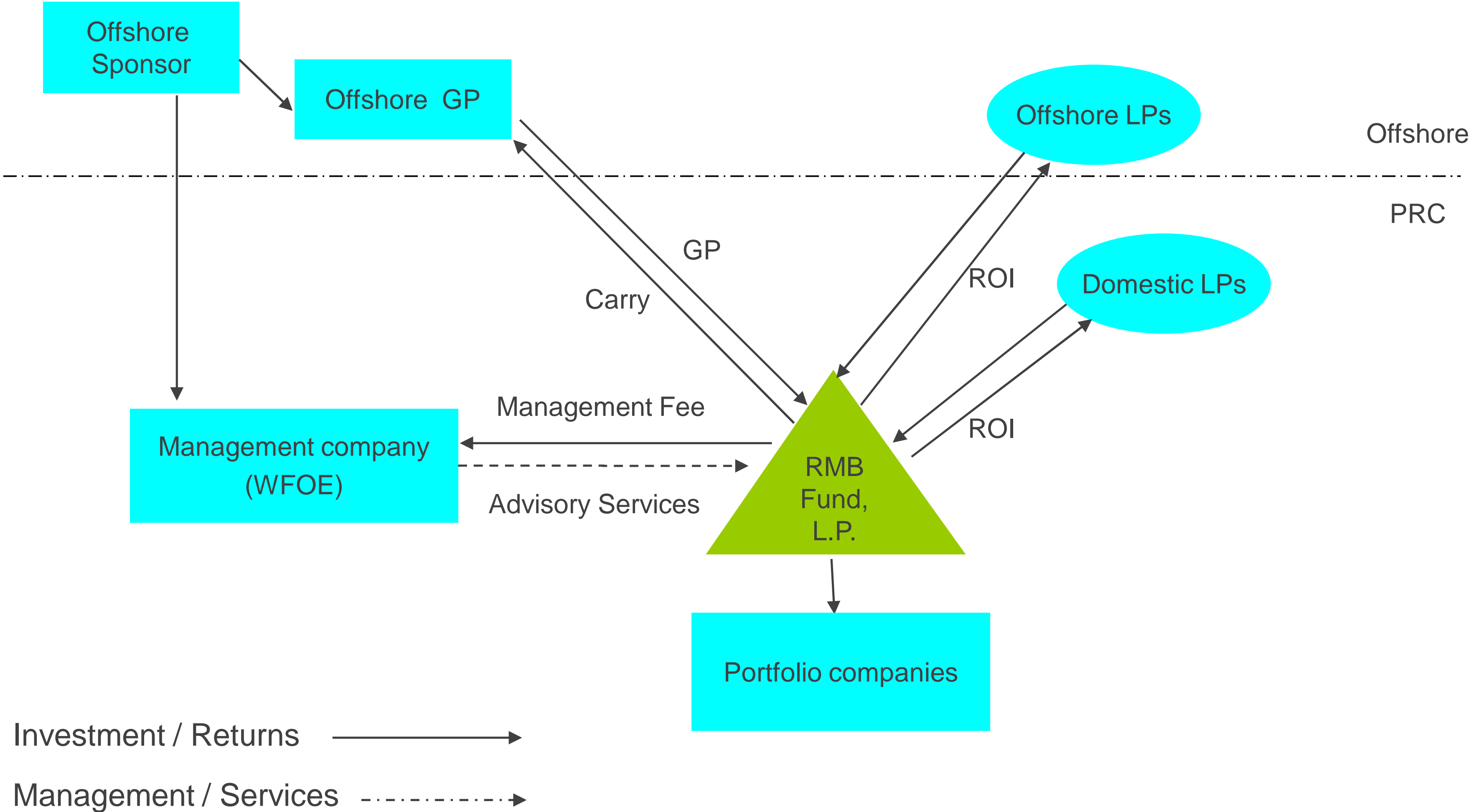
Foreign-invested Partnership

- Administrative Measures for Foreign Corporations and Individuals to Establish Partnerships in China (the "Measures"), issued at the end of 2009, effective March 1, 2010.
  - A new form for foreign investors to invest in China: foreign invested partnership ("FIP").
- Key features of an FIP
  - An FIP may be formed by two or more foreign partners or by foreign partners and Chinese partners.
  - No approval by the Ministry of Commerce required; registration with the State Administration of Industry and Commerce only.
  - No minimum registered capital required.
  - Flexible profit distribution.
  - No tax at the partnership level; flow-through treatment.

Foreign-invested Partnership

- Use of FIPs
  - The Measures encourage foreign investors with advanced technology and management experience to set up FIPs in China to promote the development of modern services sector of China.
  - Local regulations on private equity funds and private equity management entities, e.g., Beijing, Shanghai and Tianjin.
- Uncertainties about FIPs
  - -Regulatory regime is not clearly defined.
  - Tax treatment is not clearly provided for: e.g., 10% or 25% on foreign corporate partners, nature of the income, etc.

Foreign-invested Partnership: RMB Fund

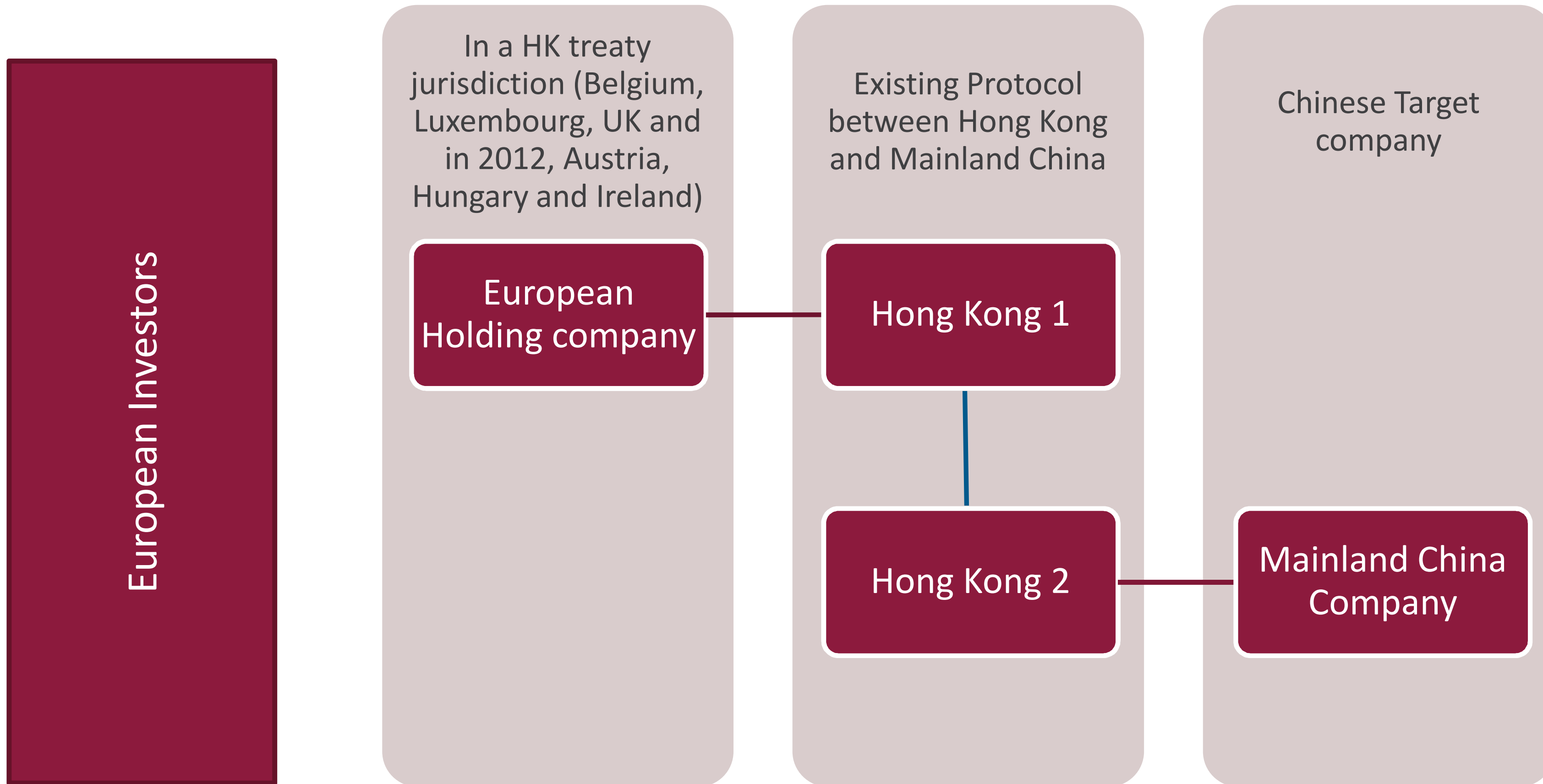


Typical investment structures of a US company and a European company

- Features to consider

Tax features	Non tax features
Treaty with China/ treaty network (focus on WHT rates and right to tax capital gains on shares)	Country risk and environment (corporate framework, administrative burden, etc.)
Capital duty on equity contribution	Availability of qualified services providers
Taxation of dividends received	Suitable banking environment
Taxation of interest	Accessibility (cf. substance requirements)
Taxation of capital gains on shares	Others
Withholding tax rates	
Others (rulings, exit strategies, etc.)	

European Investment structure

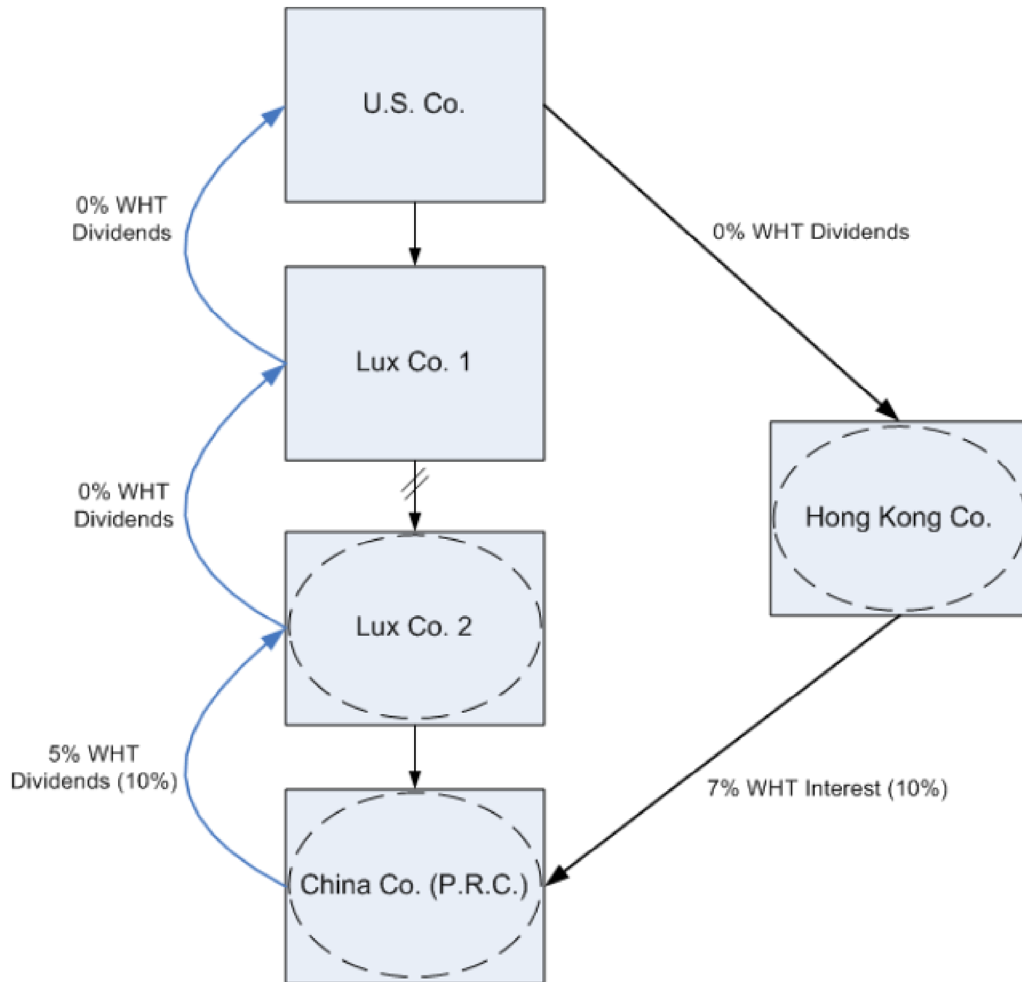


- Jurisdiction for the intermediary vehicle
  - A Hong Kong company is often used
    - Existing favourable treaty between China and Hong Kong:
      - Reduced withholding tax rates on dividends (5% subject to 25% participation), interest (7%) and royalties (7%).
    - Hong Kong's treaty network includes Luxembourg and Belgium, i.e., countries commonly used by EU investors.
    - "Classical"/usual jurisdiction for investment in China by Asian investors
    - Drawback: 0.2% stamp duty upon sale of the HK company.
  - Mauritius may also be used as a conduit – often used by U.S. investors.

- Typical solution:
  - Use of an intermediary foreign company as holding vehicle.
  - Sale of such intermediary holding upon exit.
  - The sale of the foreign vehicle does not trigger the Chinese 10% taxation that applies upon direct disposals of significant Chinese shareholdings.

However attention should be paid to Beneficial Ownership requirement and Circular 698

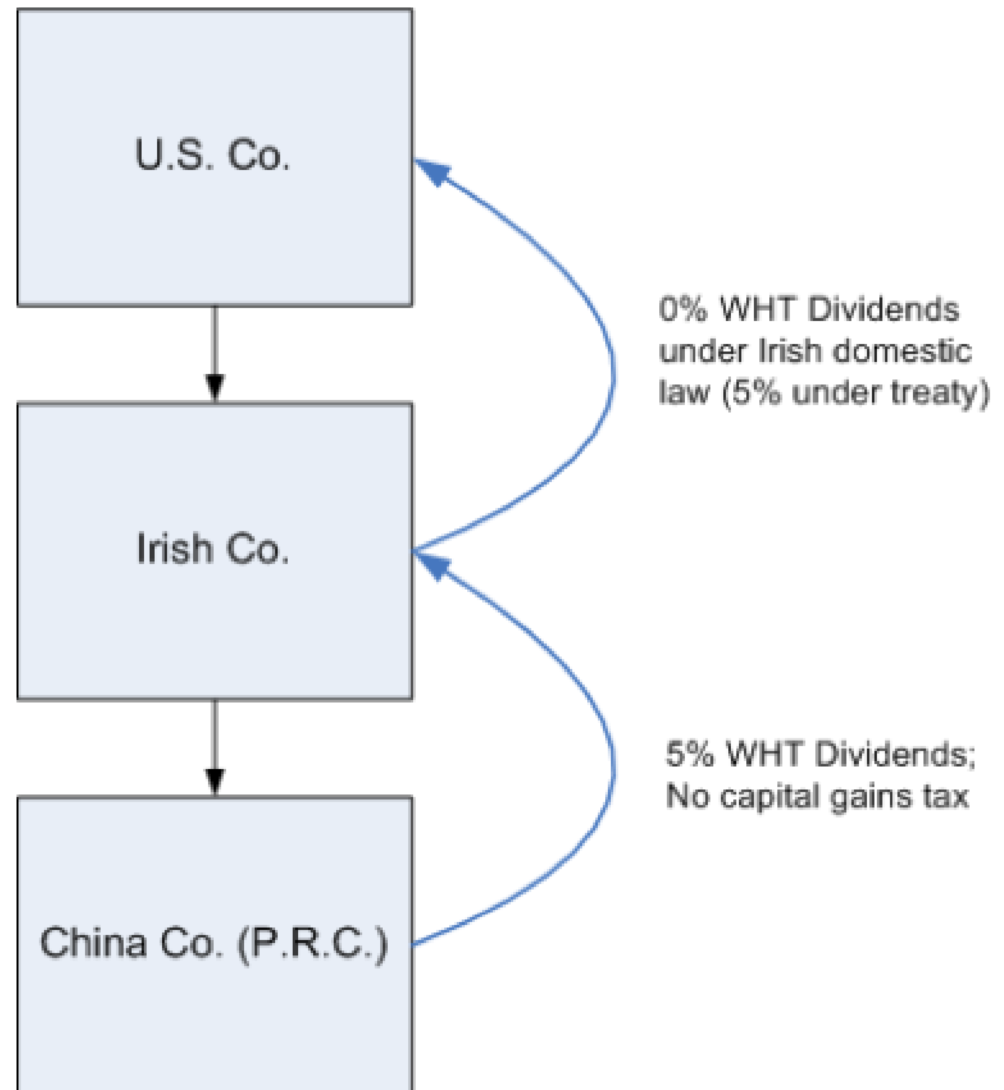
Investment Structures from the U.S. to China: Luxembourg Example



- U.S. Co. uses Hong Kong Co. as a financing sub for China Co.
- China Co. subject to WHT of 5% on dividends paid to Lux Co. 2 (rather than normal 10%).
- No WHT for Lux Co 1 and 2 for dividends paid to U.S. Co.
- Dividends Lux Co. 1 and 2 receive are exempt from tax in Luxembourg.
- China Co. subject to WHT of 7% on interest paid to Hong Kong (rather than normal 10%).
- No WHT for Hong Kong on dividends paid to U.S. Co.
- Exit of Lux Co. 2 to divest of China Co. should not cause capital gain or stamp tax in Luxembourg or China.

Investment Structures from the U.S. to China: Ireland Example

- Ireland putatively taxes dividends received from China Co. at 12.5%, but gives double tax relief under Irish foreign tax credit for underlying Chinese taxes and Chinese withholding tax.



Questions

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