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China Reinforces Tax Administration of Share Transfers by Non-resident Enterprises

China's State Administration of Taxation (SAT) recently issued a circular reinforcing the tax administration of share transfers by non-resident enterprises. The circular, the Notice of Reinforcing the Administration of Enterprise Income Tax on Share Transfer Income of Non-resident Enterprises (GuoShuiHan [2009] No.698, Circular 698), issued on 10 December 2009, is retroactively effective from 1 January 2008. It covers taxation of non-resident enterprises which transfer non-listed shares of PRC resident enterprises or specific overseas holding vehicles with underlying PRC enterprises.

For a non-resident enterprise transferring the shares of a PRC resident enterprise, Circular 698 requires the transferor to perform tax filings if there is no withholding agent or the withholding agent fails to fulfill the withholding obligation. For a non-resident enterprise transferring an offshore holding company with underlying PRC resident enterprises in certain circumstances, the circular requires the transferor to provide specific documents to the tax authorities for tax assessment. In the latter case, the authorities may apply the general anti avoidance rule to evaluate the deal and impose PRC taxes on the share transfer upon a successful challenge of the business substance of the holding structures.

Tax Filing Obligations

In case a non-resident enterprise transfers the shares of a PRC resident enterprise and there is no withholding agent or the withholding agent fails to fulfill the withholding obligation, the transferor shall perform tax filings within seven days commencing from the agreed date of the share transfer, or from the date when a transferor actually receives the purchase price that is paid prior to the agreed transfer date. Tax returns shall be filed to the in-charge tax authorities where the PRC target enterprises are located.

Calculation of Capital Gain

Capital gain, or share transfer income in PRC tax terminology, is defined as the share transfer price minus the cost of the shares. Share transfer price includes all types of considerations received by the transferor, including cash, non-monetary assets, equity interest, etc. The cost of the shares refers to the actual capital contribution made by the transferor to the target enterprise, or the purchase price paid by the transferor when acquiring the target enterprise. Circular 698 omits the situation that the transferor may make additional capital contributions after the acquisition of the target enterprise, where the cost of the shares should be the sum of the share purchase price and any subsequent capital contributions. It is not clear whether this issue will be solved by another circular, or simply by local practice.

The most debatable rule is the treatment of retained earnings (after-tax reserves and undistributed profits) of the target enterprise. Under the old income tax law for foreign-invested enterprises (FIEs) and foreign enterprises, dividends distributed to foreign enterprises by FIEs are exempted from withholding tax, and the retained earnings of targets can be regarded as constructive dividends and thus

excluded from the share transfer price. Circular 698, however, changes this position, requiring the retained earnings be included in the share transfer price and thus be included in the taxable capital gain. The logic of this change may be the fact that the new enterprise income tax law has cancelled the exemption of withholding tax on dividends distributed by FIEs. The question is that the neutralization rule is not observed if we consider the two following factors: (1) retained earnings attributable to profits earned by FIEs prior to 2008, even if distributed after 2008, can still be exempted from withholding tax for foreign investors; (2) the applicable withholding tax rate on dividends may differ from that on capital gains. For example, certain jurisdictions with favourable tax treaties with Mainland China, such as Hong Kong, Singapore and Mauritius, provide for a 5% withholding tax rate on dividends while maintaining the 10% rate on capital gains (if taxable).

This change will force transferors to make some flexible arrangements prior to consummating the transactions, such as converting the retained earnings of the target enterprises into registered capital to step up the cost of the shares, or causing the target enterprises to make dividend distributions prior to the share transfer so that the retained earnings could enjoy tax exemption or reduced tax rate applicable to dividends.

Indirect/Offshore Share Transfers

Though there are already quite a few high-profile cases[1] where the PRC tax authorities claimed taxing rights on offshore share transfers where non-resident enterprises[2] transferred their offshore holding vehicles with underlying PRC resident enterprises, it is Circular 698 that for the first time lags down the administrative procedures for taxation of such offshore share transfers.

If a non-resident enterprise transfers an offshore holding company with underlying PRC resident enterprises and the jurisdiction of the offshore holding company has an effective tax rate lower than 12.5% (half of China's 25% income tax rate) or does not tax its residents on overseas income, the non-resident transferor shall provide the following documents and information to the in-charge tax authorities where the underlying PRC resident enterprises are located:

- Share Purchase Agreement;
- The relation between the transferor and the offshore holding company in respect of cash flow, operation, purchase and sales activities, etc;
- The business operation, personnel, financial accounts and properties of the offshore holding company;
- The relationship between the offshore holding company and the PRC target enterprises in respect of cash flow, operations, purchase and sales activities, etc;
- Explanation of the reasonable business purpose for the transferor to set up the offshore holding company;
- Other documents required by the authorities.

The in-charge authorities will evaluate the offshore transaction for PRC tax purposes. If the transferor is regarded as abusing the business structure (setting up holding companies without a business purpose) so as to indirectly transfer the PRC underlying enterprise to avoid PRC tax liabilities, the in-charge tax authorities may, upon approval of the SAT, re-characterise the transaction under the doctrine of substance over form. If the challenge is successful, the existence of the offshore holding company can be ignored and thus the offshore transfer will be treated as a transfer of the underlying PRC resident enterprises, which becomes subject to PRC withholding income tax.

[1] *Such as the Chongqing Case where the Chongqing tax bureau required a Singaporean company to pay PRC withholding tax for transferring another Singapore company which holds equity interest in a PRC equity joint venture.*

[2] *Technically, the general anti avoidance rule can also apply to the transfer of an offshore holding company that does not hold any underlying PRC enterprise but holds some underlying PRC assets, such as real properties. Holding companies with PRC underlying assets are not covered by Circular 698 but may be caught by local authorities.*

If a party is challenged by the authorities without advance preparation, it may find other ways to reduce its tax liabilities. If an offshore holding company is completely ignored, any costs or losses incurred by the offshore holding company (such as maintainance costs, financing cost or previous acquisition losses) would not be deductible for PRC tax purposes. If there is any evidence that the offshore holding company is effectively managed in China, the taxpayer may propose that the offshore holding company is a PRC resident enterprise (similar to the check-the-box election), and thus the transfer of the offshore holding company is taxable in China without application of the general anti avoidance rule. If that proposal is accepted, the shares being transferred, for PRC tax purpose, will be that of the holding company instead of the underlying PRC resident enterprise. Relevant costs or losses of the offshore holding company will be counted as costs of the share transfer and become deductible for PRC tax purposes, thus reducing the tax liability of the transferor.

Purchase Price Allocation

Circular 698 made another first in China's tax regime. It requires the purchase price to be properly allocated among different target enterprises if a transaction involves the simultaneous transfer of multiple target enterprises, including both PRC resident enterprises and non-PRC-resident enterprises. If there are transaction documents for the aggregate transaction as well as for transfer of separate target enterprises, such documents shall be provided to the in-charge tax authorities together. If there are only transaction documents for the aggregate transactions, the PRC target enterprises shall provide to their in-charge tax authorities the detailed information of each target enterprise in the aggregate transactions and properly allocate the purchase price to the PRC target enterprises. If the price allocation is inappropriate, the tax authorities may make adjustments using reasonable methods.

In addition, where a non-resident enterprise transfers the shares of a PRC resident enterprise to its related parties using a non-arm's length price, the tax authorities can make adjustment to the price.

Purchase price allocation is a critical tax issue in asset deals, or equity deals involving multiple jurisdictions. It is the first time that China has explicitly required the proper allocation of purchase price in M&A transactions. Both buyers and sellers should pay attention to this development as it involves both tax planning opportunities and tax compliance risks.

Tax-free Restructures

Where a non-resident enterprise deriving a capital gain is entitled to tax-free treatment pursuant to the M&A tax rules, it shall provide documentation to the in-charge tax authorities to demonstrate that it meets the relevant requirements for tax-free treatment. Additionally, the provincial tax authorities need to ratify the documentation.

Concluding Remarks

The current global economic crisis poses significant challenges to revenue authorities who try every method to ensure that their revenue targets can be met. China is no different. In its annual work guidance (Key Points of National Tax Work) issued to local tax authorities in 2008 and 2009, the SAT repeatedly required local authorities to enhance the tax administration of non-resident enterprises. The recent legislation and administrative practice echoes the requirements.

Equipped with the general anti avoidance rule and relevant circulars, China's tax authorities are increasingly reaching their taxing hands to non-resident enterprises, in particular targeting large M&A transactions.

Traditional offshore transactions are faced with more and more challenges. Nowadays, it is no longer an

easy job to achieve a tax-free exit from China. Dealmakers should adjust their expectations and pay more attention to tax matters when structuring and executing China-related transactions. Particular attention shall be paid to the establishment of business substance for offshore holding structures so as to withstand any potential challenges.

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