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China

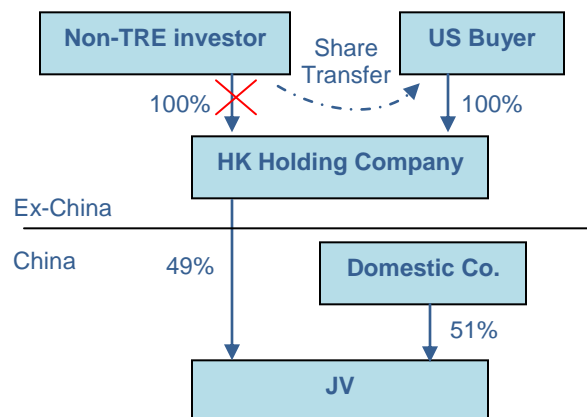
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China's Anti-tax Avoidance Effort against Overseas Indirect Equity Transfer Swings into Action

On December 10, 2009, the State Administration of Taxation ("SAT") released Circular 698 which requires foreign investors (i.e., non-Chinese tax resident enterprises, or "Non-TREs") to report indirect transfers of a Chinese company's equity. On June 8, 2010, a real-life case of indirect transfer was posted on the official website of a local-level state tax bureau in Jiangdu ("Jiangdu STB") of Jiangsu Province ("the Jiangdu Case").

Key Facts of the Jiangdu Case

The holding structure and the indirect transfer transaction are depicted below:



- In 2007, the Non-TRE investor (a renowned US-based investment fund), through its wholly owned Hong Kong intermediate holding company, acquired 49% shares of a Chinese domestic company, which then became a joint venture ("JV").
- In early 2009, in the course of normal tax administration of the JV, the Jiangdu STB learned that the Non-TRE investor might indirectly transfer its equity in the JV.
- In January 2010, the Non-TRE investor transferred the JV to a US Buyer by disposing its shares in the Hong Kong intermediate holding company.
- The Jiangdu STB claimed that this transaction was, in substance, an indirect transfer of the shares of the JV and thus should be subject to China withholding tax.
- After several rounds of negotiation, the Non-TRE investor agreed to file a tax return and paid China tax amounting to RMB 173 million (roughly US\$ 25 million) in May 2010.

Observations

Reporting Obligation and Detection by the Chinese Tax Authorities via Various Sources of Information

- In the Jiangdu Case, the Non-TRE did not voluntarily report the transfer of the Hong Kong intermediate holding company as required by Circular 698.
- Instead, the Chinese tax authorities learned of the indirect transfer when the Jiangdu STB carried out normal administrative procedures for the Chinese JV.
- This suggests that reporting an indirect transfer is not a prerequisite for applying the General Anti-avoidance Rule ("GAAR"). Even if the Non-TRE investors do not report the indirect transfers, the Chinese tax authorities may still detect it and invoke GAAR where applicable.

Assessment of "Substance" and "Commercial Purpose"

- In the assessment of an indirect transfer, the Chinese tax authorities would examine the key factors of "commercial purpose" and "substance" when determining whether to invoke GAAR.
- In the Jiangdu Case, the Jiangdu STB found that the Hong Kong intermediate holding company had no employees, assets (other than the investment in the JV) liabilities, and no other investments or other business.
- Thus the Jiangdu STB determined that the Hong Kong company was a special purpose

vehicle ("SPV") without substance and its creation and subsequent disposal was for the purpose of avoiding Chinese tax.

- In addition, the Jiangdu STB found a public announcement on the US Buyer's website which mentioned the completion of the JV's acquisition in China. The announcement provided detailed information about the JV, but did not mention that the Hong Kong intermediate holding company was acquired in the transaction. The Jiangdu STB regarded this as strong evidence that the transaction, in nature, was conducted solely for the transfer of the JV's equity.

Conclusion

- Interposing offshore SPVs in low-tax jurisdictions is a common investment holding structure for multinational's investments in China, in particular, international investment funds.
- The Jiangdu Case sets an important precedent to Non-TRE investors and may be considered a signal that the Chinese tax authorities are more actively approaching how they detect indirect transfers.
- Therefore, Non-TRE investors may wish to review their existing holding structures and overseas transfers, after considering the Jiangdu Case.
- Non-TRE investors may also wish to review their SPV's operations and documentation, in case the Chinese tax authorities challenge their overseas indirect transfers.

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