

China targets offshore firms' indirect equity transfers of Chinese companies

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Introduction

International tax compliance has been in the forefront of tax developments during the past year, and industrialized and developing countries have heightened their scrutiny of offshore transactions in an effort to recover tax revenues.

The U.S. Congress currently is considering proposed legislation to require non-U.S. financial institutions and other foreign entities that have U.S. investments to disclose U.S. account holders or investors or face a 30 percent U.S. withholding tax on U.S. source passive income and the gross proceeds from the sale of U.S. stock or securities.

The Indian tax authorities in the Vodafone Essar case have asserted that the indirect sale of a controlling interest in an Indian company by a non-Indian company to an unrelated non-Indian company is a taxable transaction; India also has proposed legislation to tax these indirect transfers.

The Australian tax authorities have challenged and are further considering the disposition of Australian entities indirectly owned by tax haven private equity funds through an interposed treaty protected structure.

Now, China tax authorities have announced that they intend to scrutinize offshore indirect transfers of Chinese equity interest by nonresidents of China through information reporting, to determine whether the main purpose of the transfer is for Chinese tax avoidance and to tax those transactions that lack commercial purpose and substance.

China's new international tax enforcement initiative is contained in Notice 698 1 (hereinafter, the Notice) and its legal basis appears to be premised on China's general anti-avoidance rule (GAAR) under the new People's Republic of China Enterprise Income Tax Law (EIT Law). The Notice applies to transactions of nonresident enterprises transferring equity interest in PRC resident enterprises, including those occurring entirely outside of China between nonresident sellers and buyers.

¹ *Guo Shui Han [2009] No. 698, issued Dec. 10, 2009, "Notice on Strengthening the Administration on Collection of Enterprise Income Tax on Income From Equity Transfers by Nonresident Enterprises."*

The notice also deals with a direct transfer by a nonresident Chinese enterprise of an equity interest in a resident Chinese enterprise to either a resident enterprise or a nonresident enterprise and reaffirms prior guidance that if a nonresident enterprise disposes of an equity interest in a resident enterprise

with respect to which there has not been proper withholding at the source, the nonresident enterprise is required to file a tax return in China (within seven days after the equity transfer date) and pay the capital gains tax equivalent to the amount that should have been withheld. The notice contains guidance with respect to the determination of the equity transfer price, income from an equity transfer (i.e., gain), the cost basis in the equity, and the equity transfer price and cost basis when a currency other than the original currency is used for the acquisition or disposition of the equity interest in the resident enterprise. This portion of the notice is noncontroversial and is intended primarily to clarify issues incidental to the transfer of an equity interest in a resident enterprise by a nonresident enterprise.

International tax advisers will need to review current holding company structures for Chinese enterprises and plan how to deal with Notice 698 in structuring cross-border transactions involving Chinese enterprises.

The paradigm transaction involves the indirect transfer of an equity interest in a Chinese enterprise through the sale of stock in a nonresident enterprise that owns the equity interest of the Chinese enterprise (Nonresident Holdco).

Under the Notice, the nonresident transferor of the Nonresident Holdco is required to make a disclosure if the Nonresident Holdco that owns the Chinese enterprise and whose stock is sold is located in a jurisdiction that is low taxed or does not tax foreign source income.

Based on an evaluation of the information required to be disclosed, the Chinese tax authorities can disregard the form of the transaction if it lacks commercial purpose and tax the actual controlling nonresident shareholder of the Nonresident Holdco by reference to the economic substance of the transaction. The Notice is effective from Jan. 1, 2008, the date that the new EIT Law entered into force, and thus has retroactive effect.

The Notice raises important jurisdictional issues. On a more granular level, international tax advisers will need to review current holding company structures for Chinese enterprises and plan how to deal with the Notice in structuring cross-border transactions involving Chinese enterprises. This article summarizes the Notice and its implications on cross-border mergers and acquisitions and other restructurings involving Chinese entities.

Background

Under the EIT Law, a "Resident Enterprise" is an enterprise incorporated in China or organized outside of China whose effective

management is in China. As used herein, the term Resident Enterprise refers to a Chinese incorporated enterprise. A Resident Enterprise is taxable on its worldwide income.

The Chinese tax authorities can investigate where a transaction involves treaty shopping, abuse of corporate form, or tax havens, or lacks a business purpose. If a transaction violates the general anti-avoidance rule, authorities can recharacterize the transaction according to its economic substance and deny the tax benefit.

A “Nonresident Enterprise” is an enterprise organized outside of China whose effective management is not within China. A Nonresident Enterprise is taxable on a net basis on Chinese source income derived by an establishment or site in China and on non-Chinese source income that has an actual connection to a Chinese establishment or site.

A Nonresident Enterprise is taxable on a gross basis through withholding at source on Chinese source passive income, to include the disposition of the equity interest of a Resident Enterprise, whether to a Resident Enterprise or a Nonresident Enterprise. The rate of withholding is 10 percent unless reduced under a bilateral income tax treaty.

The EIT Law contains a GAAR. Under that rule, the Chinese tax authorities are empowered to make reasonable adjustments where an enterprise implements an arrangement without reasonable business purpose to reduce its taxable income or profit. The Implementing Regulations of the EIT Law provide that the term “without reasonable business purpose” refers to arrangements whose main purpose is to obtain tax benefits such as reduction, elimination, or deferral of tax payments.

As further detailed in a chapter on GAAR under the Implementing Measures on Special Tax Adjustments, the Chinese tax authorities can investigate a transaction where the transaction involves treaty shopping, abuse of corporate form, or tax havens, or lacks a business purpose. If a transaction violates GAAR, the Chinese tax authorities can recharacterize the transaction according to its economic substance and deny the tax benefit. Any GAAR investigation or adjustment must be approved by the State Administration of Taxation.

The notice

Purpose

The stated purpose of the Notice is to standardize and strengthen the administration on collection of EIT on income from equity transfers by Nonresident Enterprises. The

Notice by its terms does not apply to the purchase and sale of stock of a Resident Enterprise on public securities markets by Nonresident Enterprises.

Indirect transfers

Under the Notice, an indirect transfer is the transfer by a Nonresident Enterprise to another enterprise (Nonresident Enterprise or Resident Enterprise) of an equity interest in a Nonresident Holdco that owns an equity interest in a Resident Enterprise. A typical example of this transaction is depicted where Nonresident Enterprise 1 sells its interest in the Nonresident Holdco to Nonresident Enterprise 2.

The Notice provides rules as to the timing and contents of information reporting and cross-references other operating rules that may be applied by the Chinese tax authorities to deal with the indirect transfer of an equity interest in Resident Enterprises (other than publicly traded enterprises) by Nonresident Enterprises, to include transfer pricing and the application of anti-abuse rules.

When disclosure is triggered

The “actual controlling” Nonresident Enterprise that makes an indirect transfer is required to make a disclosure to the local PRC tax authority in charge of the Resident Enterprise within 30 days after signing the equity transfer

agreement if:

- the actual tax burden in the jurisdiction of residence of the Nonresident Holdco is less than 12.5 percent; or
- the jurisdiction of residence of the Nonresident Holdco does not tax foreign-source income.

Information required to be disclosed

The Notice requires disclosure of the following information:

- the equity transfer contract;
- information reflecting the actual controlling Nonresident Enterprise's relationship with the Nonresident Holdco in respect of funding, operation, sales and purchases, etc.;
- information on manufacturing and operations, personnel, accounting, assets, etc., of the Nonresident Holdco;
- information reflecting the Nonresident Holdco's relationship with the Resident Enterprise in respect of funding, operation, sales and purchases, etc.;
- a statement that the transferred Nonresident Holdco was established by the actual controlling Nonresident Enterprise with reasonable business purposes; and
- other relevant information that may be required by the PRC tax authority.

Application of other rules

Substance over form

If an actual controlling Nonresident Enterprise makes an indirect transfer through "abuse of organization form and without reasonable business purpose," which results in the avoidance of the EIT withholding tax, the local tax authority in charge, upon the review and confirmation by the SAT, may disregard the form of the tax arrangements through use of the Nonresident Holdco, recharacterize the equity transfer according to its economic substance, and impose EIT on the actual controlling Nonresident Enterprise.

In determining the amount of tax due, the PRC tax authority can apply the following operating rules.

Arm's-length pricing

The PRC tax authority has the authority, based on reasonable methods, to adjust the transfer price if the Nonresident Enterprise transfers an equity interest in a Resident Enterprise to a related party on a non-arm's length basis, which results in a reduced taxable income.

Allocation of purchase price of resident enterprises

When an actual controlling Nonresident Enterprise simultaneously transfers equity interests in multiple holding companies that are Resident Enterprises and Nonresident Enterprises within or without China, the transferred Resident Enterprise

(i.e., the target) is required to provide the local PRC tax authority the agreements relating to the entire transaction and the separate contract involving the target.

If there is no separate contract with respect to the target, the target must provide to the PRC tax authority detailed information with respect to each of the holding companies transferred in the overall transaction so that the local PRC tax authority can accurately determine the transfer price of the target. If the transfer price cannot be precisely allocated, the local PRC tax authority is authorized to select a reasonable method to adjust the transfer price.

Special restructuring

If a Nonresident Enterprise derives capital gains from an equity transfer that satisfies the conditions for special restructuring under Cai Shui [2009] No. 59 and the special tax deferral treatment is elected, the Nonresident Enterprise must submit written materials to the local PRC tax authority to prove that the conditions for special restructuring are satisfied, subject to the approval of the provincial tax authority.

Sanctions for noncompliance

Sanctions are not specified in the Notice other than a general reference to the PRC Law on Tax Collection and Administration.

Comments

Jurisdictional basis for requiring disclosure

Or taxing indirect transfers

As an initial matter, based on the form of the transaction, an indirect transfer of a Chinese Resident Enterprise would not be subject to Chinese tax jurisdiction as the person selling the equity interest is a Nonresident Holdco and the source of income from the transaction would be outside of China. If that is the case, then how can China jurisdictionally assert that it is entitled to obtain information reporting, or impose taxation on a transaction that ostensibly is totally outside of China (except for the fact that the Nonresident Holdco owns an equity interest in a Resident Enterprise)?

The apparent technical basis for China's assertion of jurisdiction is based on an expansive reading of GAAR, whereby the Chinese tax authorities are authorized to apply a substance over form analysis and disregard a nonresident enterprise, particularly a tax haven enterprise, that lacks a sound commercial purpose in its formation or operation and substance.² Based on the foregoing authority, it would appear that the Chinese tax authorities believe that they have the right to request reporting when a Nonresident Enterprise makes an indirect transfer through a Nonresident Holdco that is low taxed or whose foreign source income is exempt from taxation.

² Article 47 of the EIT Law provides that if an enterprise enters into any business arrangement without reasonable business purposes that results in reduced taxable revenue or income, the tax authority is entitled to make adjustments based on reasonable methods. Article 120 of the Implementing Regulations of the EIT Law provides that the term "without reasonable business purpose" refers to arrangements whose primary purpose is to reduce, avoid, or defer tax payments. Articles 92 through 94 of Implementing Measures on Special Tax Adjustments (Guo Shui Fa [2009] No. 2) provide that under GAAR, the PRC tax authorities may investigate (i) abuse of tax treaties, (ii) abuse of the forms of enterprise organization, (iii) tax avoidance through tax havens, and (iv) other business arrangements without reasonable business purposes. Tax authorities are required to follow the precept of "substance over form" to include the tax effect of the arrangement. The tax authorities are empowered to redefine the nature of a tax avoidance arrangement based on the economic substance and cancel the tax benefit enjoyed by the enterprise from the tax avoidance arrangement. For an enterprise with no economic substance, especially when the enterprise is established in a tax haven and thus leads to the tax avoidance of its related or unrelated parties, the enterprise can be deemed not to exist.

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Further, upon examination of the information, the local Chinese tax authorities upon approval of the SAT may disregard the Nonresident Holdco³ and assert taxation on the basis that in substance the actual controlling Nonresident Enterprise is the enterprise that should be treated as having derived income from the transfer of the equity interest in a Resident Enterprise, thereby generating Chinese source income subject to taxation.⁴

³ In evaluating the substance of the indirect transfer, the Chinese tax authorities likely would focus on the reasonable business purposes for the establishment and maintenance of the Nonresident Holdco, rather than the operational factors, which oftentimes may not be present.

⁴ EIT Law, Art. 7(3). While the EIT Law is silent on whether this sourcing rule applies to an indirect transfer of an equity interest in a Resident Enterprise, it might be argued that under the practice

of legal interpretation in China, an indirect transfer of a Resident Enterprise is sourced in the PRC and subject to PRC taxation unless an explicit exclusion exists for such indirect transfer. The Notice affirms that an indirect transfer of equity interest in a PRC company is taxable in China. Another possible rationale, consistent with the foregoing rationale for asserting sourcing in indirect transfer cases might be based on provisions contained in certain PRC bilateral income tax treaties. For example, Paragraph 5 of Article 13 of the Capital Gains Article of the PRC-Singapore income tax treaty provides as follows: "Subject to paragraph 4, gains derived by a resident of a Contracting State from the alienation of shares, participation, or other rights in the capital of a company or other legal person which is a resident of the other Contracting State may be taxed in that other Contracting State if the recipient of the gains, at any time during the twelve-month period preceding such alienation, had a participation, directly or indirectly, of at least 25 per cent in the capital of that company or other legal person." A similar provision is also found in the second protocol of the China-Hong Kong tax arrangement, the protocol of the China-Mauritius income tax treaty and other PRC bilateral income tax treaties. It should be noted that the foregoing type of capital gains provision is a significant departure

from the Organization for Economic Cooperation and Development Model Income Tax Treaty and is based on the rationale that the sale of a substantial holding of the shares of a corporation can be economically comparable to selling a proportionate share of the underlying assets of the corporation, which could be subject to tax as gains under other paragraphs of the capital gains article of the treaty if sold directly.

Holding company structuring and tax avoidance

An investor may have multiple substantive business reasons apart from tax for investing in a source country, including China, through an interposed holding or operating company. These reasons could include operational structuring, residence country structuring, business flexibility, investor convenience, approval requirements, legal and investment protection, and foreign exchange concerns.

In the past, it was common for foreign investors to interpose a foreign holding company both for business as well as for tax purposes, e.g., to avoid the lengthy approval and registration process that a direct transfer of an equity interest in a foreign invested enterprise would require and the Chinese capital gains tax. China did not actively pursue taxing an indirect equity transfer.

However, in view of the recent new tax developments in China, in particular with the focus on GAAR, commercial rationale, and substance, the tax environment in China is changing dramatically. Now, while use of an interposed nonresident enterprise for the business reasons enumerated above would appear to be fully justifiable, query how much more substance would an investor have to show in order to have the interposed entity respected for tax purposes?

In view of the Notice and other administrative releases, Nonresident Enterprises should review their current China structures to ascertain what additional actions, if any, might be taken to reinforce their business purpose and commercial substance. For Nonresident Enterprises that are considering making new investments in China, care must be taken in establishing investment structures that have commercial purpose and substance, apart from tax savings.

Additional issues

The Notice, because of its scope and breadth, raises numerous questions:

- First, the Notice is controversial because it could be viewed as having extraterritorial application without sufficient jurisdictional basis. Query, how Nonresident Enterprises will react to the requirement to report under the Notice?

- Second, if the Chinese tax authorities impose taxation of the gain in respect of an indirect transfer, that may result in double taxation. Query, how the issue of allocation of taxing rights between the source state and the residence state will be resolved in this instance, whether under the mutual agreement procedure of a bilateral income tax treaty or under internal law, particularly when China may be disregarding an entity that is considered as a valid juridical entity either in its country of formation, residence, or in the country of residence of its direct or indirect shareholder.
- Third, it is not entirely clear how to determine the “actual tax burden” to ascertain whether a jurisdiction is low taxed. For example, Ireland imposes a tax rate of 12.5 percent on nonportfolio dividends (5 percent or more ownership) paid out of trading profits from a company with which Ireland has a double tax treaty; would Ireland always pass the low tax jurisdiction test so information reporting would not be required even if its tax could be offset by Chinese foreign tax credits? So too, certain countries such as the Netherlands and Switzerland exempt certain dividends (either from domestic sources or foreign sources) under their respective holding company regimes; would these countries pass the test that the jurisdiction does not exempt foreign source dividends so as to avoid information reporting? Further, how does the Notice impact interposed entities that are resident in a jurisdiction that has entered into a bilateral income tax treaty with China that either reduces or exempts capital gains from PRC source basis taxation? For example, the treaties with Barbados, Ireland, and Switzerland exempt PRC source basis capital gains taxation (other than with respect to Chinese companies whose principal investments are real property).⁵ In addition to submission of information to substantiate the claimant’s beneficial owner status for enjoying treaty benefits as required under Notice 124 and Notice 601, query whether a treaty protected Nonresident Holdco also would be required to file information under the Notice?⁶
- Fourth, a number of the rules provided under the Notice are contained in other existing guidance, such as the transfer pricing regulations, the source withholding rules, and the M&A income tax rules. The Notice does not provide further clarification as would have been expected; for example, what business purposes will be found to be acceptable, what is considered abuse of organization form, what constitutes sufficient substance, and what materials and procedures are required for enjoying the tax deferred special restructuring regime?
- Fifth, the Notice could be construed to apply by its terms to any indirect transfer involving a Resident Enterprise, even if the Resident Enterprise comprises a de minimis portion of the overall transaction. Thus, under a plain reading of the Notice, for example, a transnational M&A transaction that happens to include an indirect transfer of an equity interest in one or more Resident Enterprises would require the controlling Nonresident Enterprise to comply with the Notice and provide the applicable information that will be subject to review by the PRC tax authority. This would entail great administrative burden on transactions that are undertaken for genuine business purposes and that incidentally happen to include the indirect transfer of a Resident Enterprise.
- Sixth, as the Notice empowers the local tax authority in charge of the Resident Enterprise to make the determinations, query whether the Notice will be evenly implemented by local tax authorities without additional operational guidance?



- Seventh, the Notice is retroactive; query, how would a Nonresident Enterprise comply with indirect transfers that were made prior to the promulgation of the Notice but within the retroactive effective date that commenced as of Jan. 1, 2008? And what are the implications of compliance or noncompliance?
- Eighth, the Notice does not deal with the consequences of noncompliance; query, what are the implications of a Nonresident Enterprise not complying with the Notice and the sanctions, if any, that Chinese tax authorities may impose. Further, how would the PRC tax authorities impose any sanctions on a Nonresident Enterprise? ⁷

⁵ In that regard, see *Guo Shui Fa [2009] No. 124* (“Notice 124”), “Administrative Measures on Claiming Tax Treaty Treatment by Nonresidents,” to clarify the procedures and documentation requirements for nonresidents wishing to obtain benefits under China’s bilateral income tax treaties. Under this circular, the treaty resident must explain its commercial substance to substantiate its tax residence and the business reason or economic

purpose of the transaction to substantiate beneficial ownership. The Chinese tax authorities will utilize the information filed to analyze and determine the adequacy of commercial substance and the rationale for the establishment by a Nonresident Enterprise of the treaty protected entity before granting treaty benefits. See also Guo Shui Han [2009] No. 601 (“Notice 601”), “Notice on How to Understand and Confirm ‘Beneficial Owner’ under Tax Treaties,” which contains guidance with respect to the definition of, and specific criteria for, “beneficial owner” in order for a treaty-protected entity to qualify for benefits under the dividends, interest, royalties, and capital gain articles of tax treaties.

⁶ In support of their inquiries, will the Chinese tax authorities now actively seek to utilize the exchange of information provisions of bilateral tax treaties or the recently concluded tax information exchange agreements with the Bahamas and the British Virgin Islands to obtain information relating to their GAAR considerations?

⁷ In this regard, see *Guo Shui Fa [2009] No. 3*, “Provisional Measures on Administration of Source Withholding on Income Tax of

Nonresident Enterprises,” which imposes on the underlying PRC Resident Enterprise an obligation to report the equity transfer between two Nonresident Enterprises and an obligation in assisting the PRC tax authorities in collecting the withholding income tax on the equity transfer between two Nonresident Enterprises. Therefore, it appears that the PRC underlying Resident Enterprise will be under pressure to request its direct or indirect parent prior to or after the equity transfer to comply with the Notice.

Conclusion

In summary, the Notice represents the most recent development of the PRC tax authorities in challenging tax arrangements that have no business purposes but avoidance of Chinese taxation. Time and experience will tell how Chinese tax authorities enforce the Notice, particularly the disregard of Nonresident Holdcos.

International tax advisers, however, now must take into account the breadth and scope of the Notice in planning cross border transactions involving Resident Enterprises.