



# Tax Briefing Paper

## SAT targets off-shore equity transactions

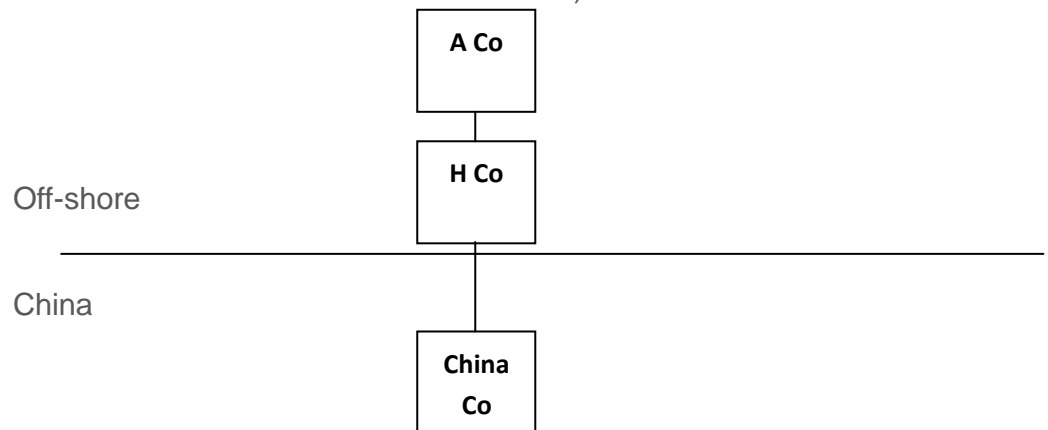
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The State Administration of Taxation (“SAT”) has, in a circular issued on 11 December 2009, indicated its intention to target off-shore transactions involving the indirect transfer of Chinese enterprises (*Notice on Strengthening the Management of Enterprise Income Tax Collection of Proceeds from Equity Transfers by Non-resident Enterprises* Guoshuihan [2009] 698) (“**Circular 698**”). Circular 698 represents the latest challenge to holding company or special purpose vehicle structures in China.

### Common Off-shore Holding Company Structure

The following is a very common off-shore holding structure in China (often referred to as a vanilla off-shore structure):



There are a number of reasons, including non-tax reasons, why inbound investments in China are structured in this fashion. One of the principal tax reasons, and relevant in terms of Circular 698, is the ability to effectively sell China Co, through transferring the equity interests in H Co, without incurring any tax liability in respect of that sale. The transfer of equity in a Chinese resident companies gives rise to tax liability. However, strictly speaking, no tax liability will arise in respect of the sale of an off-shore company by a non-resident shareholder.

The qualification to this is Article 47 of China’s Enterprise Income Tax Law (“EITL”) which is a general anti-avoidance rule (“**GAAR**”). Article 47 relevantly empowers the SAT to make an adjustment where an arrangement has been entered into that has no reasonable business purpose and results in a reduction in taxable income.

### Circular 698

Circular 698, effectively, operates in two scenarios; the direct sale of a Chinese resident enterprise and the indirect sale of such an enterprise. It first should be noted that there is an exception to Circular 698 with respect to listed shares. However, it is doubtful that this exception would apply to shares that subsequent to acquisition are listed on the stock exchange.



#### *Direct Sale of Chinese Resident Enterprise*

A direct sale of a Chinese Resident Enterprise refers to where the Chinese enterprise is sold as opposed to the holding company (H Co in the structure outlined above). This aspect of the Circular is relatively uncontroversial. It simply requires a non-resident to declare and pay any income tax liability with respect to the transfer of equity in a Chinese resident enterprise where such payment is not made, or is unable to be made, by the relevant withholding agent. Payment of such tax must be made within 7 days of the agreed equity transfer date.

#### *Indirect Sale of Chinese Resident Enterprises*

In Circular 698, relying upon the GAAR in Article 47, the SAT indicates that in certain circumstances the sale of H Co will give rise to a tax liability in China for A Co – the authorities effectively deem the transaction to be a sale of China Co. The circumstance that may give rise to such tax liability is where the SAT has formed the view that the arrangement (i.e. interposing the off-shore holding company as the shareholder of China Co) has no reasonable business purpose.

Circular 698 also contains a mechanism that aims to assist the SAT with enforcing these new rules - documentation disclosure requirements. In accordance with paragraph 5 of the Circular, where the tax rate of the jurisdiction in which H Co is a resident is less than 12.5% or the jurisdiction does not tax foreign sourced income, upon transferring the equity in H Co, A Co is required to provide the following documents to the local tax authority (within 30 days of the contracts being signed):

1. The equity transfer contract or agreement;
2. The relationships between the A Co and H Co on funds, management, procurement and marketing;
3. H Co's production, management, personnel, finance and property conditions etc;
4. The relationship between H Co and China Co on funds, management, procurement and marketing;
5. The proof of a reasonable business purpose on setting up H Co by A Co;
6. Other relevant information required by the taxation authority.

Circular 698 is stated to apply from 1 January 2008 (the date that the Enterprise Income Tax Law became operable). This is a relatively draconian measure although it could be argued, as I am sure the SAT would contend, that the Circular is consistent with the spirit of Article 47 of the EITL and therefore taxpayers have been put on notice that such arrangements are no longer acceptable. Further, the SAT has provided strong indications throughout 2009 that it intends to aggressively target such arrangements. In light of such circumstances, it is arguable, that the retroactive aspect of the Circular should not be considered harsh. Regardless of whether it is fair, the Circular permits the tax authorities to review any off-shore transactions that occurred from 1 January 2008 to date.

Paragraph 7 of the Circular empowers the tax authorities to make a tax adjustment where a transfer of equity in a Chinese resident enterprise is made to a related party and the consideration for the transfer is less than the arms-length price for the equity.

#### **Implications of the Circular**

The Circular challenges the traditional structures for investing into China and as such requires all companies to review their current structures. Our discussions



with the SAT in relation to the Circular have indicated that they do not intend to utilize it arbitrarily or aggressively.

Importantly, taxpayers will not be subject to tax under Circular 698 where they can establish a reasonable business purpose for the existence of H Co. Accordingly, a critical issue is what will be a “reasonable business purpose”. No definition or clarification of the meaning of “reasonable business purpose” has been provided by the SAT up until present and, accordingly, there is a question mark over the breadth of the term. In particular does “business” have wide or narrow meaning – it is our understanding that the SAT favours the view that “business” requires the purpose to be reasonable in the context of the business operations of the Chinese resident enterprise. A wider interpretation may suggest that a transaction that is entered into to further a commercial objective for the company or its shareholders may have a reasonable business purpose. For example, could interposing H Co for the purpose of enabling an easy transfer of the Chinese resident enterprise (i.e. without the regulatory red tape of an on-shore transaction) be a “reasonable business purpose”. Although such an interpretation is open on the language of Article 47 of the EITL, it is likely that the SAT will resist, for obvious reasons, any attempts to base a “reasonable business purpose” on such motivations.

Finally, it should also be noted that Circular 698 should be read in conjunction with Circular 601 – a notice by the SAT in respect of the term “beneficial owner” contained in China’s tax treaties. These circular together establish the SAT’s approach to the use of special purpose vehicles.

## Remaining questions

### *Enforcement*

The SAT will face a number of challenges in enforcing Circular 698. Over the past year there has been an increased willingness by taxation authorities worldwide (including some low-tax off-shore jurisdictions) to cooperate with respect to information exchange. Despite this, it will still be extremely difficult for the SAT to police all off-shore transactions. One has to assume that Circular 698 will be targeted at big-ticket transactions rather than the average sale of a Chinese enterprise. Consistent with this, early indications have been that Circular 698 will be used fairly conservatively by the tax authorities and ordinary transactions will not be targeted. However, it would not be safe to rely upon these matters in the absence of taking appropriate action to ensure that your holding company structure is compliant with the Circular.

### *Interaction with Double Tax Agreements*

Article 58 of the EITL provides that the provisions of any income tax treaties between China and a foreign government will prevail in the case of any inconsistency with the EITL. Accordingly, it must be presumed that Circular 698 is subject to the terms of any relevant income tax treaty. Importantly, there would seem to be a few income tax treaties that would assist arrangements to fall outside the terms of the Circular. For example, Article 13 of the China-Mauritius tax treaty generally prevents China, in respect of a company resident in Mauritius, from taxing capital gains from shares where the holding is less than 25% (except where such income represents gains from the alienation of a permanent establishment.) Unless it can be established that China Co is a permanent establishment of H Co, for holdings of less than 25% in China Co, no taxable event would seem to arise on a direct transfer of shares in China Co by H Co.



## Further Information

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Importantly, Article 5(7) of the China-Mauritius income tax treaty would generally prevent China Co from being considered a permanent establishment of H Co. A direct transfer of China Co by a H Co based in Mauritius would appear to not give rise to taxation in China and in which case Circular 698 would have no application. The Chinese tax authorities could invoke the GAAR generally to such an arrangement, although as yet there has been no indication that the SAT intends target such arrangements. The important point is that the transaction would be outside the terms of Circular 698 and back in the more vague territory of the GAAR.

### Extra-Territoriality

One of the common criticisms of the Circular since it was issued has been the perceived extra-territorial nature. Apart from the documentation disclosure requirements, such criticisms would seem to be misguided. Whether we like it or not, it is a generally accepted principle of taxation that tax may be imposed by a country on non-residents in respect of income sourced from that country. The terms of the OECD Model Tax Treaty accept and generally endorse this principle. It is also a generally accepted principle of international taxation, once again whether we like it or not, that tax authorities are entitled to look beyond the form of a transaction where the particular form has been chosen for the purpose of avoiding or minimising tax liability (that is, where the domestic legislation permits them to do so). Once we accept both these principles, it is difficult to contend that the SAT is not entitled to take the steps (that is, disregarding H Co for tax purpose where there is no reasonable business purpose for its existence) outlined in Circular 698.

Attempts have been made to compare the Circular with the ongoing dispute between Vodafone and the Indian tax authorities, presently before the Indian High Court, in respect of Vodafone's off-shore acquisition of Hutchinson Essar. In truth, such a comparison is a poor one because India did not have a GAAR in its tax code at the relevant time. The ability of tax authorities to tax off-shore transactions in the absence of a GAAR will usually be questionable and hence why reference was made to the United States' "doctrine of effects" – the principle that US competition law can apply to acts outside of the US where those acts have an effect inside the US – before the High Court in India.

### Conclusion

Whilst Circular 698 represents a fundamental shift in the tax treatment of off-shore equity transactions in China, it should come as no surprise given the developments in China's international tax regime over the past 24 months. Neither is the Circular inconsistent with general international legal principles as some have claimed. It is, however, imperative for all foreign investors, that have utilised an off-shore company for investing into China, to undertake a review of their current structure and implement any necessary changes.