

Corporate Tax - China

SAT targets offshore equity transactions

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Introduction

In a circular issued on December 11 2009 the State Administration of Taxation (SAT) indicated its intention to target offshore transactions involving the indirect transfer of Chinese enterprises.⁽¹⁾ The circular represents the latest challenge to holding company or special purpose vehicle structures in China.

Offshore companies often invest in Chinese companies through an offshore holding company. There are a number of reasons for structuring investments in China in this way, not all of them related to tax. One of the main advantages is the ability to sell the Chinese company by transferring the equity interests in the holding company, thereby avoiding tax liability in respect of the sale. The transfer of equity in Chinese resident companies gives rise to tax liability, but no liability arises when a non-resident shareholder sells an offshore company.

However, this position is qualified by Article 47 of the Enterprise Income Tax Law, which is a general anti-avoidance rule. Article 47 empowers the tax authorities to make an adjustment where an arrangement has no reasonable business purpose and results in a reduction in taxable income.

Key provisions

The new circular applies to the direct or indirect sale of a Chinese resident enterprise. An exception applies in respect of listed shares, but it is unlikely that this will extend to shares that are listed on a stock exchange after acquisition.

Direct sale

A direct sale of a Chinese resident enterprise takes place where the enterprise, not the holding company, is sold. This aspect of the circular is relatively uncontroversial. It simply requires a non-resident to declare and pay income tax with respect to the transfer of equity in a Chinese resident enterprise where such payment is not made (or cannot be made) by the relevant withholding agent. Payment of such tax must be made within seven days of the agreed equity transfer date.

Indirect sale

Relying upon the general anti-avoidance rule in Article 47, the SAT has indicated that in certain circumstances the sale of a holding company will give rise to tax liability in China for its parent company, as it deems such a transaction effectively to be a sale of the Chinese company. Such liability may arise where the SAT considers that the arrangement (ie, the interposition of the offshore holding company as the Chinese company's shareholder) has no reasonable business purpose.

Documentation disclosure requirements

The circular also contains a mechanism to assist the authorities in enforcing the new rules. Paragraph 5 states that if the jurisdiction in which the holding company is resident applies a tax rate of under 12.5% or does not tax foreign-sourced income, the offshore parent company is required, upon transferring the equity in the holding company, to provide the local tax authority with:

- the equity transfer contract or agreement;
- details of the relationship between the two offshore companies, and between the holding company and the Chinese company, in terms of funds, management,

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- procurement and marketing;
- details of the holding company's production, management, personnel, finance and property conditions;
- proof of a reasonable business purpose for establishing the holding company; and
- other relevant information required by the authority.

This information must be supplied within 30 days of signing the contracts.

The circular is stated to apply with effect from January 1 2008 - the date on which the law came into force. Although this appears draconian, the authorities might argue that as the circular is consistent with the spirit of Article 47 of the law, taxpayers have simply been put on notice that such arrangements are not acceptable. Furthermore, the SAT gave strong indications throughout 2009 of its intention to target such arrangements aggressively. Regardless of the fairness of the measure, it allows the tax authorities to review any offshore transactions that occurred after January 1 2008.

Paragraph 7 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 arm's-length price of the equity.

Implications

The circular challenges the traditional structures for investment in China and requires all companies to review their existing structures.

The SAT has indicated informally that it does not intend to apply the circular arbitrarily or aggressively. Most significantly, taxpayers will not be subject to tax under the circular if they can establish a reasonable business purpose for the existence of the holding company. However, the SAT has provided no definition of the term 'reasonable business purpose' and it is unclear whether 'business' has a wide or narrow meaning. The SAT is believed to see the term 'business' as requiring the purpose to be reasonable in the context of the business operations of the Chinese resident enterprise. On a wider interpretation, a transaction which is entered into in order to further a commercial objective for the company or its shareholders might be said to have a reasonable business purpose. For example, could the interposition of a holding company in order to enable an easy transfer of the Chinese resident enterprise (ie, without the regulatory restrictions and conditions of an onshore transaction) be seen as fulfilling a reasonable business purpose? Although the language of Article 47 does not exclude such an interpretation, the SAT is likely to resist attempts to equate such motivations with a reasonable business purpose.

The circular should be read in conjunction with Circular 601 on the term 'beneficial owner' in China's tax treaties. Taken together, these circulars establish the SAT's approach to the use of special purpose vehicles.

Outstanding questions

Enforcement

The SAT will face a number of challenges in enforcing Circular 698. In recent months tax authorities worldwide - including some in low-tax offshore jurisdictions - have shown greater willingness to cooperate in exchanging information. Nevertheless, the SAT will find it almost impossible to police all offshore transactions. It seems likely that the circular will be targeted at 'big-ticket' transactions, rather than the sale of an average Chinese enterprise, and will be applied conservatively. However, it would be dangerous to rely on this perceived approach, rather than taking appropriate action to ensure that a holding company structure is compliant.

Interaction with double tax agreements

Article 58 of the law provides that in the event of a conflict between the law and the provisions of an income tax treaty between China and a foreign government, the treaty provisions will prevail. Therefore, the circular is presumed to be subject to the terms of any relevant income tax treaty. A few income tax treaties appear to take arrangements outside the terms of the circular. For example, Article 13 of the tax treaty with Mauritius 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 the Chinese company is a permanent establishment of the holding company, for holdings of less than 25% in the Chinese company no taxable event would seem to arise on a direct transfer of shares in the Chinese company by the holding company.

Article 5(7) of the treaty would generally prevent the Chinese company from being considered a permanent establishment of the holding company. A direct transfer of the Chinese company by a Mauritius-based holding company appears not to give rise to taxation in China and thus the circular would not apply. The Chinese tax authorities could invoke the general anti-avoidance rule against such an arrangement, but the SAT has not yet indicated that it intends to target such arrangements. In any case, the

transaction would be outside the terms of the circular and back in the more vague territory of the general anti-avoidance rule.

Extra-territoriality

Much of the criticism of the circular has been directed at its perceived extra-territorial nature. Apart from the documentation disclosure requirements, such criticism seems to be misguided. It is a generally accepted principle of taxation that a jurisdiction may tax non-residents in respect of income sourced from the jurisdiction - a position that the Organization for Economic Cooperation and Development Model Tax Treaty accepts and generally endorses. Equally, it is accepted that tax authorities are entitled to look beyond the form of a transaction where the form has been chosen for the purpose of avoiding or minimizing tax liability (provided that national legislation permits them to do so). Given these principles, it is difficult to contend that the SAT cannot take the steps outlined in the circular and disregard the holding company for tax purposes where there is no reasonable business purpose for the company's existence.

Attempts have been made to compare the issues raised by the circular with the ongoing dispute between Vodafone and the Indian tax authorities - presently before the Indian High Court - in respect of Vodafone's offshore acquisition of Hutchinson Essar. However, the comparison is unhelpful because India did not have a general anti-avoidance rule in its tax code at the relevant time. The ability of tax authorities to tax offshore transactions in the absence of a general anti-avoidance rule will usually be questionable - hence the reference before the court to the US 'doctrine of effects' (ie, the principle that US competition law can apply to acts outside the United States where those acts have an effect inside the United States).

Comment

Although the circular represents a fundamental shift in the tax treatment of offshore equity transactions in China, it is unsurprising given the developments in China's international tax regime over the past two years. Moreover, the circular is not inconsistent with general international legal principles, as some commentators have claimed. However, all foreign investors that have used an offshore company for investing in China should undertake a review of their existing structure and implement the necessary changes.

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Endnotes

(1) Circular 698, entitled "Notice on Strengthening the Management of Enterprise Income Tax Collection of Proceeds from Equity Transfers by Non-resident Enterprises *Guoshuihan*".

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