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China Alert

A ground-breaking anti-avoidance action: China Issued New Taxation Rules regarding Offshore Indirect Transfer of Property by Non-resident Enterprises

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Background

On 10 December 2009, the State Administration of Taxation ("SAT") in China issued "Notice of Strengthening the Administration of Enterprise Income Tax for Share Transfer by Non-resident Enterprises". That is the landmark tax circular Guoshuihan [2009] No. 698 ("Circular 698") which has significant tax impact on non-resident enterprises. Although the SAT promulgated another notice "Bulletin on Several Issues Concerning the Administration of Enterprise Income Tax on Non-resident Enterprises" (SAT Bulletin [2011] No.24) ("Bulletin 24") in 2011 to provide further explanation on Circular 698, there is still much controversy over how to interpret and implement Circular 698. A number of questions are awaiting clarification.

On 6 February 2015[1], the SAT published the long awaited "Bulletin on Several Issues Relating to Enterprise Income Tax on Income Arising from Indirect Transfer of Property by Non-resident Enterprises" (SAT Bulletin [2015] No. 7) ("Bulletin 7"). Driven by anti-avoidance initiatives, Bulletin 7 provides comprehensive guidelines on how to administer Enterprise Income Tax ("EIT") on income derived from indirect transfer of property by non-resident enterprises. The bulletin will have profound impact on tax treatments and compliance related to initial public offerings, mergers and acquisitions, group restructuring as well as other capital transactions undertaken by non-resident enterprises that directly or indirectly hold properties in Mainland China.

Bulletin 7 is effective from the date of issuance, and it also applies to transactions that happened before its issue date but for which tax treatment has not been concluded.

This alert summarises our comments and the key points of Bulletin 7 as follows:

[1] *SAT Bulletin [2015] No. 7 was issued on 3 February 2015, and was published on 6 February 2015.*

Our Comments on Bulletin 7

1. Bulletin 7 has significant and striking implications on the development of anti-avoidance measures in China. In terms of its wide applicable scope and considerable tax impact, Bulletin 7 is the incomparable anti-avoidance rule the SAT issued. Bulletin 7 serves as a complementary measure to the "Administrative Measures of General Anti-Avoidance Rules (Trial Implementation)" promulgated by the SAT in December 2014, and both measures form the key taxation rules that govern indirect transfer of China Taxable Property (please see the definition below) by non-resident enterprises.

2. As compared to Circular 698, Bulletin 7 sets out clearer provisions, nevertheless, there still remain considerable uncertainty in some aspects that would require further clarification in the future.

3. Bulletin 7 sets out explicit provisions with regard to the legal responsibilities of the transferor and the transferee / withholding agent involved in the indirect transfer of China Taxable Property. If it turns out that the subject of transfer is considered as China Taxable Property by the China tax authorities, and the transaction parties have not fulfilled the relevant prescribed withholding and tax reporting obligations, they shall face relevant legal consequences.

4. Bulletin 7 shall apply to transactions that occurred before the issue date but for which tax treatment has not been concluded. For investors who have been engaged in indirect transfers of China Taxable Property that are regulated under Circular 698 (under the applicable clauses) and Bulletin 7 but have not obtained confirmation of tax treatment, they should re-examine the relevant transaction, take necessary action as soon as possible to protect their own interest and mitigate potential tax risk and impact as far as possible.

5. Bulletin 7 covers various tax aspects including double tax treaty, China domestic tax rules and related overseas tax rules. In this regard, we would strongly recommend investors to engage experienced cross-border tax professionals to conduct analysis and make recommendations for assisting them to manage the relevant tax risks before undertaking all relevant capital transactions related to China investment, which may include initial public offering, group restructuring and indirect transfer of China Taxable Property.

Scope of application under Bulletin 7

As compared to Circular 698, Bulletin 7 has a much wider applicable scope. Pursuant to Article 1 of Bulletin 7, non-resident enterprises that indirectly transfer equity interest in Chinese resident enterprises or other properties through arrangements that are executed without reasonable commercial purpose would result in avoidance of EIT liability. Such transactions that involve indirect transfers should be re-characterised as direct transfer of equity interest in Chinese resident enterprises or other properties in accordance with Article 47 of the EIT Law.

Article 47 of the EIT Law clearly specifies that if an enterprise conducts any arrangement without reasonable commercial purpose which results in reduction of its taxable revenue or income, the tax authority shall be empowered to make adjustments using reasonable methods. Article 47 of the EIT Law sets out the regulatory basis for China's general anti-avoidance rules (i.e. GAAR).

Properties of Chinese resident enterprises covered by Bulletin 7 refer to three types of taxable properties that meet the two criteria set out below:

The two criteria that should be met concurrently are:
1. Directly owned by non-resident enterprises; and
2. Income derived from such transfer should be subject to EIT in China under China tax rules

Three types of properties are considered as taxable properties:
1. Assets of an establishment or place situated in China
2. Immovable properties located in China
3. Equity investments in Chinese resident enterprises, etc
   (the three types of properties mentioned above are collectively known as "China Taxable Property")

Article 1 of Bulletin 7 further clarifies what constitutes indirect transfer of China Taxable Property. It refers to transactions conducted by a non-resident enterprise that involve transfer of equity interest and other similar interests of a foreign enterprise (excluding foreign-incorporated Chinese resident enterprises) that directly or indirectly holds China Taxable Property, with the effect of creating transactional outcomes that are identical or similar to a direct transfer of China Taxable Property. Such transactions include a restructuring of a non-resident enterprise that results in a change of shareholder(s) of the foreign enterprise. The equity transferor ("Transferor") refers to the non-resident enterprise that indirectly transfers the China Taxable Property.

Bulletin 7 provides that Article 1 shall not apply to the following situations:

1. The non-resident enterprises derive income from the indirect transfer of China Taxable Property through both buying and selling of the same listed offshore enterprise shares in the public securities market.

2. In the situation where the non-resident enterprise directly holds and transfers China Taxable Property, the income derived from such property transfer is eligible for EIT exemption in China under the provisions of the applicable tax treaty or arrangement.

Determining reasonable commercial purpose

The focus of China's anti-avoidance rules is to determine whether an enterprise reduces its taxable revenue or income through arrangements that lack reasonable commercial purpose. Bulletin 7 therefore sets out guidelines and rules for assessing the sufficiency of reasonable commercial purpose. According to Bulletin 7, to determine the sufficiency of reasonable commercial purpose, all arrangements that are related to the indirect transfer of China Taxable Property transactions should be considered as a whole, and the following factors should be used to conduct a comprehensive analysis based on actual circumstances:

1. Whether the core value of equity interest of the foreign enterprise is directly or indirectly derived from China Taxable Property;

2. Whether the assets of the foreign enterprise are mainly comprised of direct or indirect investments situated in China, or whether the revenue of the foreign enterprise is mainly sourced from China directly or indirectly;

3. Whether the actual functions undertaken by or actual risks assumed by the foreign enterprise and its subsidiaries that directly or indirectly own China Taxable Property can substantiate that the enterprise structure has economic substance;

4. The duration of the existence of the foreign enterprise's shareholder(s), business model and related organizational structures;

5. The foreign income tax payable on the indirect transfer of China Taxable Property;

6. The substitutability of indirect investment, indirect transfer of China Taxable Properties and direct investment, direct transfer of China Taxable Property from the Transferor's perspective;

7. The applicability of China tax treaty or arrangement in respect of the income derived from the indirect transfer of China Taxable Property;

8. Other relevant factors.

According to the explanatory note to Bulletin 7 published by the SAT, factor no. 3 stated above requires, through a functional and risk analysis, to determine the association of the functions undertaken and the risks assumed by the transferred enterprise and its transferred equity interest, as well as its economic substance.

With regard to factor no. 4 stated above, the explanatory note provides an example showing that if a foreign intermediary structure is set up shortly before the indirect transfer transaction, such arrangement could have negative impact on the determination of reasonable commercial purpose.

In respect of factor no. 5 stated above, the explanatory note stipulates that foreign income tax payable includes tax payable by the Transferor at its place of residence, and the tax payable at the place where the transferred enterprise is located.

The assessment factors listed above provide insight into SAT's principles in determining what constitutes unreasonable commercial purpose. However, the above factors only lay down the key principles. There appears to be considerable uncertainty about the implementation by local tax authorities.

Indirect transfer transactions that are directly determined to be without reasonable commercial purpose

Article 4 of Bulletin 7 clearly spells out that if the whole arrangement involving indirect transfer of China Taxable Property meets all of the following criteria, such arrangement would be deemed to lack reasonable commercial purpose by the SAT and therefore no analysis or assessment would need to be conducted under Article 3 of the bulletin:

1. 75% or more of the value of the foreign enterprise is derived directly or indirectly from China Taxable Property;
2. At any time within the one year before the completion of the indirect transfer of China Taxable Property, 90% or more of the total assets (excluding cash) of the foreign enterprise is directly or indirectly constituted by investment in China, or in the one year before the completion of the indirect transfer of China Taxable Property, 90% or more of the revenue of the foreign enterprise is directly or indirectly sourced from China;
3. Although the foreign enterprise and its subsidiaries that directly or indirectly hold the China Taxable Property are incorporated in the home country (region) to satisfy the organisational structure required by law, they perform limited functions and assume limited risks, and therefore could not provide sufficient justification to substantiate their economic substance;
4. The foreign income tax payable on the indirect transfer of the China Taxable Property transaction is lower than the potential China tax liability on direct transfer of the said China Taxable Property.

Safe harbour rules for intragroup transfer and tests for obtaining tax benefits

Indirect transfer of China Taxable Property that meet all criteria set out below would be considered as having reasonable commercial purpose:

1. The shareholding relationship of both transaction parties satisfies any of the following conditions

   1) The Transferor holds directly or indirectly 80% or more of the equity of the transferee

   2) The Transferee holds directly or indirectly 80% or more of the equity of Transferor

   3) 80% or more of the equity of both the Transferor and the transferee are directly or indirectly owned by the same shareholder

   If over 50% of the equity value of a foreign enterprise is directly or indirectly derived from immovable property situated in China, the shareholding percentage prescribed under item (1), (2) and (3) above shall be 100%.

2. The China income tax burden on potential subsequent indirect transfer(s) after the indirect transfer in question was completed would not be less than that on the same or a similar indirect transfer if it was conducted under the circumstance that the indirect transfer in question did not take place

3. All the consideration paid by the transferee must be in equities (excluding equities in listed enterprises) of the transferee itself or other enterprise(s) with which it has a controlling relationship of shareholding

Bulletin 7 introduces a test to determine if there is a motive for obtaining better tax benefits. According to item no. 2 stated above, if a foreign enterprise group conducts indirect transfer through group restructuring, resulting in an outcome which reduces the China income tax liability when a subsequent indirect transfer takes place, such an arrangement could be considered as lacking reasonable commercial purpose and therefore the safe harbor rule treatment may not be applied.

Tax reporting obligations of the transaction parties

Bulletin 7 clearly stipulates the tax withholding and reporting obligations of indirect transfer transactions involving China Taxable Property conducted by non-resident enterprises.

1. Preparation and submission of documents

   Unlike Circular 698, Bulletin 7 provides a voluntary mechanism for the preparation and submission of documents, which means that both transaction parties of an indirect transfer of China Taxable Property, and the Chinese resident enterprise whose equity is being indirectly transferred, can report the relevant equity transfer transaction and submit the relevant prescribed documents to the in charge tax authority.

2. Withholding and reporting obligations when the tax liability arises

   Pursuant to Article 8 of Bulletin 7, if indirect transfer of immovable property or indirect transfer of equity is subject to EIT, the entity or individual that is directly obligated by law or contract to make payment to the Transferor (i.e. seller) shall be the withholding agent.

   If the withholding agent fails to fulfill its obligation to withhold the tax, the Transferor shall report and settle the tax within 7 days from the date when the tax liability is triggered. If the withholding agent fails to withhold and the Transferor fails to settle the tax, the in charge tax authority is empowered to investigate the liability of the withholding agent in accordance with the law. Based on the relevant rules, a withholding agent who fails to comply with the withholding requirement regarding the tax which should have been withheld or collected but has not been withheld or collected shall be subject to 50% to 300% of penalty calculated based on the tax which should have been withheld or collected. However, Bulletin 7 provides that if the withholding agent who submits the documents (please refer to item 1 stated above in respect of preparation and submission of documents) based on the prescribed requirements within 30 days from the date when the equity transfer contract or agreement is signed, the withholding agent may be exempted from or subject to reduced penalties.

   The date on which the tax liability arises mentioned above refers to the date when the equity transfer agreement takes effect and the change of equity ownership of the foreign enterprise is being completed.

   According to Article 13, in the event that the Transferor does not report and settle the tax on indirect transfer of China Taxable Property in full within the prescribed time limit, and the withholding agent also fails to withhold the tax, the Transferor shall not only be liable for the tax but also be subject to a daily interest levy. Such interest shall be calculated based on the Renminbi loan base rate ("Base Rate") published by the People's Bank of China for loans in the belonging year of the unpaid tax, plus 5%. However, if the Transferor provides relevant documents, and pays tax in accordance with the rules within 30 days after the agreement or contract to transfer the equity of the foreign enterprise is signed, the applicable interest rate shall be limited to the Base Rate and the 5% additional interest levy shall be waived.

   Bulletin 7 clarifies the responsibilities of the withholding agent and the applicable penalty provisions, and it also stipulates that the Transferor shall be charged for the unpaid tax and additional interest.

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