

News Flash

China Tax and Business Advisory

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Overseas Indirect Equity Transfer by Non-China Tax Residents under Scrutiny

It is not uncommon for multinational corporations (“MNC”) to interpose a Special Purpose Vehicle (“SPV”) as an intermediate holding company for their investments in China. It is imperative to note the recent trend that the Chinese tax authorities are scrutinising such SPV investment structures in the anti-tax avoidance combat.

On 10 December 2009, the State Administration of Taxation (“SAT”) issued Circular Guoshuihan [2009] No. 698 (“Circular 698”) specifically addressing various tax issues for equity transfers by Non-China Tax Resident Enterprises (“Non-TREs”). Among other things, the most eye-catching issue is the “indirect” equity transfer undertaken by the Non-TRE outside China (hereinafter as “indirect transfer”). It demonstrates the Chinese tax authorities’ strong determination to counter and counteract avoidance of China tax on gains derived from indirect transfer of Chinese companies’ equity via disposing the equity of the SPV offshore China. Circular 698 is made effective 1 January 2008 retrospectively.

In this issue of News Flash, we will share our insights and suggestions specifically on the topic of indirect transfer. We will release another News Flash on the other tax issues addressed in Circular 698.

Trend and direction

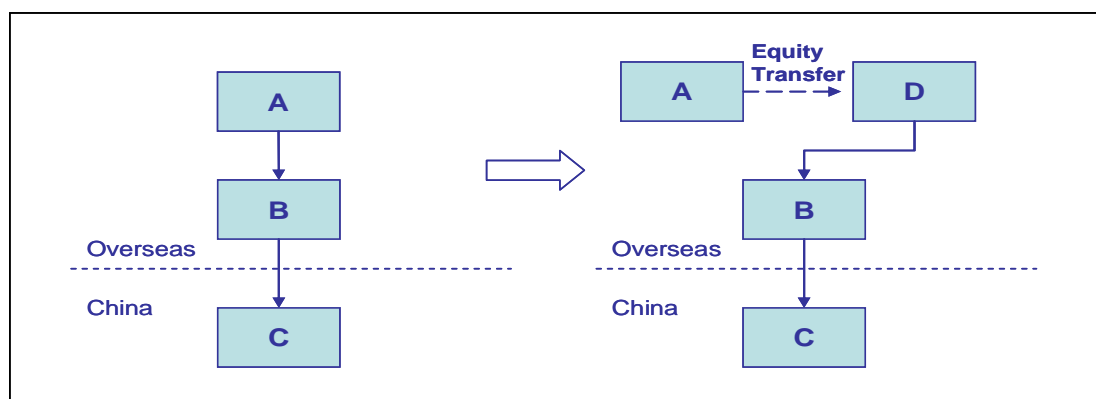
In our earlier News Flash (2009) Issue 08, we reported a case where the foreign investor disposed its Chinese investee company via disposal of a SPV outside China. The Chinese local-level tax bureau disregarded that SPV on the ground that the SPV had no substance and the purpose of interposing and disposing such SPV was solely for China tax avoidance. Though the case ended up with China withholding tax (“WHT”) being collected over the equity transfer gains, no strong legal basis was available by then as the case occurred before 2008 under the former Foreign Enterprise Income Tax (“FEIT”) regime.

Now with the introduction of the General Anti-avoidance Rule (“GAAR”) under the new Corporate Income Tax (“CIT”) regime coming into force on 1 January 2008, the Chinese tax authorities have been gearing up effort in attacking various tax avoidance arrangements and transactions. This also echoes the recent wave of attacking SPVs with tax avoidance purpose in the international tax arena. We have noted that the GAAR, where relevant, has been embodied in many new tax rules and regulations issued after 1 January 2008. Apparently, Circular 698 is one of the steps taken by the Chinese tax authorities in this direction.

Salient points of indirect transfer under Circular 698

What is indirect transfer

Circular 698 covers the transfer of equity that is directly or indirectly held by Non-TRE investors in a China Tax Resident Enterprise ("TRE"). A typical indirect transfer is depicted as follows:



In the above diagram, Non-TRE(A) transfers its equity in SPV(B) (which in turn holds the Chinese investee company(C)) to another Non-TRE(D) outside China. Such transaction is described as indirect transfer under Circular 698. Our following discussions will be based on this fact pattern.

Reporting obligation for indirect transfer

Within 30 days upon the transfer of SPV(B), Non-TRE(A) shall be obliged to report the indirect transfer to the Chinese local-level tax bureau in charge of the Chinese investee company(C), provided that SPV(B) is located in a foreign tax jurisdiction with the following profiles:

- (i) A tax jurisdiction with an effective tax rate of less than 12.5%; OR
- (ii) That jurisdiction does not tax foreign income of its TRE.

The requisite documents and information to be submitted by Non-TRE(A) are extensive:

- (1) Equity transfer contract/agreement;
- (2) Documents illustrating the relationship between the Non-TRE(A) and SPV(B) being transferred in respect of financing, operation, sales and purchase, etc.;
- (3) Documents illustrating the operation, personnel, finance and properties of the SPV(B) being transferred;
- (4) Documents illustrating the relationship between SPV(B) being transferred and the Chinese investee company(C) in respect of financing, operation, sales and purchase, etc.;
- (5) Documents illustrating the reasonable commercial purpose of the Non-TRE(A) in setting up SPV(B) being transferred; and
- (6) Other relevant documents required by the tax authority.

This reporting obligation is to help the Chinese tax authorities detect the "suspicious" indirect transfer. Obviously, the onus of proof that the interposing and disposal of SPV(B) is not for tax-avoidance purpose should lie with Non-TRE(A).

China tax implications

Based on the fact finding, the Chinese tax authorities will examine the true nature of the transfer, and may form the view that Non-TRE(A) indirectly transferred the equity in Chinese investee company(C) through the use of abusive arrangement, i.e. interposing and disposing SPV(B) for no reasonable commercial purpose, but just for avoidance of China WHT. So the Chinese tax authorities may re-characterize the equity transfer based on its "substance over form" principle and disregard the existence of SPV(B). Once SPV(B) is disregarded, the transfer should be effectively treated as Non-TRE(A) transferring the Chinese investee company(C)'s equity, and thus the transfer gain is of China source which should be subject to China WHT.

PwC Observations

Source of transfer gains

The taxing right over indirect transfer taking place overseas may be controversial because the relevant provision under the Detailed Implementation Rules (“DIR”) of the CIT Law¹ stipulates that income from transfer of the equity in a Chinese investee company shall be regarded as sourced from China. While an SPV is located outside China, the transfer of the SPV's equity by a Non-TRE should not have any China tax implication.

Given the prevailing Chinese rules on source of income for equity transfer, some MNCs interpose intermediate holding company between the overseas effective holding company and the Chinese investee company. For disposal of the Chinese investee company, it could be achieved by disposing the shares in the intermediate holding company, resulting in the transfer gains of ex-China source, and hence China-tax free consequence.

Now, the SAT relies on the GAAR provisions particularly the principle of “substance over form” (provided under the CIT Law and DIR², and elaborated under an SAT circular Guoshuifa (2009) No. 2 (“Circular 2”) entitled the “Implementation Measures of Special Tax Adjustments”³), to disregard an SPV lacking sound commercial purposes and substance. It seems the SAT has found a technical basis to re-characterize the source of the overseas transfer gain to China. However, it is a very controversial international legal and tax issue of whether the Chinese GAAR provisions and the SAT Circular could be applied to disregard an ex-China entity with the aim to restore the taxing right for China.

In any event, such approach would cause ambiguity and controversies between the Chinese tax authorities and Non-TRE transferors.

Allocation of taxing right

We do not anticipate that the Chinese tax authorities would abusively apply GAAR principle to disregard all SPVs, and impose China WHT on transfer gains derived by Non-TRE transferors offshore China because this is a matter of allocating of taxing right (international taxation) which would involve overseas jurisdictions.

Circular 698 only requires Non-TRE transferor to report the indirect transfer, provided that the SPV is located in a foreign tax jurisdiction with the following profiles: a low-tax jurisdiction with an effective tax rate of less than 12.5%; or that jurisdiction does not tax foreign income of its TRE. On one hand, the Chinese tax authorities may suspect that the interposing and disposal of the SPV in the jurisdiction with such profiles may be tax-avoidance driven. On the contrary, where the SPV is located in some other high-tax jurisdictions, then the suspicion is less obvious. The SAT has to strike the balance between the anti-tax avoidance and the allocation of taxing right between China and the foreign tax jurisdiction.

However, even the tax jurisdiction of the SPV does not impose tax on Non-TRE transferor, the home jurisdiction of Non-TRE transferor itself may still do so. Then there could be double taxation for Non-TRE transferor if China also collects WHT on the transfer gains. The SAT would still need to face the disputes with that home jurisdiction and get a mutual agreement on the taxing right.

“Main purpose” vs. “Substance”

The CIT Law and its DIR have provided GAAR provisions with the emphasis on “main purpose”, i.e. in brief, to reduce, exempt, or defer China tax.

MNCs often invest into China through an overseas SPV for reasons of legal and investment protection, foreign exchange concerns, investor-convenience, approval requirements, business flexibility, etc., apart from tax reasons. With these many non-tax reasons, the SAT has realized that it could be difficult to prove and verify whether the “main purpose” of the transfer of the SPV is for tax avoidance or not. From the administrative standpoint of the Chinese tax authorities, it would be easier and more convenient for them to examine the existence and relevancy of substance in the intermediate holding company, i.e. SPV. So the SAT has introduced the “substance over form” principle under Circular 2.

¹ Article 7(3) of the DIR

² Article 47 of the CIT Law and Article 120 of the DIR

³ Article 94 of Circular 2 states that “If a corporation does not have economic substance, especially if it is established in a tax haven for tax avoidance purposes, its existence can be disregarded for taxation purpose.”

However, there is always a question about what if the MNC is able to put forward all the sound commercial justifications as “main purpose” for interposing an SPV, which even does not have substance, as the intermediate holding company of the Chinese investee company. Would the Chinese tax authorities respect it and not disregard the SPV? Fortunately, Circular 698 has still kept the “reasonable commercial purposes” as the one of the elements in their examination (see Item (5) of the requisite documents above). Nevertheless, it would still need to take time to observe the assessing practice of the Chinese tax authorities after Circular 698 is implemented.

What “substance” for the SPV

In light of Circular 698, we believe that the Chinese tax authorities would from now on scrutinize the “substance” of the SPV in question more closely. Therefore, putting “substance” into a SPV should form the first line of defense against the potential tax avoidance challenges.

Unfortunately, Circular 698 has only provided some general and impractical guidelines to help review the “substance over form” principle in the SPV structure (see above Items (2) to (4) of the requisite documents above). In most cases, it may be impractical to expect to see “operation, sales, purchase, properties” at the SPV or the relationship with Non-TRE effective investor (transferor) and the Chinese investee company. Rather, we believe that MNCs should pay attention to the relevancy and sufficiency of the substance which should be commensurate with the commercial purposes, functions and risks of such an intermediate holding company.

Compliance for reporting obligation

Doubtlessly, the reporting obligation imposed on the Non-TRE transferors by Circular 698 will be burdensome.

It appears that there is no clear legal basis for the Chinese tax authorities to make Non-TRE transferor fulfill the reporting obligation simply because it transfers the shares of SPV outside China. The fact is at the time of the share transfer of the SPV, the Non-TRE transferor has yet to be assessed as a taxpayer to the China WHT. Hence the requirement of reporting may not be enforceable. Again, it is a very controversial international legal and tax issue on how far the Chinese GAAR and the SAT Circular 2 could be applied to require a Non-TRE for information disclosure.

As a practical matter, it should not be that difficult for the Chinese tax authorities to detect the occurrence of such share transfer. For instance, there could be announcements in public domains if the parties involved are some listed public companies. Also, where necessary, the Chinese tax authorities may be able to invoke the clause of exchange of information under relevant double tax treaties, or relevant Tax Information Exchange Agreement (TIEA)⁴, in order to get relevant and sufficient information from the tax authorities of the jurisdictions in concern.

Application of GAAR

Circular 698 requires that where the local-level tax bureau in charge of the Chinese investee company in the indirect transfer considers invoking GAAR provisions to disregard the SPV, the case shall be reported to its higher-level tax bureau and finally examined and approved by the SAT. This is in line with the requirement under Circular 2⁵.

As noted above, the SAT is aware of the sensitivity of this indirect transfer issue as it could cause disputes in allocation of taxing right between China and other tax jurisdictions. So controlling the invocation of GAAR to combat tax-avoidance driven indirect transfer at the SAT level is important and sensible. Also, it is an effective means to collect, analyse and share the fact patterns and experience of those investigation cases in different parts of China. However, if there would be a large number of such indirect transfer cases, then it remains to be seen how the SAT and local-level tax bureaus would enforce it.

Circular 698 is made effective retrospectively back to 1 January 2008. We understand that there have been some investigation cases initiated at the local levels before Circular 698. We believe that the local-level tax bureaus would rely on Circular 698 to pursue their challenges against the Non-TRE transferors.

⁴ China has concluded her first two Tax Information Exchange Agreements with Bahamas and British Virgin Islands respectively in December 2009.

⁵ Article 97 of Circular 2 states that “All general anti-avoidance investigations and adjustments must be submitted step-by-step upward to the SAT for approval”.

Group restructuring

We anticipate that Circular 698 would cause inconvenience, uncertainty or even disputes to MNCs who need to undertake indirect transfer outside China in the course of group restructuring on a global basis or regional basis. In such case, the Non-TRE transferors may still need to observe the reporting obligation in Circular 698, and hence to justify the commercial purposes and substance for the SPVs.

Circular 698 does not specifically address the indirect transfer taking place in group restructuring but just briefly refers it to another circular Caishui (2009) No. 59 (“Circular 59”) jointly issued by the SAT and the Ministry of Finance. It is not clear whether such reference is made for indirect transfer, or just direct transfer.

Our Suggestions

Need for action NOW

We have witnessed more and more efforts in attacking SPV structures for tax avoidance in the international tax arena, e.g. the Indian Vodafone case, OECD tiered list, and US draft Bills, just to name a few. The SAT does not see any reasons why China should treat such SPV structures for tax avoidance more leniently. Also the recent trend of the Chinese tax rules and regulations issued by the SAT and the investigation efforts taken by the local-level tax bureaus has demonstrated the Chinese tax authorities’ strong determination to combat anti-tax avoidance arrangements.

The Chinese tax authorities are taking actions now, and thus there is no reason for MNCs to simply wait and see. In view of the above, we believe it is time for MNCs to do something than nothing in relation to their investments in China. MNCs are highly recommended to review its current and contemplated investment structures, assess the potential tax exposures, take necessary actions to mitigate the tax risks, get prepared for sound commercial reasons to substantiate the arrangements, etc.

As said above, the SAT circulars have put so much emphasis on “substance”. It may be easy to appreciate the need of having substance in the SPVs, but how to implement? Unfortunately, the Chinese tax authorities have just provided some general and impractical guidelines on substance for SPVs in Circular 698 at this stage. However, it is time for MNCs to think about and take actions on this issue as to what, how, when, and where to build “substance” into the SPVs which are commensurate with their commercial purposes, functions and risks.

Overall Considerations

In addition to “substance”, there are also other factors to consider for the indirect transfer and its associated investment holding structure, e.g. treaty protection, accounting considerations, etc. Overall, we believe the following issues should be considered with respect to the contemplated equity transfers as well as the previous transfers occurred in 2008 and 2009:

- (i) Is it feasible to reflect “substance” in the SPV holding Chinese investments?
- (ii) What, how, when, and where to build “substance” into the SPVs?
- (iii) Is the structure entitled to treaty protection against Chinese tax on transfer gains? If yes, is the structure well maintained?
- (iv) What documentation is or should be in place for the SPV investment structure as well as the indirect transfer?
- (v) In case of transfer of an SPV between two unrelated parties, what shall be the considerations for the selling side and the buying side to protect their best interest against subsequent China tax exposures?
- (vi) Is it an option to seek assistance from Competent Authority to deal with the SAT in case the double taxation situation?
- (vii) What will be the potential Chinese tax implications from a tax accounting perspective? What are the considerations for investors subject to US FIN48 requirements?

Having said the above, it is definitely not a straight forward task to do given the lack of clear rules and the complexity of the issue. We have been following up on this topic very closely with the SAT. We will keep you updated of significant development on this topic.

In the context of this News Flash, China or the PRC refers to the People's Republic of China but excludes Hong Kong Special Administrative Region, Macao Special Administrative Region and Taiwan Region.

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