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Tax
Issue P95/2009 – 19 December 2009

Tax Analysis

PRC Tax
International and M&A Tax Services

China Wants to Impose Tax on the Sale of Foreign Company Owning Investment in China - A Trend or an Exception?

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The Chinese State Administration of Taxation (SAT) released a circular (Guoshuihan No. 698 – Circular 698) on 15 December 2009 that addresses the transfer of shares by foreign nonresident companies. This is the first guidance since the government issued the M&A tax rules, "Enterprise Income Tax Treatment of Enterprise Restructuring Transactions" (Caishui [2009] No. 59) in May 2009. Circular 698, *which is effective retroactively to 1 January 2008*, will have a significant impact on many companies that use offshore holding companies to invest in China.

Highlights of Circular 698

- Capital gains tax may be imposed on the sale of a PRC resident enterprise by a nonresident company (i.e. a direct transfer) and, in certain cases, on the sale of an offshore intermediary holding company owning a Chinese resident enterprise (i.e. an indirect transfer).

- Circular 698 will not apply to the sale on a public securities market of an equity interest in a Chinese resident enterprise by a nonresident enterprise, where the equity interest was also acquired on a public securities market by the nonresident enterprise.

- If the withholding agent fails to fulfill its withholding obligations with respect to the equity transfer, the nonresident will be required to file and remit enterprise income tax within seven days after the date of the equity transfer as stated in the legal contract or agreement.

- Gain on the equity transfer will be determined based on the difference between the consideration for the transfer and the cost of the equity interest, without taking into account any undistributed profits and reserves of the Chinese resident enterprise being transferred.

- The cost of the equity interest will be the original purchase price paid for the equity interest, or the amount invested in the Chinese resident enterprise. If multiple investments were made by the nonresident enterprise, the currency of the initial investment will have to be used and a weighted average method adopted to determine the cost of the equity interest.

- If the actual tax burden in the jurisdiction of an offshore intermediary holding company being transferred is less than 12.5%, or if the jurisdiction in which the offshore intermediary holding company resides provides an income tax exemption for foreign-source income, the nonresident investor will be

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subject to a documentation requirement. The nonresident will be required to submit all relevant documentation on the equity transfer and the relationship between the nonresident and the offshore intermediary holding company to the Chinese tax authorities within 30 days after the equity transfer agreement is signed.

- Using the "substance-over-form" principle, the Chinese tax authorities may disregard the existence of an offshore intermediary holding company if it lacks business objectives and was established for the purpose of avoiding tax.

- As noted above, Circular 698 will take effect retroactively as from 1 January 2008.

Observations

Circular 698 is an unusual undertaking with respect to taxing foreign companies on gains derived from the indirect sale of a Chinese company. Since the Chongqing Tax Bureau imposed tax on the indirect sale of a Chinese resident company in 2008, there has been considerable speculation as to whether the SAT would formally adopt this position. Circular 698 confirms that the SAT has done so.

Although Circular 698 makes it clear that the Chinese government intends to tax indirect transfers, many uncertainties still need to be clarified. It is unclear how the 12.5% effective tax rate of the offshore intermediary holding company is to be determined; for example, will the minimum 12.5% rate criterion be met if the jurisdiction of the intermediary company has a tax rate higher than 12.5% but does not tax capital gains? In the case of a direct transfer of a Chinese resident enterprise by a foreign entity, the SAT will easily be able to identify the transferee as the withholding agent; this will be more difficult in the case of an indirect transfer of a Chinese resident enterprise. It is unclear how the tax bureau will enforce taxation of such offshore transfers in practice. Where transactions involve a large group of companies in a global merger or acquisition, the requirement to disclose all of the information concerning the transaction may create an overwhelming administrative burden and involve the submission of information that will be irrelevant. From the buyer's perspective, the impact and consequences of a seller's noncompliance are not entirely clear.

Circular 698 provides very tight timelines with respect to the withholding obligation and the submission of documentation. If the withholding agent fails to file and remit the enterprise income tax related to the equity transfer, the nonresident enterprise only has seven days to ensure full compliance. From a practical perspective, this could create major issues for the nonresident because consideration for an equity transfer is often not even finalized within seven days after the close of the transaction. Further, Circular 698 does not provide any guidance for situations in which there may be purchase price adjustments after the seven-day period. Cash flow can also become a potential concern for a nonresident investor if the capital gains tax is due even before the proceeds from the transfer are received.

It is also interesting that the method to be used to calculate the proceeds from an equity transfer require the use of the currency on the initial investment rather than the Renminbi amount of the investment. If the nonresident has multiple investments in different currencies at different times, the calculation can become extremely complicated with the application of different exchange rates and the use of the weighted average method as required by Circular 698.

Where the offshore intermediary holding company is in a low-tax jurisdiction or a jurisdiction that does not tax foreign-source income, Circular 698 requires the submission of extensive documentation on the indirect transfer within 30 days. The documents required are not limited to the agreements specifically related to the transfer, but also include supporting documents detailing the relationship between the nonresident investor and the offshore holding company. If the transaction involves multiple transfers of onshore and offshore companies, the SAT requires the disclosure of details related to the entire transaction, which could potentially involve information on entities that are not relevant to the Chinese enterprise. This will likely create a tremendous challenge and compliance burden for foreign investors. Further, the circular does not specify any time line for the in-charge tax official review process and for a final decision by the tax authorities.

The most onerous aspect of Circular 698, however, is its retroactive effect. Foreign resident investors that disposed of Chinese companies indirectly after 2007 should review their transactions to determine whether additional compliance is required.

Summary

In addition to the uncertainties described above, Circular 698 creates some legal questions as to whether the Chinese government has the right to tax foreign companies and/or require them to submit information that may or may not be relevant to Chinese enterprises. Foreign investors -- whether corporate or private equity funds -- will definitely have greater administrative and compliance burdens when using offshore companies as vehicles to invest in China. Those that have legitimate reasons to use an intermediary holding company will be at risk of being taxed or will be required to spend an inordinate amount of time to comply with Circular 698 or to demonstrate their legitimacy to avoid being taxed in China.

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