TAX IMPLICATIONS

in China of restructuring a group of companies

Restructuring a group of companies may be effected through the transfer of the shares (or participations) in a Chinese subsidiary to a parent or sister company (“direct transfer”) or the transfer of the shares of a company located outside China that holds the shares (or participations) of a Chinese subsidiary (“indirect transfer”). These alternatives are regulated differently under Chinese law. The most recent notable change is that the rulewhich, prior to 2008, permitted the transfer of shares within a group of foreign invested companies at nominal value (and therefore without incurring capital gain tax) is no longer valid. To date, there are no regulations permitting financial and tax consolidation in China.

I) Indirect transfer of Chinese subsidiaries

The transfer of a parent company holding shares (or participations) in Chinese subsidiaries does not trigger any tax consequences at the level of the Chinese subsidiaries. There are no PRC tax formalities and registration duties in connection with the transfers.

However, Article 47 of the *PRC Enterprise Income Tax Law* and Article 120 of the *Enterprise Income Tax Law Implementation Rules* state that, should any business transactions be considered to lack a bona fide business purpose (i.e. are actually carried out in order to reduce, avoid or defer taxes), the Chinese tax authorities may impose tax adjustments and the capital gain derived from such indirect transfer might be considered to be China-sourced income subject to withholding tax.

Furthermore, according to *Circular* Guo Shui Fa [2009] No.698 (“Circular No.698”), which was published on 10 December 2009 but took effect retrospectively from 1 January 2008, relevant documents shall be submitted to the tax authority in charge of the Chinese tax resident enterprise for review within 30 days of the execution date of the relevant transaction agreement where:

1. the foreign investor (the effective controlling party and non-tax resident enterprise of China) indirectly transfers the equity of a Chinese tax-resident enterprise, and
2. the overseas intermediary holding company to be transferred is established in a country/region where the effective tax rate is less than 12.5% or which does not tax the overseas income of its resident.

If the tax authority determines that the non-tax resident investor (the effective controlling party) is indirectly transferring the equity in a Chinese tax resident enterprise by means of an abusive arrangement (such as a pure holding structure established in a tax haven) which does not have a reasonable commercial purpose but is made for avoiding income tax liabilities, it may, after reporting to the higher level authorities and the State Administration of Taxation for examination, re-assess the price of equity transfer based on the economic substance and disregard the existence of the overseas intermediary holding company. In such a case, the capital gain indirectly derived from the Chinese tax resident enterprise might be considered China-sourced income and be subject to withholding tax.

Circular No.698 does not expressly specify whether it also covers the transfer of the ultimate holding company of a chain of holding companies. However, it would follow logically that Circular No.698 should also apply to such circumstance.

II) Direct transfer of Chinese subsidiaries

Since 2008, capital gains have been subject to a reduced tax rate of 10%, pursuant to Article 91 of the *Enterprise Income Tax Law Implementation Rules* (the normal rate being 20% according to Article 4 of the PRC Enterprise Income Tax Law).

Most of the tax treaties concluded by China do not cap the capital gain tax. In addition, Chinese tax authorities usually consider that no capital gain tax is due for the transfer of shares by a foreign investor holding less than 25% of its Chinese subsidiary at time of transfer, based on the usual interpretation of the articles of treaties on capital gains.

The *Circular on the handling of certain issues for enterprise restructuring* (Cai Shui [2009] No.59, the "Circular No.59") was published on 30 April 2009 and took effect retrospectively from 1 January 2008. Circular No.59 encourages restructuring through cross-shareholding, and aims to boost economic growth. Consequently, where a restructuring is effected through the transfer shares other than through a cross-shareholding, the consideration for the shares shall be at market value and, in practice, shall be equal at least to the net book value of the subsidiary. The tax authority may reassess the capital gain based on this value.

Treaty shopping, or the process whereby the shares of a Chinese enterprise are transferred to a holding company located in a country or region which enjoys a more favorable tax treaty treatment than the original investor, has become a major focus of the Chinese tax authorities. Several tax circulars and measures were published in 2009 to levy taxes on the passive and active income derived from China by non-tax resident enterprises. Such measures include the tax circulars Guo Shui Fa [2009] No.124 ("Circular No.124") and Guo Shui Han [2009] No.601 ("Circular No.601"), which seek to prevent treaty shopping. Circular No.124 requires foreign investors to undergo a prior approval procedure if they wish to benefit from tax privileges on all passive incomes (including capital gains). Upon approval, foreign investors can enjoy treaty privileges, such as the usual tax exemption for capital gains if the transfer of shares is made by a foreign investor holding less than 25% of its Chinese subsidiary.

When examining applications, tax authorities have been applying Circular No.601 to assess whether foreign investors that meet the description of "beneficial owner" may enjoy preferential tax rates for certain passive income under the relevant double taxation treaty ("DTT"). A "Conduit company" (such as a pure holding structure with no commercial purpose) cannot enjoy such DTT tax rates. Circular No.601 also provides for several circumstances according to which the "beneficial owner" status will be probably denied; for instance, where an intermediary company allocates more than 60% of the dividends received from its subsidiary in China to another tax resident of a third country within 12 months.

Contact details:

Emmanuel Meril
T +86 21 6289 6363
F +86 21 6289 9696
E emmanuel.meril@shanghai.cmslegal.com

Nicolas Zhu
T +86 21 6289 6363
F +86 21 6289 9696
E nicolas.zhu@shanghai.cmslegal.com