Chinese tax authorities getting more aggressive towards offshore share transfers

by Charlie Sun

On 8 June 2010, the official website of a local level Chinese State Tax Authority in Jiangdu ('Jiangdu STA') of Jiangsu Province published a case which they have recently handled. In the Jiangdu case, a well-known US PE fund was required to pay Chinese withholding tax of US$25m on the gains derived from an offshore share transfer. The PE fund had sold to a US buyer its shares in its 100 percent Hong Kong subsidiary which in turn held 49 percent equity in a Chinese joint venture. The Jiangdu STA claimed that the Hong Kong company is a mere 'shell company' established solely for the purpose of avoiding Chinese tax. With the endorsement from the PRC State Administration of Taxation (SAT), the Jiangdu STA looked through the offshore structure and denied the existence of the Hong Kong company. They regarded the offshore share transfer as an actual transfer of the equity interests in a Chinese company, which means that the relevant gains are PRC sourced and shall be subject to PRC tax.

This is not the first case where a non-tax-resident enterprise was taxed in China for transfer of shares in an offshore intermediary company. In November 2008, the Chongqing STA adopted a similar position in a case where a Singaporean company sold its shares in its 100 percent subsidiary in Singapore which held 31.6 percent shares in a PRC company.

The above two cases deliver a strong signal that the Chinese tax authorities now seem to get really serious regarding offshore share transfers which in their substances are actually transfers of equity interests in China.

In both cases, the SAT encouraged the local STAs to make investigations on the business substance of the offshore intermediary companies and take the 'substance-over-form' attitude when analysing the offshore holding structure. In both cases, the local STAs found out that the offshore intermediary companies had no employees, no assets (other than the investment in the Chinese companies) and liabilities, no other investment and no other business. In the Jiangdu case, the Jiangdu STA also visited the website of the US buyer, which had announced that they had recently acquired the Chinese company from the PE fund without mentioning the Hong Kong company. This fact also convinced the Jiangdu STA that the interposing of the Hong Kong company cannot be justified by reasonable commercial reasons.

Legal basis – the weapon provided by Circular 698

1 January 2008 saw the enactment of the new PRC Corporate Income Tax Law ('CIT Law'). For the first time, a general anti-avoidance clause was formally included in the CIT Law system. Under such anti-avoidance clause, any transactions and legal structures aiming to reduce or avoid Chinese CIT may be denied for tax purposes, if such arrangement can not be justified by reasonable business purposes.

Further, on 10 December 2009, the SAT issued the Tax Circular No. 698 ('Circular 698'), titled 'SAT Notice on Enforcing CIT Administration regarding Income Derived by Non-Tax Resident Enterprises from Shares Transfers'. Circular 698 took effect retrospectively from 1 January 2008.

Among other issues, Circular No. 698 focuses on indirect transfer of shares in a Chinese company. In case of transfer of shares in the off-shore intermediary company which holds shares in a Chinese company, the transferor shall submit certain documents to the PRC tax authority, if the offshore intermediary company whose shares are being transferred is located in a country (or area) where: (i) the effective tax burden is lower than 12.5 percent; or (ii) no income tax is levied on offshore income of its tax residents.

If one of the above two conditions is met, according to Circular 698, the following documents must be provided by the transferor to the Chinese Tax Authority in charge of the relevant Chinese company: (i) share transfer agreement; (ii) a statement on the relationship between the foreign investor and the intermediary company in terms of funds, operation, sales and purchase, personnel, accounting and properties, etc.; (iii) a statement on the status of the intermediary company in terms of operation, personnel, accounting and properties, etc; (iii) a statement on the relationship between the intermediary company and its invested Chinese company in terms of funds, operation, sales and purchase, personnel, accounting and properties, etc.; (iv) a statement regarding the commercial purposes of establishing the intermediary company the shares in which are being transferred; and (v) other relevant documents that may be requested by the tax authority on a case by case basis.

The main purpose of the information and documentation to be submitted is to justify that the offshore intermediary company was established with reasonable commercial purposes, and not established solely for tax avoidance purposes.

On the basis of the above documents, the PRC tax authority will judge if the offshore holding structure has reasonable commercial purposes. If not, the tax authority is entitled to look-through the structure and deny the existence of the intermediary holding company, i.e., the indirect transfer of equity interests in China will be regarded and taxed as if such equity interests are directly transferred. However, if the tax authority decides to take such a position, it shall apply, level-by-level, for an approval from the SAT.

Although Circular 698 does not clearly set out the criteria under which an offshore share transfer may qualify as a taxable indirect transfer of equity interests in China, the above document list indicates what types of facts will be relevant for the Chinese tax authorities to make such a decision.

Impacts and suggestions

With the issuance of Circular 698, it can be expected that the SAT may consider taking increasing actions to enforce tax collections in offshore share transfers. The successful experiences in the Jiangdu and Chongqing cases also provide them with confidence to be more aggressive to detect and investigate similar cases.

It is common practice of international companies, especially PE funds, to interpose an intermediary company in a low tax jurisdiction to avoid Chinese withholding tax, since transferring shares in the intermediary company may cause no tax or little tax in the tax jurisdiction where the offshore intermediary company is located. After Circular 698, such tax planning ideas may no longer work smoothly in China.

In view of the above practice and regulation development, for existing investments and holding structures, foreign investors may wish to review their current holding structures and assess the risks brought by Circular 698. In order to avoid PRC tax for transfers of shares in the offshore intermediary company, actions shall be taken to build up the commercial substance of offshore intermediary companies. For future investments and holding structures, investors shall also consider the potential impact brought by Circular 698 on their exit strategies.

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