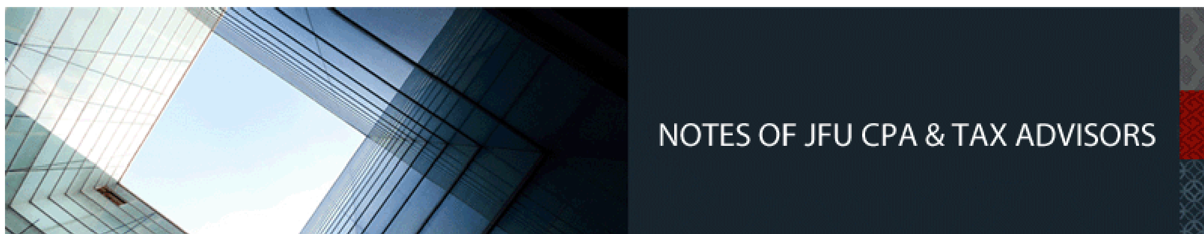
JFU | CONSULTANTS
building value on quality



Taxation of Gains from Indirect Transfer of Chinese Assets - Tax Administration Moving Towards Honor System

Source: JFU
18 February 2015

Introduction

China has the right to tax a nonresident's income sourced in China. Gains derived by a nonresident from the disposition of a valuable asset situated in China is generally taxable as China sourced income unless exempted under specific rules, such as international tax treaty provisions concerning transitional presence or portfolio assets, and domestic provisions concerning group reorganization concessions. Nevertheless, the tax administration has seen many nonresidents effecting dispositions of Chinese assets by transferring shares in foreign companies holding such assets, taking the incidence of tax offshore and thereby avoiding paying tax in China on the disposition gains.

A tax circular GSH [2009] 698 ("Circular 698") was issued by the State Administration of Taxation ("SAT") to tackle such indirect dispositions, notably imposing a mandatory obligation on sellers to return certain information as prescribed for an assessment of whether tax avoidance is involved. Taxpayers have been questioning if the administration has jurisdiction over a transaction effected entirely offshore, arguably with no incidence of tax falling on a subject of charge within China.

The SAT after lengthy deliberation issued on 6 February 2015 another circular, SAT Public Notice [2015] No. 7 ("SAT Notice 7"), to elaborate its position on the matter. The notice became effective on the date it was issued

SAT Notice 7 - The scope of charge reestablished

SAT Notice 7 did not abolish Circular 698, which attempts to tax gains from the transfer of shares in a foreign company holding equities in a Chinese company. Instead, it refines what Circular 698 seeks to do: taxing gains, otherwise avoided, accruing to nonresidents from the disposal of assets situated in China. Such gains, if not avoided, are chargeable under Article 3 of the Chinese Corporate Income Tax Law ("CITL").

SAT power to re-characterize transactions

The SAT firstly reaffirms its power to re-characterize transactions under Article 47 CITL, which deals with tax avoidance arrangements with no reasonable commercial purpose. Notice 7 then makes it clear that foreign companies deriving gains from the direct disposal of assets situated in China are taxable under Article 3 CITL, which imposes tax on foreign companies earning various forms of income sourced in China. The notice refers to such assets as "taxable Chinese assets".

Foreign companies may however enter into what can be considered tax avoidance arrangements whereby a disposal is effected indirectly. Circular 698 did attempt to identify the circumstances where

tax avoidance may exist and made it a mandatory obligation on transferors to return arrangements involving the transfer of shares in a foreign company that holds equities in a Chinese company. Where the foreign company involved is located at a place where the effective tax rate is less than 12.5%, the arrangement is likely to be considered a tax driven transaction and can be re-characterized where the commercial rationale cannot be clearly established. Tax officers, taxpayers and practitioners alike all found this approach difficult to apply in the absence of guidance on how a particular arrangement can be determined as having been entered into for tax avoidance purposes.

Reporting not mandatory but factors defined to assist with determining if tax avoidance is involved

Notice 7, now removes the mandatory reporting obligation and also defines 7 factors that should be considered in evaluating whether or not an arrangement is for tax avoidance or for a reasonable commercial purpose. The 7 factors are specified in Paragraphs 3(1) to 3(7) with Paragraph 3(8) referring to other factors relevant to the arrangement. We suppose whoever asserts any other factors outside those specified must prove their relevance in the consideration. The 7 specified factors to be considered are:

1. whether or not the value of shares in the foreign company involved is derived principally from the value of assets situated in China;
2. whether or not the assets or income of the foreign company is principally formed or derived from investments in China;
3. whether or not the functions and risks undertaken by the foreign company or its Chinese subsidiaries holding "taxable Chinese assets" can establish the fact that the corporate structure employed does have economic substance;
4. the duration of the shareholding arrangement, the business model and the corporate structure used;
5. taxability in foreign jurisdictions of gains arising from an indirect transfer of "taxable Chinese assets";
6. whether or not the direct transfer and indirect transfer are optional arrangements (supposedly referring to genuine commercial options); and
7. tax treaty provisions applicable to "taxable Chinese assets" involved.

The above factors help determine if an arrangement has a reasonable commercial purpose. Notice 7 however provided circumstances where arrangements must be regarded as having been entered into for tax avoidance purposes except for those falling into a safe haven category.

Where tax avoidance is a foregone conclusion or a safe haven is afforded

In an arrangement where <u>all</u> of the following conditions per Paragraphs 4(1) to 4(4) are satisfied, the SAT will regard the arrangement as tax avoidance, except for those falling into a safe haven category under Paragraphs 5 and 6:

1. 75% of the value of the shares in the foreign company involved is derived directly or indirectly from the value of "taxable Chinese assets";
2. 90% of the value of all the non-cash assets or income of the foreign company is derived directly or indirectly from investments in China, at any point in time, in the year before the disposal of the "taxable Chinese assets";
3. the foreign company or its subsidiaries directly or indirectly holding "taxable Chinese assets" only undertake limited functions or risks such that economic substance cannot be sufficiently substantiated; and
4. the tax effect of an indirect transfer is lower than that of a direct transfer of "taxable Chinese assets".

However in either the following circumstances, per Paragraph 5, the SAT will not seek to re-characterize a transaction giving rise to gains from an indirect transfer of "taxable Chinese assets":

1. A nonresident company derives the gains by acquiring and disposing, on the open market, the shares in a foreign company listed on an overseas exchange; or
2. If a nonresident company deriving the gains from a direct disposal of the "taxable Chinese assets" can be exempted from Chinese corporate income tax under an applicable tax treaty or similar tax arrangement.

In an intra-group arrangement where all of the following conditions per Paragraph 6(1) to 6(3) are satisfied, the SAT will regard the arrangement as one entered into for reasonable commercial purposes:

1. the transferor and the transferee are at least 80% related directly or indirectly, in terms of shareholding; a 100% relationship must exist where over 50% of the value of shares in the foreign company is derived from real properties situated in China;
2. any future indirect transfers subsequent to the safe havened indirect transfer will not be subject to less Chinese income tax otherwise chargeable without the safe havened transfer; and
3. all considerations for the intra-group transfers are settled by means of unlisted shares in related companies of the group.

Concluding remarks

Notice 7 now clearly establishes the subject of charge, and the administration's right to re-characterize tax driven transactions. The question of whether or not a transaction is tax driven can only be answered after subjecting it to a vigorous test reducing the danger of arbitrary decisions. Blatantly evasive schemes have been defined and obviously legitimate arrangements safe havened to narrow the gap for arguments. All these measures reduce ambiguity and arbitrariness, improving tax certainty.

Most importantly, the SAT takes a bold step in moving the administration towards an honor system, counting on the judgment of any parties to an indirect transfer transaction in deciding whether or not a tax liability on the disposal gain should be returned for assessment. This move may generate interesting dynamics for the parties concerned, particularly from the perspective of transferees, who will have to factor in the tax effect of not being able to step up the cost of the relevant assets in the transaction. Such calculation can be complex and behavioral consequences indeterminate. It is therefore advisable for all concerned to keep the transactions transparent in order to manage the risk upfront.

© 2015 JFU Consultants (Beijing) Limited, JFU Consultants (Hong Kong) Limited. All rights reserved. | Legal | Privacy