

# Peeling The Onion

[29th January 2010, Issue 1]

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## Peeling The Onion

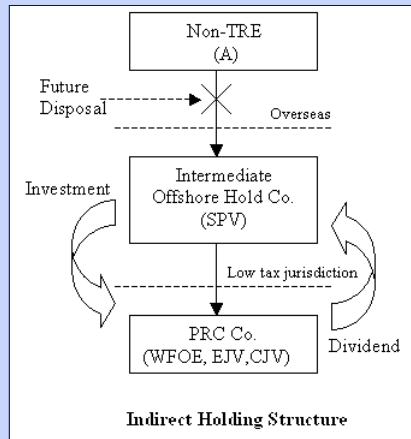
### Offshore Equity Transactions subject to PRC Tax

[29th January 2010 Issues 1]

On 10th December 2009, the State Administration of Taxation (SAT) issued Circular Guoshuihan [2009] No.698 (Circular 698) addressing tax issues for equity transfers by Non-China Tax Resident Enterprises (Non-TREs) and the circular is effective retrospectively to 1st January 2008. In this newsletter, we will elaborate Circular 698 and focus on the issues arising from "indirect equity transfer" undertaken by Non-TREs outside China.

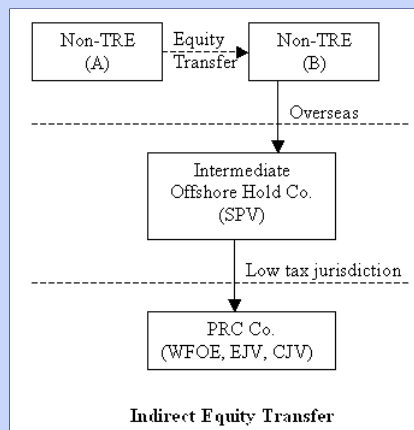
#### Indirect Holding Structure

It is common for foreign investors to use a Special Purpose Vehicle (SPV) as an intermediate holding company for their investments in China. Normally, the SPV is established in a jurisdiction that has a favorable tax treaty with China. As such, the SPV may benefit from preferential withholding tax rates under the tax treaty on dividend and other passive incomes. For example, the tax treaty with Hong Kong reduces the withholding tax rate on dividends from 10% to 5%. Second, if the foreign investor wants to dispose of the investment in China, it may sell the shares of the SPV without paying income tax in China on the capital gain from the sale. Typically, the jurisdiction where the SPV is established will also exempt the capital gain from local taxation or levy tax at a low rate. A typical indirect holding structure is illustrated as follows.



#### Indirect Equity Transfer (Offshore Equity Transaction)

A typical indirect equity transfer is as follows.



Since such transactions are purely undertaken outside China, there were no PRC tax implications for such transactions before Circular 698 came into effect.

#### Highlights of Circular 698

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China Resource Network invites  
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19th Feb 2010 Ohio

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Irish Ball 2010  
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Forum 2010  
26th Mar 2010 Beijing

LehmanBrown at the IPBA Conference  
3rd May 2010  
Singapore

Circular 698 covers the income arising from the sale of the equity interest of a resident enterprise by Non-TRE (i.e. an indirect equity transfer), excluding sale of the equity interest on a public securities market.

In the event the withholding agent fails to fulfill its withholding obligations with respect to the equity transfer, the Non-TRE will be required to file and pay the related Corporate Income Tax within seven days after the date of the equity transfer as stipulated in the equity transfer contract or agreement.

Gain on the equity transfer will be calculated based on the difference between the consideration for the transfer and the cost of the equity interest, and any undistributed profits and reserves of the PRC resident enterprise being transferred should not be deducted from the consideration for capital gain calculation purpose.

The cost of the equity interest will be the original purchase price paid for the equity interest or the amount invested in the PRC resident enterprise.

In case of an indirect equity transfer, if the SPV is located in a foreign tax jurisdiction with the following profiles:

- The effective tax rate of the jurisdiction is less than 12.5%; OR
- That jurisdiction does not tax foreign sourced income of its tax resident enterprises.

The following information related to the offshore equity transaction is required to be submitted by Non-TRE(A) to PRC tax authorities within 30 days upon the transfer:

1. The equity transfer contract or agreement;
2. The relationships between the Non-TRE(A) and SPV on funds, management, procurement and marketing;
3. SPV's production, management, personnel, finance and property conditions etc;
4. The relationship between SPV and PRC Co. on funds, management, procurement and marketing;
5. The proof of a reasonable business purpose on setting up SPV by Non-TRE(A);
6. Other relevant information required by the taxation authority.

By applying the "substance-over-form" principle, PRC 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.

PRC tax authorities may adjust the price for the equity transfer for PRC tax purpose in case the transfer is conducted between related parties and the transfer price is taken as not on arm's length basis.

In case the equity transfer meets the definition of Special Restructuring as stipulated in Circular Caishui (2009) No. 59 (Circular 59), the special tax treatments for Special Restructuring apply upon approval of tax authorities at provincial levels. Although Circular 59 is talking about direct transfer, the special tax treatments and the corresponding requirements would apply in case of indirect transfer as set out in Circular 698. As such, we would like to simply review the typical cross-border corporate restructuring and its PRC tax treatments based on Circular 59 in Appendix I.

#### **LehmanBrown Observations**

Circular 698 is one of the steps taken by the Chinese tax authorities in tackling various tax avoidance arrangements and transactions. Circular 698 will have a significant impact on many foreign investors that use offshore holding companies to invest in China.

As mentioned above, according to "substance over form" principle, the Chinese tax authorities shall have the power to re-characterize the nature of the indirect equity transfer and deny the existence of SPV if it lacks a business objective and was established for the purpose of avoiding tax, although practically how this could be implemented is to be seen. For instance, if a US company owns a Netherlands company, which in turn uses a holding company in Hong Kong to own a factory in China, and the US company sold the Netherlands company, how practically can the Chinese authorities trace back to Netherlands the gain, especially if the Netherlands-based company has other operations underneath it.

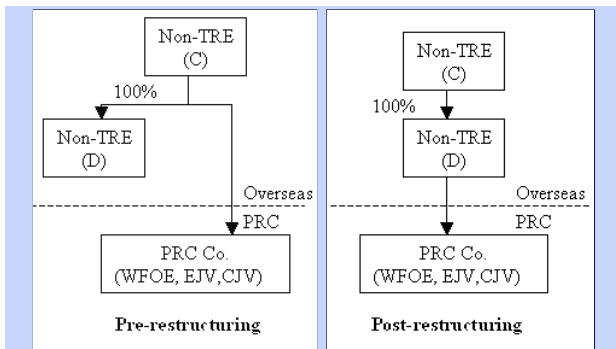
If a straight SPC situation and the transaction happens at SPV level, then it is more straight forward where the SPV would be in effect disregarded, the indirect transfer would effectively be treated as Non-TRE(A) transferring the PRC Co.'s equity, and thus the equity transfer gain is derived from China source, which should be subject to China tax. Even though in theory it appears more straight forward, in practice there are also complications, for instance, what if the holding company owns intellectual property or assets, then the value of the transaction would need to be clearly split between China-related and non-China related.

It is advisable for the enterprises that have conducted equity transfer in 2008 and 2009 to assess the associated tax risks and prepare for the potential challenges from the PRC tax authorities. Furthermore, MNCs may consider seeking professional advisories on reorganizing the holding structure of their PRC investments in light of the issuance of Circular 698.

#### **Appendix I**

##### **Cross-border corporate restructuring**

Circular 698 does not specifically address the equity transfer taking place in group restructuring but just briefly refers it to another circular Caishui (2009) No. 59 (Circular 59) jointly issued by the State Administration of Taxation and the Ministry of Finance. Hereby we would simply review the typical cross-border corporate restructuring and its PRC tax treatment.



If all the following requirements are met, then the capital gain tax could be deferred.

- Non-TRE (C) ("Transferor") transfers the equity interest in a PRC Co. to Non-TRE (D) ("Transferee"), which is 100% directly owned by the Transferor;
- The withholding tax burden on the capital gains arising from subsequent transfer of the equity interest involved shall not change as a result of the restructuring;
- The Transferor shall commit in writing not to sell the equity interest in the Transferee within 3 years after the transfer;
- The restructuring has reasonable commercial grounds and its main purpose is not for tax reduction, avoidance or postponement of tax payment;
- In an equity acquisition, the equity acquired should not be less than 75% of the total equity of the enterprise being acquired; in an asset acquisition, the assets acquired should not be less than 75% of the total assets of the enterprise that sells the assets;
- There should be no change to the original business activities within 12 consecutive months after the restructuring; and
- The deal consideration should mainly comprise of equity, i.e. equity consideration should exceed 85% of the total consideration.

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#### "Providing an alternative in China"

Peeling The Onion provides in-depth analysis of China-related business issues and aims to unravel some of the complexities faced by foreign invested enterprises in China. Peeling The Onion is produced as an extension of our regular Insights e-newsletter; both of which can be subscribed to through our website - [www.lehmanbrown.com](http://www.lehmanbrown.com).

Topic suggestions for future issues are welcomed and can be emailed to: [beijing@lehmanbrown.com](mailto:beijing@lehmanbrown.com).