

Client Alert

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China's Tax Administration Issues New Rules Governing Taxation of Offshore Indirect Transfers

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On February 3, 2015, the PRC State Administration of Taxation (“**SAT**”) released the Announcement of SAT Concerning Several Matters Relating to Corporate Income Tax on Indirect Transfer of Properties by Non-tax Resident Enterprises, Announcement [2015] No. 7 (国家税务总局关于非居民企业间接转让财产企业所得税若干问题的公告, 国家税务总局公告2015年第7号; “**Announcement 7**”). Below is a brief summary and discussion of the application of Announcement 7, which applies to indirect transfers of PRC entities or properties by offshore investors.

Announcement 7 is effective as of **February 3, 2015** and largely replaces the previous guidance in the Circular of SAT on Strengthening the Administration of Corporate Income Tax on Incomes from Equity Transfers of Non-Resident Enterprises (国家税务总局关于加强非居民企业股权转让所得企业所得税管理的通知, 国税函[2009]698号; “**Circular 698**”). It also applies to transactions that took place *before* February 3, 2015, but for which the relevant PRC tax has not yet been settled.

Announcement 7 introduces significant changes to the scope of indirect transfer transactions subject to PRC tax and the reporting and withholding obligations of the parties to an indirect transfer transaction.

APPLICATION OF ANNOUNCEMENT 7

Circular 698 only applied to the indirect transfer of equity interests in PRC entities. Announcement 7 expands the scope of indirect transfers to include transfers of (i) property rights of an “establishment or site” (which is similar to the concept of a “permanent establishment”) in China, (ii) real property in China, and (iii) equity investments in Chinese resident enterprises (collectively, “**Taxable Property**”). Thus, Announcement 7 captures not only share or other equity transfers as Circular 698 did, but also transfers of other forms of interest.

An indirect transfer of Taxable Property under Announcement 7 is defined as a transfer by a non-resident company (“**Seller**”) of an equity interest or other similar right or interest in another offshore enterprise (“**Target**”) that in turn directly or indirectly holds Taxable Property, which effectively has the same or a similar effect to a direct transfer of such Taxable Property.

REASONABLE COMMERCIAL PURPOSE

Under Announcement 7, an indirect transfer is regarded as a direct transfer of Taxable Property and subject to PRC tax if, among other things, the transfer lacks “a reasonable commercial purpose”.

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While Announcement 7 provides that the tax authorities should take into account all relevant arrangements in connection with an indirect transfer of Taxable Property in determining whether the transfer lacks a reasonable commercial purpose, it specifically highlights a list of factors that would be “comprehensively analyzed,” including:

- whether the value of Target is mainly derived (directly or indirectly) from Taxable Property;
- whether the assets of Target mainly consist of direct or indirect investments situated in China, and whether its revenue is mainly sourced directly or indirectly from China;
- whether the actual functions performed and risks assumed by Seller (and its affiliates that directly or indirectly hold Taxable Property, i.e. Target) could demonstrate that the enterprise structure has economic substance;
- how long the shareholders, operation model and relevant corporation structure of Target are in existence;
- whether the indirect transfer is taxable in the offshore jurisdictions and the relevant tax liabilities;
- the substitutability of indirect investment or indirect transfer of Taxable Property, and direct investment or direct transfer of Taxable Property, etc.;
- how a tax convention or arrangement of China will apply to such indirect transfer of Taxable Property; and
- other relevant factors.

While these factors appear to still heavily focus on the substance of the offshore enterprise, certain factors such as the substitutability of indirect transfer and direct transfer seem to look beyond the operations of the offshore enterprise to the commercial reasons behind the entire corporate structure.

Announcement 7 also specifies the conditions under which a transaction will be deemed to lack a reasonable commercial purpose and grants a safe harbor under certain qualifying circumstances, including transfers in the public securities market and certain intragroup restructuring transactions.

REPORTING OF THE TRANSACTION

Previously, under Circular 698, Seller is *required* to submit a report of an indirect transfer transaction to the PRC tax authority.

Under Announcement 7, reporting is *voluntary* rather than mandatory. Presumably, a party will elect not to report only if it is confident that there will not be taxes payable under Announcement 7.

In addition, under Announcement 7, a report may be submitted by buyer of an equity interest in Target (“**Buyer**”), Seller, or the underlying PRC subsidiaries.

From Buyer’s perspective, it should have an incentive to report the transaction under Announcement 7 since this mitigates their risk of being subject to penalties for not withholding or under-withholding taxes on the transaction, as described below.

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WITHHOLDING THE PAYMENT OF TAXES

Previously, under Circular 698, there is no requirement for Buyer to withhold any taxes, or for Seller to remit any taxes to the PRC tax authority. Generally, taxes were only due on an audit or examination. Under Announcement 7, the tax liability arises on the date when the equity transfer contract/agreement takes effect and the transfer of equity interest in Target is completed (the “**Relevant Date**”).

Under Announcement 7, *Buyer is required to withhold the applicable taxes* and submit them to the PRC tax authority. Announcement 7 does not specify exactly when Buyer must submit the withheld taxes, although presumably it must be done shortly after the Relevant Date (e.g. 7 days after the Relevant Date – see Seller’s obligations below).

If Buyer does not withhold (or under-withholds), then Seller is required to report the transaction to the PRC tax authority and pay the applicable taxes within 7 days after Relevant Date. Seller must also submit documents showing the calculation of the sales proceeds and the amount of taxes payable. Further, if Seller fails to pay tax in full within the prescribed time limit, it is subject to late payment interest calculated daily, applying the benchmark rate published by the People’s Bank of China if Seller has reported the transaction within 30 days after the signing date of the transaction document. If Seller has not so reported, the daily interest rate is the benchmark rate plus 5%.

If Buyer does not withhold (or under-withholds), and Seller fails to pay the tax, then the PRC tax authority may impose penalties on Buyer. Generally, the penalties range from 50% to 300% of the unpaid taxes.

However, Announcement 7 states that if Buyer has reported the transaction within 30 days after the signing date of the transaction agreement, Buyer may be exempted from or receive reduced penalties.

THINGS TO WATCH FOR

Generally, the “applicable taxes” on an indirect transfer is 10% of the capital gains on the transaction. Capital gains are generally calculated as (i) the sales proceeds *minus* (ii) Seller’s tax basis in the transferred equity or property.

Although Announcement 7 requires Buyer to withhold the applicable taxes, it does not specify how Buyer must obtain the information necessary to calculate the applicable taxes or whether Buyer is allowed to rely on information provided by Seller. For example, if Seller fails to disclose pertinent information to Buyer for the purpose of calculating the applicable taxes, would Buyer still be subject to penalties for any under-withholding of taxes? In addition, what if the parties disagree on whether the transaction is subject to taxation under Announcement 7? These questions remain unanswered, and it will be interesting to see how SAT will address these issues in implementing Announcement 7 and in subsequent guidance.

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