How China Taxes Indirect Transfers

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On 6 February 2015, China’s State Administration of Taxation (SAT) issued Public Notice [2015] No. 7 (Public Notice 7) which deals with indirect transfers of Chinese taxable assets. It substantially replaces both Circular 698 and Bulletin 24 and introduces new tax liabilities and responsibilities which are significantly different from the previous rules. Public Notice 7 has retroactive effect to 1 January 2008, and thus affects indirect transfers of shares in Chinese companies which have not yet been decided upon by the Chinese tax authorities. Public Notice 7 may have a bearing on the sale of hotel properties or hotel operating subsidiaries in China if they are to be transferred along with their foreign holding company, where the seller sells the shares of the foreign holding company to a third party buyer. Internal reorganisations, however, may be exempt from Chinese income tax. Public Notice 7 has some positive and quite a number of negative aspects which are discussed below.

What is Public Notice 7 about?

If a foreign investor sells or reorganises shares (and equity-like interests) in another foreign company (“Foreign Company”) which directly or indirectly holds Chinese taxable assets, and if this effectively has a similar effect to directly transferring these Chinese assets, then any gain attributable to the Chinese assets will be subject to Chinese income tax if the manner in which the sale or reorganisation is conducted does not have a bona fide commercial purpose. There will be no income tax liability if the manner in which the transfer is conducted has a bona fide commercial purpose.

Unlike previously, Chinese taxable assets now include (1) assets attributable to an establishment in China, (2) immovable property in China and (3) shares in Chinese resident companies. Items 1 and 2 are new items which have been brought within the scope of the Chinese income tax triggered by an indirect transfer.

What happens if the indirect transfer lacks a bona fide commercial purpose?

The gain from an indirect transfer of the property of an "establishment or place" situated in China will be treated as income that is effectively connected with that "establishment or place" and thus, subject to 25% Chinese income tax. If the gain relates to an indirect transfer of real property situated in China, or to an indirect transfer of equity interests in Chinese resident companies, it will be treated as China-sourced income and be subject to 10% withholding tax.

Positive aspects of Public Notice 7

Unlike Circular 698, Public Notice 7 no longer imposes an obligation on the transferor to report the transfer to the Chinese tax authorities. However, if the transferor does not report the transfer and it transpires that the transfer is subject to income tax because it lacks sufficient bona fide commercial purpose, then the transferor will be subject to severe penalties.

A sale of shares of the Foreign Company through normal trading on a stock exchange is exempt from the Public
Notice 7 tax liability. Also exempt are sales of shares of the Foreign Company which would have been exempt from Chinese income tax under an applicable tax treaty if the transferor sold the Chinese assets directly.

Public Notice 7 provides more guidance as to what constitutes bona fide commercial purpose. While it says that one should consider all the facts of the case, it singles out the following criteria as being of special importance: (1) whether the equity value of the Foreign Company is mainly derived directly or indirectly from Chinese taxable assets; (2) whether the assets or income of the Foreign Company are mainly derived directly or indirectly from Chinese taxable assets; (3) whether the functions performed and risks assumed by the Foreign Company and its direct and indirect subsidiaries that hold Chinese taxable assets can justify the economic substance of the organisational structure; (4) whether foreign income tax is paid on the indirect transfer; (5) whether and how a tax treaty applies to the indirect transfer; (6) the length of time that the shareholders, business model and the organisational structure of the Foreign Company have been in existence; (7) whether it would have been possible for the transferor to directly invest in, and directly transfer the Chinese taxable assets, instead of doing so indirectly.

Public Notice 7 gives clarity when an indirect transfer is deemed to lack sufficient bona fide commercial purpose. If all the following criteria are satisfied (1) 75% or more of the equity value of the Foreign Company is derived directly or indirectly from Chinese taxable assets (2) 90% or more of the asset value (excluding cash) or the income of the Foreign Company is derived from investments in China during any moment within one year prior to the indirect transfer (3) the functions performed and risks assumed by the Foreign Company and any of its direct or indirect subsidiaries are limited and insufficient to justify the economic substance of the organisational structure (4) the income tax paid on the indirect transfer in both the country of the transferor and the country where the Foreign Company is established is lower than the Chinese income tax if a direct transfer of the Chinese taxable assets would have taken place.

Public Notice 7 contains a safe harbour for qualifying internal reorganisations. The following three conditions must be satisfied: (1) the transferor and transferee are related companies, either because one owns at least 80 percent of the equity of the other, or a third party owns at least 80 percent of both transferor or transferee (if it concerns immovable assets in China, the test is not 80 percent but 100 percent) (2) the new holding structure created after the reorganisation should not result in a lower Chinese income tax liability if the Foreign Company would be transferred (3) the transferee acquires the equity of the Foreign Company by either issuing its own equity or equity of a company controlled by the transferee (this excludes publicly traded stock).

Public Notice 7 provides better protection for taxpayers and clarity on procedure if the Chinese tax authority wants to tax an indirect transfer. They must first obtain prior approval from the SAT on all major steps of an investigation and they must give the taxpayer an opportunity to appeal against an adjustment decision before this decision can be finalised.

**Negative aspects of Public Notice 7**

The scope of situations affected by Public Notice 7 now includes Foreign Companies directly, or indirectly, owning Chinese immovable assets and assets attributable to an establishment in China. Previously it only included the transfer of equity in a Foreign Company which directly, or indirectly, owns equity in a Chinese company.

If the indirect transfer lacks bona fide commercial purpose, both the transferor, the transferee and the Chinese company whose equity is indirectly being transferred have a reporting obligation, failing which penalties will be due. Under the previous rules, only the transferor had a reporting obligation. This raises a serious practical challenge for the purchaser, who is often unable to assess whether the transfer is subject to Chinese income tax and what the amount of the tax liability is.
The party acquiring the equity in the Foreign Company, or its paying agent, is primarily responsible for paying the Chinese tax in the event the transaction lacks bona fide commercial purpose, failing which the transferor will be liable to pay the Chinese income tax. If the transferor fails to pay the income tax, the party acquiring the equity in the Foreign Company will be liable for the income tax due plus a penalty. The penalty could range between 50 percent and 300 percent of the income tax liability, subject to a waiver or reduction of the penalty if the acquirer reports the transaction within 30 days after the date of the transfer. In addition, the transferor will be liable to a penalty if neither the transferee, or the transferor, have paid the income tax on the transfer. The offshore seller has an obligation to file a tax return and pay tax within seven days from the date when the tax liability arises if the purchaser (or its withholding agent) fails to withhold the tax. If the offshore seller fails to pay the income tax in full within the prescribed time limit, the offshore seller is subject to a daily interest rate equal to the benchmark RMB lending rate published by the People's Bank of China plus five percentage points. For the indirect transfer of the property of an "establishment or place" situated in China, the "establishment or place" must include the capital gains in its taxable income of the tax year.

Regrettably, the Chinese tax authority has no obligation to make a determination on taxability. In most cases, the offshore seller and the "establishment or place" are not able to determine whether the indirect transfer is taxable in China within the prescribed time limit. As Public Notice 7 does not address this point, there is uncertainty whether the tax authorities will recognise the tax paid in prior indirect transfers when determining the tax basis in subsequent direct or indirect transfers.

In conclusion

Although Public Notice 7 seems to suggest that only those situations will be taxable where the value, or income producing capacity, of the Chinese assets exceeds that of any non-Chinese assets included in an indirect transfer, there is, unfortunately, still uncertainty how this will play out if one, or more, intermediary holding companies in a structure are relatively passive companies. It is not helpful that the SAT is not required to state its view as to whether an indirect transfer is taxable or not. This presents significant risks for the buyer and uncertainty for the seller. If an indirect transfer of Chinese assets lacks sufficient bona fide commercial purpose, the seller is still liable for the income tax liability on the sale and he is required to report the same to the SAT. What is new is that the purchaser now has a withholding and reporting obligation and can be liable if the seller does not pay the tax. This is problematic as there will now need to be an overt discussion on the amount of the tax that is to be paid and therefore, the amount that is withheld (or held in escrow), previously something that sellers in practice were generally very reluctant to discuss with purchasers.

Purchasing parties will need to amend their Sale and Purchase Agreements to reflect the new withholding and reporting obligations in order to protect themselves when they acquire assets which are subject to Public Notice 7. We have typically advised purchasers to agree in advance on an informal basis with the tax authorities what the tax liability is and withhold that amount from the purchase price. In addition, the purchaser needs an indemnity from the seller if the taxable amount is higher than the original estimate.

Investors should keep sufficient evidence on record to substantiate the reasonable commercial purpose criteria, including minutes of board of directors meetings, shareholders meetings and correspondence with the Chinese tax authority, if any.

1. Generally, nowadays, it is not permissible for Chinese real property to be owned by a foreign incorporated company as real property must generally be held by a Chinese incorporated company. Public Notice 7 would apply if the foreign seller would sell the shares of the foreign holding company owning the Chinese property company.
The documents required to voluntarily report the indirect transfer include: (i) equity transfer agreement, (ii) corporate ownership structure charts before and after the equity transfer, (iii) prior two years of financial and accounting statements for all intermediate holding companies, and (iv) a statement that the indirect transfer is not taxable.

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