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SAT issues new rules on indirect transfers of assets by nonresident enterprises

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On 6 February 2015, China's State Administration of Taxation (SAT) issued new guidance (Bulletin [2015] No. 7, "Bulletin 7") on the PRC tax treatment of an indirect transfer of assets by a nonresident enterprise. Bulletin 7 is the latest regulatory instrument on indirect transfers and follows two previous sets of guidance issued in 2009 and 2011: the "Notice on Strengthening the Administration of Enterprise Income Tax on Income from the Transfer of Shares by Nonresident Enterprises" (Guoshuihan [2009] Circular No. 698, "Circular 698") and the "Bulletin on Several Issues Concerning the Administration of Income Tax on Nonresident Enterprises" (Bulletin of SAT [2011] No. 24, "Bulletin 24").

Under Circular 698, a nonresident enterprise transferring shares in an offshore intermediary enterprise that directly or indirectly holds an equity interest in a PRC enterprise are subject to PRC tax on the gains from the transfer if the PRC tax authorities determine that the arrangement lacks a *bona fide* commercial purpose and re-characterize the indirect transfer as a direct transfer of the PRC enterprise. Bulletin 24 clarifies certain aspects of the rules in Circular 698.

Bulletin 7 does not replace Circular 698 and Bulletin 24 in their entirety. Instead, it abolishes certain provisions and provides more comprehensive guidelines on a number of issues, as explained below. While Bulletin 7 is effective from the date of issuance, it also applies to transactions that took place before the date of issuance but for which the relevant PRC tax treatment has not been decided upon by the Chinese tax authorities. Thus, Bulletin 7 will affect both future and past transactions.

Highlights of Bulletin 7

Scope of application

Bulletin 7 first describes when an indirect transfer by a nonresident enterprise becomes taxable in China. Article 1 states that "when a nonresident enterprise engages in an indirect transfer of assets ("Transferor"), including shares of Chinese resident enterprises, through an arrangement that does not have a *bona fide* commercial purpose in order to avoid paying enterprise income tax (EIT), the transaction should be re-characterized as a direct transfer of the Chinese assets in accordance with article 47 of the EIT Law." This description is consistent with Circular 698.

"Assets, including shares of Chinese resident enterprises" are further defined to mean three types of assets, gains on the disposal of which are subject to EIT in China when the assets are directly held by nonresident enterprises. These assets, which are collectively defined as "Chinese Taxable Assets," are:

- Assets attributed to an establishment in China;
- Immovable property in China; and
- Shares in Chinese resident enterprises.

The term "Chinese Taxable Assets" does not appear in Circular 698; the circular only makes reference to indirect transfers of shares in Chinese resident enterprises. As a result, Bulletin 7 effectively expands the scope of indirect transfers subject to PRC tax.

Bulletin 7 further clarifies the meaning of "an indirect transfer of Chinese Taxable Assets." It refers to a transfer of shares and equity-like interests ("Shares") in a nonresident intermediary enterprise that directly or indirectly holds Chinese Taxable Assets (a "Nonresident Intermediary Enterprise") that effectively has the same or a similar effect to directly transferring Chinese Taxable Assets, including a reorganization of a nonresident enterprise that results in a change in the shareholders of the Nonresident Intermediary Enterprise. Thus, the substance of a transaction must be analyzed to determine whether it can be considered to constitute an indirect transfer of Chinese Taxable Assets within the meaning of Bulletin 7.

Article 5 of Bulletin 7 specifies two situations that are not subject to the application of the Bulletin, effectively creating two safe harbors:

- 1) *Normal trading of listed shares:* Where a nonresident enterprise derives income from an indirect transfer of Chinese Taxable Assets by acquiring and selling Shares in an offshore listed enterprise on a public market; and
- 2) *Tax treaty exemption exception:* Where there is an indirect transfer of Chinese Taxable Assets, but if the Transferor directly disposed of Chinese Taxable Assets, the income from the transfer would be exempt from EIT in China under an applicable tax treaty or arrangement.

Reporting requirements

Bulletin 7 substantially changes the reporting requirements in Circular 698:

- *Mandatory to voluntary:* Under Circular 698, transactions meeting certain criteria had to be reported to the relevant PRC tax authorities. In Bulletin 7, there is no such mandatory reporting requirement for any type of transaction. Instead, a relevant party has discretion as to whether to report a transaction.
- *Expanded reporting parties:* Circular 698 imposed the reporting obligation only on the Transferor; under Bulletin 7, however, a transaction may be reported by either party to a transaction or by the PRC enterprise whose shares are to be indirectly transferred. Further, Bulletin 7 makes it clear that the PRC tax authorities may request information about an indirect transfer from any of these parties, or from a person that participated in the planning of a transaction. This is a significant change that could affect the duties of tax advisors.

Determination of a bona fide commercial purpose

As compared with Circular 698, Bulletin 7 provides more detailed guidance on how to determine a *bona fide* commercial purpose. Bulletin 7 lists specific factors that need to be considered; describes a “blacklisted” situation in which a transaction will be deemed to lack a commercial purpose; and grants a safe harbor for qualifying group reorganizations (discussed below).

Factors to be considered: Article 3 of Bulletin 7 specifies that all arrangements related to an indirect transfer of Chinese Taxable Assets must be taken into account and lists a number of specific factors to be considered:

- Whether the equity value of the Nonresident Intermediary Enterprise is mainly derived directly or indirectly from Chinese Taxable Assets;
- Whether the assets of the Nonresident Intermediary Enterprise mainly consist directly or indirectly of investments in China or whether the income of the Nonresident Intermediary Enterprise mainly consists directly or indirectly of income sourced from China;
- Whether the functions performed and risks assumed by the Nonresident Intermediary Enterprise and its direct or indirect subsidiaries that hold Chinese Taxable Assets can justify the economic substance of the organizational structure;
- The length of time the shareholders, business model and relevant organizational structure of the Nonresident Intermediary Enterprise has been in existence;
- Whether foreign income tax is paid on income from the indirect transfer of Chinese Taxable Assets;
- Whether it would have been possible for the Transferor to directly invest in and directly transfer the Chinese Taxable Assets rather than indirectly invest in and indirectly transfer the Chinese Taxable Assets; and
- How a tax treaty or an arrangement applies to the indirect transfer of the Chinese Taxable Assets.

Blacklisted transactions: A transaction will be deemed to lack a *bona fide* commercial purpose and thus be subject to PRC tax under Bulletin 7 if *all* of the following conditions are satisfied, unless the safe harbor for qualifying group reorganizations applies:

- 75% or more of the equity value of the Nonresident Intermediary Enterprise is derived directly or indirectly from Chinese Taxable Assets;
- At any time during the one year before the indirect transfer of Chinese Taxable Assets takes place, 90% or more of the asset value of the Nonresident Intermediary Enterprise (excluding cash) is comprised directly or indirectly of investments in China, or 90% or more of its income is derived directly or indirectly from China;
- The functions performed and risks assumed by the Nonresident Intermediary Enterprise and any of its subsidiaries that directly or indirectly hold the Chinese Taxable Assets are limited and are insufficient to prove their economic substance; and
- The foreign tax payable on the gain derived from the indirect transfer of the Chinese Taxable Assets is lower than the potential Chinese tax on the direct transfer of such assets.

The Interpretation Notes accompanying Bulletin 7 clarify that the foreign tax to be taken into account in the fourth bullet includes tax imposed by the country where the Transferor is located, as well as tax levied by the country where the Nonresident Intermediary Enterprise resides.

Safe harbor for qualifying group reorganizations

Article 6 of Bulletin 7 provides for a safe harbor for indirect transfers resulting from qualifying group internal reorganizations. An indirect transfer that satisfies *all* of the following three conditions will be deemed to have a *bona fide* commercial purpose and thus will not be taxable under Bulletin 7:

- 1) The Transferor and the transferee are qualifying related enterprises, which will be the case if any of the following applies:
 - The Transferor directly or indirectly owns 80% or more of the shares in the transferee;
 - The transferee directly or indirectly owns 80% or more of the shares in the Transferor; or
 - 80% or more of the shares of both the Transferor and transferee are directly or indirectly owned by the same shareholder.Where more than 50% of the value of the equity interest of the Nonresident Intermediary Enterprise is derived directly or indirectly from immovable assets located in China, the qualifying ownership requirement will be increased to 100%.
- 2) After the indirect transfer ("First Indirect Transfer"), the PRC tax payable on a potential subsequent indirect transfer of the same Chinese Taxable Assets is no lower than the PRC tax that could have been payable on a similar or an identical indirect transfer if the First Indirect Transfer did not take place; and
- 3) All the consideration paid by the transferee must consist of its own shares or shares of a related enterprise with which the transferee has a controlling relationship (excluding shares of listed companies).

The safe harbor for qualifying group reorganizations is welcomed but the third requirement relating to equity consideration will put some constraints on enterprises intending to utilize this safe harbor and will require careful planning. Additionally, it is unclear whether the related enterprise in the third requirement with which the transferee has a controlling relationship refers only to a subsidiary of the transferee or whether it also refers to a parent company of the transferee.

Failure to withhold and pay tax

Bulletin 7 clarifies two issues that have resulted in controversy under Circular 698: whether any party to the transaction has a withholding obligation and how the interest on the tax payable should be calculated.

Bulletin 7 imposes a withholding obligation on the payer, which in most, but not all cases, will be the transferee. Article 8 of Bulletin 7 stipulates that "an entity or individual that has a direct payment obligation to a Transferor is required to act as the withholding agent for tax payable on an indirect transfer of immovable property and shares."

Article 8 also specifies that, if a withholding agent fails to withhold tax, and the Transferor fails to pay the tax, the in-charge tax authorities may hold the withholding agent liable under the PRC Tax Collection and Administration Law, which allows for the imposition of a penalty of 50% to 300% of the unpaid tax on the withholding agent. However, article 8 provides that the penalty may be reduced or waived if the withholding agent submits the required documents within 30 days after the transfer agreement has been signed.

Where no tax has been withheld by the withholding agent and no or insufficient tax has been paid by the Transferor in a timely manner, article 13 of Bulletin 7 makes it clear that interest will be imposed on the Transferor. If the Transferor submits the required documents within 30 days after the transfer agreement has been signed or has timely paid some tax, the base interest rate will apply in computing interest; if the Transferor has failed to submit the required documents or has not paid any tax timely, the applicable interest rate will be the base interest rate, plus five percentage points. The base interest rate is the prime renminbi lending rate published by the People's Bank of China in the year to which the unpaid tax is attributed for loans having the same term as the unpaid tax.

The risk of facing a penalty should motivate the transferee in a transaction to report the transaction or at least to negotiate with the Transferor on how to protect itself against such a risk. Similarly, the higher interest rate on the Transferor in a potentially taxable transaction may provide an incentive for the Transferor to report the transaction.

Administrative measures on GAAR

On 2 December 2014, the SAT issued regulations on the application of the general anti-avoidance rule (GAAR). Since Circular 698 and Bulletin 7 are an application of the GAAR, article 11 of Bulletin 7 stipulates that the GAAR regulations should be followed when an in-charge tax authority initiates an investigation of an indirect transfer and makes an adjustment. This hopefully will improve the administration of the indirect transfer rules by the in-charge tax authorities and offer potential taxpayers more certainty and protection. For instance, according to the GAAR regulations, the in-charge tax authority must seek approval from the SAT at all major steps of an investigation and give the potential taxpayer an opportunity to appeal an adjustment decision of the in-charge tax authority before this decision can be finalized.

Comments and recommendations

Bulletin 7 provides comprehensive guidance on indirect transfers of Chinese Taxable Assets, potentially improving the administration of the indirect transfer rules by the PRC tax authorities and providing more certainty for taxpayers. Parties intending to undertake indirect transfers of Chinese Taxable Assets in the future and parties that have undertaken such transfers in the past (except for transactions that have been decided upon by the relevant PRC tax authorities) should review Bulletin 7 closely and analyze how it may affect them. This includes determining whether any remedial steps are necessary and whether any disclosure and tax provisions in the financial statements will be necessary.

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