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SAT clarifies Individual Income Tax treatment of proceeds from equity transfers

On 14 December 2010, the Chinese State Administration of Taxation (“SAT”) issued guidance ("Announcement on issues concerning the verification of the tax base relating to equity transfers by individuals" (SAT Bulletin No. 27 of 2010)) that clarifies certain issues relating to the taxation of an equity transfer (excluding transfers of the shares of listed companies) by an individual. The Bulletin is effective after 30 days from the date of issuance.

The Bulletin was released in response to some outstanding issues arising from a circular issued in May 2009 (Guoshuihan [2009] No. 285 – "Circular 285"). Circular 285 provided guidance to the local tax authorities with a view to improving the enforcement of the tax administration on equity transfers by individuals. According to the circular, where the proceeds from an equity transfer are “perceivably low” (e.g. a transfer at cost or at a discount) without a justifiable reason, the tax authority in-charge reserves the right to adjust the tax base by reference to the net asset value per share or net asset value in proportion to the shares held by the individual shareholder. Circular 285, however, only set out a legal framework with respect to the taxation of an equity transfer by an individual; it did not provide a definition or guidance on relevant terms such as "perceivably low" and "justifiable reasons," which could result in uncertainty for the tax authorities and taxpayers alike. The new Bulletin is designed to clarify these issues and includes guidance on the methodology for determining whether the proceeds are "perceivably low without a justifiable reason" and the reassessment methods available to the local tax authorities.

Highlights of the Bulletin

1. Definition of "perceivably low"

Circular 285 specifies that the local tax authorities should assess the reasonableness of an equity transfer by an individual and determine whether the transfer is commercially realistic and whether it has a bona fide business purpose. The Bulletin further emphasizes that the proceeds received by an individual from an equity transfer should be at fair market value. The proceeds may be considered as "perceivably low" in the following cases:

- The proceeds are lower than the original investment cost or lower than the aggregate of the purchase consideration and the taxes paid for acquiring the equity;
- The proceeds are lower than the value of the corresponding net assets;

- The proceeds are lower than the price that would have been obtained had the equity been transferred by a shareholder of the same enterprise under the same or similar conditions;

- The proceeds are lower than the price that would have been obtained had the equity of another enterprise in the same industry been transferred under the same or similar conditions; or

- In other circumstances as specified by the tax authority in-charge.

2. Definition of "justifiable reason"

According to the Bulletin, the following circumstances could constitute justifiable reasons if the proceeds are considered to be perceivably low:

- The investee enterprise was in a loss position for three or more consecutive years;

- The low proceeds arose from national policy or related adjustments;

- The transferee is either the spouse, parent, child, grandparent, grandchild or sibling of the transferor, or any person of whom the transferor is a legal dependent; or

- In other reasonable circumstances as specified by the tax authority in-charge.

3. Reassessment methods

If the proceeds are considered as perceivably low without a justifiable reason, the Bulletin specifies that the tax authority in-charge can reassess the tax base using the following methods:

- By reference to the net asset value per share or the net asset value in proportion to the shares held by the transferor. Where the aggregate of intellectual property, land use rights, real estate, exploration or mining rights, shares, etc. exceeds 50% of the total assets of the investee enterprise, the net asset value of the enterprise must be assessed by an appraiser.

- By reference to the price that would be obtained had the equity been transferred by a shareholder of the same enterprise under the same or similar conditions.

- By reference to the price that would be obtained had the equity of another enterprise in the same industry been transferred under the same or similar conditions.

If the taxpayer disagrees with the reassessment methods adopted by the tax authority in-charge, he/she should provide documents supporting the objection. After a proper review and examination, the tax authority may adopt another reasonable methodology for reassessing the tax base.

The Bulletin also mentions that, where an individual transfers shares acquired from others, the deductible tax base should be the aggregate of the purchase consideration and the taxes previously paid by the transferor.

Comments

With the continuing economic development in the Mainland, investments by individuals are likely to become more common and increase in popularity. However, the lack of awareness and the high mobility of individuals could create problems and uncertainty for the tax administration of individual equity transfers; the new Bulletin evidences the SAT’s intent to ensure that the administration of such transfers is effective and appropriate.

Because the pricing of an equity transfer between individuals likely will be based on factors that may be subjective, there may be differing interpretations of the reasonableness of the pricing. It is worth noting that the Bulletin seems to accept that a transfer at a price lower than cost between certain family members is commercially reasonable in the context of an individual equity transfer. Whether this position can be expanded to apply to other similar situations is unclear; for example, whether an equity transfer at cost or at a discount between an individual and an entity wholly owned by transferor's spouse / parents / children would fall within the scope of the Bulletin still needs to be clarified.

In addition, Article 8 of the PRC Individual Income Tax Laws stipulates that the transferor should be the taxpayer that bears the individual income tax liability and the payer (i.e. the transferee) should be the withholding agent. However, where an individual transfers an equity interest to a non-PRC individual or entity, whether or not the non-PRC transferee (i.e. the payer) would have the withholding obligation seems to be uncertain in practice. Even if the tax authorities believe the non-PRC transferee has the withholding obligation, there are practical difficulties for the transferee because of the absence of clear and standardized guidance. Investors should monitor local practices, as there may be disputes on whether the tax authority would demand the unpaid taxes from the non-PRC transferee or even the investee enterprise in China if the transferor does not discharge the individual income tax liability.

If you wish to receive further technical support or advice, please feel free to contact one of our tax professionals.

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