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China releases clarification rules on Circular 698

The State Administration of Taxation (the "SAT") issued Bulletin of the State Administration of Taxation [2011] No. 24 (the "Bulletin") on 28 March 2011, in which various issues regarding the tax administration for non-PRC resident enterprises were addressed. The Bulletin takes effect from 1 April 2011 and also applies to transactions that have occurred prior to its issuance for which the relevant PRC tax matters have not been dealt with. This Tax Analysis summarizes in detail the two major areas in this Bulletin: 1. Clarifications on Guoshuihan [2009] No. 698 ("Circular 698") and 2. Other non-resident tax matters.

1. Clarifications on Circular 698

Of particular significance would be the SAT's clarifications of certain aspects of the controversial Circular 698[1] in the Bulletin.

Circular 698 has been a subject of considerable controversy since its issuance on 10 December 2009, not least due to the lack of clarity in the fundamental parameters under which it would apply to non-resident enterprises. The SAT has now sought to clarify these parameters and certain other aspects of Circular 698 under Article 6 of the Bulletin. We will discuss each clause of Article 6 below:

Clause 1: If a non-resident enterprise transfers a PRC resident enterprise directly, and the relevant sales and purchase contract or agreement stipulates that the consideration of the sale is to be paid by instalments, the recognition of income from the sale should take place on the date on which the related sales and purchase contract or agreement takes effect and upon the completion of procedures in respect of the share transfer.

Clause 1 seeks to address transactions whereby consideration is paid by instalments, which are not specifically addressed in Circular 698, by clarifying the timing of income recognition. However, it does not explicitly state whether non-resident enterprises in such circumstances should have to report and pay Enterprise Income Tax ("EIT") to the local tax authorities within 7 days from the date of the share transfer or receipt of consideration, whichever is earlier, as stipulated in Article 2 of Circular 698. Further, it does not address the situation

[1] Please refer to Tax Analysis Issue P95/2009: China Wants To Impose Tax on the Sale of Foreign Company Owning Investment in China - A Trend or an Exception? dated 19 December 2009 for Deloitte's tax commentary on Circular 698.

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where the consideration or purchase price may be adjusted due to events that occur subsequent to the effective date of sales and purchase agreement and completion of share transfer procedures.

Clause 2: "Listed shares in Chinese resident enterprises bought and sold over a public securities market" as referred to in Article 1 of Circular 698 are defined as those whereby the party from whom the shares are purchased, the party to whom the shares are sold, quantity of the shares and price of the shares are not determined upfront between the buyer and seller, but are determined based on the normal trading principles of a public securities market.

The transfers of listed shares in Chinese resident enterprises bought and sold over a public securities market are not subject to Circular 698. With the above clarification, it appears that the cases whereby a non-resident enterprise purchases and sells such listed shares in Chinese resident enterprises via over-the-counter trade sales and private placements are covered by Circular 698.

Clause 3 seeks to define the three parameters stipulated in Article 5 of Circular 698, which, if a non-resident enterprise were to fall under, would be subject to Circular 698 reporting requirements.

Article 5 of Circular 698 imposes certain reporting requirements on a "foreign investor (party with effective control)" (**境外投资方 (实际控制方)**) that indirectly divests of shares in a Chinese resident enterprise by disposing of an intermediate holding company, if:

- the intermediate holding company is located in a jurisdiction where it has an effective tax burden of less than 12.5%, or
- the jurisdiction does not tax foreign-sourced income.

i. "Foreign investor (party with effective control)"

There has been considerable controversy as to what constitutes "foreign investor (party with effective control)", as Circular 698 is silent on the matter. The Bulletin has now clarified that Circular 698 reporting requirement applies to ALL foreign investors who have indirectly transferred a Chinese resident enterprise. As such, it seems to mean that even 1% indirect ownership in the Chinese resident enterprise would be subject to the reporting requirements of Circular 698. This may be much stricter than some interpretations of the rules, whereby parties without majority shareholdings (<50% or <25%) or effective control from an accounting perspective would not be subject to Circular 698. Non-resident investors which had sought to get around Circular 698 reporting requirements by contending that they do not have "effective control" over the Chinese resident enterprise would also now be obliged to comply with these requirements by virtue of the Bulletin.

ii. "Effective tax burden"

The Bulletin clarifies various interpretations of Circular 698 whereby the effective tax burden was thought to be the tax of the offshore intermediary company that is being sold, the head line tax rate of the jurisdiction in which the holding company is located, etc.

The Bulletin has clarified that the "effective tax burden" refers to the effective tax imposed on the gains on the share transfer transaction per se. Therefore, it appears that as long as the gain is taxed at a rate of not lower than 12.5% in the intermediary holding jurisdiction, the transferor would not be required to report under Circular 698.

iii. "Does not tax foreign-sourced income"

Due to the way Article 5 of Circular 698 is worded, it may be interpreted that this condition would apply if the offshore intermediary jurisdiction does not tax foreign-sourced income. The Bulletin has now clarified that this condition would apply only if foreign-sourced gains on the share transfer transaction are not taxed in the intermediary holding jurisdiction. It does not seem to cover situations whereby the offshore intermediary jurisdiction does not impose tax on other types of foreign-sourced income such as dividends and interest. However, further clarifications would be needed for jurisdictions that do not tax the capital gains by virtue of reasons such as concessions or participation exemption regimes.

Clause 4: If two or more non-resident enterprises were to undertake an indirect transfer of the equity in a PRC resident enterprise, one of the non-resident enterprises could, in accordance with Article 5 of Circular 698, report the indirect transfer to the local PRC tax bureau where the PRC resident enterprise is located.

This implies that a group of non-resident investors can decide on one investor to undertake Circular 698 reporting filing on behalf of the other investors. Given that the Bulletin requires all investors to comply with Circular 698, this should serve to reduce the overall administrative burden, especially for those investors with minority interests. As a result of this, investors should be aware of this requirement in their sales and purchase agreement discussions and agree on an appropriate mechanism to elect an investor to fulfil the Circular 698 reporting obligations on behalf of the other affected investors.

Clause 5: If a non-resident enterprise were to undertake an indirect transfer of two or more PRC resident enterprises located in different provinces (cities), the non-resident transferor could choose to report the indirect transfer to any one of the local PRC tax bureaus in those provinces (cities). The chosen PRC tax bureau would liaise with the other relevant PRC tax bureaus to assess whether the non-resident enterprise should be subject to EIT on the transaction and report to the SAT. If the non-resident enterprise were assessed to EIT, it will have to pay the tax due to all the relevant PRC tax bureaus.

This should resolve the uncertainty as to which local PRC tax bureau should be approached in cases whereby a group of PRC resident enterprises (established in different locations) is disposed as part of an indirect transfer.

2. Other non-resident tax matters

Apart from matters relating to Circular 698, Articles 1 to 5 of the Bulletin also provide clarifications on a host of other matters that concern the taxation of non-residents. These are discussed below:

Article 1 - Timing of withholding tax

The Bulletin has helped to provide more certainty in the timing of withholding tax on payments, in the event of different contractual payment and actual payment dates. For example, a PRC enterprise may pay income such as interest, rent or royalties to a non-resident enterprise under a relevant contract or agreement. The PRC enterprise may not actually make such payments in accordance with the contract or agreement, or may delay payment due to changes or amendments made to the contract or agreement. However, if the PRC enterprise were to book that expense in its accounts and claim a deduction for the expense in its EIT return filed for that tax year, it would have to withhold tax on the related income (payable to non-resident enterprise) when filing its EIT return for that tax year.

The PRC enterprise may also capitalize the interest, rent or royalties in the cost of an asset or pre-operating expense and only claim deductions for the depreciation or amortization expenses in future periods after the asset has been put to use or business operations commence. In such cases, the PRC enterprise should withhold tax on the income when filing its EIT return for the tax year when the income (payable to non-resident enterprise) is capitalized. This seems to contradict the matching principle in the previous paragraph where the withholding tax is paid when the expenses are claimed. In this case, the cost will be capitalized and a deduction will not yet be claimed. However, the withholding tax payment will be duly accelerated.

Lastly, in the event the actual payment is made by the PRC resident enterprise to the non-resident enterprise before the contractual payment date, tax should be withheld in accordance with the EIT Law as at actual payment date.

<u>Article 2</u> - Guarantee fees

Guarantee fees received by a non-resident enterprise that are sourced from China would be subject to EIT at the rate applicable to interest income. Such guarantee fees are defined in Article 2 of the Bulletin as guarantee fees or fees of similar nature paid by a PRC enterprise, establishment or individual for the guarantee provided by the non-resident enterprise in relation to lending, trading, freight of goods, subcontract processing, renting, the undertaking of a contracted project, etc.

The Bulletin defines guarantee fees to include guarantee payments in relation to non-lending activities, such as trading, freight of goods, subcontract processing, renting, the undertaking of a contracted project, etc. It is unclear whether the Bulletin aims to recharacterize these guarantee fees as interest or simply refer to the withholding tax rate for interest for these guarantee fees. Such distinction is important because under certain double tax treaties (such as those mainland China has entered into with Hong Kong and Singapore) interest may be entitled to a preferential interest withholding tax rate. However, the term "interest" in double tax treaties generally means *"income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits."* With the Bulletin, it may be possible to interpret that guarantee fees in relation to the lending activities received by an eligible non-resident enterprise may qualify for a preferential interest treaty withholding tax rate. However, there may be a question as to whether guarantee fees arising from the other non-lending activities as referred to in the Bulletin would similarly qualify.

<u>Article 3</u> - Transfer of land use rights

Gains recognized from the transfer of land use rights by a non-resident enterprise without an establishment in China, or one with an establishment but where the gains cannot be attributable to the establishment in substance, would be subject to EIT on a withholding basis. Such gains should be calculated with reference to the consideration received for the land use rights, less the tax base of the rights. The EIT payable on the gains should be withheld by the relevant withholding agent. While the Bulletin does not provide a definition of "tax base", reference may be made to Article 66(1) of the Implementation Rules to the EIT Law, which defines the tax base of purchased intangible asset as the purchase price, relevant taxes and expenses paid, and other expenditures directly attributable to putting an asset into condition for its intended use.

<u>Article 4</u> - Finance leases and rental income from immovable property

Clause 1 of Article 4 addresses the situation whereby a non-resident enterprise without an establishment in China extends a finance lease of equipment or other items for use by a PRC enterprise, where the ownership of the equipment or items would be transferred to the PRC enterprise by the end of the lease (including transfers undertaken at a certain price). The net lease income received by the non-resident enterprise within the lease term should be calculated using the finance lease income (including any transfer price payable at the end of the lease under the finance lease agreement) less the price of the equipment or item. The net lease income would be treated as interest and subject to EIT and it should be withheld by the PRC enterprise.

Under Clause 2 of Article 4, non-resident enterprises that lease houses, buildings or other immovable property in China, but do not have establishments in China through which to provide daily management of such immovable property, would be subject to EIT on the gross rental income derived. The PRC EIT payable should be withheld by the PRC tenant when the rent is paid to the non-resident enterprise, or when the rent falls due.

However, if the non-resident enterprise were to send personnel to China, or engage other enterprises or individuals in China to provide daily management of the immovable property, it should be regarded as having an establishment in China, and the non-resident enterprise should undertake the reporting and payment of the PRC EIT payable within the deadlines stipulated in the EIT Law. That said, it is uncertain if this requirement would apply if the non-resident enterprise is resident of a jurisdiction that has entered into a double tax treaty with China, and such daily immovable property management activities in China do not fall within the permanent establishment definition of that treaty. Nevertheless, in the absence of a double tax treaty, Clause 2 of Article 4 would seem to imply that the non-resident enterprise should pay EIT on the business profits attributed to the establishment in China and be subject to the statutory EIT rate of 25%. If so, this requirement will significantly affect property investment holding companies that typically outsource or set up management companies to carry out the day-to-day property management activities.

Article 5 - Income from equity investment such as dividends and profit distributions

EIT on such income from equity interests paid to a non-resident enterprise by a PRC enterprise should be withheld by the latter on the date that the decision to distribute dividends or profits is made. If the actual payment date precedes said decision date, tax should be withheld by the PRC enterprise on the actual payment date.

3. Conclusion

The Bulletin has served to clarify the SAT's administrative practices on various taxation matters of non-residents. In this regard, our overall observation is that the SAT has reiterated the EIT principle that tax is to be charged and withheld on payments made to non-residents when such payments are accrued.

For non-resident enterprises holding PRC investments indirectly via offshore holding companies, the singular most significant development of the Bulletin would be the SAT's clarification of Circular 698. As outlined above, the SAT has introduced several positive changes geared towards reducing the administrative burden of non-resident enterprises and in providing more certainty in administrative procedures. However, the SAT's definitions of certain parameters such as "effective tax burden" and "not taxing foreign-sourced income" may open up further questions necessitating clarification.

Moreover, since the Bulletin provides that Circular 698 reporting requirements should apply to all investors undertaking an indirect disposal of PRC resident enterprise, there are still many practical issues on how actively the local PRC tax bureaus would, or could, seek to strictly enforce Circular 698. Currently, it would appear that Circular 698 reporting is undertaken on a voluntary and self-reporting basis. That said, local tax bureaus have been increasing their enforcement efforts on Circular 698, as evident from recent high profile audit cases. Nevertheless, whether a non-resident would ultimately be subject to PRC EIT on any gains derived from an indirect transfer of PRC resident enterprises should depend on whether the transaction is considered as one that is "abusive of companies' legal forms and without bona fide commercial purposes", as stated in Article 6 of Circular 698. That said, based on publicly available information on high-profile cases in Chongqing and Jiangdu, the local tax bureaus have appeared to focus more on the business substance of the intermediary holding companies than their legal form or commercial purposes. In this important aspect, the Bulletin has not shed light on the SAT's official position.

In light of the above, it should reasonably be expected of the SAT to issue further clarifications and guidance on the above issues in the near future. In the meantime, taxpayers would benefit from undertaking regular reviews of their current PRC investment holding structures to identify any potential tax risks that may arise due to evolving PRC tax rules.

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