China makes single largest share transfer tax assessment

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An unidentified Cayman Islands investment fund and two unidentified British Virgin Islands corporations recently were assessed a total of CNY 450 million (about $74.36 million) in Chinese enterprise income tax on gains from four separate transfers of a 95% indirect ownership interest in a Chinese-resident company, Chinese news media reported on 3 January 2014.

The assessment – the latest in a spate of major tax assessments involving indirect share transfers -- reportedly is the country's single largest such tax assessment to date. (For prior coverage, see China issues substantial tax bill for Cayman company's indirect share transfer.)

A tax office of China's State Administration of Taxation (SAT) in Zhejiang Province received an inquiry letter on 30 September 2011, from a US international law firm that represented the Cayman Islands investment fund. The law firm asked whether the fund's transfer of an indirect ownership interest in the Chinese company would trigger Chinese tax liability. The tax bureau soon initiated a tax investigation.

The investigation revealed that a Cayman Islands holding company that was 26.32% owned by the investment fund and 73.68% owned by the two B.V.I. corporations indirectly held a 95% ownership interest in the Chinese company through a Hong Kong holding company. The Chinese company was incorporated in 2004 and had registered capital of $320 million.

The investment fund and the two B.V.I. corporations sold all of their shares in the Cayman Islands holding company to another foreign company in a series of separate transactions between June and November 2011. As a result of those transactions, the transferee obtained the 95% indirect ownership interest in the Chinese company through the Cayman Islands and Hong Kong holding companies.

During the ensuing investigation, one of the two B.V.I. transferors submitted to the tax bureau a legal opinion letter issued by five well-known tax experts. The letter argued that the investment fund's transfer of an indirect ownership interest in the Chinese entity had reasonable commercial purpose. The transferor that submitted the letter did not reveal its own transaction in that letter. However, the tax bureau discovered the series of transactions from public information that was disclosed by the transferee's controlling corporation through the Hong Kong Stock Exchange.

The tax bureau found that the Hong Kong holding company had no substantial business activity other than its investment in the Chinese company. The tax bureau therefore concluded that the four indirect transfers had no reasonable business purpose.

The tax bureau then determined that the investment fund and the two B.V.I. corporations avoided Chinese tax on the equity transfers through two-tier intermediate holding companies. With approval from the SAT, the tax bureau assessed EIT at 10% on the gains derived from the four transactions.

As of 3 January, the bureau had received CNY 105 million (about $17.35 million) of the tax assessment and was pursuing the remainder.