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Indirect offshore, direct offshore and onshore disposals in an M&A context

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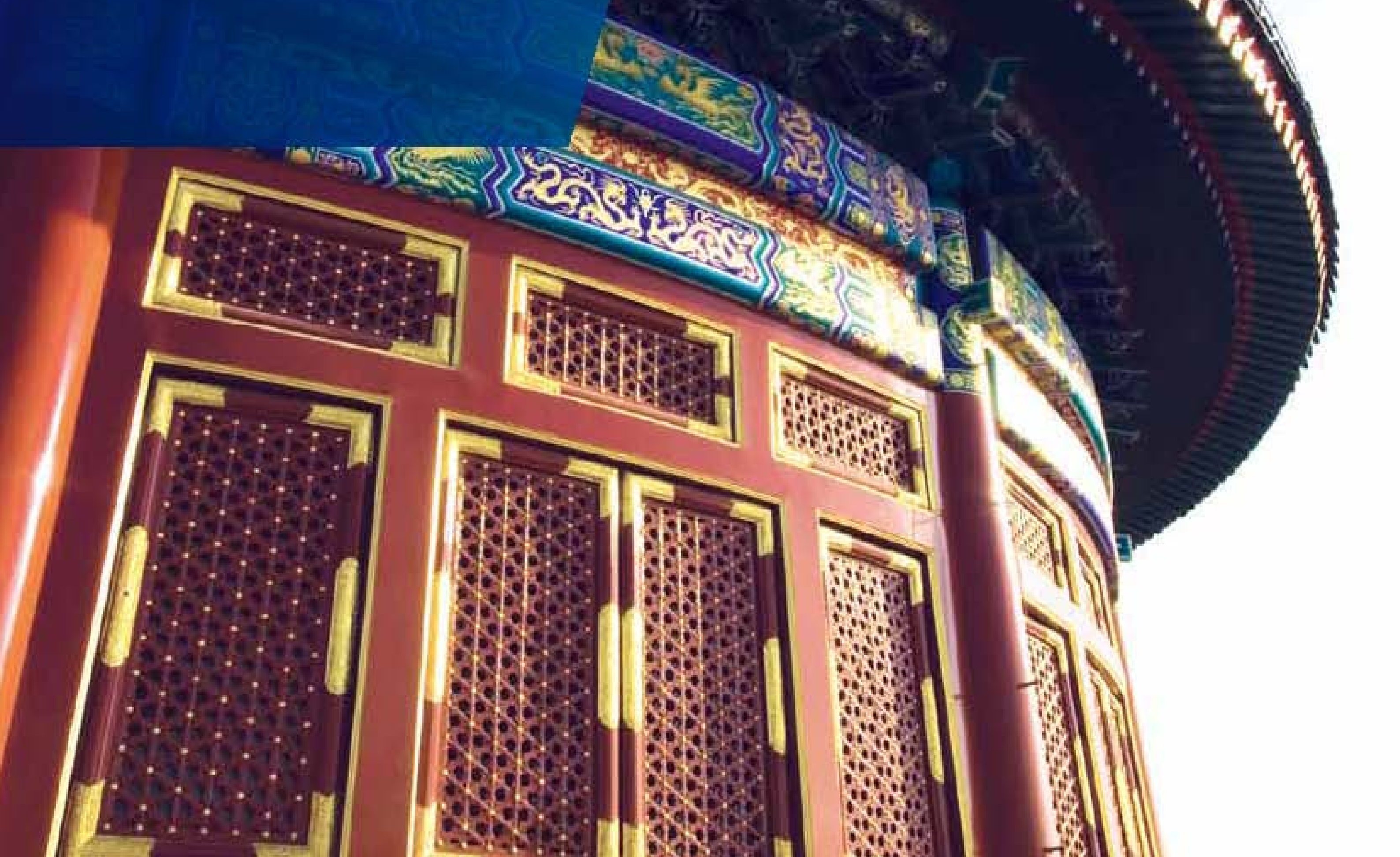

Introduction

This publication follows on from the initial article in this series, 'Beneficial Ownership and Indirect Disposals', published in March 2010. The first issue outlined the provisions of the then newly introduced circulars, Guoshuifa 601 (Circular 601) and Guoshuihan No.698 (Circular 698). The former circular deals with the beneficial ownership qualification criteria for investors seeking to claim tax treaty benefits, while the latter imposes reporting requirements and tax enforcement measures against tax-motivated disposals of offshore holding companies of PRC enterprises. Circulars 601 and 698 were recognised to be part of the State Administration of Taxation's (SAT) efforts to strengthen the enforcement of taxes against foreign investors, and were focused on two areas of PRC tax law administration that were of particular concern to the SAT. For a detailed description of the content of the circulars, please access Issue 1 here.

Since Issue 1 of this series was released, the general macro-trend in China points to a more 'foreign investor-friendly' environment under which the PRC regulatory authorities have introduced measures that, on the whole, have made it easier for foreigners to invest in China[1]. Such measures include the loosening of regulations concerning the economic sectors that are permissible for foreign investment, as well as the facilitation of new modes of foreign investment e.g. Chinese limited liability partnerships, and the reduction in 'red tape' e.g. quickening the vetting of cross-border M&A proposals, together with the recently announced near threefold expansion of the QFII investment quota in China's listed markets. With these changes in the regulatory environment as a backdrop, the developments on the tax front have been somewhat less benign. As the SAT have developed further clarifying circulars on Circulars 601 and 698, and as cases of the application of these circulars by the local tax authorities have come to light, the full rigour with which the PRC tax authorities intend to apply these rules has become apparent. This has given impetus for foreign investors to closely examine the continued effectiveness of existing investment and exit strategies and explore other planning opportunities.

Investment exit strategies

In this issue, we focus on the taxation of three types of investment exits, which may be undertaken by foreign investors into the PRC and which have been the focus of the PRC tax authorities. These include an offshore indirect disposal, an offshore direct exit and an onshore exit. Contextually and by way of illustration, we draw on the KPMG China experience in helping our clients to deal with the challenges posed by these developments as they have emerged.

Following the introduction of Circular 698 in late 2009, a Chinese tax charge may arise on offshore indirect disposals and thus, the use of tax-motivated investment structures designed to facilitate such disposals has been questioned and challenged. Further, a tightened approach to scrutinising the location of effective management of offshore holding companies has led to sales of offshore incorporated companies increasingly being treated as giving rise to taxable China sourced gains. Furthermore, a holding company, resident in a tax treaty jurisdiction, which seeks to claim treaty relief, from the capital gains tax applicable to gains on a direct disposal of equity in the Chinese investee company, could also face complications. This is particularly where the Chinese tax authorities adopt the economic 'substance' criteria, set out in Circular 601, in determining whether to approve an application of the tax relief claim.

[1] There have, of course, been certain developments which have limited the ease of investment for foreigners, such as the recently introduced national security measures, which have increased regulatory scrutiny of inbound M&A into China, and the limitations imposed on the use of Variable Interest Entities, but the general trend has to been facilitate investment.

Separately, we have also seen greater interest from foreign investors in exploring the structure of holding equity in Chinese enterprises via Chinese limited partnerships established in the form of RMB funds. Exit from the investment is then by means of an 'onshore exit' sale by the Chinese partnership and repatriation of the sales proceeds abroad. However, the tax law and foreign exchange regulations governing such an investment remain unclear in application. Therefore, in the worst case, this could lead to a Chinese corporate income tax of 25 percent being imposed on the exit gains made by foreign passive investors. We expect that the coming years are likely to see a move towards actions in bolstering substance, if commercially feasible, in offshore holding companies to facilitate treaty relief claims on offshore direct exits and, as and when the law and regulations are clarified, the increasing use of partnerships for onshore holding of investments and exits as the tax law administration matures.

Offshore indirect exits – The introduction of Circular 698

Pre-Circular 698, the 'common' practice among foreign investors into China (whether corporate or financial) was to hold the equity in the Chinese enterprise via a chain of offshore companies (some or all of which were incorporated in tax havens). Exit was achieved through disposal of the offshore company holding the Chinese equity by the next offshore company further up the chain. The resulting capital gain was considered to be outside the scope of Chinese tax as it was technically sourced outside China and arose to a non-resident.

However, from December 2009, Circular 698 announced rules and reporting requirements (retroactive to January 2008) aimed at countering what the Chinese authorities regard to be the abuse of the offshore disposal route. The reporting requirement for the transferor applies where a controlling shareholder indirectly transfers shares in a Chinese company by selling his shares in a holding company in an intermediary jurisdiction, and either the effective tax rate in the intermediary jurisdiction is less than 12.5 percent or the intermediary jurisdiction otherwise exempts foreign source income. Where it is concluded with the approval of the SAT, that the indirect transfer constitutes an 'abuse of organisational form' and there is no reasonable business purpose, the tax authorities are entitled, using the General Anti-avoidance Rule (GAAR, Article 47 of the Enterprise Income Tax Law), to treat the transaction as a sale of the shares held in Chinese companies by the intermediary holding company.

While initially the precise enforcement approach, which the PRC tax authorities would take to Circular 698 was unclear, it progressively became apparent in a series of high profile cases involving several well-known private equity investors and others (leading examples being enforcement cases undertaken by tax authorities in Jiangdu, Henan, Shantou and Guizhou), that the PRC authorities have applied the GAAR measure as a 'weapon of choice' in dealing with the perceived abusive use of offshore disposal structures to avoid PRC withholding tax on gains realised from investments in PRC companies. Circular 698 has now become the 'hot-button' issue in cross-border M&A in China, undermining the historic practice of an offshore indirect exit. It should be noted that taxing indirect offshore disposals (outside the context of companies deriving their value from immovable property) is still, in a global context, quite a novel innovation, with few countries (most notably India, the suspected inspiration for Circular 698) having introduced such provisions or taxing approaches to-date.

This approach clearly undermines the offshore indirect exit approach. When applying Circular 698, the Chinese tax authorities typically have regard to the level of economic substance of offshore holding companies (e.g. staff, business premises, and operating assets of individual offshore companies in comparison with the amount of income realised) in determining whether there has been abuse of an organisational form and whether the company was established for reasonable business purposes. As such, difficulties can even arise for strategic investments by multinationals, which have substantial staff and operating assets across their operations but perhaps not within the specific company to which the disposal gains arise. The problems are even greater for private equity funds as these typically do not require or in fact establish substantive operational presence in the offshore holding companies.

Offshore indirect exits –Circular 698 uncertainties and Vodafone-China Mobile case

The difficulty created for investment exits by Circular 698 is largely due to the uncertainty surrounding the manner in which it is to apply and the approach adopted by Chinese tax authorities. For example, it is not clear what the purchaser should do if he is buying the shares in an offshore holding company and is concerned that the vendor may be liable to Chinese tax under Circular 698. While tax should be imposed on the vendor when the PRC GAAR is applied pursuant to Circular 698, there have been cases in which the PRC tax authorities have sought to collect tax from the target or from the purchaser by way of withholding tax. Furthermore, the purchaser may be at risk of the PRC tax authorities adjusting its base cost (in the shares of the acquired offshore holding company) to recoup tax unpaid by the vendor on an onward disposal by the purchaser. Practically speaking, an increasing number of purchasers are requiring, as a condition precedent to acquisition closing, that vendors fulfil the Circular 698 reporting requirements to effectively crystallise any potential tax liabilities, which the vendor must settle. Subsequently, this should give the purchaser greater security from the tax authorities, either in terms of being pursued for the vendor's tax liability or having their base cost diminished.

Various other uncertainties and difficulties exist concerning the compliance with the reporting obligations, calculation of the tax arising, and the interaction of Circular 698 with China's network of tax treaties (particularly regarding the availability of tax credits) and with the Chinese corporate reorganisation relief provisions under the domestic tax laws. This is further complicated as the PRC tax authorities currently adopt a rather one dimensional approach of looking at the 'commercial substance' of the holding company as effectively the sole criteria for the

evaluation of 'reasonable business purposes', when determining whether or not to invoke the provision of GAAR against offshore exits by foreign investors. While Announcement 24 issued in March 2011 did clarify some of the notification and tax settlement requirements, numerous significant and substantive uncertainties remain.

The future direction of Circular 698 is subject to conjecture. Certainly local and state tax authorities are set to become more proficient at information collection relevant to Circular 698 tax impositions. For example, the SAT and the State Administration for Industry and Commerce established an information sharing platform for details of equity transfers this year. Independently, at a regional level, the recently established co-operation mechanism between the Anhui State Tax Bureau and the Anhui Bureau of Commerce involves the latter supplying the former with equity transfer approval documents, and could well be adopted by other regions. Further, tax authorities are increasingly showing their adeptness at collecting information from public sources (such as listed company annual reports) to pursue claims. On the basis of recent experience, it is reasonable to assume that there will continue to be a particular focus among tax authorities when imposing tax pursuant to Circular 698, on offshore structures holding (through PRC entities) interests in PRC real estate.

Regarding the scope and operation of Circular 698 itself, in mid-2011, a draft supplementary circular to Circular 698, which was informally distributed to various professional services firms and others for comment, set out a proposal to exempt transfers, in the context of an internal restructuring, from the reporting requirements and tax imposition pursuant to Circular 698. This was felt by many to indicate that the SAT was taking heed of industry concerns and 'reining in' the far-reaching effects of Circular 698. While the circular has not yet been issued, it still appears to be the intent of the SAT to introduce this relief in due course. However, perhaps heartened by the Indian government's decision to legislate for the imposition of tax on indirect offshore transfers of Indian assets (following the adverse outcome of the Vodafone case for the Indian tax authorities), it also appears that the SAT is intent on introducing new rigours into the application of Circular 698.

There have been indications that the SAT may move to specifically state that, where tax is applied pursuant to Circular 698, the base cost for the disposal gains calculation for the non-resident disposer will be limited to the amount put into the underlying PRC company as registered capital. This could lead to a situation where, if a non-resident company injects share capital into an offshore company holding a PRC company, and the offshore company provides the funds to the PRC company partly as equity and partly as debt, then the amounts put in as debt could be lost from the base cost. Applying the rules in this manner would effectively incentivise non-residents to dispose their interests in the PRC company directly (rather than disposing of the offshore company).

The exception to the above treatment would be that, where an offshore holding company is acquired, and the disposer has reported and paid any required tax, the base cost for future disposal may then be taken to be the acquisition consideration. This means that in all other situations, the registered capital in the PRC company will constitute the base cost. While such treatment had already been considered a risk, explicitly providing for this would clearly shift the Circular 698 burden to the buyer (unless appropriate contractual protections are secured). Further, there are indications that there may be an expansion of reportable transactions, with PRC resident enterprises being subject to indirect offshore transfer potentially being required to report this fact to the tax authorities and provide relevant information as required. The further evolution of the SAT's position on such matters will be watched with interest.

Beyond Circular 698, an additional tax risk arising for offshore indirect disposals of equity in PRC companies was recently highlighted in the Vodafone-China Mobile case, first publicised in April 2011. The gain on the sale of an offshore company may simply be regarded as PRC sourced on the basis of the offshore company's deemed PRC tax residence under PRC domestic tax laws (broadly based on place of effective management). As the PRC tax authorities have recently enhanced their efforts to regularise the registered tax resident status of foreign incorporated enterprises controlled by PRC residents, and are putting a compliance system in place, foreign investors may find themselves increasingly exposed to Chinese tax where they make offshore indirect disposals of Chinese investments. SPA negotiations may also be complicated where investors seek to obtain warranties and indemnities that the deal target is not effectively managed from the PRC.

Given the above, since the inception of Circular 698, the offshore indirect disposal of equity in a Chinese enterprise is certainly less clear-cut from a tax perspective than was previously the case (and may potentially become actively discouraged). Going forward, it is likely that structuring efforts will focus on creating a basis for a supportable treaty relief claim on an offshore direct exit, if such relief is allowed to be claimed under PRC tax laws.

Offshore direct exits – Circular 601 DTA issues

Under Chinese domestic law, the capital gain on disposal of shares in a Chinese company by a foreign shareholder is taxable in China at 10 percent. As such, direct M&A investments into China seek to use an appropriate tax treaty jurisdiction holding company to mitigate this exposure. By way of example, for shareholdings that are less than 25 percent, the Hong Kong, Singapore and Mauritius treaties offer protection (with the Swiss and Irish treaties offering protection for shareholdings of any size). However, none of these treaties provide for capital gains tax relief where the Chinese company is land-rich.

However, over the last three years, the Chinese tax authorities have implemented several measures to limit the scope of 'treaty shopping' and other perceived treaty abuse practices. Firstly, Circular Guoshuifa No.2 of 2009 provides specifically that 'abuse of treaties' is to be regarded as one of the tax avoidance arrangements to which the GAAR applies. The resulting difficulties arising where DTA relief is sought on an M&A transaction exit are even more pronounced for private equity investments than for strategic investments.

Secondly, Circulars Guoshuifa 124 and Guoshuihan 81 issued in 2009 introduced procedural requirements that make it easier for the tax authorities to identify cases where the taxpayer is relying on treaty protection by requiring investors to make applications to local tax authorities.

Thirdly, Circular 601 sets out the factors that the Chinese tax authorities will take into account in deciding whether tax treaty beneficial ownership requirements are satisfied. To be considered the beneficial owner, a company must not only control the disposition of the income and the underlying property, but also generally should conduct substantial business operations. A number of negative factors that point towards a company not being the beneficial owner are listed; given the focus on 'substance' criteria, many commentators argue that the Chinese definition effectively functions as a hybrid of the concept of beneficial ownership (as understood in international tax practice) and anti-abuse rules aimed at treaty shopping.

One matter is whether the Circular 601 guidance on the determination of beneficial ownership should have any bearing on Double Taxation Agreements (DTA) capital gains tax relief claims. Beneficial ownership is a standard requirement in the dividends, interest and royalties articles in treaties, but not in the capital gains article. Neither the Chinese domestic law nor the Circulars issued by the SAT treat beneficial ownership as a qualifying criterion for treaty capital gains relief. Nevertheless, there have been Chinese assessed tax cases (such as the Xuzhou case in March 2010 and the Shenzhen case in September 2011) in which treaty relief for capital gains has been denied on the basis of a lack of commercial substance at the level of the treaty benefit claimant, with the Chinese tax authorities having regard and pointing to the list of 'adverse factors' set out in Circular 601 in making the determination. The tax community operate on the basis that whether or not the Chinese tax authorities consider there to be an implicit beneficial ownership requirement in relation to capital gains relief, or whether the Chinese authorities are simply applying the GAAR in relation to perceived treaty shopping, foreign investors looking to avail of treaty relief must ensure that the 601 criteria are satisfied.

As with Circular 698, Circular 601 focuses heavily on 'substance' (staff, premises, other activities etc). However, whether the 'substance' in group companies in the same jurisdiction as the claimant (or in another jurisdiction with equivalent treaty provision) can be referred to in supporting a treaty relief claim (or whether some other group company can make a claim) is aa little uncertain.. This is further exacerbated by the fact that Chinese domestic tax law does not contain an explicit provision allowing a non-legal owner of Chinese shares to make tax treaty claims, and applications by a group company for tax treaty benefits would be subject to case-by-case negotiation with the local Chinese tax authorities. While in mid-2011, a draft clarifying circular to Circular 601 was circulated by the SAT to the tax industry and outlined certain circumstances in which a claim can be made on the basis of substance in group holding companies the circular, is still under discussion and it may still be some time before the final version is issued.

In summary, recent experience is that the Chinese authorities are increasingly challenging treaty-based claims and companies will need to examine their existing or proposed holding company structures, consider their robustness and take remedial action where appropriate.

Onshore exits – Tax and regulatory uncertainty of partnership arrangements

Foreign partners have been allowed to invest in Chinese limited partnerships since the relevant measures and implementing regulations came into effect in March 2010. Given the limited legal formalities with which investors can contribute capital, limited partnerships are increasingly used in the private equity context for holding minority holdings in Chinese companies. Apart from attracting domestic investors via the Chinese partnership structure, in an increasing number of cases, the partnership may also be permitted to make investments without the same level of regulatory approvals as a direct investment from overseas.

However, Chinese tax law is somewhat unclear on many aspects of the taxation of partnerships due to the principal source of guidance - Notice 159 - providing very limited details. The general principle is that a Chinese partnership is not a taxable person for Chinese tax purposes. While it is provided that a partnership's Chinese resident partners are subject to Corporate Income Tax or Individual Income Tax (as appropriate) on their respective profit shares, there is no explicit provision on how non-Chinese resident partners are to be taxed with respect to their share of the income from the partnership. In particular, although a 'flow-through' tax treatment is applied to partnership income, it is unclear whether the character of the partnership income is 'flow-through'. So in principle, while a foreign partner could look to eliminate dividend withholding exposures on its participation in an active business in China through a partnership (where the tax authorities treat the partnership as a taxable establishment of the foreign partner), issues may be thrown up for disposals of passive holdings by the partnership.

Where a foreign partner invests in a Chinese partnership, which generates gains on disposal of Chinese equity investments, it is unclear whether the foreign partner will be treated as realising the disposal gain for withholding tax purposes, and whether treaty relief will be granted if there is a beneficial treaty in place between the residence jurisdiction of the foreign partner and China. The PRC tax authorities may take the position that the income arises from a taxable establishment of the foreign partner in China due to the activities of the General Partner or its manager and levy tax at 25 percent. The lack of clarity in the law in relation to these matters means that they are open to interpretation, and negotiation with the tax authorities on a case-by-case basis may be necessary.

With regards to the legal and regulatory treatment of partnerships, it appears that a foreign-invested partnership is not subject to the capital maintenance requirements applicable to companies. It does not need to create a legal reserve, and it can distribute cash to the partners as allowed by the partnership agreement rather than only to the extent of accumulated profits. However, the exchange control position for partnerships is unclear and as such, the mechanics of making capital contributions and taking the cash out need to be agreed on a case-by-case basis with the relevant office of the State Administration of Foreign Exchange for the time being. Furthermore, the circumstances in which the registration authorities will approve of the establishment of a foreign invested partnership are not clear.

Implications for investment structuring in future

In summary, for foreign investors into China, the issuance of Circular 698 has rendered the offshore indirect disposal an uncertain mechanism of investment exit from a tax perspective, and this has focused attention on offshore direct exits and onshore exits. If, from a regulatory perspective, investment and exit from Chinese investments by an offshore company is possible, and if sufficient substance exists to support a treaty claim, an offshore direct investment and exit may be the preferred option. However, there may be cases where, from a commercial and regulatory perspective (or on consideration of the needs of co-investing Chinese partners), an investment via a Chinese partnership is more workable. In that case, the uncertainties created by the undeveloped nature of Chinese partnership taxation will have to be considered and overcome until such time as the law is further clarified.

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