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China Alert

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SAT clarifies notification and taxation requirements of indirect disposal of equity interests

Regulation discussed in this issue:

- Announcement on Corporate Income Tax Administration of Non-resident Enterprises, SAT Announcement [2011] No. 24 (Announcement 24), issued by the SAT on 28 March 2011, effective from 1 April 2011

Background

In Announcement 24, the State Administration of Taxation (SAT) clarifies certain aspects of the rules on the direct and indirect disposal of Chinese equity interests by non-resident enterprises. This announcement gives further guidance on the timing of the realisation of capital gains from direct disposals, the meaning of open market acquisition and disposition of listed securities and the meaning of the effective tax burden on disposal of shares in offshore holding companies. Announcement 24 also simplifies the procedure for complying with the offshore indirect disposal rules. However, the announcement does not touch on the important question of what will constitute an abuse of the organisational structure by a foreign investor and the tax treaty implications of the offshore indirect disposal rules.

The rules on offshore indirect disposal are contained in the circular, Guo Shui Han [2009] No. 698 (Circular 698). Basically, according to Circular 698, where a foreign investor disposes of an equity interest in an enterprise in China by selling shares in an offshore holding company, the foreign investor will be required to notify the Chinese tax authority of such disposition where the relevant criteria are met; where the foreign investor is found to have abused its organisational structure with a view to avoiding Corporate Income Tax (CIT) liability, the Chinese tax authority is empowered to re-characterise the share transfer transaction based on its economic substance and deny the existence of the offshore holding company. For details, please refer to China alert 2010 Issue No. 1 and PRC Non-resident enterprise series 2010 Issue No. 1.

The key points of Announcement 24 and our comments on them are set out below:

1. How to decide the timing of realisation of the gain from a direct disposal of equity interest where the sales proceeds are paid by instalments

According to Announcement 24, where a non-resident enterprise directly disposes of an equity interest in a resident enterprise in China and the contract or agreement for the transfer of the equity interest adopts an instalment payment method, the non-resident enterprise shall recognise the realisation of the revenue when the contract or agreement becomes effective and the procedure for changing the ownership of the equity interest is completed.

It is not clear from Announcement 24 what it is meant by the changing of the ownership of the equity interest is completed. One way of interpreting this rule is that the change of the ownership is completed when the Ministry of Commerce or the local authorised office has approved the transfer of the equity interest. In practice, it is advisable to clarify this issue with the tax authority in charge.

2. What is it meant by "securities in Chinese resident enterprises that are bought and sold in open stock exchanges" as mentioned in Article 1 of Circular 698?

According to Article 1 of Circular 698, "income from the transfer of equity interests" refers to income derived from the transfer by non-resident enterprises of equity interests in resident enterprises in China (not including securities in Chinese resident enterprises that are bought and sold in open stock exchanges).

Announcement 24 states that such excluded transfers refer to transactions where the counterparties, quantities and prices of the purchase and sale of the securities are not agreed in advance by the buyers and sellers and are determined in accordance with the ordinary trading rules of open stock exchanges.

It follows that the purchase and sale of listed securities by pre-identified buyers and sellers via contracts directly entered into by them should not fall within the scope of the excluded transfers, and the gain from such transfer may still be subject to CIT. However, Announcement 24 does not clarify, in the case of offshore indirect disposals, whether the exclusion provisions refer to the equity interests in the Chinese resident enterprises or the shares in the offshore holding companies or both.

3. What is it meant by "foreign investors (effective controlling parties)" as mentioned in Articles 5, 6 and 8 of Circular 698?

According to Articles 5, 6 and 8 of Circular 698, where foreign investors (effective controlling parties) indirectly transfer equity interests in resident enterprises in China, the former shall notify the Chinese tax authority of such transfers where the relevant criteria are met. Where the foreign investors (effective controlling parties) are found to have indirectly transferred the equity interests in the Chinese resident enterprises via arrangements such as the abuse of their organisational structures without any reasonable commercial objectives, thus avoiding CIT liability, the Chinese tax authorities can re-characterise such transactions based on their economic substance and deny the existence of the offshore holding companies. Where foreign investors (effective controlling parties) transfer the equity interests in several onshore or offshore holding companies at the same time, the Chinese resident enterprises whose equity interests are being transferred shall provide the Chinese tax authority with the entire transfer contracts as well as the

sub-contracts that affect the Chinese resident enterprises themselves. Where there are no such sub-contracts, the Chinese resident enterprises shall provide the Chinese tax authorities in charge with the detailed information on each and every offshore holding company involved in the entire transfer, accurately identifying the transfer prices for the Chinese resident enterprises.

Announcement 24 states that "foreign investors (effective controlling parties)" in the context of the abovementioned provisions refer to all the investors that indirectly transfer the equity interests in the Chinese resident enterprises. In other words, such investors are not confined to those which have effective control over the Chinese resident enterprises only. As such, even non-resident enterprises which indirectly have minority interests in the Chinese resident enterprises will be subject to the rules in Circular 698.

4. What is it meant by "effective tax burden" and "do not impose corporate income tax" as mentioned in Article 5 of Circular 698?

According to Article 5 of Circular 698, where foreign investors (effective controlling parties) indirectly transfer equity interests in resident enterprises in China, the former shall, within 30 days of the conclusion of the contracts for the transfer of equity interests, notify the Chinese tax authority of such transfers if the countries or territories in which the offshore holding companies whose shares are being transferred have an "effective tax burden" of less than 12.5 percent or "do not impose corporate income tax" on the offshore income of their residents.

Announcement 24 states that "effective tax burden" refers to the effective tax burden in respect of the income from the transfer of the equity interests. In other words, the concept of effective tax burden in this context does not refer to the effective tax burden of the foreign investors (effective controlling parties) as a whole and only that in respect of the income derived from the transfer of the equity interests in the offshore holding companies.

Announcement 24 also states that "do not impose corporate income tax" refers to the non-imposition of corporate income tax on the income from the transfer of equity interests. In other words, the concept of non-imposition of corporate income tax on offshore income does not apply to the offshore income of the foreign investors (effective controlling parties) other than that from the transfer of equity interests.

5. What if two or more foreign investors indirectly dispose of the equity interests in a Chinese resident enterprise at the same time?

According to Announcement 24, where two or more foreign investors dispose of the equity interests in a Chinese resident enterprise at the same time, one of the foreign investor may notify the Chinese tax authority in charge of the Chinese resident enterprise of the indirect disposal in accordance with Article 5 of Circular 698. In other words, that one foreign investor may represent the other foreign investors in making the notification and providing the relevant information.

6. What if a foreign investor indirectly transfers equity interests in two or more Chinese resident enterprises that are not located in the same province or municipality at the same time?

According to Announcement 24, where a foreign investor indirectly transfers equity interests in two or more Chinese resident enterprises at the same time, and the Chinese resident enterprises are not in the same province or municipality, the foreign investor may choose to notify the Chinese tax authority in charge of one of the Chinese resident enterprises only in accordance with Article 5 of Circular 698. In that case, the provincial or municipal tax authority of that location will co-ordinate and discuss with the tax

authorities from other provinces or municipalities to decide if the transfers should be subject to tax, and report the outcome of the discussion to SAT. If it is decided that tax will be imposed, the foreign investor shall, however, pay the tax to the tax authorities in charge of the Chinese resident enterprises separately.

Presumably, combining the rules mentioned in Points 5 and 6, where two or more foreign investors indirectly dispose of two or more Chinese resident enterprises at the same time, one of the foreign investors may choose to notify the tax authority in charge of one of the Chinese resident enterprises of the transfers only.

KPMG observation

Announcement 24 basically only addresses certain implementation issues in relation to the notification and tax settlement requirements and procedures in Circular 698. The announcement has given greater clarity on the question of the taxation of the transfer of listed securities and the concept of effective tax burden in the context of notification of indirect disposals. It has also simplified the notification procedure where there are two or more foreign investors or where there are two or more Chinese resident enterprises whose equity interests are the subject of transfer.

However, critical matters such as what will constitute the abuse of organisational structures and what will qualify as reasonable business objectives are not dealt with. Announcement 24 also does not cover the issue of the tax treaty implications of indirect disposals. For example, where the foreign investor resident in a country that has a tax treaty with China disposes of shares in an offshore holding company that holds shares in a Chinese resident enterprise, it is not clear at present as to whether the tax treaty between China and the foreign investor's country will apply, should the Chinese tax authority deny the existence of the offshore holding company.

There is also the question as to whether a non-resident enterprise will be able to obtain foreign tax credit from its country's tax administration if it pays CIT on indirect disposal under Circular 698. Therefore, non-resident enterprises may resort to seek advice from the competent authorities in their countries before agreeing to settle any tax liability under Circular 698. It is likely that SAT will issue circulars to deal with more fundamental issues arising from the implementation of Circular 698.

Contact us

Khoonming Ho
Partner in Charge, Tax
China and Hong Kong SAR
Tel. +86 (10) 8508 7082
khoonming.ho@kpmg.com

Beijing/Shenyang
David Ling
Partner in Charge, Tax
Northern China
Tel. +86 (10) 8508 7083
david.ling@kpmg.com

Qingdao
Vincent Pang
Tel. +86 (532) 8907 1728
vincent.pang@kpmg.com

Shanghai/Nanjing
Lewis Lu
Partner in Charge, Tax
Central China
Tel. +86 (21) 2212 3421
lewis.lu@kpmg.com

Hangzhou
Martin Ng
Tel. +86 (571) 2803 8081
martin.ng@kpmg.com

Chengdu
Anthony Chau
Tel. +86 (28) 8673 3916
anthony.chau@kpmg.com

Guangzhou
Lilly Li
Tel. +86 (20) 3813 8999
lilly.li@kpmg.com

Fuzhou/Xiamen
Jean Jin Li
Tel. +86 (592) 2150 888
jean.j.li@kpmg.com

Shenzhen
Eileen Sun
Partner in Charge, Tax
Southern China
Tel. +86 (755) 2547 1188
eileen.gh.sun@kpmg.com

Hong Kong
Karmen Yeung
Tel. +852 2143 8753
karmen.yeung@kpmg.com

Northern China
David Ling
Partner in Charge, Tax
Northern China
Tel. +86 (10) 8508 7083
david.ling@kpmg.com

Vaughn Barber
Tel. +86 (10) 8508 7071
vaughn.barber@kpmg.com

Roger Di
Tel. +86 (10) 8508 7512
roger.di@kpmg.com

John Gu
Tel. +86 (10) 8508 7095
john.gu@kpmg.com

Jonathan Jia
Tel. +86 (10) 8508 7517
jonathan.jia@kpmg.com

Vincent Pang
Tel. +86 (10) 8508 7516
+86 (532) 8907 1728
vincent.pang@kpmg.com

Michael Wong
Tel. +86 (10) 8508 7085
michael.wong@kpmg.com

Irene Yan
Tel. +86 (10) 8508 7508
irene.yan@kpmg.com

Tracy Zhang
Tel. +86 (10) 8508 7509
tracy.h.zhang@kpmg.com

Catherine Zhao
Tel. +86 (10) 8508 7515
catherine.zhao@kpmg.com

Hiroyuki Takahashi
Tel. +86 (10) 8508 7078
hiroyuki.takahashi@kpmg.com

Leonard Zhang
Tel. +86 (10) 8508 7511
leonard.zhang@kpmg.com

Central China
Lewis Lu
Partner in Charge, Tax
Central China
Tel. +86 (21) 2212 3421
lewis.lu@kpmg.com

Anthony Chau
Tel. +86 (21) 2212 3206
+86 (28) 8673 3916
anthony.chau@kpmg.com

Cheng Chi
Tel. +86 (21) 2212 3433
cheng.chi@kpmg.com

Bolivia Cheung
Tel. +86 (21) 2212 3268
bolivia.cheung@kpmg.com

Dawn Foo
Tel. +86 (21) 2212 3412
dawn.foo@kpmg.com

Chris Ho
Tel. +86 (21) 2212 3406
chris.ho@kpmg.com

Sunny Leung
Tel. +86 (21) 2212 3488
sunny.leung@kpmg.com

Martin Ng
Tel. +86 (21) 2212 2881
+86 (571) 2803 8081
martin.ng@kpmg.com

Yasuhiko Otani
Tel. +86 (21) 2212 3360
yasuhiko.otani@kpmg.com

Grace Xie
Tel. +86 (21) 2212 3422
grace.xie@kpmg.com

Zichong Xu
Tel. +86 (21) 2212 3404
zichong.xu@kpmg.com

Jennifer Weng
Tel. +86 (21) 2212 3431
jennifer.weng@kpmg.com

William Zhang
Tel. +86 (21) 2212 3415
william.zhang@kpmg.com

David Huang
Tel. +86 (21) 2212 3605
david.huang@kpmg.com

Amy Rao
Tel. +86 (21) 2212 3208
amy.rao@kpmg.com

Southern China
Eileen Sun
Partner in Charge, Tax
Southern China
Tel. +86 (755) 2547 1188
eileen.gh.sun@kpmg.com

Jean Jin Li
Tel. +86 (755) 2547 1128
+86 (592) 2150 888
jean.j.li@kpmg.com

Jean Ngan Li
Tel. +86 (755) 2547 1198
jean.li@kpmg.com

Lilly Li
Tel. +86 (20) 3813 8999
lilly.li@kpmg.com

Kelly Liao
Tel. +86 (20) 3813 8668
kelly.liao@kpmg.com

Angie Ho
Tel. +86 (755) 2547 1276
angie.ho@kpmg.com

Hong Kong
Ayesha Macpherson
Partner in Charge, Tax
Hong Kong SAR
Tel. +852 2826 7165
ayesha.macpherson@kpmg.com

Chris Abbiss
Tel. +852 2826 7226
chris.abbiss@kpmg.com

Darren Bowdern
Tel. +852 2826 7166
darren.bowdern@kpmg.com

Alex Capri
Tel. +852 2826 7223
alex.capri@kpmg.com

Barbara Forrest
Tel. +852 2978 8941
barbara.forrest@kpmg.com

Ken Harvey
Tel. +852 2685 7806
ken.harvey@kpmg.com

Nigel Hobler
Tel. +852 2143 8784
nigel.hobler@kpmg.com

Charles Kinsley
Tel. +852 2826 8070
charles.kinsley@kpmg.com

John Kondos
Tel. +852 2685 7457
john.kondos@kpmg.com

Curtis Ng
Tel. +852 2143 8709
curtis.ng@kpmg.com

Kari Pahlman
Tel. +852 2143 8777
kari.pahlman@kpmg.com

John Timpany
Tel. +852 2143 8790
john.timpany@kpmg.com

Christopher Xing
Tel. +852 2978 8965
christopher.xing@kpmg.com

Karmen Yeung
Tel. +852 2143 8753
karmen.yeung@kpmg.com

Jennifer Wong
Tel. +852 2978 8288
jennifer.wong@kpmg.com

kpmg.com/cn