



Taxable capital gains may arise on withdrawal or reduction of capital

Regulation discussed in this issue:

- Announcement on Certain Corporate Income Tax Issues, SAT Announcement [2011] No. 34 (Announcement 34), issued by the State Administration of Taxation on 9 June 2011, effective from 1 July 2011

Background

The State Administration of Taxation (SAT) issued the announcement [2011] No. 34 (Announcement 34) on 9 June 2011 to deal with, among other issues, the Corporate Income Tax (CIT) treatment of the withdrawal or reduction of capital. Basically, the proceeds derived by investors may be divided into (1) return of capital, (2) dividends and (3) capital gains. These components will have different CIT treatments. Announcement 34 takes effect from 1 July 2011.

The salient points of the provisions on the CIT treatment of the withdrawal and reduction of capital and our comments on them are set out below:

1. How will the withdrawal or reduction of capital be treated for CIT purposes?

When an investment enterprise (referred to as "investor" hereinafter) withdraws or reduces its investment in an invested enterprise (referred to as "investee" hereinafter), the considerations that the investor obtains as a result of the capital withdrawal or reduction may be divided into the following components:

- The part that corresponds with the original capital in the investee: this part will be treated as the return of capital to the investor
- The part that corresponds with the accumulated undistributed profits and revenue reserves in the investee that are attributed to the withdrawn or reduced capital of the investor: this part will be treated as the dividend income of the investor

- The remaining part: this part will be treated as the gain derived from the transfer of assets i.e. capital gain. If this amount is negative, this will be treated as capital losses.

2. Do the "investors" referred to in this announcement refer to resident enterprises, non-resident enterprises or both?

Announcement 34 is not specific on this point. There is a possibility that the principle underlying the rules can apply to both resident and non-resident investors. In practice, it is advisable to inquire with the tax authorities in charge at the local level in this regard beforehand.

3. What if the abovementioned rules are applied to resident investors in China?

Announcement 34 does not prescribe the CIT treatment of the different parts of the proceeds as mentioned in Point 1. However, based on the basic principles and rules in the CIT Law, if the investor is a resident enterprise, the CIT treatment of the three parts should be as follows:

- Return of capital: this part should not form part of the taxable income of the investor as the original capital is deductible
- Dividend income: this part should not form part of the taxable income of the investor as dividends received by a resident enterprise from another resident enterprise should be exempt income according to Article 26(2) of the CIT Law
- Capital gains: this part should form part of the taxable income of the investor according to Article 16 of Implementation Rules for CIT Law. However, in the case of capital losses, the investor may claim deduction in calculating its taxable income for CIT purposes.

4. What if the abovementioned rules are applied to non-resident investors?

Again, Announcement 34 does not prescribe the CIT treatment of the three parts of the proceeds. However, based on the basic principles and rules in the CIT Law, if the investor is a non-resident enterprise, the CIT treatment of the three parts should be as follows:

- Return of capital: this should not form part of the taxable income of the investor as the original capital is deductible for Withholding Tax (WHT) purposes in accordance with paragraph 3 of the circular, Guo Shui Han [2009] No. 698 (Circular 698);
- Dividend income: this should form part of the taxable income of the investor as dividends received by a non-resident enterprise from a resident enterprise should be subject to Withholding Tax (WHT) according to Article 6 of Implementation Rules for CIT Law. However, certain tax treaties provide reduced WHT rates where the relevant conditions are met
- Capital gains: this should form part of the taxable income of the investor according to Article 6 of Implementation Rules for CIT Law. Certain tax treaties provide WHT exemption on the transfer of shares or equity interests where the relevant conditions are met.

However, it is not clear if such tax treaty relief should apply to capital gains that are recognised upon capital withdrawal or reduction rather than share transfer. It is also not clear if the rollover relief contained in the circular, Cai Shui [2009] No. 59 (Circular 59), will also apply to capital gains arising from capital withdrawal or reduction as opposed to share transfer.

In the case of capital losses, at present, we are not aware of any provisions in the CIT Law that allow a non-resident investor to set off the losses against its capital gains in China.

A summary of the possible implications of abovementioned rules for resident and non-resident investors is set out in Appendix A.

5. What happens if there are capital reserves in the investee that are attributable to the investor making the capital withdrawal or reduction?

Announcement 34 does not specifically address the issue of capital reserves. In practice, the CIT treatment of capital reserves may depend on the nature of the reserves. For example, if the reserves have arisen from contribution by the investor in addition to the registered capital such as share premiums, they may qualify as "original capital" and be treated as return of capital. However, if the reserves have arisen from windfall gains to the investee, then they may form part of the capital gains or dividends of the investor making the capital withdrawal or reduction.

6. How do the rules in Announcement 34 compare with the CIT rules on liquidation?

The rules in Announcement 34 are very similar to those on liquidation. According to Article 11 of Implementation Rules for CIT Law and the circular, Cai Shui [2009] No. 60 (Circular 60), in a liquidation, the part of residual assets obtained by an investor from the investee can also be divided into three parts as mentioned in Point 1 above.

7. How do the rules in Announcement 34 compare with the CIT rules on transfer of shares or equity interests?

It appears that the key difference is that in the case of share or equity interest transfer, the accumulated undistributed profits and revenue reserves will not be excluded from the sales proceeds in calculating the capital gains for CIT purposes. This treatment applies to both resident and non-resident investors.

Such differences in CIT treatment between share transfer and capital withdrawal / reduction may affect the tax neutrality and create scope for tax planning.

For example, a resident investor that wishes to transfer its equity interests in the investee to another party may choose to withdraw or reduce its capital in the investee and have the other party inject new capital into the investee. By doing that rather than transferring the equity interest, the investor will have part of its proceeds exempt from CIT as dividends.

On the other hand, a non-resident enterprise that is eligible for WHT exemption on capital gains under a tax treaty may choose to transfer the equity interests to another party to realise tax-exempt capital gains, rather than withdrawing or reducing its capital and having part of its proceeds taxed as dividends (in practice, however, for non-resident enterprises, it is very difficult to obtain approval for capital withdrawal or reduction.)

It is not clear if the tax authorities intend to have different rules for the CIT treatment of capital withdrawal / reduction and share transfer. In addition, it should be noted that there are general anti-avoidance provisions in the CIT Law. As such, in practice, investors are advised to seek clearance from the tax authorities in charge before carrying out important decisions about their investments.

8. Will Announcement 34 be applicable to the situation where the foreign investor in a co-operative (or contractual) joint venture (CJV) recoup its investment before the expiry of the term of CJV?

It is not clear if Announcement 34 will apply to such a situation because it is a very special form of capital withdrawal or reduction. Therefore, consultation with your tax advisors is highly recommended.

9. What will be the tax impact of the loss of the investee on an investor?

Announcement 34 also provides that where the investee has incurred losses, it can carry forward the losses to be utilised in future years. However, the investor should not reduce the cost of investment for CIT purposes, and it should not obtain any deduction on such reduction in investment costs as investment losses.

KPMG observations

Capital withdrawal / reduction is an issue that is of interest to many foreign investors because the foreign exchange controls and the strict rules on the computation of distributable income have created cash traps for foreign investment enterprises in China. In practice, it is still difficult to obtain approval for capital withdrawal or reduction. Nevertheless, there are some successful cases. Location, timing and relationships with the relevant authorities can play a part in the success or failure of such approval applications.

Announcement 34 has brought some degree of clarity to the CIT treatment of capital withdrawal and reduction. However, as can be seen from above, there are still many unanswered questions. As such, it is important for businesses to seek professional advice and obtain clarification from the tax authorities before embarking upon major exercises that affect capital investments.

Appendix A - Possible CIT implications of rules in Announcement 34 on capital withdrawal / reduction for investors

Composition of assets obtained upon capital withdrawal / reduction	Resident investor	Non-resident investor
Return of capital	Not part of taxable income (Note 1)	Not part of taxable income (Note 1)
Dividend income	Not part of taxable income (Note 2)	Part of taxable income (Note 3)
Capital gains	Part of taxable income	Part of taxable income (Note 4)

Notes

1. Because the cost of investment is deductible.
2. Because dividends paid by a resident enterprise to another resident enterprise are exempt from CIT where conditions are satisfied.
3. The WHT rate may be reduced under certain tax treaties when the relevant conditions are met.
4. The WHT exemption may be available under certain tax treaties when the relevant conditions are met.

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