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China alert

Issue 23 – July 2011

Offshore indirect disposal enforcement case for individual may only be a one-off case for now

Matter discussed in this issue:

- Notice of the State Administration of Taxation on Strengthening the Administration of Corporate Income Tax on Gains derived by Non-resident Enterprises from Equity Transfers, Guo Shui Han [2009] No. 698 ('Circular 698')
- Informal indications that the imposition of tax by the Shenzhen Local Tax Bureau, on the indirect offshore disposal of an equity interest in a Chinese company by a non-resident individual, may be limited on its facts

Background

As outlined in China alert 17, the Shenzhen Local Tax Bureau (Shenzhen LTB) was recently reported to have collected tax of RMB13.68m from the indirect disposal of shares in a Chinese enterprise by a non-resident individual.

The Corporate Income Tax (CIT) Law contains a general anti-avoidance rule (GAAR) which may be used in cases of perceived abuse of organisational forms and pursuant to Circular 698, to re-characterise an offshore indirect transfer as a direct disposal of the underlying equity interest in the Chinese company by a non-resident disposer, allowing the gain to be subject to Chinese tax. While the Individual Income Tax (IIT) Law prima facie does not contain an equivalent GAAR provision, the actions of the Shenzhen LTB had raised the question as to whether the application of the GAAR had been somehow extended to non-resident individual disposers. Insofar as any application of the GAAR requires the approval of the State Administration of Taxation (SAT), it was questioned whether the imposition of tax in this case indicated a change of policy by the SAT.

There are now informal indications that this case may have been a one-off, particular to its facts, and that an overall change of policy, involving an expansion of the application of the GAAR, is not necessarily implied. Such indications are not inconsistent with our interpretation of the IIT Law as currently worded. Nevertheless, taxpayers would be well advised to take care where the circumstances of their disposals closely approximate the circumstances in the Shenzhen case.

Facts of the case in Shenzhen and manner in which tax was imposed

As outlined in China Alert 17, an individual, understood to be a tax resident of Hong Kong, realised a gain on the disposal of his shareholding in a Hong Kong incorporated company, which held a Chinese subsidiary, the value of which had substantially increased in the period since its establishment. The initial Chinese media reports indicated that the Shenzhen LTB viewed the transaction as an abuse of organisational form and lacking in commercial substance, given the Hong Kong company's small registered capital and lack of substantive operating activities. The Shenzhen LTB, therefore, obtained the approval of the SAT to re-characterise the transaction as a transfer of the equity in the Chinese incorporated subsidiary, and subjected the gain to tax.

There are now informal indications that the Shenzhen LTB approached the SAT for approval once they had established the factual background to the case, including the contractual arrangements surrounding the share transfer, and had determined that the underlying assets subject to transfer were indeed shares in a Chinese company. While the SAT did approve the imposition of tax in this case, the basis on which they did so is not known. As such, this case could be viewed as a one-off, which may be distinguished on its facts and future indirect transfer cases will need to be assessed on a case-by-case basis to determine whether gains arising may properly viewed as taxable in China. The Shenzhen case does not necessarily establish the principle that the CIT GAAR may be readily utilised to apply the provisions of the IIT Law. It was further indicated that the SAT does not intend, at present, to issue a circular expanding the scope of application of taxes on indirect offshore transfers to individuals.

KPMG observations

The clarifications which have emerged on the facts of this case may be seen as somewhat reassuring for taxpayers. As there have been prior cases of action by local tax authorities pre-empting a broader national tax policy change (such as the Chongqing case which pre-empted the introduction of Circular 698) there had naturally been some consideration as to whether the Shenzhen case was the pre-cursor to a new circular of general application to offshore indirect disposals by individuals.

The current indications are that such a circular is not immediately in prospect, and that there does not yet appear to be any emerging tax principle of applying the CIT GAAR to the IIT Law. However, individuals should be aware that, in circumstances akin to those in the Shenzhen case, the imposition of Chinese tax is not precluded, and particular care and external advice should be taken with transaction documentation.

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