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CHINA TAX ALERT

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Tax treaty relief on transferring land rich enterprises and substantial shareholding interests clarified

Regulations discussed in this issue:

- Interpretations on Clauses of the Agreement between the Government of the People's Republic of China and the Government of the Republic of Singapore for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and of the Protocol thereto, Guo Shui Fa [2010] No. 75 (Circular 75)
- Announcement on Issues Concerning the Clauses on Capital Gains in Tax Agreements, SAT Announcement [2012] No. 59 (Announcement 59)

Background

On 31 December 2012 the State Administration of Taxation (SAT) of the People’s Republic of China (PRC) issued Announcement 59, which clarifies the manner in which the capital gains tax articles of China’s double tax agreements (DTAs) are to be applied. The clarifications are generally welcome as they provide greater certainty to non-residents with regards to the availability of DTA relief from PRC withholding tax (WHT) on capital gains arising from disposals of PRC equity investments. However, the clarified approach could potentially overstate the degree to which Chinese enterprises are identified as land-rich in equity transfers and result in frequent denials of DTA relief on these grounds.

Specifically, Announcement 59 offers more detailed guidance on the determination of whether China retains the right to subject gains, arising on the disposal of equity in a Chinese enterprise by a non-resident, to WHT at 10 percent. It elaborates on the circumstances in which a Chinese enterprise is considered to derive more than 50 percent of its value from immovable property, and the circumstances in which a non-resident disposer of equity in a Chinese enterprise is considered to hold at least 25 percent of that enterprise. Non-resident enterprises seeking Chinese DTA relief on transfers of equity investment in China should pay close attention to this determination mechanism.

Announcement 59

The existing guidance on the application of the capital gains article in a DTA is set out in Circular 75, which was issued in 2010 to streamline the interpretation and application of DTAs entered into by China with other jurisdictions. Although Circular 75 focuses on the interpretation of the articles in the PRC-Singapore DTA, the guidance provided is noted to be equally relevant to other Chinese DTAs that have similar provisions as those in the PRC-Singapore DTA. Announcement 59 serves to complement Circular 75 in the following two aspects.

Transferring a "land rich" Chinese company

The first topic addressed by Announcement 59 is the determination of whether a Chinese company is "land rich" in the context of a DTA. Since the 2010 revisions to the Barbados-China DTA, all of China's DTAs have reserved taxing rights to China on disposals of equity in a land-rich Chinese enterprise. Chinese DTAs typically define a "land rich" Chinese company as a Chinese enterprise that directly or indirectly derives more than 50 percent of its value from Chinese immovable property.

Announcement 59 clarifies that, in determining whether a Chinese enterprise derives its value largely from immovable property, liabilities of the enterprise are to be disregarded, and regard solely had to the enterprise assets ("gross asset approach"). This gross asset approach is generally consistent with the OECD Commentary.

Furthermore, Announcement 59 states that the determination of whether the 50 percent threshold is crossed should be made using the values of the enterprise assets as recorded in the financial statements prepared in accordance with PRC GAAP. However, the value attributed to land and land use rights should not be lower than the fair market value of comparable adjacent or similar land and land use rights. Essentially, fair market value should be used for land and land usage rights, which has a high potential to appreciate in China; the book value approach should be applied for the rest of the assets.

Transferring a Chinese company that is not "land rich"

The second area clarified by Announcement 59 is the determination of the 25 percent shareholding in Article 13 of the PRC-Singapore DTA. Specifically, when a Singaporean company transfers an equity interest in a Chinese company that is not "land rich," and has owned directly or indirectly at least 25 percent of the capital in the Chinese investee company at any time during the preceding 12-month period, gains from the equity transfer are subject to Chinese corporate income tax. A number of Chinese DTAs contain provisions similar to this "25 percent shareholding" provision in the PRC-Singapore DTA.

Circular 75 provides examples to illustrate how to determine whether the "25 percent shareholding" threshold is met. In addition to direct ownership and indirect ownership, Circular 75 introduces the "significant interest relationships" notion, similar to the "constructive ownership" concept in the US federal income tax system. In short, direct ownership, indirect ownership, and "constructive ownership" should be combined in deciding whether the 25 percent threshold is breached.

Announcement 59 provides additional refinement to Circular 75. With respect to direct ownership in the Chinese enterprise, the Announcement notes that where nominees are used by a non-resident to hold equity in the Chinese enterprise, then the nominee holdings will be considered in determining whether the 25 percent threshold is met.

Announcement 59 also clarifies how indirect holdings in the Chinese enterprise are to be taken into account in determining whether the 25 percent threshold is met. Such indirect holdings need only be included in the calculation where the holding in the intermediate holding company, through which equity in the Chinese enterprise is held, is at least 10 percent of the total share capital of that company.

The Announcement also defines more clearly, for both non-resident individual and corporate disposers of Chinese equity, who is to be considered to be related persons with 'significant interest relationships'. The 10 percent threshold for including indirect holdings in the Chinese enterprise is equally relevant in determining the holdings of such related persons.

The SAT has also issued an explanatory note for Announcement 59 which provides a number of illustrative examples clarifying the application of the Announcement's provisions. Importantly, the explanatory note also reiterates a statement made in Circular 75, that where a non-resident person disposes of another non-resident enterprise, which in turn holds a land-rich Chinese enterprise, then this disposal does not normally fall within the scope of Chinese taxation, except where the general anti-avoidance rule is invoked (e.g., a Circular 698 situation). In this regard the Chinese tax provisions governing disposals of land-rich enterprises differ from the more extensive approach taken by some other jurisdictions, such as the Taxable Australian Real Property (TARP) provisions in Australia.

KPMG observations

The clarifications on the 25 percent threshold determination should be viewed as helpful, as the definition of persons with 'significant interest relationships' is now more precise, and the need to consider every minor holding in the Chinese enterprise (whether held indirectly by the disposer itself or 'constructively held') is mitigated by the exclusion of those indirect holdings through intermediate holding companies of which less than 10 percent are held.

However, the land-rich clarifications could prove problematic, depending on how they are actually applied by local tax authorities in practice. If Chinese enterprise asset values were to be generally determined on the basis of their accounting values, with solely immovable property stepped up to higher fair market value, more enterprises would fall into the "land rich" category. This could particularly be the case in light of the steadily increasing Chinese real estate prices of recent years.

While the OECD Commentary on the matter is brief, the instruction to compare 'the value of the immovable property to the value of all the property owned by the company' would appear to fairly require a comparison of like with like, i.e., fair market values used for both the immovable property and all other enterprise assets. Mixing the fair market value of immovable property with the book values of other assets in one computation could lead to skewed results. In addition, some countries require assessment of the fair market value of all assets in making the determination, potentially including assets such as goodwill, know-how, unregistered patents or trademarks which may not be carried on the balance sheet. While this does not appear to be the approach outlined in Announcement 59, it is to be hoped that the PRC tax authorities will take a balanced view, considering all the facts, in making the land-rich determination.

Announcement 59 reiterates the requirement set out in Circular 75 that in making the land-rich determination the consideration is whether at any time during the 3-year period prior to the disposal, more than 50 percent of the value of the Chinese enterprise is derived from immovable property. In practice an uncertainty exists as to what the Chinese tax authorities will regard as acceptable valuation evidence that the company has never breached the land-rich threshold over a 3-year span. Drawing on the experience of some other jurisdictions it has been found that an approach which takes into account valuation reports prepared on dates of material real estate acquisition and disposal and other significant dates such as the fiscal year ends has been acceptable and workable for both taxpayers and tax authorities. Adoption of such an approach in China may well be advisable.

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