New tax frontiers in China: taxing indirect share transfers

In 2009, the PRC tax authorities released Circular 698 decreeing offshore sales that indirectly transfer a PRC company could be reportable and taxable in China if the transaction lacked reasonable business purpose. When the Circular was first introduced, many taxpayers questioned whether the PRC tax authorities were legally sanctioned to impose such requirements. However, given increasingly pronounced General Anti-Avoidance Rules in both China and other developed countries, taxpayers have begun to embrace such requirements despite resistance from some who still consider Circular 698 unorthodox.

Criticism regarding implementation of Circular 698 arose in terms of which transactions are targeted, definition of business purpose, reporting and tax collection method, exemptions and other administrative matters. In response, following much speculation over the years, the PRC tax authorities eventually revised Circular 698, culminating in the release of Announcement 7 in February 2015.

The new Announcement 7 rules depart significantly from the old Circular 698 in several major respects, including – now – a far broader range of “Chinese taxable property” potentially being subject to indirect transfer case assessment, introduction of a withholding tax (WHT) mechanism, and a new approach to reporting transactions. In depth guidance on “reasonable business purpose” (or lack thereof) and safe harbor rules are also included.

As with Circular 698, Announcement 7 focuses on the transfer of equity in foreign tax resident enterprises that directly or indirectly hold Chinese taxable property. However, the Announcement further expands the scope by including any transaction involving a “transfer of equity and other similar interests” in the foreign enterprise that “results in transactional outcomes which are identical or similar to a direct transfer of the Chinese taxable property”. This widens the net considerably, potentially encompassing transactions such as transfer of partnership interests or convertible debt, share dilutions, direct holding of real estate by an offshore company etc.

In addition, the new WHT mechanism obligates the buyer to withhold the relevant taxes or report the transaction within a certain period to avoid penalties – necessitating greater care when drafting sales/purchase agreements (SPAs) to ensure protection for both buyer and seller. Further, while the expanded safe harbor rules offer relief for internal group reorganization, land-rich companies would still be subject to heavy scrutiny.

And while rigorous tests can now help determine if a “reasonable business purpose” is met (failing of which could mean immediate tax dues), other conditions might exist, which taxpayers themselves must self-assess to determine whether the transaction is reportable or taxable. Again, such new testing pushes the onus to the transaction parties in gathering supporting evidence on business purpose.

Since issuance of Circular 698, China’s indirect offshore disposal tax rules have become regarded as a highly challenging aspect of foreign investments in China. While the changes under Announcement 7 have been welcome, uncertainties remain such as treatment of pre-Announcement 7 transactions, aligning different tax authorities’ views in assessing reasonable business purpose, and impact on overseas tax payers in terms of foreign tax credits.

In practice, consensus between buyers and sellers on potential tax liability – and thus on amounts to be held in escrow or withheld/remitted – will be difficult given: 1) absence of guidance in Announcement 7 on China asset valuation; 2) inherent uncertainties on current PRC capital gains assessment, especially for open cases given that Announcement 7 has been retroactive since Circular 698 was released; and 3) inevitable differences between buyers/sellers in interpreting reasonable business purpose given both parties are “on the hook” for tax enforcement.

This will likely mean protracted deal negotiations, drafting of SPAs and heavier reliance on advisors.

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