Client Alert

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Managing Offshore Holding Companies from China: Recent Case May Suggest Increased Tax Risk

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As our readers know, foreign investments into the People's Republic of China ("**PRC**") are typically structured through one or more holding companies domiciled in offshore jurisdictions. Planned and implemented properly, an offshore holding company structure can provide investors with enhanced governance and economic rights, ease of public listing and disposal without triggering onshore regulatory approvals, and reduced withholding tax rates on returns of their PRC investments compared to a direct investment into a PRC entity.

In recent years, however, the PRC State Administration of Taxation ("**SAT**") has issued a series of circulars that evidence a significantly increased scrutiny on the use of offshore holding companies to structure foreign ownership in operating businesses in the PRC. In *Guoshuihan [2009] No. 601* ("**Circular 601**"), for example, the SAT emphasized that an offshore holding company may only take advantage of the preferential withholding tax rates under a double tax treaty between the PRC and the offshore jurisdiction if the holding company is the "beneficial owner" of the applicable income. Among other things, Circular 601 requires a "beneficial owner" to have substantive operating activities and not be merely an agent or "conduit".

Similarly, pursuant to *Guoshuihan [2009] No. 698* ("**Circular 698**"), a disposal of an offshore holding company that lacks a "reasonable business purpose" and represents an "abuse of organizational form" ("滥用组织形式") is subject to challenge by the SAT. In such a case, the SAT may deny the existence of the offshore holding company and recharacterize the transaction as a disposal of the underlying PRC resident company, resulting in PRC-sourced capital gains subject to a 10% withholding tax.

Provided there is a reasonable business purpose for use of an offshore holding company (such as the purpose of pursuing an IPO and listing in Hong Kong or the U.S.), it is generally believed that Circular 698 would not apply to the sale of a holding company that is listed on the Hong Kong Stock Exchange, since the SAT is unlikely to challenge the existence of a publicly traded company on the basis that it is an abuse of organizational form. A recent case reported by the China Taxation News, however, highlighted one situation in which such a sale may be subject to PRC taxation, even without recourse to Circular 698.

THE HEILONGJIANG CASE

On August 30th, 2013, the China Taxation News reported that in August 2012, the Cayman Islands subsidiary of a U.S. private equity fund paid CNY 279 million (≈$45.6 million USD) in PRC enterprise income tax ("**EIT**") and interest to an SAT bureau in Heilongjiang Province after the bureau determined that the subsidiary avoided EIT on the transfer of shares in a company listed on the Hong Kong Stock Exchange.

According to the report, in 2011, the fund's Cayman Islands subsidiary ("**Cayman Seller**") agreed to sell to a U.S. publicly traded company shares in a Cayman Islands company listed on the Hong Kong Stock Exchange ("**Cayman**

Holdco"). Cayman Holdco had four PRC subsidiaries, and a majority of Cayman Holdco's officers who were responsible for its business operations and management worked out of one of the PRC subsidiaries. Cayman Holdco's management department personnel were also located in that subsidiary.

In accordance with Circular 698, Cayman Seller submitted a letter to the SAT local Heilongjiang bureau, claiming EIT exemption on the capital gains from the transaction.

The transaction drew the bureau's scrutiny. Notably, however, the bureau did not challenge the transaction under Circular 698, signaling its tacit recognition that it would be difficult to justify the application of the Circular and characterize a publicly traded company as a tax shelter.

Instead, the bureau asserted that PRC tax was payable on the transaction on the rationale that Cayman Holdco should be treated as a PRC resident company, since it was effectively managed by personnel based in one of its PRC subsidiaries. The transfer of Cayman Holdco shares, therefore, would be viewed as generating PRC-source capital gains subject to a 10% withholding tax.

ANALYSIS

Under extensive amendments to PRC's EIT Law promulgated in 2008, a PRC resident company includes any domestic or foreign company that is "effectively managed" in the PRC. PRC resident companies must pay EIT on their worldwide income; and outbound payments (including dividends and interests) by PRC resident companies are generally subject to PRC withholding tax.

To date, the most detailed guidance on "effective management" comes from two recent SAT publications: *Guoshuihan [2009] No. 82*, and *Announcement [2011] No. 45* (the "**Effective Management Guidance**"). The Effective Management Guidance sets forth (i) specific scenarios in which a company would be treated as a PRC resident company by being effectively managed in the PRC; (ii) the EIT consequences of such treatment, and (iii) various registration and reporting requirements.

The Effective Management Guidance, however, addresses only foreign companies that are "**PRC-Controlled**" – i.e., foreign companies whose main investor is a PRC company or company group.[1] For this reason, it has generally been thought that without further official guidance, the SAT would not apply these rules to foreign companies that are not PRC-Controlled.

The Heilongjiang case, however, could represent precisely such an application and an expansion of SAT's position on the applicable scope of the "effective management" rules. Unfortunately, the report of the case did not specify whether Cayman Holdco was PRC-Controlled. If it was not, then the case shows that even a foreign, publicly traded company that is not PRC-Controlled could be characterized as a PRC resident company as long as it is "effectively managed" in the PRC. Given the number of offshore holding companies that are managed from the PRC at some level, such a sweeping application of the "effective management" rules would have significant PRC tax implications.

[1] The Guidance does not explain what constitutes a "main investor" or whether there is a required shareholding percentage. It is clear, however, that only a PRC company (rather than a PRC individual) could be a "main investor" for this purpose.

LOOKING FORWARD

If the Heilongjiang case proves to have a wider precedential effect in future cases reviewed by other SAT bureaus such that a non PRC-Controlled offshore holding company is treated as a PRC resident company, the PRC tax consequences will be far-reaching, including:

- EIT would be imposed on the holding company's worldwide income;
- PRC withholding tax would be imposed on all dividends, interest and royalties paid by the holding company (for example, at a 10% rate if the recipient is a U.S. person); and
- PRC withholding tax would be imposed on all capital gains from the sale of the holding company (at a 10% rate if the seller is a U.S. person and owns more than 25% of the company).

In addition, further guidance from the U.S. Internal Revenue Service ("**IRS**") is needed on whether U.S. taxpayers would be able to claim a foreign tax credit against their U.S. income tax liabilities for PRC taxes imposed under the "effective management" rules. IRS officials have previously stated that paying certain foreign tax assessments without first consulting with the U.S. Competent Authority can jeopardize a taxpayer's ability to claim a foreign tax credit in the United States.

Given the severity of these consequences, investors might consider taking steps to ensure that their offshore holding companies would not be treated as "effectively managed" in the PRC. Possible planning measures to consider might include:

- Ensuring that the holding company's major financial and operational decisions are not made or approved by PRC companies or personnel working out of such companies (and, in cases where management personnel hold dual roles with appointments at both the holding company and the operating entity levels, ensuring that the holding company's decisions are documented as being made by holding company officers in their capacity as such);
- Ensuring that the holding company's board meetings are held outside of the PRC;
- To the extent practicable, ensuring that a majority of the holding company's directors and senior management personnel do not ordinarily reside in the PRC;
- Ensuring that senior management personnel and those responsible for the operation of the holding company do not perform their duties – in their capacity as holding company officers – inside the PRC; and
- Keeping the holding company's major properties, books and records (including corporate chops / seals and minutes of board meetings and shareholder meetings) outside of the PRC.

Similarly, in order to avoid subjecting the disposal of an offshore holding company to PRC taxation under Circular 698, investors might consider adopting measures to reduce the risk that the disposal would be viewed as an "abuse of organizational form". Possible planning measures to consider might include:

- Structuring the offshore holding company to conduct substantive business activities (e.g. procurement, sales and marketing, and treasury center duties);

- Ensuring that the sale of the holding company is not the practical equivalent of the sale of the underlying PRC company by, for example, contributing to the holding company other business operations and/or investment assets that are unrelated to the PRC company. The longer that the holding company has held the operations and assets prior to the disposal, the stronger the inference that the holding company is not merely a shell entity; and
- Ensuring that the purchase agreement and other corporate documents do not suggest or indicate that the actual purpose of the disposal is to transfer the underlying PRC company. The documents should not, for example, describe the transaction as the sale of the underlying PRC company.

We await further guidance from the SAT on the exact scope of the Heilongjiang case, its precedential value, and its intended effect on the "effective management" rules. Also, given the development of the "effective management" rules in the PRC and India, query whether other BRIC nations and emerging economies will begin taking a similar approach in expanding the scope of their home country taxation.

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