

China Law Update Blog

The Latest Developments On China Law

SheppardMullin

Presented By

美国盛智律师事务所

China Law Update

June 21, 2011 by Sheppard Mullin

China Clarifies and Expands Reporting Obligations of Foreign Enterprises on Indirect Equity Transfers

On March 28, 2011, China's State Administration of Taxation ("SAT") issued Announcement No. 24 regarding Several Problems of Regulation on Income Tax of Non-resident Enterprises (the "Announcement"), effective beginning April 1, 2011. The Announcement applies to all outstanding tax liabilities incurred but not paid before April 1, 2011.

- **General Introduction**

The Announcement clarified the tax reporting obligations of non-resident enterprises to make payments related to interest, leasing fees, guarantee expenses, property rentals, equity investments and transfers originating from China. More importantly, the Announcement contains interpretations of Guo Shui Han [2009] No. 698 relating to Regulations on Enhancement of Income Tax of Non-resident Enterprises ("Circular 698") which requires, among other things, all foreign enterprises to report their gains from any indirect transfers of Chinese-resident enterprises to the applicable Chinese tax authorities.

- **Key Points**

Circular 698 requires foreign enterprises involved in any indirect transfers of equity of a Chinese-resident enterprise (an "Indirect Transfer") to provide relevant transaction materials to an applicable Chinese tax authority if (i) the tax rate imposed by the country (region) where the overseas holding company was established is less than 12.5%, or (ii) the aforesaid country (region) does not levy income tax on income of its residents.

Circular 698 also affords SAT and its local authorities the power to pierce the corporate veil of the overseas holding company and impose income taxes on any foreign enterprise for the gains resulting from the Indirect Transfer if such transfer was done in order to avoid paying taxes on income reportable to the Chinese authorities and without any reasonable business purpose. The difference between the equity transfer price and the equity cost price will be the basis for computing the taxable gain.

On May 11, 2011, China Taxation News reported that Shantou Tax Bureau of Guangdong Province ("Shantou Bureau") successfully pursued and collected approximately RMB7.2 million in income tax on the capital gains of a British Virgin Islands company (the "BVI Company")

derived from the Indirect Transfer of a PRC company in Shantou (the “Shantou Company”) to a foreign company in accordance with Circular 698. The Shantou Bureau discovered that the BVI Company indirectly owned an 100% equity interest in a Hong Kong company via two intermediary BVI companies. The Shantou Company, in turn, was wholly-owned by the Hong Kong Company.

By reviewing equity transaction documents of relevant companies as required by the Shantou Bureau, the Shantou Bureau discovered that the overseas intermediary companies connecting the BVI Company and the Shantou Company were all established in countries or regions whose tax jurisdictions do not extend to foreign-sourced income and that these intermediary companies have no other investment activities and were established solely to avoid taxes. Thus, due to its philosophy of substance-over-form, the Shantou Bureau determined that the BVI Company, in actuality, directly transferred equity interests of the Shantou Company and that it must pay equity transfer income taxes to the Chinese tax authorities.

Further, the Announcement clarified some of the points in Circular 698. Concerning the scope of Circular 698, the Announcement indicated that Circular 698 applies not only to a foreign enterprise who is the “actual controlling party” of the Chinese resident enterprise, in which its ownership is being indirectly transferred, but any foreign enterprises that are involved in the Indirect Transfer, regardless of whether such foreign enterprises have had any control over the subsidiary being transferred.

The Announcement also explained that if there are multiple foreign enterprises involved in the Indirect Transfer, any of the foreign enterprises involved can submit relevant transaction documents to the local tax authority where the Chinese resident enterprise was formed. If the Indirect Transfer affects two or more Chinese resident enterprises located in different provinces, the foreign enterprise is allowed to choose to which province’s tax authority it will submit the relevant transaction documents.

- **Conclusion**

The Announcement provided guidance for foreign enterprises to fulfill their tax-reporting obligations imposed by SAT under Circular 698 in connection with an Indirect Transfer. The Announcement firmly establishes that SAT has the authority to tax every transfer taking place outside of China that indirectly affects a Chinese resident enterprise pursuant to Circular 698. Further, although neither the Announcement nor Circular 698 requires an approval or registration of these transfers, submission of the relevant transaction documents to an applicable tax authority is encouraged.

Authored By:

[Willow Wei](#)
86.21.2321.6033
wwei@sheppardmullin.com