

China Tax & Investment News



Breaking the boundary - a story about a non-resident individual who was taxed in China for an offshore indirect transfer of a PRC equity interest

Introduction

The China Taxation News, which is sponsored by the State Administration of Taxation (SAT), recently reported a case on the collection of Individual Income Tax (IIT) of RMB13,680,000 by the Shenzhen(SZ) Local Tax Bureau on a capital gain arising from an indirect transfer of an equity interest in a Chinese company through an offshore transfer of its Hong Kong parent by a Hong Kong resident individual (the SZ Case). This is the first public tax case where IIT was imposed by the China tax authority on gains derived by a non-resident individual from an indirect transfer of a China company. This issue of China Tax & Investment News discusses and analyzes the details of the case.

An investment story of a Hong Kong businessman

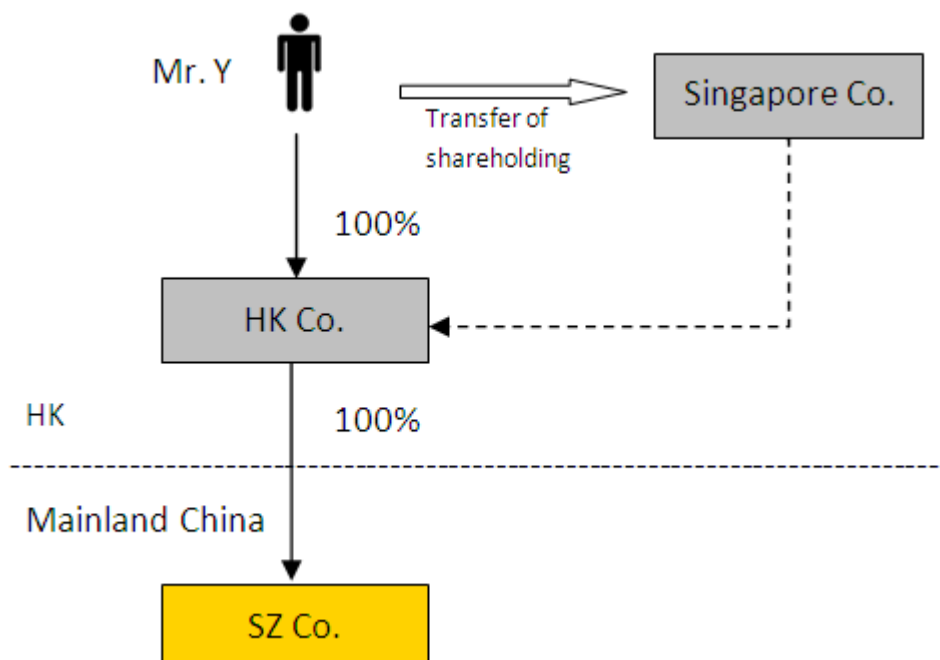
A decade ago, a businessman in Hong Kong (Mr. Y) noticed the great potential of Mainland China ("China" is interchangeably used), and was attracted by its cheaper labor cost and preferential tax/business treatment for foreign investments. He made a decision to invest in China. Under regulatory constraints back then, as a foreign individual, Mr. Y knew that a direct investment under his own name would face a lot of hurdles. Same as many foreign individuals, he set up an investment holding company in his resident jurisdiction - Hong Kong - and used it as the platform for his investment in China. After 10 years of operation, this Hong Kong company was sold to another investor. It appears that the story should come to an end here; however, the China tax authority added an exceptional ending.

The China Taxation News reported that the SZ Local Tax Bureau collected IIT of RMB13,680,000 on a capital gain arising from an indirect transfer of an equity interest in a Chinese company by a Hong Kong resident individual. This is the first public case where IIT was imposed by the China tax authority on gains derived from an indirect transfer of PRC shareholding by a non-resident individual. The technical bases quoted in the SZ Case such as General Anti-Avoidance Rule (GAAR), business substance, look-through of shell company are all related to Corporate Income Tax (CIT). It is therefore unclear as to whether it is technically correct and appropriate to apply the aforesaid CIT principles to IIT beyond the regulatory boundary and further position it as “a breakthrough in tax practice” or “passing through the bottleneck of applying tax anti-avoidance concepts and measures among different taxes.”

The fact of the SZ Case

According to the report of the China Taxation News, the Hong Kong businessman, Mr. Y, set up a company with a registered capital of HKD10,000 in Hong Kong (HK Co.). In year 2000, HK Co. established a wholly owned subsidiary in SZ (SZ Co.) to engage in the logistics business and acquire a sizable storage facility. After 10 years of operation, HK Co. was sold to a Singapore company by Mr. Y and as a result, SZ Co. was also been transferred indirectly. The total transaction price was around HKD200,000,000.

► The holding structure



► How the China tax authority learned about the case

According to Circular Guoshuihan [2009] No. 698 (Circular 698), non-resident transferors are required to report their share transfer transactions, together with the relevant supporting documentation including share transfer agreements, after they indirectly transferred their equity interests in China companies via disposal of intermediate holding companies with the transaction subject to a tax below 12.5%. As Circular 698 only applies to CIT, the HK resident individual is technically not subject to the abovementioned reporting obligation. How could the China tax authority learn about the transaction and obtain the relevant contract/agreements of equity transfer? We understand from a verbal discussion with relevant tax officials that the case was discovered when the in-charge tax officials carried out a routine tax administrative procedure on SZ Co.. The tax authority then started to follow up on this case and obtained the relevant documents such as the share transfer agreement and other information.

► How the tax authority looked into the case

According to the China Taxation News, due to the fact that HK Co. has no substantial business activities, the SZ Local Tax Bureau held the view that the gain derived from the equity transfer was in effect coming from the asset appreciation of SZ Co. as the equity transfer involved not only HK Co. but also SZ Co. simultaneously. In this respect, the SZ tax authority concluded that the substance of the equity transfer of HK Co. is actually the indirect transfer of SZ Co. with the aim to avoid China tax. As stated in the report of the China Taxation News, with the blessing of the SAT, the SZ Local Tax Bureau decided to levy IIT on Mr. Y. The in-charge tax authority further clarified that the equity transfer agreement between Mr. Y and the Singapore Co. stated that the transfer of equity of HK Co. includes the assets of SZ Co., where the values appraised by the designated valuer was also specified. Hence, the SZ Local Tax Bureau deemed this equity transfer as a transfer of assets within China and as a result the associated gain should be subject to IIT at 20% under the category of "income derived from transfer of property".

Our observations

Once reported, the SZ Case has become a hot topic. Ever since the release of Circular 698, there have been a number of offshore indirect transfer transactions carried out by non-resident sellers with intermediate holding companies being considered as a lack of business substance and looked through by China tax authorities. Examples include the cases in Chongqing, Xinjiang, Jiangdu, Nanjing and Shantou. In all these cases, China tax authorities challenged the non-resident enterprises involved. The SZ Case is the first case in which a non-resident individual was taxed. The report only disclosed limited background information and we would like to shed light on the following:

► Legal basis of the SZ Case

We understand that the abovementioned indirect transfer cases occurred previously were supported by the Chapter of "Special Tax Adjustment" and the general anti-avoidance rules (GAAR) set forth by the CIT Law and Circular 698. In-charge tax authorities would report to the SAT for final scrutiny to disregard the overseas holding companies if these companies were established for the purpose of tax avoidance without business reason, where the transactions could be regarded as a PRC equity transfer and Chinese tax liabilities would be triggered. However, both GAAR and Circular 698 are technically applicable to corporate taxpayers only. It is a general principle that individuals should be governed by the IIT law and relevant regulations only. Till now, no regulation stipulates that the GAAR and the determination of "conduit company" of "look-through" principal set forth by Circular 698 can also apply to individuals.

The China Taxation News also pointed out the legal basis issue. In the current case of indirect transfer of SZ Co. through HK Co., if the HK ultimate shareholder is an enterprise with the legal person status, the tax authority has the legitimate authority to look through the intermediate holding company as abuse of organizational form and without business purposes, and thus deem the transaction as a transfer of interest in a domestic company and impose tax accordingly. However, it is interesting to note that though the news recognized the lack of a sound legal basis, it defines the SZ Case as a "breakthrough" in tax practice and will advance the development of tax legislation, overcome the bottleneck of applying tax anti-avoidance concepts among different taxes, and be seen as a milestone in achieving "fairness" and exercising the sovereignty of China over taxing right. As everyone knows, being different from many western countries (e.g. US, UK) using the common law system, China has a civil law system which is based on *ius scriptum*. Without specific laws or regulations that can be followed, for cases like the SZ Case, the SZ tax authority's conduct might be questionable as to whether it is a "breakthrough in practice" or indeed "overriding the law".

Further to the China Taxation News, the SZ Local Tax Bureau reported the SZ Case in its own website. It mentioned that there is indeed no legal basis on IIT tax anti-avoidance. However, the SAT in its reply to the SZ tax authority confirmed that the transfer actually consisted of assets owned by HK Co. and SZ Co., respectively, and thus the transaction involved this China sourced income derived from disposal of SZ Co. In addition, we understand that the direct evidence of the tax assessment is a specific provision of "the transaction considerations include transfer of assets of SZ Co." contained in the equity transfer agreement. If this is the case, the question would be whether the taxable base of IIT assessment should be the entire transfer price or the amount attributed to SZ Co. only; if it is the latter, how should the gain attributable to SZ Co. be determined? Meanwhile, if only disposal of HK Co was stated in the agreement, would it reduce the probability of triggering IIT liabilities in China? Relevant individuals are encouraged to review the contents of their agreements for equity transfer arrangements so as to avoid being challenged by the tax authorities due to the wording used in the agreements.

We understand that there were different views between departments of the SZ Local Tax Bureau as to whether the transaction shall be taxed or not. Finally, the decision was made upon approval by the SAT. We have been trying to get direct information on the view of the in-charge SAT official and find out the technical basis adopted to support the tax assessment, but as of the date of this newsletter, we cannot obtain an official answer.

► Business purpose and commercial substance

Apart from the issue of legal basis, the tax authority considered that HK Co. was lacking commercial substance, and causally called it a “conduit company” or “shell company”, and used it as the main reason for imposing tax in SZ Case. The GAAR under the CIT law stipulates “where enterprises implement other arrangements without reasonable business purposes in order to reduce their taxable revenue or income, the tax authority has the right to adjust in accordance with reasonable methods.” Circular 698 further reaffirms that “for indirectly transferring equity interest in a Chinese resident enterprise without a reasonable business purpose, the in-charge tax authority can re-define the nature of such equity transfer transaction in accordance with the economic substance, and deny the existence of the offshore holding company used for such taxation arrangement.” However, the interpretation of “without a reasonable business purpose” in Circular 698 is still unclear at the moment and no further detailed guidance has been issued.

In the earlier circular, Guoshuihan [2009] No.601 (Circular 601), on whether the non-resident enterprises can qualify as “beneficial owner” to enjoy the treaty benefits, the term of conduit company is defined to be “those companies that are established for the purposes of evading and reducing taxes, such kind of companies are only registered in the country where they are located so as to satisfy legal form requirements in laws and do not engage in any substantive operation activities of production, marketing and management.” Circular 601 also prescribes seven factors that are considered as negative for a non-resident to pass the beneficial ownership test. These factors are widely considered to be the basis to determine whether the enterprises have commercial substance (Please refer to our previous International Tax and Transaction Tax Bulletin Issue No. 2009002 for more details, which was released on 18 November 2009). Although Circular 601 applies only to passive income (i.e. dividend, interest and royalty fees, etc.) but not capital gains, in practice, these factors might be used as references in determining whether a company has reasonable “business purposes and commercial substances,” in a capital gain case.

In the SZ Case, even though HK Co. is pure a holding company which does not carry out any other business activities, it is obvious that the Hong Kong resident who set up the company in Hong Kong has a proper and legitimate business purpose due to the fact that it is convenient for him to involve in the day to day operation of HK Co. and to hold the China entity so as to meet the regulatory requirements at that time. Also HK Co. has been in existence for 10 years. Although such arrangement has led to certain tax benefits, it shall not be denied that HK Co. has an overall business purpose, while the possibility of avoiding tax on purpose should be considerably low. From the wording of the news release, the tax authority looked through HK Co. because it has no other business activities except for investments in SZ Co. and is considered as “shell company”, while the proper business purpose of HK Co. was completely ignored. If this is the case, all of the similar intermediate holding companies can be considered having no commercial substance and looked through for China tax purposes. Compared to the definition of “conduit company” in the OECD convention, it appears that the Chinese tax authorities are much stricter in the interpretation of such principle.

► Administrative review and appeal approaches

According to the prevailing “Rules for Taxation Administrative Review”, taxpayers who disagree with the decision of the in-charge tax authority can apply for administrative reviews with competent tax authorities (usually the upper level bureau supervising the in-charge tax bureau) after the relevant tax is paid. If the taxpayers are not satisfied with the result of the administrative review, they may resort to legal proceedings.

The report also mentioned there were big divergences between tax authorities and taxpayers on whether the capital gain of equity transfer derived by the Hong Kong individual should be taxable in China. The SZ tax authority has sought advice from the SAT before the IIT assessment. According to the information available, it seems that Mr. Y did not apply for tax administrative review, (i.e. voluntarily giving up the right of appeal). However, as indicated in the report, this case was approved by the SAT which means the assessment made by the SZ tax authority has the blessing from the SAT. According to the relevant administrative review regulations, the SAT is the highest tax authority making the final decisions of tax administrative review. Unless the blessing was indeed informal, even if the taxpayer applies for tax administrative review, the chance of success would be not high. Also, if there is no professional advisor to provide technical support, the lawsuit process will also be very difficult.

▶ The implication of this case for future practice

It is reported that this case is a “breakthrough in practice”, which is also the first case in China regarding a non-resident individual who was assessed with PRC IIT upon transferring foreign equity with underlying PRC assets. However, it may be inferred that the series of indirect transfer cases involving PRC companies, which were broadly reported by the media and internally circulated among the authorities, could have a considerable impact on tax officials in terms of taxing concepts and principles in similar cases. On the other hand, the business community is more concerned on whether this case will become a reference case of indirect share transfer by non-resident individuals. Since the SZ case is finally approved by the SAT, even without legal basis, it is possible for the local tax authorities to consider and use this case as reference or a guiding principle when dealing with non-resident individuals indirectly transferring shares of Chinese companies.

▶ Trend or exception

As discussed previously, the GAAR was firstly introduced in the CIT Law which became effective in 2008, the SAT subsequently issued circulars to strengthen the tax administration and collection with respect to non-residents, and to prevent tax-motivated arrangements in cross border transactions. Among these circulars, Circular 698 has drawn a lot of attention. It sets forth the guideline on share transfer of PRC companies by non-resident enterprises and especially allows the tax authority to adopt the “look through” principle to deny the existence of intermediate holding companies without commercial substance. However, there is no similar circular in the IIT arena.

Since this case was agreed and approved by the SAT, it has potentially revealed the SAT’s position. Circular 698 was released after the Chongqing case (For more details of the Chongqing case, please refer to our previous International Tax and Transaction Tax Bulletin on 15 June 2009.), which brought up new possibilities for Chinese tax authority to strengthen the tax administration over non-resident enterprises indirectly transferring shares of PRC companies through offshore intermediate holding companies. Nevertheless, considering the fundamental difference in terms of the legal basis between CIT and IIT regulations, it is hard to predict whether tax legislators will release new IIT regulations in future based on the SZ Case.

Recommendations

Despite of the repeated discussions from a legal perspective, Circular 698 or GAAR are only applicable to corporate taxpayers and governed by the framework of the CIT Law. The announcement of the SZ Case has completely reversed the generally recognized technical grounds. For those cases involving individuals who indirectly transfer shares of Chinese companies, regardless of whether they already occurred or are to be occurred, the individual, the target company, or the foreign buyer should all pay attention to the impact of this case. We encourage the relevant parties to seek assistance from professional advisors on the review of the relevant contracts, communication with tax officials etc., in order to clarify the potential IIT implications, the corresponding withholding obligation, and subsequent tax liabilities. If the assessment is considered unreasonable, taxpayers should not easily give up on the right to pursue a reasonable result with sound reasoning.

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