Offshore Equity Transactions: Implications of Recent Changes to Corporate Tax Law in China


COMMON STRUCTURE FOR OFFSHORE ENTITIES INVESTING IN CHINA

Offshore entities (such as Cayman Islands and British Virgin Islands companies) commonly invest in China through offshore special purpose vehicles. There are various reasons for structuring investments in this way. One of the primary advantages of using this structure is to avoid any tax liability on the sale of the Chinese tax resident enterprise. Usually, the transfer of equity in a Chinese tax resident company raises tax liability; however, no tax liability arises when a non-Chinese tax resident enterprise sells its equity interest to another non-Chinese tax resident enterprise.

CIRCULAR 698

Scope of Circular 698

Circular 698 covers the taxation on gains arising from transfers of the equity of a Chinese tax resident enterprise directly or indirectly by non-Chinese tax resident enterprises. However, gains arising from the transfers of shares of a publicly listed Chinese resident enterprise are excluded from the scope of Circular 698.

Under the Circular, an indirect transfer occurs when an offshore company (Company A) sells the equity in its offshore holding company (Company B), which owns shares of a Chinese tax resident enterprise (Company C), to another non-Chinese tax resident enterprise (Company D) located outside of China. A direct transfer is when Company C is sold.

Even though Circular 698 applies to direct transfers, it only requires that the payment of tax to be made within seven days of the equity transfer date. The primary impact of Circular 698 falls on indirect transfers. For indirect transfers, Circular 698 is triggered if Company B is located in a jurisdiction with an effective tax rate of less than 12.5%, or a jurisdiction does not tax the foreign income of its residents, such as Hong Kong.

What obligations will be imposed on Company A?

If Circular 698 is triggered, then Company A is obligated to report this transaction to the Chinese local tax bureau (where Company C is located in China), within 30 days of the transfer and provide that tax bureau with the following documents:

- Equity transfer contract/agreement.
- Documents describing the relationship between the two offshore companies (Company A & Company B) with respect to financing, operations, sales and purchases, etc.
- Documents describing Company B, such as details about production, personnel, finance, management and property conditions.
- Documents describing the relationship between the Company B and Company C with respect to financing, operations, sales and purchase, etc.
- Proof of a reasonable business purpose for establishing Company B; and
- Other relevant documents required by the local tax bureau.

After reviewing the documents described above to determine the true nature of the transfer, the Chinese tax authorities may conclude that Company A (the non-Chinese tax resident enterprise) was abusing the offshore structure to avoid Chinese tax liability without a reasonable business purpose. If the Chinese tax authorities reach that conclusion, they may disregard the existence of Company B based on the “substance over form” principle. If the existence of Company B is disregarded, then the transfer will be treated as a non-Chinese tax resident enterprise (Company A) transferring equity of a Chinese investee company (Company C). The gains from such a transfer will be regarded as China sourced and will be subject to the Chinese Enterprise Income Tax.

1 Ogier’s role is specifically limited to the offshore legal aspects of any private equity transaction and it does not provide Hong Kong or PRC legal or tax advice.
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CONCERNS ARISING FROM CIRCULAR 698

No clear definition of “reasonable business purpose”

Circular 698 states that if a non-Chinese tax resident enterprise can establish a “reasonable business purpose” for the existence of the holding company, no tax liability will arise. Article 47 of the Chinese Enterprise Income Tax Law also gives the Chinese tax authorities discretion to adjust the tax method if a non-Chinese tax resident enterprise makes arrangements (e.g. operating through a holding company) to decrease its tax liability without any reasonable business purpose. While both Circular 698 and Article 47 of the Chinese Enterprise Income Tax Law use the term “reasonable business purpose”, the SAT has not defined the term “reasonable business purpose” and it remains unclear how SAT will interpret this key phrase.

Concept of “Indirect transfer” opens to broad interpretation

Circular 698 states that all foreign entities are obligated to submit the documents described above to the Chinese tax authorities if there are indirect transfers of Chinese tax resident enterprises and such transfers are made in low tax or no tax jurisdictions. However, the term “indirect transfer” has not been defined. The danger of not defining this term is that reporting obligations may be imposed on any international M&A transactions involving transferring parties located outside of China which indirectly hold equity interests in China, no matter how small the transfers are.

For example, Company B owns 100% of Company C through many levels of intermediary holding companies in many different jurisdictions, and Company Y, a non-Chinese tax resident enterprise, purchases all of the issued share capital of Company B from Company A. Circular 698 may still apply to this case, and if so, it would require documents explaining the relationship at each level. In other words, the scope of “indirect transfer” could be very broad, and the application of that phrase could subject a wide range of transactions to reporting obligations.

Possible occurrence of double taxation

As described above, if the tax jurisdiction of Company B imposes low or no tax on Company A, then it would trigger the application of Circular 698 to Company A. This would mean that Company A may have a tax liability in China. However, if Company A’s home jurisdiction imposes a tax liability on Company A, then there is a possibility that Company A could be subject to double taxation. The SAT has recognised this double taxation problem and established mutual arrangements on tax rights with certain offshore jurisdictions. Advisors should be cognisant of these arrangements when determining which domicile should be utilised in an M&A transaction (albeit that this may well not be the determinative factor in electing such domicile).

COMMENTS

Circular 698 should be viewed as a fundamental change in the taxation of offshore equity transactions in China. Although there are still some unclear issues with respect to Circular 698, foreign enterprises which have invested in Chinese tax resident enterprises through offshore companies are advised to review their existing structures and make necessary revisions to accommodate for Circular 698. Moreover, because Circular 698 applies retroactively from January 2008, it is recommended that foreign investors review their activity over the past two years with Circular 698 in mind and be aware that Chinese tax authorities may challenge such transactions.

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