Paul Hastings
StayCurrent
A Client Alert from Paul Hastings
March 2010

China Targets Equity Transfers by Nonresident Investors

BY ALEXANDER M. LEE AND MAGGIE MOURADIAN

On December 10, 2009, China's State Administration of Taxation ("SAT") issued a circular that addresses equity transfers by foreign investors. The circular, Guoshuihan [2009] No. 698 ("Circular 698"), applies retroactively to all transactions after 2007 and represents just another weapon that the Chinese tax authorities have wielded in their anti-tax avoidance combat. It addresses both (i) the direct sale of a Chinese investee company and (ii) the indirect sale of such an enterprise through the sale of shares in an intermediate holding company. The latter scenario has captured the most attention because it will have a significant impact on companies that use offshore holding vehicles for their investments in China.

Indirect Sale of Chinese Investee Companies

It is not uncommon for foreign investors to interpose a Special Purpose Vehicle ("SPV") as an intermediate holding company for their investments in China. In addition to various non-tax reasons, there are several important tax benefits that may drive this choice of structure. First, if the SPV is established in a jurisdiction that has a favorable tax treaty with China, the SPV may benefit from preferential withholding tax rates on dividend income and other passive income. Second, if the foreign investor wants to dispose of the investment in China, it may sell the shares of the SPV without triggering income tax in China with respect to the sale. If the jurisdiction where the SPV is established also exempts the capital gain from local taxation or taxes it at a low rate, then the foreign investor can effectively sell its investment in China and incur very little tax liability.

Recharacterization of Transaction under "Substance-over-Form" Principles

In Circular 698, the SAT announced that it will evaluate "indirect equity transfers" in which a foreign investor disposes of its investment in an SPV that, in turn, holds the underlying Chinese investment. In certain circumstances, the SAT indicates that it may disregard the existence of the SPV if it lacks a reasonable business purpose and was established to avoid corporate income tax. If the SPV is disregarded, the transaction should be effectively treated as a direct transfer of the Chinese investee company's equity by the foreign investor. Since the transfer gain, as recharacterized, would be sourced in China, it should be subject to China withholding taxes.

Reporting Requirements

Circular 698 also contains a mechanism to assist the SAT with enforcing these new rules – reporting requirements. This reporting obligation only applies, however, if the SPV is located in a jurisdiction that (i) has an effective tax rate lower than 12.5% or (ii) does not tax its residents on overseas income. If either of these requirements is met, the foreign investor must provide the following documents to the relevant Chinese tax authorities within 30 days of the equity transfer contract being signed:

- The equity transfer contract or agreement;
- Documents illustrating the relationship between the foreign investor and the SPV with respect to funds, management, and purchase and sale activities;
- Documents illustrating the business operations, personnel, financial accounts and properties of the SPV;
- Documents illustrating the relationship between the SPV and Chinese investee company with respect to funds, management, and purchase and sale activities;
- Explanation of the foreign investor's reasonable business purpose in setting up the SPV; and
- Other relevant information required by the tax authorities.

Observations

There are several things to note about these new rules. First, the SAT has provided no clarification on the meaning of "reasonable business purpose." Foreign investors may, for instance, invest into China through SPVs for various non-tax reasons, including legal and investment protection, foreign exchange concerns, investor convenience, approval requirements, and business flexibility. It remains uncertain whether the breadth of the term "reasonable business purpose" extends to these purposes.

Second, even if the SPV's tax jurisdiction does not impose tax on the transfer gains, the home jurisdiction of the foreign investor may still do so. This raises the possibility of double taxation for the foreign investor if China also collects withholding tax on the transfer gains. The SAT would then need to resolve disputes with that home jurisdiction and obtain a mutual agreement on the taxing right.

Third, the reporting obligation imposed on indirect equity transfers will undoubtedly create a tremendous compliance burden for foreign investors — even those that have legitimate non-tax reasons for using SPVs to invest in China. The documents that must be disclosed to the Chinese tax authorities are not limited to the agreements specifically related to the transfer, but also include documents detailing the relationship between the foreign investor and the SPV. It is unclear whether the Chinese tax authorities have an indisputable legal basis to enforce this obligation because, at the time of the SPV share transfer, the foreign investor has yet to be assessed for Chinese withholding tax. Nonetheless, the Chinese tax authorities may be able to invoke the exchange-of-information clause under relevant tax treaties in order to obtain relevant information.

Direct Sale of Chinese Investee Companies

Circular 698 also covers the taxation of gains arising from the direct transfer of equity in a Chinese investee company by a foreign investor. However, gains derived from buying and selling shares of Chinese investee companies listed on a stock exchange are specifically excluded from the scope of Circular 698.

Calculation of Equity Transfer Income

Circular 698 defines the equity transfer income as the difference between the equity transfer price and the cost of the shares. The equity transfer price includes all types of consideration received by the foreign investor, including cash, non-monetary assets, and equity. If the foreign investor transfers the shares to a related party using a non-arm's length price, the Chinese tax authorities may adjust the equity transfer price. The cost of the shares refers to (i) the purchase price paid by the foreign investor when acquiring the Chinese investee company or (ii) the capital contribution made by the foreign investor to the Chinese investee company to acquire its equity (or thereafter).

The most controversial rule pertains to the treatment of the retained earnings of the Chinese investee company. Under the former tax regime that applied to foreign-invested enterprises ("FIE"), the retained earnings of the Chinese investee company could be excluded from the equity transfer price in calculating the taxable gain. Circular 698 now requires that the retained earnings of the Chinese investee company be included in the equity transfer price. This new rule may give rise to double taxation where the retained earnings are taxed once upon the equity transfer and then again when they are distributed as dividends to the new shareholders.

Withholding Obligations

In cases where the withholding agent fails to fulfill its withholding obligation, Circular 698 provides that the foreign investor itself must self-declare and pay withholding taxes on the equity transfer gains to the Chinese tax authorities. In that case, the foreign investor must make all required tax filings within seven days from the agreed upon date of the share transfer or from the date when the foreign investor actually receives the proceeds of the share transfer, whichever is earlier.

Conclusion

Circular 698 reflects the growing trend among Chinese tax authorities to scrutinize and counteract potential tax-avoidance transactions in the international tax arena. Foreign investors will undoubtedly face greater administrative and compliance burdens when using SPVs to invest in China. These investors should particularly heed Circular 698's retroactive effect. Thus, foreign investors that disposed of Chinese investee companies after 2007 should review their transactions to determine whether they have fully complied with these new rules. They should also review their current structures and prepare for potential challenges from Chinese tax authorities, particularly with respect to their business reasons for entering into SPV arrangements.

✧ ✧ ✧

As required by U.S. Treasury Regulations governing tax practice, you are hereby advised that any written tax advice contained herein was not written or intended to be used (and cannot be used) by any taxpayer for the purpose of avoiding penalties that may be imposed under the Internal Revenue Code.

If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

Atlanta
Philip Marzetti
404-815-2258
philipmarzetti@paulhastings.com

London
Arun Birla
44-20-3023-5176
arunbirla@paulhastings.com

Los Angeles
Alexander Lee
213-683-6160
alexanderlee@paulhastings.com

Maggie Mouradian
213-683-6327
maggiemouradian@paulhastings.com

New York
Andrew Short
212-318-6018
andrewshort@paulhastings.com

Orange County
Douglas Schaaf
714-668-6221
douglasschaaf@paulhastings.com

Palo Alto
Thomas S. Wisialowski
650-320-1820
thomaswisialowski@paulhastings.com

Washington, D.C.
Robert E. Culbertson
202-551-1748
robculbertson@paulhastings.com

18 Offices Worldwide | Paul, Hastings, Janofsky & Walker LLP | www.paulhastings.com

Stay*Current* is published solely for the interests of friends and clients of Paul, Hastings, Janofsky & Walker LLP and should in no way be relied upon or construed as legal advice. The views expressed in this publication reflect those of the authors and not necessarily the views of Paul Hastings. For specific information on recent developments or particular factual situations, the opinion of legal counsel should be sought. These materials may be considered ATTORNEY ADVERTISING in some jurisdictions. Paul Hastings is a limited liability partnership. Copyright © 2010 Paul, Hastings, Janofsky & Walker LLP.

IRS Circular 230 Disclosure: As required by U.S. Treasury Regulations governing tax practice, you are hereby advised that any written tax advice contained herein or attached was not written or intended to be used (and cannot be used) by any taxpayer for the purpose of avoiding penalties that may be imposed under the U.S. Internal Revenue Code.