A totally different tax landscape for offshore indirect transfer – wider, clearer & more challenging

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In brief

According to the circular Guoshuihan [2009] No. 698 (Circular 698) issued by the State Administration of Taxation (SAT) in 2009, a transfer of a foreign company that holds the equity interest in an underlying China Tax Resident Enterprises (TREs) (hereinafter as the ‘offshore indirect equity transfer’) may be subject to China Corporate Income Tax (CIT), if the arrangement is considered as an abusive use of company structure without reasonable commercial purpose. Such provision had a wide-spread impact as many foreign investors invest in China via a foreign intermediate holding company. The SAT has been working in the last couple of years to improve the tax rules in relation to such offshore indirect equity transfer.

In early February 2015, the SAT released a Public Notice [2015] No. 7 (Public Notice 7) to supersede the current Chinese tax rules in relation to the offshore indirect equity transfer. Public Notice 7 introduces a new tax regime that is significantly different from that under Circular 698. Firstly, it opens the China tax net wider to capture not only offshore indirect equity transfer transactions addressed under Circular 698 but also transactions involving transfer of immovable property in China and assets held under the establishment and place (E&P) in China of a foreign company through the offshore transfer of a foreign intermediate holding company (collectively called ‘offshore indirect transfer of China Taxable Properties’). Public Notice 7 also addresses the term ‘transfer of the equity interest in a foreign intermediate holding company’ widely. In addition, Public Notice 7 provides clearer criteria than Circular 698 on how to assess ‘reasonable commercial purposes’ and introduces ‘safe harbour’ scenarios. However, it also brings challenges to both the foreign transferor and transferee of the offshore indirect transfer as they have to make self-assessment on whether the transaction should be subject to CIT and to file or withhold the CIT accordingly.

Public Notice 7 presents a totally different tax landscape for foreign investors holding China Taxable Properties with foreign intermediate holding company structure. These foreign investors should plan ahead as and when they invest, hold and divest their China Taxable Properties to manage their China tax exposures.

In detail

The provisions introduced in Public Notice 7 are significantly more and different from those under Circular 698. In formulating the new rules, the SAT aimed to strike the balance between protecting China’s taxing right and attracting foreign investments. It also strived to provide certainty to both taxpayers in terms of compliance and tax authorities in terms of enforcement. The key points of Public Notice 7 are highlighted as below.

Wider scope

While Circular 698 only targets offshore indirect equity transfer of Chinese TREs, Public Notice 7 extends the scope to capture all ‘China Taxable Properties’. This new concept of ‘China Taxable Properties’ is defined to include not only equity investment in Chinese TREs, but also immovable properties located in China and assets of an establishment or place of foreign company in China. In other words, if the foreign intermediate holding company being transferred is holding (directly or indirectly) immovable properties in China or assets held by E&P in China, such transaction would also fall within the scope of Public Notice 7.

In addition, the ‘transfer of the equity interest in a foreign
intermediate holding company’ is defined very widely in Public Notice 7 to cover any changes in the shareholder of that foreign company being transferred in the course of the group’s overseas restructurings. It is also necessary to note that the scope of ‘equity’ is extended to include ‘other similar rights’. Obviously Public Notice 7 is trying to capture as many scenarios as possible into its applicable scope.

**New approach**

In general, the mandatory reporting obligation of a foreign transferor in offshore indirect equity transfers set out in Circular 698 (which we have been questioning its practical implementation) has now been removed. Instead, the foreign transferor is facing a totally different approach by the SAT in Public Notice 7 to tackle offshore indirect transfers of China Taxable Properties:

- Firstly, Public Notice 7 provides at the outset seven general criteria (plus ‘other relevant criteria’) for assessing whether there are reasonable commercial purposes for an offshore indirect transfer. The foreign transferor should carry out self-assessment for its offshore indirect transfer.

- Among these criteria, four are classified as ‘Red Zone’ with some quantifiable benchmarks, i.e. the transfer meeting such ‘Red Zone’ criteria is seen as without reasonable commercial purposes. In such case, the transfer should be re-characterised as a ‘direct transfer’ and thus subject to CIT. The foreign transferor is required to report and pay the relevant CIT to the Chinese tax authorities within a prescribed timeline.

- In the contrary, there are also ‘safe harbour’ scenarios to be regarded as ‘Green Zone’, i.e. the transfer falling in such scenarios has reasonable commercial purposes. Public Notice 7 does not impose any further requirements on the foreign transferor.

- In case the foreign transferor cannot come to any position after its self-assessment, it is provided with an avenue to present its case to the Chinese tax authority for a determination.

  - Last but not least, even if the foreign transferor does not undergo any tax reporting or payment as per Public Notice 7, the Chinese tax authority could still launch a GAAR investigation on suspicious transactions and, where necessary, make adjustments according to the Chinese General Anti-Avoidance Rules (GAAR).

  Apart from stipulating the obligations for the foreign transferor, Public Notice 7 also imposes onerous reporting and tax withholding responsibilities on the transferee no matter it is a foreign or domestic party.

Failure to report and settle the CIT liability for a taxable transaction would cause Interest Levy for the foreign transferor and penalty for the transferee.

Public Notice 7 uses this new approach to alleviate the mandatory compliance burden on the parties to offshore indirect transfers. However, these parties from now on would be fully responsible for carrying out self-assessment and taking relevant actions.

**General criteria for assessing reasonable commercial purposes**

Before the issuance of Public Notice 7, the lack of clear criteria to assess reasonable commercial purposes resulted in inconsistent assessment practices at the local level. The local-level tax authorities usually relied on ‘substance test’ (looking for existence of people, office, assets or other tangibles) to determine whether an offshore indirect transfer should be re-characterised and subject to China tax.

We are glad to see that Public Notice 7 reiterates the importance of the ‘reasonable commercial purpose’ which is the key principle laid down in the CIT Law. It provides seven general criteria (plus ‘other relevant criteria’) which should be examined holistically for the assessment, including:

1. the China proportion in the equity value of the shares of the foreign company being transferred;
2. the China proportion in the asset value or income of the foreign company being transferred;
3. the functions performed and risks undertaken by the foreign company being transferred and its subsidiaries;
4. the duration of existence of the shareholders, business model of the foreign company and related organisational structure;
5. the situation regarding foreign income tax payment for the offshore indirect equity transfer;
6. whether the indirect investment and indirect transfer can be substituted by direct investment and direct transfer;
7. the applicability of any treaty protection;
8. other factors, etc.

These criteria are crucial to substantiate both ‘reasonable commercial purpose’ and ‘economic substance’. Assessment of these criteria would be vital for the foreign transferor to decide whether to voluntarily pay CIT or report the transaction to the in-charge tax authority for determination, and for the transferee to decide whether to withhold CIT. However, as some criteria lack clear indicative benchmark, it may still be difficult to come to a conclusion in some cases. It would not be surprising to see different judgement among different tax authorities, at least at the beginning stage of implementation of Public Notice 7.

**‘Green Zone’**

Public Notice 7 provides safe harbour scenarios (Green Zone) where an offshore indirect transfer of China Taxable Properties would be excluded from being subject to China tax.

Firstly, either one of the following two scenarios would not be subject to re-characterisation:

1. The foreign transferor buys and sells the shares of the same listed overseas company through public stock exchanges; or
2. Where the foreign transferor would otherwise directly hold and transfer the China Taxable Property, the income from such direct transfer would be exempted from CIT under the applicable tax treaty or tax arrangement.
In addition, qualified internal group restructurings which fulfil ALL of the following criteria would be considered as having reasonable commercial purposes:

- The shareholding relationship of the foreign transferor and transferee should be 80% or more (100% for overseas companies that are property-rich);
- The internal group restructuring would not result in the reduction in the CIT burden on the gain arising on the subsequent potential indirect transfer; and
- The deal consideration of the transfer is totally settled in the form of equity (not including the equity of listed enterprises) of the transferee or its subsidiaries.

These safe harbour scenarios should be welcomed by foreign investors. In particular, the internal group restructuring relief will be most welcomed by multinational corporations (MNCs) as some of them have been eagerly waiting for this green light to go ahead with their internal group restructurings overseas. Nevertheless, requirement for the settlement through equity payment would cause changes in inter-group shareholding relationship and thus making this part of the Green Zone less desirable. It is also notable that offshore indirect transfers involving property-rich companies are subject to a harsher shareholding requirement (i.e. 100%) in order to qualify for the safe harbour treatment for internal group restructurings.

If an offshore indirect transfer does not fall in any scenario in the Green Zone, it does not necessarily mean the transaction should immediately be subject to CIT. The general criteria should still be considered to assess the commercial purposes of the transaction.

‘Red Zone’

Contrary to the Green Zone, Public Notice 7 provides the following four unfavourable conditions which are based on criteria 1, 2, 3 and 6 of the seven general criteria above. If an offshore indirect equity transfer meets ALL these conditions, it would be considered as a transaction lacking reasonable commercial purpose straight away (Red Zone) and thus taxable to CIT:

1. 75% or more of the value of the overseas company being transferred is derived directly or indirectly from China Taxable Properties;
2. 90% or more of the total assets of the foreign company (not including cash) is directly or indirectly derived from China Taxable Properties, or 90% or more of its income is directly or indirectly derived from China;
3. The foreign company and its subsidiaries which directly or indirectly hold the China Taxable Properties perform limited functions and undertake limited risks which are not commensurate to their economics substance;
4. The foreign income tax payable for the indirect transfer of China Taxable Properties is less than the possible tax burden in China on the direct transfer of such China Taxable Properties.

There is a question of whether the transaction is immediately ‘safe’ if it does not meet all of the above unfavourable conditions. We believe that the Chinese tax authorities are not willing to jump into this conclusion. Therefore, it is always advisable for the foreign transferor to walk through the seven general criteria and prepare more positive arguments, followed by proper documentation.

Consequences for failure in withholding and/or paying tax

In the event that the transferee does not withhold CIT (and the foreign transferor fails to pay the CIT in due course either), the foreign transferor would be subject to a daily Interest Levy calculated based on the Renminbi loan base rate published by the People’s Bank of China plus 5 percentage points in accordance with the Interest Levy clauses under the CIT Laws. If the transferor has reported the transaction to the Chinese tax authorities within 30 days of signing the equity transfer contract, the additional 5 percentage points would be waived.

It is worth noting that Public Notice 7 has clearly stated that the payer of the sales consideration (which is usually the transferee) should withhold CIT for the offshore indirect equity transfer if the transaction is subject to CIT. Failure to fulfil the withholding obligation may trigger a penalty of 50% to three times of the amount of the CIT liability based on the relevant provisions in Tax Collection and Administration Law (TCAL). This penalty may be reduced or waived if the withholding agent has reported the transaction to the Chinese tax authorities within 30 days of signing the equity transfer contract. This is the first time the SAT explicitly states that the transferee, including a foreign one, would have such heavy monetary consequence. Doubtless to say, this stipulation would cause the transferee, especially an unrelated party, to be very cautious about the China tax position of the foreign transferor in such offshore indirect transfer deal.

The takeaway

Public Notice 7 brings a new landscape for tax treatments on offshore indirect transfer transactions. It imposes more responsibilities on the transaction parties to assess and make their decision. Both foreign transferor and transferee should examine carefully the facts and merits of each transaction and may take different strategies accordingly.

The foreign transferor may take the following into consideration:

- If the transaction falls into the Green Zone, Public Notice 7 does not specify any necessary action in this situation. It is advisable for the foreign transferor to keep sufficient documentation in place to substantiate that the transaction fulfills the conditions for the Green Zone.
- If the transaction falls into the Red Zone, technically it would be subject to CIT upon the invoking of GAAR by the SAT. Unfortunately Public Notice 7 simply requires tax payment by the foreign transferor on such transactions after self-assessment. Technically GAAR is a provision which only the Chinese tax authorities can invoke to attack tax avoidance transactions but is not available to the foreign transferor for invoking by itself. If the foreign transferor pays CIT in this situation, the CIT paid would likely be considered as voluntary tax and not eligible for Foreign Tax Credit at the foreign transferor’s home country.
- Other than the above situations, the foreign transferor should assess the transaction against the seven general criteria holistically.
to assess whether the transaction is justifiable as having reasonable commercial purposes. If the foreign transferor still cannot decide after assessment, it may consider reporting the transaction to the in-charge tax authority and let it make a determination. Unfortunately Public Notice 7 does not stipulate whether, how or when the in-charge tax authority should respond to such reporting. So there is still uncertainty even if the foreign transferor chooses to report. In any event, reporting the transaction would reduce the Interest Levy by 5 percentage points in case the transaction is eventually determined to be subject to CIT. The foreign transferor should weigh the pros and cons of the reporting with reference to the facts and merits of each case.

On the transferee’s side, it is equally, if not more, challenging to assess the transaction and decide whether to withhold CIT. Similar to the foreign transferor, the transferee may also choose to report the transaction to the in-charge tax authority to reduce its exposure to penalty and also endeavour to secure a step-up of the tax cost base for its purchase.

Given the complexity mentioned above, it is advisable for both foreign transferor and transferee to discuss how to handle the China tax matters for the offshore indirect transfer and reach a consensus.

Public Notice 7 still leaves several uncertain but important issues, such as how to allocate the gains attributable to China Taxable Properties in the case of a regional offshore indirect transfer; the cost base of China Taxable Properties after a few transfers including direct and indirect, etc. We are eager to see the SAT release further clarifications on these important issues for the new regime of offshore indirect transfer.

Finally, Public Notice 7 has demonstrated the Chinese tax authority’s determination to combat erosion of China’s tax base through offshore indirect transfers. It may be time for MNCs to re-consider whether it is really necessary to use an intermediate holding structure for their investments in China, and if so, they have to document properly their reasonable commercial purposes.

**Endnote**

1. For our analysis of Circular 698 and China tax implications of offshore indirect equity transfers, please refer to our China Tax News Flash [2009] Issue 27.


4. A property-rich company refers to a company which derives more than 50% of its value, directly or indirectly, from immovable properties situated in China.

5. Articles 121 and 122 (under Special Tax Adjustment chapter) of the Detailed Implementation Rules to the CIT Law.
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