CHINA TAXES NON-RESIDENTS’ GAINS FROM INDIRECT TRANSFERS OF ASSETS

On 3 February 2015, the State Administration of Taxation (“SAT”) of the PRC issued Public Notice [2015] No. 7 (国家税务总局公告 2015年第7号) entitled Public Notice Regarding Collection of Corporate Income Tax by Indirect Transfer of Assets by Non-Resident Companies (关于非居民企业间接转让财产企业所得税若干问题的公告) (“Notice 7”). Notice 7 came into immediate effect.

The Notice effectively empowers the SAT to levy Corporate Income Tax (“CIT”) on the gains made by non-resident companies from the indirect transfer of assets in China. It repeals tax rules in Articles 5 and 6 of the Notice on Strengthening the Administration of Corporate Income Tax on Income from the Transfer of Shares by Non-Resident Companies (Guoshuihan [2009] Circular No. 698) (“Circular 698”). It also extends the general anti-avoidance rule in Article 47 of the Corporate Income Tax Law of China (“CIT Law”). In addition, Notice 7 provides greater clarity on the requirements for the reporting, assessment, and collection of taxes resulting from the indirect transfer of assets in China.

This Update takes a look at the key requirements of Notice 7.

**Indirect Transfer of Taxable China Assets**

Non-resident companies are liable for CIT on the gains made from the direct transfer of certain assets in China. Assets (“Taxable China Assets”) that are subject to this tax are:

- movable property owned by an establishment or place of business in China;
- immovable property in China; and
- equity interests in companies incorporated in China.

Article 1 of Notice 7 provides that if a non-resident company indirectly transfers Taxable China Assets through an arrangement that does not have a “reasonable business purpose” in order to avoid liability for CIT, the indirect transfer will be recharacterised as a direct transfer of the Taxable China Assets in accordance with Article 47 of the CIT Law.

Typically, an indirect transfer of Taxable China Assets occurs when a non-resident company transfers the equity interest in another non-resident company that directly or indirectly holds those Taxable China Assets (the “Target Company”).
Reasonable Business Purpose Test

Under Article 120 of the Implementation Rules of the CIT Law, an arrangement will be deemed to not have a “reasonable business purpose” if its main purpose is to reduce, avoid, or defer tax payments. Notice 7 provides that the following factors will be taken into account in determining whether the indirect transfer has a “reasonable business purpose”:

- Whether the value of the Target Company derives mainly, directly or indirectly, from the Taxable China Assets;
- Whether the assets of the Target Company consist mainly, directly or indirectly, of investment in China or whether the income of the Target Company arises mainly, directly or indirectly, from a China source;
- Whether the functions and risks undertaken on the part of the Target Company and its subsidiaries can justify the economic substance of the organisation structure;
- The length of the time the foreign shareholder(s), the business model, and the relevant organisational structure of the Target Company have been in existence;
- Whether foreign income tax is leviable on the indirect transfer;
- Whether the indirect investment in China could have been made through a direct investment and whether the indirect transfer could have been made through a direct transfer;
- Whether there is an applicable tax treaty or arrangement governing the indirect transfer; and
- Any other factors as may be determined to be relevant by the tax authority in its discretion.

Deemed lack of “reasonable business purpose”

Notwithstanding the above factors, an indirect transfer will be deemed to lack a “reasonable business purpose” if all of the following conditions are satisfied:

- The Taxable China Assets account for at least 75%, directly or indirectly, of the equity value of the Target Company;
- At least 90% of the Target Company’s total assets (excluding cash) consist, directly or indirectly, of investment in China at any time within the 12 months immediately preceding the transfer, or at least 90% of its revenue comes, directly or indirectly, from a China source within the 12 months immediately preceding the transfer;
- The functions performed and risks assumed by the Target Company and its offshore subsidiaries directly or indirectly holding the Taxable China Assets are limited and insufficient with respect to their economic substance; and
- The foreign income tax from the indirect transfer is less than the Chinese CIT that would occur if the Taxable China Assets were directly transferred.

**Safe Harbour Rules**

Under Article 5 of Notice 7, the following safe harbour rules apply to indirect transfers:

- **Publicly traded company**: If a non-resident company buys and sells publicly traded shares in a listed company holding Taxable China Assets, such gains will not be subject to tax in China.
- **Treaty exemption**: If a non-resident company is not exposed to CIT in China on the gains from the direct sale of the Taxable China Assets under an applicable tax treaty, the indirect transfer will not be exposed to CIT in China.

**Corporate restructurings**

Article 6 of Notice 7 provides for a safe harbour for indirect transfers resulting from a corporate restructuring. If the restructuring satisfies all of the conditions set out in Article 6, it will be deemed to have a “reasonable business purpose”. The conditions are as follows:

- The transferor and the transferee must be qualifying related companies;
- The Chinese tax burden of the subsequent possible indirect transfer by the transferee must not be less than that of the first indirect transfer under the same or similar circumstances; and
- The consideration paid by the transferee must consist solely of shares of the transferee or the shares of the controlling company of the transferee (excluding the shares of a listed company).

To be qualifying related companies, the transferor and transferee must meet any one of the following requirements:

- The transferor holds, directly or indirectly, a total of at least 80% of the shares in the transferee or vice versa; or
- If more than 50% of the equity value of the Target Company is from immovable properties located in China, all of the shares of both the transferor and the transferee are held, directly or indirectly, by the same shareholder; in any other case, the common shareholder must hold at least 80% of the shares of both the transferor and the transferee.

Where there are multiple intermediary companies, the percentage of shareholding is to be derived by multiplying the shareholding percentages along the holding chain.
Documents for Tax Filing

Under Articles 9 and 10 of Notice 7, both parties to an indirect transfer, the Chinese resident company whose indirect ownership is transferred, and the tax adviser may be required by the competent Chinese tax authority to submit the following documents for tax filing purposes:

- The share transfer agreement (with Chinese translation if not in Chinese);
- The organisational charts immediately before and after the transfer;
- The financial statements for the past two financial years of the Target Company and its subsidiaries;
- An explanation as to why the indirect transfer should not be recharacterised as a direct transfer;
- Information about the business, operations, employees, accounting, assets, etc of the Target Company and its subsidiaries as well as internal and external audit;
- An asset valuation report and other basis for determining the value/pricing of the transferred shares;
- The income tax payable outside China for the transfer;
- Evidence for the applicability of Articles 5 and 6 of Notice 7; and
- Any other documents as may be required.

Penalties

Article 15 of the Notice provides that CIT is payable after the share transfer agreement comes into effect and the registration of the share transfers is completed.

If the withholding agent fails to withhold tax and the transferor fails to pay the tax, the following penalties will apply under Article 8 of Notice 7:

- **Penalties applicable to the withholding agent:**
  - The relevant PRC tax authority may impose a penalty on the withholding agent at between 50% and 300% of the tax that the agent failed to withhold.
  - In addition, the agent will be required to pay interest on the unwithheld tax at the benchmark loan interest rate announced by the People’s Bank of China.

- **Penalties applicable to the transferor:**
  - The transferor will be required to pay interest on the unpaid tax at a rate that will be 5% above the benchmark loan interest rate announced by People’s Bank of China.
However, if the transferor has voluntarily provided the relevant Chinese tax authority with the documents required under Article 9 within 30 days following the signing of the share transfer agreement, the interest rate payable on the unpaid tax will be equal to the benchmark loan interest rate announced by People’s Bank of China.

If you would like information on this or any other area of law, you may wish to contact the partner at WongPartnership that you normally deal with or any of the following partners:

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