



China Tax Bulletin

Welcome to White & Case's monthly China Tax Bulletin. This client bulletin includes updates and analyses on recent tax regulations, ensuring you stay up to date on tax developments important to your business.

Scrutiny on Indirect Equity Transfer Strengthened

The common practice to establish a holding company between an operating enterprise in China and foreign investors has been under scrutiny for tax avoidance, since the Enterprise Income Tax Law ("EITL") entered into force on January 1, 2008. After the eye-catching Chongqing case released in November 2008, the State Administration of Taxation ("SAT") issued Guoshuihan [2009] No. 698 ("Circular 698") dated December 10, 2009 to strengthen administration on the indirect equity transfer by nonresident enterprises. Circular 698 took effect retroactively from January 1, 2008.

General Rules on Equity Transfer

Circular 698 apparently applies to all types of direct or indirect transfers of equity in resident enterprises by nonresident enterprises. General rules on equity transfer do not deviate from tax laws and regulations previously applicable to nonresident enterprises.

Calculation of Equity Transfer Gain

Circular 698 provides the following formula to calculate equity transfer gain:

Equity transfer gain = Equity transfer price - Equity cost

Equity transfer price refers to a consideration received for the equity transferred, including cash, non-cash assets or other interests. Where a nonresident enterprise transfers a right to receive retained earnings along with the equity, the part of consideration received for such right cannot be deducted from the equity transfer price. Equity cost means the paid-in capital invested into a resident enterprise or the original purchase price paid to acquire the equity. The currency of initial capital investment or equity purchase shall be the benchmark currency for the purpose of calculating equity transfer gain.

Stock of Listed Chinese Resident Enterprises Excluded

Circular 698 only applies to transfer of equity in non-listed resident enterprises. Currently, nonresident enterprises still have limited access to invest in listed Chinese resident enterprises. Tax treatment of equity transfer in listed Chinese resident enterprises is subject to different rules.

Transfer Pricing

Article 7 of Circular 698 states that the tax authorities can adjust the equity transfer price according to a reasonable method, if two conditions are met: (1) the equity transfer is a related party transaction, and (2) the equity transfer price is not based on the arm-length principle.

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Procedural Requirements

Circular 698 restates the tax withholding requirements on nonresident enterprises set forth in Article 15 of Guoshuifa [2009] No. 3. Where a withholding agent fails to act, a nonresident enterprise transferor is required to file a tax return with the in-charge tax authorities within seven days after the agreed transfer date or the actual payment date, whichever is earlier.

Indirect Equity Transfer

Special Purpose Vehicles (“SPVs”) Challenged

Under Article 6 of Circular 698, the tax authorities can recharacterize an indirect equity transfer by disregarding the existence of an offshore holding company, if an upper-tier foreign investor is deemed to abuse the holding company structure and seek to avoid Chinese enterprise income tax through indirect transfer of equity in a Chinese resident enterprise without reasonable business purpose. This particular provision is in line with a variety of anti-avoidance tax rules issued by the SAT in 2009.

Codification of Tax Ruling in Chongqing Case

Article 6 of Circular 698 codifies the tax ruling in Chongqing case. The facts of Chongqing case are quite simple. A Singaporean parent company (“P Co.”) sold its Singaporean wholly-owned subsidiary, which was an SPV and held 31.6 percent equity in a Chinese company (“Target”) at Chongqing, to another Chinese company located at Chongqing as well. Chongqing State Taxation Bureau (“CSTB”) challenged the transaction. The SPV did not have any business operation other than holding 31.6 percent of equity in the Target. The SPV had a small amount of paid-in capital, at 100 Singapore dollars. The CSTB disregarded the existence of the SPV and recharacterized the transaction as an indirect transfer of equity in the Target. In reaching its decision, the CSTB cited the general anti-avoidance tax rules, including the “substance over form” principle. Thus, gains derived from the transfer by the P Co. were subject to 10 percent withholding tax. The Chongqing case was a surprise to multinational companies and tax professionals in China.

Vague and Unclear Legal Standard

Article 6 of Circular 698 is a challenge from a tax planning standpoint. It does not clearly define the indirect equity transfer. Nor does it draw a line on how to structure a holding company without abusing it. It is unclear what tier of holding structure or what percentage of equity being transferred will trigger the tax avoidance alarm. As a result, Article 6 of Circular 698 throws tremendous uncertainties into the tax planning for multinational companies without offering a sound and predictable roadmap.

Controversial Filing Requirements

Questionable Extraterritorial Jurisdiction

Under Article 5 of Circular 698, a foreign investor with actual control will be required to file indirect transfer of equity in Chinese resident enterprises with the in-charge tax authorities within thirty days upon the execution of the contract, if such foreign investor transfers equity in an overseas holding company located in a jurisdiction, which has either an effective tax rate lower than 12.5 percent or no tax on foreign-source income. The in-charge tax authorities refer to the tax bureaus at the location of Chinese resident enterprises subject to the indirect equity transfer.

Onerous Compliance Burden

Regardless of how tiny percentage the indirect Chinese equity is involved in the transfer or how remote a Chinese resident enterprise is connected in the holding structure, a foreign investor falling into the extraterritorial jurisdiction must file the following documents with the in-charge tax authorities:

- Equity transfer contract or agreement;
- Relationship between the foreign investor and the holding company being transferred with respect to capital, operation, sales and purchase;
- Information of the holding company being transferred in terms of operation, personnel, accounting and assets;
- Relationship between the holding company being transferred and Chinese resident enterprises subject to the indirect equity transfer with respect to capital, operation, sales and purchase;
- Statement on reasonable business purposes to establish the holding company being transferred; and
- Other relevant documents required by the tax authorities.

Where a foreign investor with actual control transfers equity interests in several onshore or offshore holding companies, a set of complete documentation must be provided to the in-charge tax authorities. The transfer price should be accurately allocated to Chinese resident enterprises subject to the transfer. Otherwise, the in-charge tax authorities could make adjustments based on a reasonable method.

Our Observations

Circular 698 is highly controversial. The SAT imposed overly broad requirements without giving clear implementation guidance. The holding structure similar to the Chongqing case is certainly the first target of Circular 698. Since the SAT has limited channels to learn of the equity transfer occurring overseas, the filing requirements are intended to serve as a giant information net catching unspecified overseas equity transfers. Nevertheless, Circular 698 will surely create a headache to tax compliance officers among multinational companies and foreign investors. It remains to be seen how the tax authorities will enforce Circular 698.

Taxation of Foreign Partners Pending Despite the Issuance of Legal Rules on Foreign-Invested Partnerships

Foreign-invested partnership (“FIP”) has been allowed as a legitimate form of business entity in principle for more than two years, although it has so far remained unavailable to foreign investors in practice due to a lack of specific rules. Recently, the State Council issued specific legal rules applicable to the FIPs. Hailed as a significant improvement, the new FIP rules fail to directly address the taxation of foreign partners. To a certain extent, the tax rules applicable to partnerships with domestic partners could provide helpful starting points for considering the tax consequences of FIPs. Nevertheless, many FIP tax issues will remain outstanding until the release of official rules.

Specifically, the Partnership Law, which entered into force on June 1, 2007, allows foreign enterprises and individuals to set up a partnership within China, but it took more than two years for the specific rules to come out. The State Council Order No. 567 dated November 25, 2009 released the long-awaited Administrative Measures on Foreign Enterprises and Individuals to Establish Partnerships in China (“Measures”), which will take effect from March 1, 2010.

Under Article 11 of the Measures, an FIP is taxed in accordance with relevant tax laws and regulations, which currently do not have any FIP-specific rules. Thus, the SAT is actively considering the FIP tax rules but the exact time frame still remains unclear. Before the issuance of the FIP tax rules, it would be helpful to review the tax rules applicable to partnerships with domestic enterprises and individuals as partners, which include Caishui [2001] No. 91, Guoshuihan [2001] No. 84, Caishui [2008] No. 65, and Caishui [2008] No. 159.

Tax Rules Applicable to Partnerships with Domestic Partners

The salient points of the tax rules applicable to partnerships with domestic partners are as follows:

- A partnership is treated as a pass-through entity for income tax purposes. Taxable income of partners is subject to respective individual and enterprise income tax. Such taxable income is determined at the partnership level, equal to gross income minus costs, expenses and losses, and then allocated to all partners pursuant to the allocation method specified in the partnership agreement, which cannot exclude any partner from the allocation.
- A modified entity approach applies to the character of income on the part of partners. Income generally passes through to partners as business profits of partnership (i.e., ordinary income), regardless of its original character. As an exception, interest or dividends received by a partnership are treated as if they had been directly received by partners and are taxed as interest or dividends to partners.
- Although entire income of partnership is allocated to partners for the purpose of calculating partners' current tax liabilities, a partnership could distribute only a portion of such income to partners and keep the remaining as retained profits. Since partners are currently taxed on retained profits, while the relevant rules are silent on this, future distribution of retained profits from previous years are expected to be exempt from tax. Otherwise, it could create an issue of double taxation on the same income.
- Operating losses can be carried forward for five years at the level of partnership and cannot be allocated to partners. Similarly, if a partner has interests in more than one partnership, losses of one partnership cannot offset against profits from the other partnership. For an enterprise partner, losses of partnership cannot offset against its profits from other sources for the purpose of calculating enterprise income tax.
- Foreign income tax paid on foreign-sourced income can be credited against individual income tax. It is unclear how enterprise partners could apply foreign tax credits to reduce their tax liabilities.

Tax Rules Applicable to the FIPs Still Pending

The rules summarized above should apply to the FIPs in general. However, currently, there is no rule on how the foreign partners should be taxed. In our view, the upcoming FIP tax rules are expected to cover the following areas:

- Will the character of income with respect to dividends, interest, royalties and capital gains pass through from an FIP to its foreign partners?
- What will be the applicable tax rate of income allocated to the foreign partners of an FIP? The character of income will determine the applicable tax rate.
- How will foreign tax credits be allocated to foreign partners of an FIP?
- Will foreign partners of an FIP be deemed to have a permanent establishment in China? If an FIP is a limited partnership versus a general partnership, will this make any difference?
- Will the tax treaty benefits apply to income allocated to foreign partners of an FIP?
- What will be the tax filing or withholding requirements with respect to income allocated to foreign partners of an FIP?

Anti-Tax Avoidance through Tax Information Exchange Strengthened

Tax information exchange is emerging as a valuable tool for anti-tax avoidance purposes. Depending on the circumstances, China has either entered into tax treaties incorporating an exchange of tax information article or signed stand alone agreements on tax information exchange with foreign jurisdictions. Through tax information exchange, Chinese tax authorities can acquire factual information and thus apply domestic tax laws and tax treaties accordingly. Recently, China separately concluded Tax Information Exchange Agreement (“TIEA”) with the Commonwealth of the Bahamas (“Bahamas”) and British Virgin Islands (“BVI”), the two popular tax havens. In addition, Chinese tax authorities aggressively targeted tax avoidance by utilizing tax information exchange, as reported in a Xiamen transfer pricing adjustment case.

Tax Information Exchange with Tax Havens

On December 1, 2009, China signed TIEA with Bahamas, which ranks among the leading gateway jurisdictions investing in China. On December 7, 2009, China similarly signed TIEA with BVI, which has consistently been the second largest source of foreign direct investment in China after Hong Kong. Both TIEAs contain critical

articles with respect to tax information exchange between China and these counterparties. The conclusion of the TIEAs with two offshore finance centers was intended to combat tax avoidance using tax havens by China.

Xiamen Transfer Pricing Adjustment Case

On December 9, 2009, the SAT reported the decision of the first transfer pricing adjustment case using exchange of information after a five-year investigation. The transfer pricing case involved a foreign-invested leather shoe manufacturer in Xiamen. Although the manufacture reported losses or thin profits in the previous years, it expanded quickly in terms of annual production and registered capital. The abnormality attracted the attention of Xiamen State Taxation Bureau (“XSTB”).

The main client of the Xiamen manufacturer was a company in the United States (“US”), which tightly controlled the manufacturing process and price determination. Since the major shareholders of the Xiamen manufacturer were individuals, it was difficult for the XSTB to determine whether the two entities were related parties. Nevertheless, all payments from the US company were remitted to the Xiamen manufacturer through an offshore bank, whose head office was located in the same place as the individual shareholders of the Xiamen manufacturer resided.

Upon the SAT approval, the XSTB requested relevant information of the remittance bank account and its owner from the competent tax authorities with jurisdiction over the offshore bank involved. After nine months, the XSTB received the exchanged information, which confirmed the Xiamen manufacturer’s major shareholder as the owner of the offshore bank account. Based on available information, the XSTB concluded that the two entities were indeed related parties. As such, the transfer pricing rules applied to the related party transactions. Given the adjusted taxable income of the Xiamen manufacturer, the XSTB collected under-paid tax amount of RMB 2.93 million.

Deduction of Charitable Donation Clarified

Qualified charitable donation made by an enterprise or individual can be deducted from taxable income. On December 31, 2008, Caishui [2008] No. 160 was issued to provide guidance on deduction of charitable donation by the Ministry of Finance (“MOF”), the SAT and the Ministry of Civil Affairs. Nevertheless, many implementation issues remained outstanding. On December 8, 2009, the MOF and the SAT jointly released Caishui [2009] No. 124 (“Circular 124”) to further clarify deduction of charitable donation. Circular 124 became retroactively effective from January 1, 2008.

Under Circular 124, the deduction amount for an enterprise is allowed up to 12 percent of its total annual profits. The enterprise can make a qualified charitable donation only through governments at the county level or above, or an eligible charitable social organization (“CSO”). In general, a CSO is conditioned upon the annual review of its application under the following requirements: (1) it meets the criteria set forth in Article 52 of the EITL Implementation Rules; (2) its personnel administration is directly managed by relevant governmental agencies at the county level or above; (3) donation revenues and expenditures are separately accounted for; and (4) public interest expenditures are no less than 70 percent of total donation revenues in the past three consecutive years prior to the application. A list of eligible CSOs will be jointly released by relevant governmental authorities on yearly basis. The lists for 2008 and 2009 were announced on August 20, 2009.

To claim the deduction, an enterprise must present an official donation receipt printed by relevant governmental authorities and sealed by an eligible CSO. Cash donations are calculated based on the amount actually received. In-kind donations are determined at the fair market value, supported by the documentation provided by the enterprise donor. Absent such supporting documentation, an eligible CSO cannot provide an official donation receipt for the deduction purposes. The in-charge tax authorities will review the charitable donation deduction claimed by the enterprise donors against the list of eligible CSOs.

Income Tax Exemption to Non-Profit Organizations Clarified

Under Article 26(4) of the EITL and Article 85 of its Implementation Rules, a qualified non-profit organization (“NPO”) is exempt from income tax, except for income derived from unrelated business activities. Nevertheless, there was no legal standard on tax-exempt income or the qualification of NPOs until November 11, 2009, when the MOF and the SAT jointly issued Caishui [2009] No. 122 (“Circular 122”) and Caishui [2009] No. 123 (“Circular 123”), which clarify the scope of tax-exempt income and define the qualification of a NPO. Circulars 122 and 123 have retrospective effect from January 1, 2008.

Scope of Tax-Exempt Income

Under Circular 122, tax-exempt income of a NPO includes the following:

- Donation from other entities or individuals;
- Governmental subsidies, other than financial provisions pursuant to Article 7 of the EITL or income derived from services performed for the government;

- Membership fees collected pursuant to rules issued by civil affairs or finance departments at provincial level or above; and
- Bank deposit interest generated from non-taxable income and tax-exempt income.

Qualification for Tax Exemption

According to Circular 123, a NPO can apply for tax exemption if it meets the following conditions:

- The NPO is a public institution, social organization, foundation, civil non-enterprise entity, religious activity venue or other recognized organization, which is established or registered under relevant laws and regulations, and which passed annual inspection in the year prior to the application for tax exemption, except for a newly established NPO.
- The NPO is engaged in public interest or not-for-profit activities primarily within China.
- All income received by the NPO is used for public interest or not-for-profit purposes within the scope of its registration or charter, except covering relevant and reasonable expenses.
- The NPO does not distribute its property and fruits, other than paying reasonable staff compensations.
- Upon the dissolution, the remaining assets of the NPO shall be used for public interest or not-for-profit purposes, or be assigned as gifts to organizations with the same nature or purpose by the registration administration with the public notice, under the NPO’s registration or charter.
- A contributor, who is a legal person, an individual or an organization other than the government at whatever level, does not retain any legal rights to the property contributed to the NPO.
- Staff salaries and benefits shall be within the regulated range without disguised distribution of the NPO’s property, with average staff salary up to two times of average local salary level per capita in the previous year and staff benefits to be determined in accordance with relevant rules.
- Taxable and tax-exempt income, costs, expenses and losses shall be separately accounted for.

The qualification for tax-exemption is valid for five years. A NPO can renew its qualification within three months before the expiration.

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