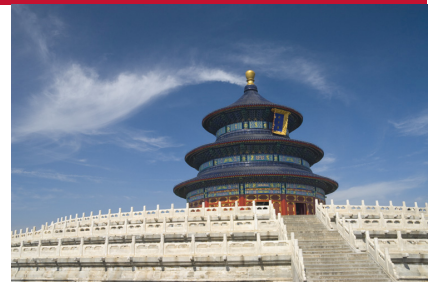


# China Tax Bulletin

July 2010

## In This Issue....

- First Indirect Equity Transfer Case Reported
- Withholding Tax on China-Sourced Interest Received by Banks' Overseas Branches Clarified
- Exchange of Information Article of the Hong Kong-Mainland China Tax Agreement Updated



White & Case is a leading global law firm with lawyers in 36 offices across 25 countries. Whether in established or emerging markets, the hallmark of White & Case is our complete dedication to the business priorities and legal needs of our clients.

If you have questions or comments regarding this bulletin, please contact:

Yongjun Peter Ni  
Partner  
+ 86 21 6132 5930  
yni@whitecase.com

**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.**

## First Indirect Equity Transfer Case Reported

Since Guoshuihan [2009] No. 698 ("Circular 698") was released by the State Administration of Taxation ("SAT") on December 10, 2009, foreign investors and their tax advisors have demonstrated a considerable amount of uneasiness about the implementation process.

Circular 698 was intended to strengthen the administration on indirect transfers of equity in non-listed Chinese resident enterprises by nonresident enterprises (please refer to our [China Tax Bulletin February 2010](#) for more information about Circular 698). In short, a nonresident enterprise transferring an offshore holding company that holds a Chinese resident enterprise is required to file the indirect equity transfer with the Chinese tax authorities, if the offshore holding company being transferred is located in a low-tax jurisdiction. If the nonresident enterprise is considered to be abusing the holding structure without any reasonable business purpose, the Chinese tax authorities would disregard the existence of the offshore holding company and recharacterize the transaction as a taxable direct equity transfer.

On June 8, 2010, it was reported that the local tax authorities had collected a tax payment of RMB 173 million on capital gains derived from an indirect transfer of equity in a foreign-invested enterprise ("Target") at Yangzhou City, Jiangsu Province. As a matter of fact, this is the first reported case in the area of indirect equity transfers after Circular 698 was issued. In summary, the Target was jointly owned by a Chinese resident enterprise in Jiangsu Province and a Hong Kong company ("Holdco"). The Holdco, which had a 49 percent equity interest in the Target, was a 100 percent owned subsidiary of a foreign company ("Seller"). In January 2010, the Seller transferred its 100 percent equity interest in the Holdco to another foreign company ("Buyer"), which was in turn owned by a company in the United States.

Since none of the Buyer, the Seller or the Holdco was a Chinese resident enterprise, the Seller had a view that there should be no Chinese capital gain tax on the transaction. Nevertheless, the Chinese tax authorities disagreed. The Jiangdu State Taxation Bureau ("JSTB") initially noticed the transaction at its planning stage in early 2009. Once the JSTB learned of the execution of the transaction on January 14, 2010, it aggressively stepped in and requested the transaction documents pursuant to Circular 698. While the Seller eventually provided three transaction documents including the transfer agreement, the JSTB separately looked through the Internet to gather more relevant information. Apparently the public announcement released by the Buyer side only mentioned the acquisition of the equity interest in the Target.

It is worth noting that the SAT and the Jiangsu and Yangzhou tax authorities got involved in the process and closely worked with the JSTB in reviewing the transaction. The key was centered on the assessment of the Holdco, which was found to have no personnel and no other asset, liability, investment or business than the investment in the Target. The JSTB then concluded to disregard the Holdco and recharacterize the transaction as a direct equity transfer of the Target based on the substance over form principle. The Seller ultimately accepted the JSTB's decision and promptly made the tax payment.

Clearly this case is a warning shot for foreign investors with investments in China, especially private equity funds. The tax authorities in other locations are expected to follow suit soon. Foreign investors should consider baking the possible Chinese taxes into their return calculations.

### **Withholding Tax on China-Sourced Interest Received by Banks' Overseas Branches Clarified**

The treatment of interest is generally a key part of the tax treaties concluded by China with other countries. On June 2, 2010, the SAT issued Guoshuihan [2010] No. 266 ("**Circular 266**") to further clarify the tax treatment of China-sourced interest received by overseas branches of foreign and domestic financial institutions. For this purpose, China-sourced interest refers to the interest paid by either a Chinese resident enterprise or a Chinese permanent establishment of a nonresident enterprise.

Where China-sourced interest is received by an overseas branch of a Chinese resident bank, there is no tax treaty benefit available to such interest. Instead, Circular 266 states the application of Guoshuihan [2008] No. 955 ("**Circular 955**") to this scenario. Under Circular 955, such interest is subject to a 10 percent withholding tax. This tax treatment is consistent with what was specified on China-sourced interest received by a foreign branch of Bank of China by Guoshuihan [2001] No. 189.

Where China-sourced interest is received by an overseas branch of a nonresident bank, Circular 266 generally looks to the jurisdiction of the head office for the tax treatment. Such interest received by the overseas branch can enjoy the benefits offered by the tax treaty between the jurisdiction of the head office and China, unless those benefits are exclusively available to the head office only without including other branches. In any event, Guoshuifa [2009] No. 124 continues to apply to the application requirements for claiming the tax treaty benefits.

### **Exchange of Information Article of the Hong Kong-Mainland China Tax Agreement Updated**

On May 27, 2010, China and Hong Kong signed a third protocol ("**Protocol**") to the comprehensive double taxation agreement ("**DTA**"). The DTA was concluded in 2006, with an exchange of information ("**EOI**") article based on the 2001 UN model. The Protocol updated the EOI article in accordance with the most recent OECD model. Under the new EOI article, neither Hong Kong nor Mainland China can refuse to provide information on the ground of lack of domestic interest or the bank secrecy restriction. This Protocol is consistent with the recent trend of Hong Kong's DTA practice.

This bulletin is provided for your convenience and does not constitute legal advice. It is prepared for the general information of our clients and other interested persons. This bulletin should not be acted upon in any specific situation without appropriate legal advice and it may include links to websites other than the White & Case website.

White & Case has no responsibility for any websites other than its own and does not endorse the information, content, presentation or accuracy, or make any warranty, express or implied, regarding any other website.

This bulletin is protected by copyright. Material appearing herein may be reproduced or translated with appropriate credit.

## Tax at White & Case

White & Case provides clients with the most effective tax-related legal advice available. We consistently deliver excellent results for our clients by providing innovative, efficient tax solutions. The breadth and depth of the Tax practice's success is evidenced by the numerous awards we have received from organizations, such as *International Tax Review*, *Chambers & Partners*, *Legal 500*, *Chambers Global* and *Global Counsel*, including:

- International Firm of the Year at the Asia Tax Awards—*International Tax Review*, 2009
- Tier One for China Tax (Foreign Firms)—*Asia Pacific Legal 500*, 2009
- Tier One China Tax Practice (Foreign Firms)—*Chambers Asia*, 2008
- A leading law firm for China and Hong Kong tax—*International Tax Review*, 2010
- Tier One for Hong Kong tax planning—*International Tax Review* poll, 2009
- Firm of the Year for Hong Kong Tax—*Asian-Counsel*, 2008

Our Tax practice in China and across the globe works with clients to meet international tax challenges. We help clients execute international tax-planning strategies and resolve the tax controversies that often accompany cross-border investments and transactions. Our tax controversy experience helps clients resolve tax audits, domestic appeals and government-to-government negotiations.

Our team in China is comprised of preeminent lawyers based in Shanghai, Beijing and Hong Kong, who are recognized for their accomplishments in transfer pricing, as well as for the tax aspects of corporate mergers, acquisitions, reorganizations and joint ventures. Additionally, they provide counsel on inbound and outbound syndicated investment structures involving real property, distressed debt and other assets, financial products and global trading, mutual funds and other domestic and cross-border taxation advisory matters.

## Our Firm

White & Case is a leading global law firm with lawyers in 36 offices across 25 countries. We advise on virtually every area of law that affects cross-border business and our knowledge, like our clients' interests, transcends geographic boundaries. Our lawyers are an integral, often long-established part of the business community, giving clients access to local, English and US law capabilities plus a unique appreciation of the political, economic and geographic environments in which they operate. At the same time, working between offices and cross-jurisdiction is second nature and we have the experience, infrastructure and processes in place to make it happen effortlessly.

We work with some of the world's most well-established and most respected companies—including two thirds of the *Global Fortune 100* and half of the *Fortune 500*—as well as start-up visionaries, governments and state-owned entities. Some of our independent accolades include:

- "A superb firm with an excellent practice and great global coverage, White & Case is respected by both peers and clients."—*Chambers Global 2009*
- Five Firm of the Year Awards 2009—*Asian-Counsel*
- Dealmaker of the Year 2009—*American Lawyer*
- Top Global Bankruptcy Law Firm 2009—*The Deal*
- Top Tier in Global Arbitration 2009—*Focus Europe*
- Global Elite in Antitrust/Competition 2009—*Global Competition Review*
- Corporate Finance Deal of the Year 2009—*Latin Lawyer*