L&P

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Restructuring and Capital Gains Tax (CGT) in China

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1. What are Capital Gains?

Capital gains are the (unrealized or realized) increase in value of a capital asset exceeding the initial investment (or purchase price). The gain is not realized until the asset is sold (or any other remuneration received). A capital gain may result from a short-term (one year or less) or long-term (more than one year) investments and may be subject to income taxes.

While capital gains are generally associated with shares or funds due to their inherent price volatility, a capital gain can occur on any share or any asset that is sold/transferred for a price higher than the original investment/purchase price. Realized capital gains or losses occur when an asset is actually sold or transferred. Realized capital gains may trigger a taxable event. Unrealized gains and losses, sometimes referred to as paper gains or losses, reflect an increase or decrease in an investment's value and this may trigger a taxable event as well. A capital loss is incurred when there is a decrease in the capital asset's value compared to the asset's purchase price. Under certain circumstances, such tax losses can be used and offset against taxable profits

2. Tax Consequences of Capital Gains for Companies in China

There is no separate or specific CGT in China. Capital gains (and losses) of companies generally are combined with operating profits and taxed at the normal Enterprise Income Tax (EIT) rate of 25 %. The taxable income of a Chinese enterprise generally includes operating profits, capital gains and passive income, such as interest, royalties and rents. Dividends received from a foreign entity must be included in the taxable income of a Chinese company as well.

3. Identification of latent risks related to the restructuring of a Chinese company

The ownership of a Chinese subsidiaries by a non-resident companies is often organized through an intermediary holding company in a third country. (such as Hong Kong, Singapore, Switzerland etc.) These ownership structures can provide tax advantages and easier management control and other synchronisation effects.

Usually the profit is generated in the jurisdiction where the holding company is located or registered. Nevertheless, some jurisdictions apply capital gains tax in the country where the **asset is registered or domiciled**. Many agreements *for the avoidance of double taxation on income and the prevention of fiscal evasion with respect to taxes on income and on capital* ("DTA") can allow the resident state of the company which is being sold (the asset) to tax this transaction as well.

For example, the DTA China-Germany states in Art. 13 (5):

> *Gains derived by a resident of a Contracting State from the alienation of shares (…) of a company which is a resident of the other Contracting State may be taxed in that other Contracting State if the first-mentioned resident, at any time during the 12-month period preceding the alienation has owned, directly or indirectly, at least 25 per cent of the shares of that company.*

Similar regulations are contained in the DTAs with Singapore and Hong Kong.

In principle, China uses this right and taxes the sale of shares of a Chinese company by a foreign parent holding company at a rate of 10%. Chinese tax authorities also generally tax capital gains received indirectly by selling de facto a Chinese subsidiary by an indirect transfer, even if the transfer is only due to an internal restructuring and no money is received and no share price is paid.

Therefore, even internal corporate restructurings can trigger a negative tax impact.

However, there are some exceptions, which we would like to discuss based on the current legal regulations.

4. Amendments of the tax rules on indirect transfers of Chinese investments and exemptions referring to CGT in China

The State Administration of Taxation (SAT) issued Circular No. 698 in 2009. Then the SAT issued Bulletin [2015] No. 7 on 6 February 2015 and Bulletin [2017] No. 37 on 17 October 2017.

The upgrades by Bulletin [2015] No. 7 and Bulletin [2017] No. 37 abolish certain provisions in Circular No. 698 and provide more comprehensive guidelines on several issues when an indirect transfer by a non-resident enterprise becomes taxable in China. In Bulletin [2015] No. 7 the term "**Chinese Taxable Assets**" appears for the first time. A non-resident enterprise that is transferring shares from its offshore holding company that directly or indirectly holds equity interests in a Chinese enterprise may become subject to Chinese tax on any capital gains from the transfer, whether realized or not.

The prerequisite is that the holding company owns (directly or indirectly) shares in a Chinese subsidiary and the transaction is **classified as not having a bona fide** commercial purpose and therefore re-characterizes the indirect transfer as a direct transfer of a Chinese enterprise/company.

However, Article 5 of Bulletin [2015] No. 7 specifies two situations/exemptions which create safe harbour rules:

- **Normal trading of listed shares**
  Where a non-resident enterprise derives income from an indirect transfer of Chinese taxable assets by acquiring and selling shares in an offshore public listed enterprise on a public market, such capital gains are not taxed in China.
- **DTA or tax treaty exemption/exception**
  Where there is an indirect transfer of Chinese taxable assets or the transferor directly disposes a Chinese taxable asset, the income/consideration from the transfer would then be exempt from EIT in China, if the applicable DTA or similar arrangement obliges China to this exemption. In most cases, however, this is not the case (see above).

5. Changes of the reporting requirement by Bulletin No. 7

The reporting requirement has been changed **from mandatory to voluntary**. Under the old Circular No. 698, transactions had to be reported to the proper tax authorities. Bulletin No. 7 however does not contain an obligation to report any "qualifying transactions". Therefore, a relevant party has the discretion whether to report a transaction or not, provided that the party believes such transaction is a "qualifying transaction" and therefore is not subject to taxation in China.

Obviously, if no filing is done, there is no guarantee on whether the transaction is secure. Without a China tax authority's formal judgment, a self-assessed "qualifying transaction" might not be safe and the risk for future penalties remains. For that reason, we still recommend submitting the necessary documents to the tax authorities.

The Bulletin also extends the reporting parties. Under Circular No. 698, the reporting obligation was only imposed on the transferor/seller. Based on Bulletin [2015] No. 7, a transaction may be reported by either party to the transaction or by the Chinese enterprise whose shares are indirectly transferred, if the Chinese tax authorities request it. According to Article 10 of the Bulletin [2015] No. 7, the Chinese tax authorities may request information about an indirect transfer from any of the parties involved, or from a person that participated in the planning of a transaction. This significant change also affects the duties of legal and tax consultants.

6. Identification of a bona fide commercial purpose

Bulletin [2015] No. 7 provides a more detailed guidance on how to determine a **bona fide commercial purpose**. The Bulletin lists specific factors that need to be considered and describes blacklisted situations in which a transaction will be deemed to be lacking commercial purpose and therefore becomes taxable.

Article 3 of Bulletin [2015] No. 7 specifies that all arrangements related to an indirect transfer of Chinese taxable assets must be considered to qualify as bona fide transaction and lists the following specific factors:

- Whether the equity value (price, consideration) received by the non-resident holding company is mainly derived directly or indirectly from Chinese taxable assets;
- whether the assets of the non-resident holding company mainly consists directly or indirectly of investments in China;
- whether the functions performed, and risks assumed by a holding company and its subsidiaries that hold Chinese taxable assets can justify the economic substance of the organizational structure;
- the duration of the shareholding and duration and changes of the business model;
- the duration of the relevant organizational structures of the non-resident holding company and how long it has been in existence;
- whether **a foreign income tax is paid on income** from the indirect transfer of Chinese taxable assets;
- whether it would have been possible for the transferor to directly invest in and transfer the Chinese taxable assets rather than indirectly invest and transfer the Chinese taxable assets;
- if and how a tax treaty or an arrangement applies to the indirect transfer of the Chinese taxable assets.

7. Blacklisted Situations

A transaction is blacklisted if the following conditions are fulfilled. In this case the transaction will be deemed as lacking a bona fide commercial purpose and therefore be subject to the CGT of 10 % in China.

- 75% or less of the equity value of the non-resident holding company is derived directly or indirectly from Chinese taxable assets;
- at any time during a one-year period before the indirect transfer of the Chinese taxable assets, 90% or more of the asset value of the non-resident holding company (e.g. company from Singapore or Hong Kong) is comprised directly or indirectly of investments in China, or 90% or more of its income is derived directly or indirectly from China;
- the functions performed, and risks assumed by the non-resident holding company (and any of its subsidiaries) that directly or indirectly hold the Chinese taxable assets are limited and are insufficient to prove their economic substance;

- the foreign tax payable or actual tax paid on the gain derived from the indirect transfer of the Chinese taxable assets is lower than the potential Chinese tax on the direct transfer of such assets.

8. Safe harbour rules for internal reorganizations

Article 6 of Bulletin [2015] No. 7 provides "Safe Harbour Rules" for indirect transfers due to internal reorganizations. An indirect transfer that satisfies the following conditions will be deemed to have a bona fide commercial purpose and not trigger a taxable event.

The transferor and the transferee are qualified in the following situations:

- The transferor directly or indirectly owns 80% or more of the shares in the transferee;
- the transferee directly or indirectly owns 80% or more of the shares in the transferor;
- or 80% or more of the shares of both the transferor and transferee are directly or indirectly owned by the same shareholder.

Besides, all the consideration paid by the transferee must originate from its own shares or shares of a related enterprise with which the transferee has a controlling relationship (excluding shares of listed companies).

9. Failure to withhold and pay tax

Bulletin [2015] No. 7 clarifies whether any party of the transaction has a withholding obligation and the interest on the payable tax. Bulletin [2015] No. 7 imposes a withholding obligation on the payer, which will be the transferee in most cases. Thus, in general the transferee will be the withholding agent.

Article 8 of Bulletin [2015] No. 7 specifies that as a general rule, if a withholding agent fails to withhold the payable taxes and the transferor also fails to pay, the tax authorities may hold the transferee as the withholding agent liable under the Chinese law.

Bulletin [2017] No. 37 further specifies the following two different situations:

(1) The withholding agent fails to withhold the payable taxes

In accordance with Article 12 of the Bulletin [2017] No. 37, the competent tax authorities shall order the withholding agent to withhold the payable taxes and pursue liabilities of the withholding agent as per the Chinese law. If needed, the tax authorities may pursue the unpaid taxes from the transferor.

However, the above provision fails in providing detailed guidance on its implementation, such as whether the tax authorities can directly pursue payable taxes from the withholding agent or if it should first pursue the transferor. If the transferee has made full payment of the transfer price to the transferor, should the transferee as withholding agent still be liable for such withholding obligation?

According to Article 8 of Bulletin [2015] No. 7, the liabilities of the withholding agent may be reduced or waived if it completes document filing as per Article 9 of Bulletin [2015] No. 7 within 30 days after the transfer agreement has been signed.

The risk of facing such liabilities should motivate the transferee in a transaction to report the transaction or at least to negotiate with the transferor on how to protect itself against such a risk.

(2) The withholding agent has withheld the payable taxes, but has failed to pay the same to the tax authorities

Article 14 of the Bulletin [2017] No. 37 specifies that in any of the following circumstances, the withholding agent shall be regarded to have withheld but not paid the tax:

- Where the withholding agent has clearly told the payee that the tax due has been withheld;
- Where the withholding tax due has been listed separately in the financial and accounting books;
- Where it has separately deducted the tax in its tax returns or has started to separately amortize and deduct the deductible tax;
- Other evidence that the tax has been withheld.

In such case, as per Article 68 of the Law of the People's Republic of China on the Administration of Tax Collection, the competent tax authorities shall pursue the withholding agent for taxes and penalties. This implies that the transferor shall be released from liabilities.

10. Chinese court case on the topic "Offshore Merger by Absorption" (Shandong Case)

In December 2015, a Chinese district court ruled that an offshore upstream merger which was carried out by two Italian companies was disqualified from receiving the tax-free treatment under Circular No. 59 (issued by the SAT on 30 April 2009).

An Italian parent company passed a resolution to merge with its wholly-owned Italian subsidiary. As a result of the merger, the Italian parent company as the surviving company acquired all the Italian subsidiary's assets and debts including the 33%

shares in a Chinese resident company. The Italian subsidiary was deregistered after the merger. Afterwards, the Chinese tax bureau issued a notice to the Italian parent company, which stated that the merger had resulted in a taxable Chinese share transfer. Thus, the tax bureau taxed the internal restructuring with a CGT of 10% with regard to the 33% shares in the Chinese resident company.

However, the Italian parent company thought that the merger had satisfied the conditions for the tax-free treatment in Article 5 of Circular No. 59 and therefore should not trigger EIT liability in China.

After requesting a revocation at the tax authorities, the Italian parent company brought the case to court. The tax authorities declined the request with the argument that the transfer did not meet the additional conditions in Article 7 of Circular No. 59 limits qualifying cross-border share or asset acquisitions to the following three scenarios:

- ➢ A transfer of the shares of a Chinese company by a non-resident company to its wholly owned non-resident subsidiary (foreign-to-foreign reorganization), where the transferor holds the shares of the subsidiary for a minimum of a three-year period after the transfer;
- ➢ or a transfer of the shares of a Chinese company by a non-resident company to its wholly-owned Chinese subsidiary;
- ➢ or a transfer of the assets of a Chinese company to its wholly-owned non-resident subsidiary.

The court held that it was proper for the tax bureau to characterize the restructuring as a share transfer based on the following reasons:

- ➢ The merger led directly to a change of ownership of more than 33% of the shares in the target company and Bulletin No. 72 (published on 12 December 2013) states that a transfer of shares following an offshore merger means a transfer of shares by a non-resident company.
- ➢ for a qualification of a tax-free treatment, Article 7 of Circular No. 59 requires for a cross-border share that the transferor holds 100% of the shares in the offshore transferee. Whereas in this case (Shandong Case), it was the other way around. The transferee was holding 100% shares in the transferor. Therefore, the court held that the offshore merger was disqualified from receiving the tax-free treatment.

It remains to be seen how the jurisprudence will develop regarding to this topic.

11. Summary

➢ If an indirect transfer of Chinese assets lacks sufficient bona fide commercial purpose, the seller is liable for income (capital gains) tax on the sale, including reporting the same to the SAT. The purchaser also has a withholding and reporting obligation. This is problematic as there will now need to be an discussion on the amount of the tax that is to be paid and therefore the amount that is withheld or held in escrow.

➢ Purchasing parties will need to amend their sale and purchase agreements to reflect the new withholding and reporting obligations to protect themselves when acquiring assets.

➢ Investors should keep sufficient evidence on record to substantiate the reasonable commercial purpose criteria, including minutes of board of directors' meetings, shareholders' meetings and correspondence with the SAT, if any.

➢ Since there is no advance tax ruling available in China and the practice of handling tax matters varies a lot between different cities, a careful planning is advised.

We hope that the information provided in this brochure was helpful for you.
If you have any further questions, please do not hesitate to contact us.

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