New rules widen taxation of indirect transfers of Chinese assets and clarify tax avoidance

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The China State Administration of Taxation recently issued a notice extending the taxation of capital gains by non-Chinese tax residents arising from indirect transfers of Chinese assets. Where indirect transfers of equity in Chinese entities were already subject to capital gains tax based on Circular 698, Notice 7 now extends taxation to indirect transfers of other Chinese assets. Notice 7 also provides clearer guidance on what constitutes tax avoidance by non-Chinese tax residents. We advise clients to carefully assess the potential impact of Notice 7 on recent and possible future transactions.

In December 2009, the Chinese State Administration of Taxation (SAT) published Circular 698. The circular requires non-Chinese tax residents established in a jurisdiction with an effective tax rate of less than 12.5% to notify the relevant Chinese tax authority of any indirect transfer of Chinese equity. (The meaning of an indirect transfer of Chinese equity is a transfer of shares in an intermediate offshore company holding equity in a Chinese subsidiary). If the tax authority finds that the intermediate offshore company lacks a reasonable business purpose and was put in place to avoid paying taxes in China, it can disregard the existence of the intermediate company and treat the transfer as a direct transfer of equity in a Chinese entity. The seller's capital gains from the sale will then be treated as income sourced in China and be taxed at a rate of 10%, subject to a potential reduction under any applicable tax treaty.

Circular 698 does not define "reasonable business purpose". And although some guidance can be found in other regulations, there has been uncertainty among non-Chinese tax residents about the circular's scope.

On 6 February 2015, the SAT published Notice 7 with immediate effect. It has retroactive effect on tax obligations that have not yet been settled with the tax authorities. Notice 7 extends the scope of taxation on indirect transfers to include movable and immovable assets and assets attributable to an establishment in China.

Notice 7 furthermore provides clearer guidance on whether an offshore intermediate company is considered to have a reasonable business purpose.

Pursuant to Notice 7, any indirect transfer of Chinese assets lacks a reasonable business purpose if each of the following conditions has been met:

- at least 75% of the offshore company's value is derived from Chinese assets
- at any time during the preceding one-year period, at least 90% of the offshore company's total assets (excluding cash) consisted of investments in China or at least 90% of the offshore company's revenues were derived from China
- the offshore company lacks substance and has limited risk exposure
- the foreign income tax burden on the indirect transfer is lower than the Chinese income tax burden that would apply in the case of a direct transfer.

Notice 7 contains safe harbour provisions, exempting certain indirect transfers from taxation in China, such as intra-group transfers and transfers of shares in companies listed outside China.

The transaction reporting obligation set out in Circular 698 has been abolished. Notice 7 introduces voluntary reporting to the Chinese tax authorities by taxpayers or withholding agents. However, the transferor will have to pay interest if it fails to timely pay income tax on the indirect transfer.

Notice 7 does not completely replace Circular 698, but provides further guidance on taxation of indirect transfers of taxable Chinese assets. The abolishment of mandatory reporting obligations under Circular 698 is a welcome change, allowing flexibility between transaction parties in how they allocate reporting obligations and indemnities.