

China Tax News

Further clarifications on indirect share transfers and other China sourced income

Key Points

- SAT issued Circular [2011] No. 24 (Circular 24) on 28 March 2011 which is effective from 1 April 2011
- Circular 24 provides additional guidance on the application of Circular [2009] No. 698 (Circular 698) on reporting requirements for indirect share transfers
- Circular 24 covers several aspects of tax administration for non-tax resident enterprises

Main content

Circular 24 covers two areas of income received by non-residents, i.e. income from indirect share transfer and other income. The probably most interesting section of Circular 24 is the last section 6, which gives some guidance on indirect share transfers.

Circular 698 creates a basis to gather extensive information about offshore transactions with regard to share transfers. Its purpose is to fight tax avoidance under which offshore Special Purpose Vehicles (SPV) have been established for the only purpose to avoid capital gains tax in China. Typical cases would be such with a shareholder in BVI (British Virgin Islands) or Mauritius holding shares in a China operating company. Under such scenario, the Chinese tax authorities would have the right to disregard the existence of the offshore holding company and levy Corporate Income Tax (CIT) on the indirect equity transfer. In a recent case, the tax authority in Jiangdu city has levied CIT with the amount of 173 million RMB on such indirect equity transfer.

As these cases are under scrutiny by the tax authorities, the clarifications in Circular 24 should be helpful.

1. Clarifications on direct and indirect share transfers

- Circular 24 clarifies the timing principle on when to recognize the investment income in cases where the share transfer agreement determines payment in installments. Once a non-resident enterprise transfers its shares in a resident enterprise directly, the transaction income shall be recognized on the date when the contract comes into effect and the equity transfer procedures are completed.
- Circular 24 also defines "buying or selling shares in a domestic resident enterprise on the open securities market", which means that the object, amount and price of the stock should be determined by general trading rules on the open securities market.

- Furthermore, the term "overseas investors (actual controller)" has been clarified as to include all investors who indirectly transfer their equity in domestic resident enterprises; "actual tax obligations" means the actual tax obligations for the income from equity transfer, and "income tax exemption" means the exemption from CIT for income resulting from equity transfer;
- Where two or more overseas investors simultaneously and indirectly transfer their equity in a resident enterprise, one of such investors may, following the regulations in Circular 698, submit relevant materials to the local competent taxation authority at the place where the resident enterprise is located.
- Where foreign investors simultaneously and indirectly transfer their equity in two or more resident enterprises which are located in different provinces (municipalities), such investors may, following the regulations in Circular 698, submit relevant materials to the competent taxation authority at the place where one of the resident enterprises is located, and the supervising taxation bureaus in the different provinces (municipalities) shall discuss and then decide whether or not to impose a tax, and report the same to the State Administration of Taxation; if a tax collection decision is made, the overseas investors shall pay tax respectively to the competent taxation authorities at the places where the relevant domestic resident enterprises are located.

2. Other income

- Withholding of CIT on compensation on equity

Once a resident enterprise pays a dividend (or other type of equity consideration) to a non-resident enterprise, the resident enterprise shall withhold CIT on the date when the profit distribution decision is made. If the equity compensation is actually paid before the profit distribution decision is made, the CIT shall be withheld when the payment is made.

- Withholding of CIT on overdue income
 - If a resident enterprise signs an agreement with a non-resident enterprise with respect to income such as interest, rents and royalties, but the domestic enterprise fails to pay the aforesaid sum on the date specified in the agreement or the payments are deferred per changing or modifying the agreement, while the amount has been included in the current cost or expenditure of the domestic enterprise in total and has been treated as tax deductible expense, CIT shall be withheld by the domestic enterprise. The tax should be withheld during filing the annual CIT return.
 - If the aforesaid due but unpaid sum is capitalized as assets or booked as the preparation expenditure of the enterprise and such sum will be included in the cost or expenditure by installments as well as deducted before tax by the domestic enterprise, yearly after such asset is put into use or the production and operation start, CIT on the total sum shall be withheld. Withholding

should be made during filing the annual CIT return for the year of capitalization or when being booked as the preparation expenditure.

- In case that the actual payments are made by the resident enterprise to the non-resident enterprise before the contractual payment date, the tax will be withheld at the actual payment date according to the CIT Law.

- Guarantee fees

Where a non-resident enterprise obtains guarantee fees from China, it shall calculate the amount of CIT at a tax rate of 10% for interest income specified in the Corporate Income Tax Law. The guarantee fees mentioned refer to the guarantee fees which are paid or borne by a domestic enterprise, institution or individual for the receipt of guarantee services from a non-resident enterprise in economic activities such as loan application, buying and selling, goods transportation, processing, rental and project contracting or fees of the same nature.

Where a double tax agreement (DTA) is in place, the DTA withholding tax rate is applicable. Prior application is required.

- Income from transfer of land use rights

Income or gains obtained by a non-resident enterprise without any branch or establishment within the territory of China or income obtained by a non-resident enterprise with branches or establishments within China that have nothing to do with the transfer, should be subject to CIT on a withholding basis for transferring their land use right in China.

The assignee as withholding agent shall withhold the CIT when paying the land use right transfer fee in any case.

- Income tax on income from finance lease and immovable property lease

- Where a non-resident enterprise without any branch or establishment within China leases its equipment or goods to a resident enterprise by finance leasing, and the ownership of the equipment or goods belongs to the resident enterprise after the expiration of the lease period. Where the non-resident enterprise collects rent according to the term specified by the contract, the sum of rent (including the sum which is paid to the domestic enterprise after the expiration of the lease period) less the price of the equipment or goods shall be treated as interest income from a loan; the resident enterprise shall withhold the CIT when making the rental payment.
- Where a non-resident enterprise without any branch or establishment conducts management within China and leases its immovable property in China, the CIT on the income from the leasing shall be calculated on the basis of all rental income. The domestic tenants shall withhold the CIT when paying the rent or when the rent is due and payable.

Observations of WTS

Circular 24 helps to provide more certainty on the timing of the withholding tax on payments.

1. Circular 24 further clarifies the administrative practices on various taxation issues of non-resident enterprises, which gives a clear signal that the SAT will strengthen the tax collection management on the payment to non-resident enterprises. The Corporate Income Tax under such situations should be paid and withheld when such payments are accrued or made.
2. It seems that the SAT has been taking great efforts regarding the tax collection management on non-resident enterprises. Circular 24 for example, asks for the reporting requirement of all the investors undertaking the indirect disposal of resident enterprises. Some detailed requirements are however necessary for further clarification; as a result, the investment structure should be reviewed in order to avoid any tax risk.
3. Combined with the Circular 698, Circular 24 provides more practical guidelines regarding the administrative procedures on the tax collection of non-resident enterprises. The tax management issues on leasing income, guarantee fees and transaction income from land use rights have come to more certainty.

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