



# PRC Non-Resident Enterprise Tax Series: Beneficial Ownership & Indirect Disposals

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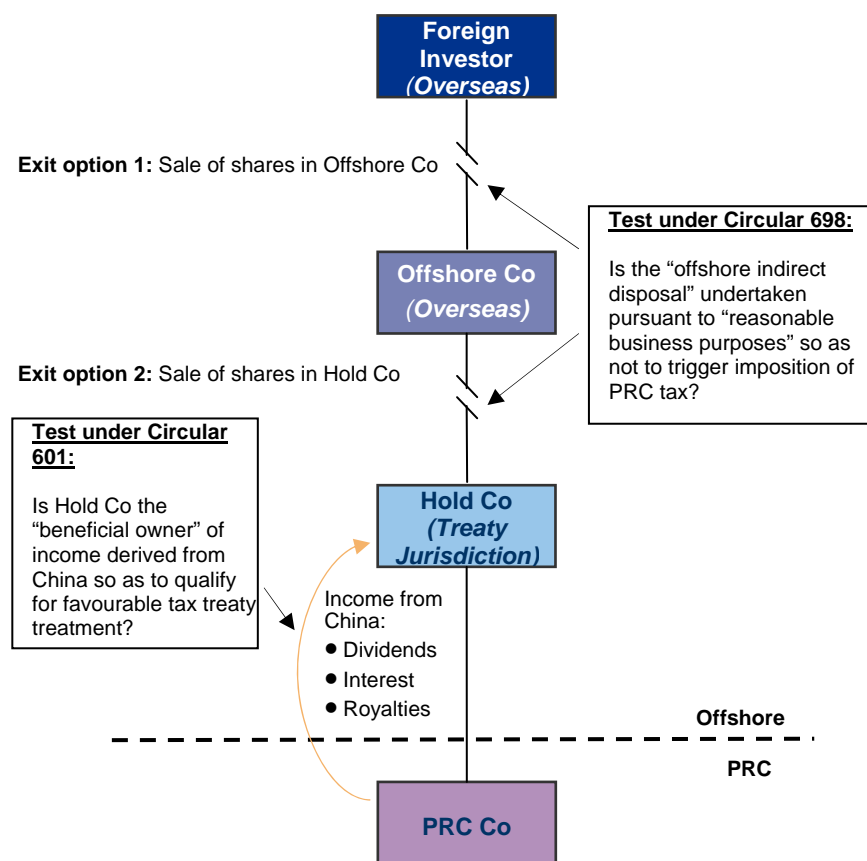
# Introduction

Over recent months, the PRC tax authorities have introduced several significant tax circulars which, if fully implemented, would pose far-reaching compliance requirements and hurdles for foreign investors seeking to implement tax effective investment holding structures in the PRC. The main tax circulars have introduced additional qualification criteria for investors seeking to claim tax treaty benefits and have also imposed reporting and tax enforcement measures against investors undertaking tax-motivated disposals of offshore holding companies of PRC investments.

This article is the first in the series, which shall discuss the principles that appear to underlie the recently introduced tax circulars of the State Administration of Taxation (“SAT”). These articles will also address the major issues and potential risk areas for investors, as well as some possible solutions or remedial actions that investors could consider to adopt in order to navigate through this increasingly complex area of China tax law.

## 1. The new measure’s main impact on investment structuring

The recent tax circular’s impact on investment structure planning is centred around two main areas: firstly, where investors derive income from the PRC directly and are seeking to apply favourable withholding tax rates or treatment under applicable double tax treaties; and secondly, where investors exit from PRC investments indirectly at the offshore holding company level. The “tests” that are required by the two new tax circulars are illustrated diagrammatically below:



*Guoshuihan [2009] No. 601* ("**Circular 601**") deals with the requirement in double tax treaties that the recipient of PRC sourced interest, dividends and royalties should have "**beneficial ownership**" over the relevant income in order to qualify for any preferential double tax treaty treatment.

*Guoshuihan [2009] No. 698* ("**Circular 698**")<sup>1</sup> deals with "**indirect offshore share disposals**" undertaken by investors. Such disposals may be required to be disclosed to the PRC in-charge tax authorities and may potentially be subject to PRC taxation where they are considered to be motivated by tax-avoidance purposes.

## **2. Beneficial ownership requirement under Notice 601**

In many of the double tax treaties entered into between the PRC and overseas jurisdictions, any preferential withholding tax rates applicable for income such as dividends, interest and royalties are only available where the recipient constitutes the "beneficial owner" of such income. In this respect, Circular 601 outlines the SAT's interpretive guidelines of the qualification criteria applying to a "beneficial owner". The circular requires that a beneficial owner, amongst other criteria, must have substantive operating activities and not be considered to be an agent or a "conduit".

In accordance with the "substance over form" principle, Circular 601 further identifies the following "adverse factors" which may be reviewed by the PRC in-charge tax authorities to assess that a recipient of income should not qualify as the beneficial owner, including:

1. where the recipient is obligated to distribute all or a significant portion (e.g., 60% or more) of the income to another jurisdiction within a determined period (e.g., 12 months);
2. the recipient does not undertake any other business activities apart from holding the investment;
3. the recipient's assets, size of operations, personnel are too small as compared to the income derived;
4. the recipient does not have the right to dispose of the assets or does not bear the risks of ownership;
5. the recipient is subject to very low or no tax in the tax treaty jurisdiction; and
6. where there are effective "back-to-back" arrangements implemented with respect to loan or royalties arrangements.

While the differentiation of a "beneficial owner" from an agent or a conduit company under Circular 601 is consistent with the OECD tax treaty interpretive guidelines and certain overseas judicial interpretations, many of the "adverse factors" set out under Circular 601 expand on, if not appear to go beyond such overseas interpretative principles. An investor may well pose the question, for instance, as to how factor No. 5 above (pertaining to the tax payment position, or lack thereof, of the income recipient in its jurisdiction of tax residency) should influence, one way or another, its position as the "beneficial owner" of the income (in accordance with its ordinary meaning). In this light, Circular 601 could perhaps be considered to be directed at "treaty shopping" practices and not merely "beneficial ownership" claims.

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1. Circular 698 was issued on 10 December 2009

### 3. Anti-avoidance rules expanded to offshore indirect share transfers under Circular 698

As compared to Circular 601, Circular 698 is clearly grounded upon the application of the PRC general anti-tax avoidance rules (“**GAAR**”) first introduced under the Corporate Income Tax Law (“**CIT Law**”) from 1 January 2008, which were further clarified under Circular 2, whereby GAAR is defined to specifically include cases where a taxpayer has engaged in “abuse of organisational form”.

The main operating articles of Circular 698 are twofold: firstly, investors are required to disclose reportable transactions to PRC tax authorities where the offshore investor undertakes an indirect shares disposal of offshore investment holding companies that ultimately hold PRC resident enterprise(s) (“**Offshore Disposal**”); secondly, where such Offshore Disposal triggers the application of GAAR, the transaction would be subject to tax authorities’ adjustment and treated as a taxable disposal of the underlying PRC company directly.

#### *Reporting requirement under Circular 698*

The reporting requirements under Circular 698 for an Offshore Disposal are triggered where:

1. the jurisdiction of the entity(ies) whose shares are transferred has an effective tax burden of less than 12.5%, or
2. such jurisdiction exempts its residents from tax on offshore income.

A reportable transaction is required to be disclosed by the offshore investor to the PRC in-charge tax authorities within 30 days of signing the share transfer agreement along with the required documentation;<sup>2</sup> and the offshore investor is required to provide an explanation of the “reasonable business purposes” with respect to the establishment of the investment structure and undertaking of the share disposal.

Generally speaking, for intermediate holding companies whose shares are transferred, it is often the case that no effective tax burden arises in the jurisdiction of the transferred entity as such companies are commonly established in low tax jurisdictions or otherwise not subject to effective tax in jurisdictions that grant capital gains relief on such disposals; hence, by applying the “effective tax burden” test outlined under Not 698, a significant proportion of Offshore Disposals may need to be reported to the tax authorities.

#### *Offshore Disposal subject to GAAR challenge*

For a reportable transaction under Circular 698, where the offshore investor fails to adequately demonstrate “reasonable business purpose” pertaining to the Offshore Disposal, the PRC tax authorities could seek to apply GAAR to challenge the Offshore Disposal on the basis that it amounts to an “abuse of organisational form” and re-characterise the transaction by “denying the existence” of the offshore holding company. In that instance,

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2. The following specific documents and information are required to be submitted to the PRC tax authorities under Circular 698: (i) Share transfer agreement or contract; (ii) the relationship between the offshore investor and the offshore holding company being transferred with regard to capital funding, operations, sales and purchases etc.; (iii) information regarding the operations, employees, bookkeeping, and assets of the offshore holding company whose shares are transferred by the offshore investor; (iv) the relationship between the offshore holding company being transferred by the offshore investor and the PRC resident enterprise, with regard to capital funding, operations, sales and purchases etc.; (v) an explanation of the reasonable business purposes of the offshore investor with respect to the establishment of the offshore holding enterprise (whose shares are transferred); and (vi) other relevant documents requested by the PRC tax authorities.

based on certain precedent cases<sup>3</sup>, the seller would likely be taken to have derived a PRC sourced capital gain (as though the seller had disposed of the PRC resident company directly) and is thus subject to PRC taxation (generally applying at 10% on realised gain on a withholding basis).

#### *Demonstration of “reasonable business purposes” by the offshore investor*

Although the demonstration of “reasonable business purposes” is a key component of the reporting required from the offshore investor under Circular 698, the term is not specifically defined under the circular. Rather, further guidance is to be found in the CIT Law GAAR provision which refers to “transactions without reasonable business purposes” as meaning transactions that have the “reduction, avoidance or deferral of paying taxes as the primary purposes”. Hence, the demonstration of “reasonable business purposes” could be interpreted as to require the offshore investor to positively show commercial and business purposes which outweigh any tax motivated purposes as the “primary purpose” of the investor in implementing a particular investment structure.

In the context of foreign investors investing in the PRC, it is often the case that the foreign investor would undertake a PRC investment through a special purpose vehicle (“**SPV**”) established in a jurisdiction which has entered into a double tax treaty / arrangement with the PRC. In ascertaining the “reasonable business purpose” of the foreign investor in establishing the SPV in a tax treaty jurisdiction, there may be commercial/legal reasons for the foreign investor to achieve many non-tax benefits, including:

1. to enable asset segregation (for separate and additional legal protection) and investment management purposes;
2. relative ease with which the SPV can be formed and administered;
3. greater familiarity, certainty and transparency with the legal system and compliance obligations in the jurisdiction of establishment of the SPV; and
4. better access to and ease of implementing a greater number of financing options or co-investment arrangements.

While the above factors are non-exhaustive and foreign investors may well have other supporting factors in place to demonstrate “reasonable business purposes”, the uncertainty in the application of Circular 698 is the extent to which the PRC tax authorities would readily accept such factors offered by the foreign investor and specific assessments would likely vary in practice depending on the factual pattern of the case.

#### **4. How can foreign investors navigate through Circulars 601 and 698?**

Circulars 601 and 698 present a myriad of tax structuring issues which would vary for each foreign investor. While it may be difficult to arrive at “fail safe” solutions which would cater for all investors, there are certain overriding principles which should underlie foreign investors’ implementation of PRC investment structures from the two principal perspectives

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<sup>3</sup>3. For instance, the PRC authorities have publicised some examples of cases where they have denied tax treaty benefits where the non-tax resident enterprise lacks sufficient commercial substance in the tax treaty jurisdiction (e.g., Guoshuihan [2008] No. 1076), and the Chongqing case under which the offshore seller of a Singapore incorporated company was treated as having derived a PRC sourced gain on the basis that the entity transferred was “lowly capitalised” and did not carry on “substantive business activities”.

of i) qualification as “beneficial owner” pursuant to tax treaty for Circular 601 purposes and ii) ensuring any offshore exit does not contravene Circular 698.

*“Substance” requirements for a “beneficial owner” and qualification for tax treaty benefit*

As Circular 601 appears to be premised on the SAT’s concerns over “treaty shopping” practices, the main question for overseas investors seeking to rely on a favourable double tax treaty is the extent to which economic substance is required to be instilled within the income recipient for the latter to be considered the “beneficial owner” for the purposes of the notice. Such substance requirements would likely be in addition to those which are required within the investor’s own jurisdiction of tax residency (i.e., conditions required for the latter to be in a position to obtain a tax residency certificate therein). The following are some steps and procedures which may be considered to be adopted by the investor (referred to as “**Hold Co**”):

- Hold Co should have a properly constituted board of directors (ideally the majority of such directors should comprise of persons resident in the relevant jurisdiction) to make *bona fide* decisions regarding the offshore SPV(s)’ income, assets and business operations, with all decisions made at the board meetings fully documented;

For example, to overcome the first condition under Notice 601, such board meetings should decide on matters regarding the receipt of income from PRC investee company(s) and how the income is to be “dealt with” by the company; this should be helpful in the company demonstrating a positive claim of ownership over such income, and also that the company should not be considered to be “obligated” to distribute a proportion of its income to another jurisdiction within a determined period.

- Hold Co should have some (or at least one) employee to carry out substantive activities in the tax residency jurisdiction.
- Consistent with the above, Hold Co should also have actual business premises in the tax residency jurisdiction.
- Hold Co should be capitalised with sufficient appropriate shareholder capital.
- Wherever possible, Hold Co should have assets and activities other than that, which give rise to the China-sourced income; and.
- For “back-to-back” loan and royalty arrangements which may be challenged under Circular 601, such arrangements typically arise where the recipient has entered into separate agreements with third parties to pass on the income received on essentially the same terms; hence, to mitigate the risk of falling foul of this condition under Circular 601, it would be helpful for there to be an “arm’s length margin” retained by the income recipient in its jurisdiction of residency.

The current PRC tax administration law, specifically, *Guoshuifa [2009] No. 124* (“Circular 124”) imposes certain compliance requirements on a taxpayer qualifying for tax treaty benefits claims through application or recordal procedures. Investors would need to exercise care when completing the application for tax treaty relief as required by Circular 124 as much of the information required to be disclosed is related to beneficial ownership requirements as set out under Circular 601. In this respect, it would also be important for the investor to fully document the steps and procedures undertaken to instil substance

within an investment structure so as to be in a position to substantiate these as the need arises.

*Reporting of Offshore Disposals and substantiation of "reasonable business purposes" under Circular 698*

For investors who currently have an offshore holding company structure for China investments and intend to undertake an "Offshore Disposal" in the future, such investors would be well advised to assess the potential application of Circular 698 with respect to (i) confirming whether reporting and tax compliance obligations would likely arise; and (ii) ensuring that any required disclosures to the PRC tax authorities appropriately addresses and minimises any GAAR risks from crystallising.

In particular, the existing structure should be reviewed to assess whether (and how) Circular 698 could impact the investor's future disposal plans. Such an assessment would likely be centred around the "robustness" of the established investment structure in light of Circular 698, and the appropriate remedial actions the investor should adopt. In this regard, the following considerations would be relevant:

- As Circular 698 draws from GAAR and seeks to challenge Offshore Disposals effected pursuant to an "abuse of organisational form", holding companies within the investment structure that are artificial and which do not have substance are particularly at risk of being challenged. In this light, the SPVs established in tax haven jurisdictions would appear to be the primary targets of such enforcement actions. Where this is the case, the investor may need to consider structuring alternatives and whether it is feasible to transition to a more defensible investment holding structure (for example for such entities to be "migrated" to appropriate tax treaty jurisdictions), subject to the application of GAAR.
- Where an intermediate holding company is the subject matter of the intended disposal, the Circular 698 disclosures would require the investor to provide "reasonable business purposes" for the establishment of the investment holding structure and the circumstances of the sale. For this purpose, the substance factors we have discussed above with regard to "beneficial ownership" applying to the direct investment holding company would also appear to be directly relevant.

In practice, although the current PRC tax law administration system does not have an "advance ruling" system to allow tax payers to gain comfort and certainty before implementing transactions, investors may well be advised to seek to engage in a dialogue with the in-charge tax authorities or the SAT beforehand (or possibly lobby for an advance ruling system to be introduced).

## 5. Concluding remarks

The driving factors behind the SAT's issuance of Circulars 601 and 698 could perhaps be attributed to the historical position over the past several decades where the local tax authorities have been seen to be somewhat lax in their administration of foreign investors applying for tax treaty relief and offshore tax share transfers being unduly conducted on a tax-free basis. While the SAT is mindful that it will take time for local-level tax bureaux to be able to develop the necessary technical knowledge and expertise, the issued circulars are aimed at kick-starting the enforcement process. At the same time, to ensure that there is overall "quality control" over enforcement cases, local-level tax bureaux are urged to report any problematic or difficult cases encountered in practice to the SAT.

From the investor's perspective, it would appear that the combined effect of Circulars 601 and 698 is that commercial substance should be instilled throughout the investment structure up to the corporate holding level where the investor is contemplating an Offshore Disposal. Viewed in this light, the days of "simple tax planning" by foreign investors for China investments may well be considered to be a thing of the past, and investors would need to devote more time and resources to appropriately deal with the tax structuring issues brought on by the new tax circulars.

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