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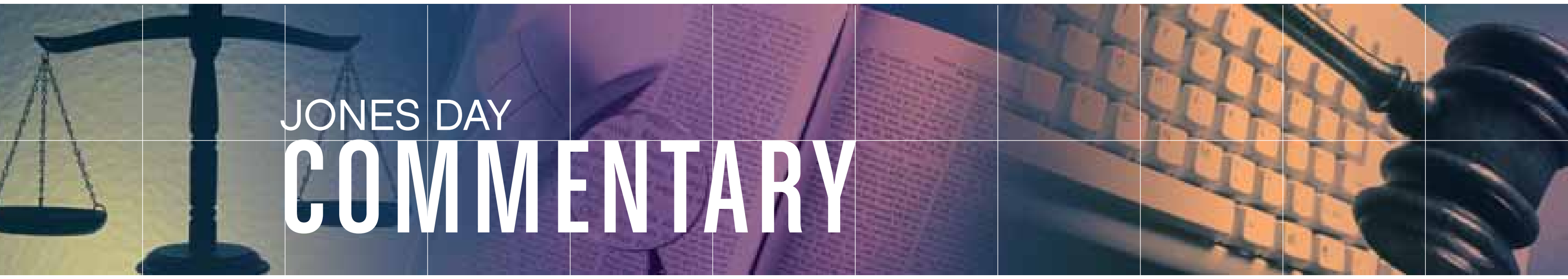

CHINA MAY TAX INDIRECT TRANSFER OF SHARES IN CHINESE COMPANIES

On December 10, 2009, the State Administration of Taxation issued the Notice on Strengthening the Administration of Corporate Income Tax Concerning Equity Transfer for Nonresident Enterprises, Guo Shui Han [2009] No. 698 (the "Notice"). The Notice provides a new interpretation of Chinese tax law, which may have significant implications for direct and indirect transfers of shares of Chinese companies by nonresident companies. The Notice is effective retroactively to January 1, 2008.

COMPUTATION OF CAPITAL GAIN

When a nonresident enterprise transfers equity interest in a Chinese resident enterprise, the nonresident enterprise generally should be liable for China's corporate income tax at 10 percent of the gain, if any, derived from the transfer. The gain is the transfer price in excess of the cost of investment in the equity. If the nonresident enterprise directly invested in the Chinese resident enterprise, the cost of investment is the amount of actual contribution made by the nonresident enterprise; if the nonresident enterprise acquired the equity from other investors, the cost is the consideration actually paid for the equity. At the time of transfer, if the Chinese resident enterprise has undistributed retained earnings and various reserves allocated from its after-tax profits, the nonresident transferor cannot deduct such retained earnings and reserves in computing capital gain. This provision is consistent with the general rule of withholding tax on dividends paid to nonresident enterprises.

However, the Notice does not distinguish pre-2008 earnings from post-2007 earnings. According to the current tax law and regulations, a nonresident shareholder is subject to 10 percent withholding tax on dividends paid by a resident enterprise. However, if the dividends are distributed out of the earnings generated prior to January 1, 2008, such withholding tax is exempted. If this nondeduction rule provided in the Notice applies to pre-2008 earnings, such application would be inconsistent with the exception to the general rule of withholding tax on dividends concerning pre-2008 earnings and may result in additional tax on the transfer of equity. Suppose a nonresident enterprise N contributed 100 as registered capital to its wholly owned Chinese subsidiary S; S has 20 of pre-2008 retained earnings. If N sells shares of S for 180, N would have a capital gain of 80 (180 – 100). However, if N distributes a dividend of 20 before the share transfer and then sells the shares for 160, N would have a gain of only 60 (160 – 100) and would not be subject to withholding tax on the dividend of 20.

INDIRECT TRANSFER OF A CHINESE COMPANY

According to Article 7 of the Implementation Rules for the Corporate Income Tax Law, the income from the transfer of equity investment should be sourced to the location of the invested enterprise. Based on this sourcing rule, if a nonresident enterprise owns an overseas holding company that is also a nonresident enterprise, which in turn invests in a Chinese company, the gain on the sale of shares of the overseas holding company should be sourced to the location of the overseas holding company and generally would not be taxable in China. According to the Notice, however, if the overseas holding company is located in a jurisdiction where the effective tax burden is less than 12.5 percent or where offshore income is not taxed, the nonresident transferor will be required to provide the Chinese tax authority in charge, within 30 days of the execution of the share transfer agreement, the following:

- The share transfer agreement;
- Information on the relationship between the nonresident transferor/investor and the overseas holding company transferred in the areas of capital, business, purchase and sales, etc.;
- Information on the production, business, personnel, accounting, property, etc., of the overseas holding company transferred;
- Information on the relationship between the overseas holding company transferred and the Chinese resident enterprise in the areas of capital, business, purchase and sales, etc.;
- An explanation of the reasonable commercial purpose for the establishment of the overseas holding company transferred; and
- Other information that may be required by the tax authority.

If the tax authority in charge believes that the indirect transfer of equity interest in the Chinese resident enterprise was undertaken to avoid Chinese tax by abusing the organizational form and that it lacks a reasonable commercial purpose, the tax authority may re-characterize the equity transfer based on economic substance and disregard the overseas holding company. Such re-determination of the nature of the transfer must be reported by the tax authority in charge to and confirmed by the State Administration of Taxation.

EXCEPTION

The Notice does not apply to direct or indirect transfers of shares of Chinese resident enterprises that are bought and sold on stock exchanges. It appears that this exception is not available to a foreign investor that directly or indirectly invests in a Chinese resident enterprise before the Chinese enterprise is listed on a stock exchange and subsequently directly or indirectly sells the shares of the Chinese enterprise on the stock exchange after the Chinese company is listed.

LAWYER CONTACT

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