



JONES DAY
COMMENTARY

CHINA COLLECTS TAX ON INDIRECT EQUITY TRANSFER

Recently, Jiandu City State Tax Bureau in Jiangsu Province, China, collected RMB173 million (US\$25.4 million) on capital gain on an indirect transfer of 49 percent equity interest in a Chinese company. This is the first publicized victory of Chinese tax authorities on their campaign against nonresident shareholders for the indirect transfer of equity interest in Chinese resident enterprises since the State Administration of Taxation issued the Notice on Strengthening the Administration of Corporate Income Tax Concerning Equity Transfer for Non-resident Enterprises, Guo Shui Han [2009] No. 698, in December 2009.

China tax law and regulations impose 10 percent income tax on the gains derived by nonresident enterprise shareholders from the transfer of equity interest in China resident enterprises. Guo Shui Han [2009] No. 698 requires that if a nonresident shareholder indirectly transfers the equity of a China resident enterprise by a transfer of shares of an overseas holding company and the effective tax in the holding company jurisdiction is lower than 12.5 percent, the nonresident shareholder should file certain information including the share transfer agreement with the Chinese tax authority. If the tax authority believes that

the indirect transfer of equity interest in the Chinese resident enterprise is to avoid China tax by abusing organizational form and without reasonable business purpose, the tax authority may recharacterize the equity transfer based on economic substance and disregard the overseas holding company. For detailed discussions of the tax circular, please see our *Commentary* in December 2009, "China May Tax Indirect Transfer of Shares in Chinese Companies."

In the current case, Foreign Company A owned 100 percent of a Hong Kong company; the Hong Kong company owns 49 percent of a Chinese company. In January 2010, Foreign Company A transferred shares of the Hong Kong company to Foreign Company B with a gain of US\$254 million. It appears that Foreign Company A did not voluntarily file the required documents with respect to the transfer in accordance with Guo Shui Han [2009] No. 698. The Chinese tax authority requested the transfer agreement from the parties to the transaction, including Foreign Company B. The Chinese tax authorities determined that the transaction in substance is to transfer 49 percent of the Chinese company and therefore should be taxable in China. The facts that the tax authorities use to

support the determination include the announcement made by the U.S. parent of Foreign Company B that they completed acquisition of 49 percent of the Chinese company without mentioning the Hong Kong company, and the Hong Kong company has no employees, other assets and liabilities, other investment, or other business. After several negotiations, Foreign Company A paid the tax.

The case has demonstrated that China tax authorities are aggressive on the enforcement of “anti-tax avoidance” circulars with respect to nonresident enterprises, including tax on indirect transfer of equity in China resident enterprises. Multinational corporations should review their China investment structure and reassess risks in relation to China anti-avoidance regulations.

LAWYER CONTACT

For further information, please contact your principal Firm representative or the lawyer listed below. General email messages may be sent using our “Contact Us” form, which can be found at www.jonesday.com.

Fuli Cao

+86 10 5866 1223

fcao@jonesday.com

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