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China Alert

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# Have offshore indirect disposal rules been extended to disposals by non-resident individuals?

## Matters discussed in this issue:

- Notice of the State Administration of Taxation on Strengthening the Administration of Corporate Income Tax on Gains derived by Non-resident Enterprises from Equity Transfers, Guo Shui Han [2009] No. 698 (Circular 698).
- Reported case of the application by the Shenzhen local tax bureau of the general anti-avoidance rule, contained in the CIT Law, to tax an indirect offshore disposal of an equity interest in a Chinese company by a non-resident individual.

### Background

According to recent Chinese media reports, the Shenzhen Local Tax Bureau (Shenzhen LTB) recently collected tax in the amount of RMB 13.68 million from the indirect disposal of shares in a Chinese enterprise by a non-resident individual. It is, however, unclear as to whether it is Individual Income Tax (IIT) or Corporate Income Tax (CIT) which was collected.

The general anti-avoidance rule (GAAR), contained in Article 47 of the CIT Law, may be used, pursuant to Circular 698, to re-characterise an offshore indirect transfer as a direct disposal of the underlying equity interest in the Chinese company by the non-resident disposer (typically being a foreign corporation). Such re-characterisation is applied to arrangements involving an abusive use of organisational forms, where the taxpayer is unable to demonstrate economic substance in the offshore company.

While Circular 698 has been used by the Chinese tax authorities in a number of high-profile cases involving non-resident corporate sellers, the position adopted by some practitioners has been that the GAAR provision, contained solely within the CIT Law, should not apply to individuals, as they should be subject to IIT on their taxable gains pursuant to the IIT Law, which, prima facie, does not contain an equivalent GAAR provision. This new case appears to indicate that the State Administration of Taxation (SAT) (which, under Circular 2, must approve any application of the GAAR by a local tax bureau) does not view this technical reading as an insurmountable hurdle to the application of the GAAR to tax a non-resident individual disposer.

**Facts of the case in Shenzhen**

An individual, understood to be a tax resident of Hong Kong, established a Hong Kong incorporated company, which in turn established a Chinese incorporated subsidiary in 2000. The Chinese subsidiary established a logistics business based out of Shenzhen, which acquired substantial warehousing facilities, the value of which increased substantially over the course of ten years. In 2010, the individual transferred the shares in the Hong Kong company to a Singapore company for a consideration of RMB 200 million.

The Shenzhen LTB, following an investigation and correspondence with the individual, obtained SAT approval to re-characterise the transaction as a transfer of the equity in the Chinese incorporated subsidiary, and subjected the gain to tax of RMB 13.68 million. The Shenzhen LTB viewed the transaction as an abuse of organisational form and lacking commercial substance. This conclusion was primarily based on the fact that the Hong Kong company had a small registered capital (HKD 10,000/RMB 8,300) relative to the transfer price of RMB 200 million, and did not have substantive operating activities; as such, it was seen to be a shell or conduit for GAAR purposes.

**KPMG observations**

First of all, it is important to note that the possibility that the abovementioned case has been misreported by the media cannot be ruled out as such misreporting has happened before. However, it is important for taxpayers to be aware that the risk of Circular 698 being applied to non-resident individuals might not be as remote as it was previously thought.

The media reports do not make clear the technical basis adopted by the Shenzhen LTB in imposing the tax charge. For instance, the media reports do not directly mention an application of Circular 698. However, the factors referred to by the Shenzhen LTB in analysing the transaction, such as the lack of substantive operating activities in the Hong Kong company leading to it being viewed as a conduit, and the manner in which the GAAR was applied to look through the Hong Kong company to regard the transaction as being a transfer of the equity in the Chinese company, indicate that the Shenzhen LTB dealt with the transaction in a manner consistent with the principles contained in Circular 698 for application to non-resident corporations.

From this case, it would appear that the ambit of China's offshore indirect transfer taxing provisions, applicable for transfers by non-resident corporations in Circular 698, has been expanded to encompass share transfers by non-resident individuals with the endorsement of the SAT. As a consequence, non-resident individuals indirectly disposing of equity interests in Chinese companies, by transferring shares in offshore holding companies with limited commercial substance, should be aware that the gains realised may be subjected to Chinese tax. Further, the case would also likely result in the Circular 698 transferor reporting also being extended to foreign individuals where the requisite conditions are satisfied.

It is unclear from media reports if it was IIT or CIT that was collected. However, if it was the former, insofar as the IIT Law does not contain a specific provision allowing for the use of a GAAR, it would appear that the Shenzhen LTB has imported the concept from the CIT Law for the purposes of applying the IIT Law to an offshore individual. Technically, this is quite an expansive reading of the IIT Law provisions and the Chinese legislature and SAT may perhaps consider the introduction of regulations/specific circulars to explicitly provide for the application of a GAAR under the IIT Law. Whatever the basis adopted by the tax authorities, it is hoped that the SAT will provide further clarification, in due course, as to the basis adopted in this case so as to provide more certainty to taxpayers. The same applies to the other matters of uncertainty in relation to the application of Circular 698, such as its interaction with China's tax treaty network. For more information, please click here.

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