

CHINA TAX ALERT

ISSUE 36 | December 2013

SAT issues clarification on non-resident enterprises electing for “special tax treatment” of PRC equity interest transfers

Regulations discussed in this issue:

- *Public Announcement Regarding “Special Tax Treatment” on Equity Transfer Transactions by Non-resident Enterprises*, issued by the SAT on 12 December 2013, GongGao [2013] No.72 (“Announcement 72”)
- *Circular on Several Issues on Corporate Income Tax Treatments for Corporate Restructuring Transactions* issued by the Ministry of Finance and the SAT on 30 April 2009, Caishui [2009] No. 59 (“Circular 59”), effective from 1 January 2008
- *Public Announcement Regarding the Administrative Measures on Corporate Income Tax Treatments for Corporate Reorganisation*, issued by the SAT on 26 July 2010, GongGao [2010] No.4 (“Announcement 4”)

The State Administration of Taxation (SAT) issued the *Public Announcement Regarding “Special Tax Treatment” on Equity Transfer Transactions by Non-resident Enterprises* (“Announcement 72”) on 12 December, 2013. The Announcement is a welcomed development as transaction parties now have more specific guidance on the recordal filing requirement for “special tax treatment” of certain cross-border corporate re-organisation involving PRC equity interest transfers. Note, however, that the timeline for the recordal filing has now been “brought forward” to within 30 days of the equity interest transfer being effected, whilst previously the relevant recordal filing was only due upon lodgement of the PRC company’s annual CIT return (which can be 5 months after the end of the financial year). Further, Announcement 72 stipulates that subsequent to an “Qualifying Transfer” where the “special tax treatment” has been elected, the retained earnings of the PRC entity accumulated prior to being transferred shall not be entitled to any reduction in dividend withholding tax (WHT) rate accorded under the relevant tax treaty between China and the transferee’s (i.e. the new shareholder’s) jurisdiction if dividend is distributed after the equity transfer transaction.

Background

The SAT issued Announcement 72 to require taxpayers to make recordal filing to the local tax authorities on the election of “special tax treatment” (in the form of tax deferral) for certain equity transfer transactions of PRC entity pursuant to Circular 59 (“Qualifying Transfer”). The administrative guidance in Announcement 72 include, amongst others, responsible party for tax recordal filing, specific documentation requirements and the actions required of the tax authorities. Further, where offshore corporate transactions involving mergers and corporate splits result in a shareholding change in a PRC entity, these could also fall within the scope of Announcement 72.

Announcement 72, taking effect from the date of issuance of 12 December 2013, is welcomed as it provides for clarity on the fulfillment of administrative procedures for the election of “special tax treatment” on the two types of cross-border Qualifying Transfers by way of

Regulations discussed in this issue (Cont'd):

- *Circular on the Strengthening of Administration of Corporate Income Tax Assessment on Income of Non-resident Enterprises from Transfer of Equity Interests*, issued by the SAT on 10 December 2009, Guoshuihan [2009] No. 698 ("Circular 698")

recordal filing with PRC tax authorities; it also supplements and updates the previous requirements of Circular 59 and Circular 698. It is important for investors to comply with the requirements under Announcement 72 in order to receive "special tax treatment".

Application scope of Circular 72

Announcement 72 deals with two types of "Qualifying Transfer" by non-resident enterprises specified in Circular 59 if specific conditions are met:¹

- **Type 1 "Foreign-to-Foreign" transfer:** Transfer by a non-resident enterprise of its shareholdings in a PRC entity to its wholly-owned (100%) subsidiary (another non-resident enterprise) may qualify for the "special tax treatment" provided that the WHT rate applicable to the gain on the future disposal of such shareholdings is not reduced, and that the non-resident transferor makes a written promise to the tax authorities that it will not dispose of its interest in the non-resident transferee within three years of the re-organisation. Announcement 72 further clarifies that an equity transfer of PRC entity resulting from an offshore merger or de-merger of its non-resident enterprise shareholders shall fall within the scope of the Type 1 "Qualifying Transfer".
- **Type 2 "Foreign-to-China" transfer:** Transfer by a non-resident enterprise of its shareholdings in a PRC entity to its wholly-owned (100%) PRC subsidiary (PRC tax resident).

Recordal filing required under Circular 72

Compared to the compliance requirements set out in Circular 698 and Announcement 4, issued in December 2009 and July 2010 respectively, Announcement 72 provides more specific and updated guidance to both the taxpayers and the local tax authorities in handling tax recordal filing regarding the election of "special tax treatment" for Type 1 and Type 2 "Qualifying Transfer". Previous rules applicable to non-resident taxpayers electing for "special tax treatment" for Qualifying Transfer set out in Clause 9 of Circular 698 are now rescinded and replaced by the rules set out in Announcement 72.

	Type 1 "Foreign-to-Foreign" transfer:	Type 2 "Foreign-to-China" transfer:
Reporting timeline	• Within 30 days from the effective date of equity transfer agreement <u>and</u> upon completion of the requisite government approval procedures for changing of shareholder	
Responsible tax bureau	• The in-charge tax bureau of the <i>PRC entity being transferred</i>	• The in-charge tax bureau of the <i>transferee</i>
Documentation requirements	• A prescribed tax recordal form • Information on the Qualifying Transfer, including	

¹ Pursuant to Circular 59, specific conditions must be satisfied to qualify for the election of "special tax treatment". The conditions include: reasonable business purposes, continuity of substantive operations and continuity of interest, certain threshold requirements with respect to assets, shareholdings, and share (boot) and non-share considerations. For equity transfer transactions involving non-resident enterprises (e.g. Type 1 and Type 2 described herein, additional qualifying conditions must also be met. For details, please refer to KPMG China Alert Issue 39, May 2009 (http://www.kpmg.com/cn/en/virtual_library/Tax/china_alert/2009/Issue39_0509.pdf) and KPMG China Alert Issue 12, September 2010 (<http://www.kpmg.com/cn/en/IssuesAndInsights/ArticlesPublications/Newsletters/ChinaAlerts/Documents/china-alert-1009-12.pdf>)

	<p>business purposes, documentary proof for satisfying all of the qualifying conditions for the “special tax treatment”, group organisational chart before and after the re-organisation, etc.</p> <ul style="list-style-type: none"> • Equity transfer agreement (with certified Chinese translation) • Approval documents issued by the relevant government authorities on the change of shareholder • Information on the accumulated retained earnings position of the PRC entity being transferred as at the time of the equity transfer • Other information requested by the tax authorities
Tax authorities’ response timeframe	<ul style="list-style-type: none"> • The responsible local tax bureau shall issue an “opinion” on the “special tax treatment” within 30 days of the recordal filing (and stamp the recordal form), and submit such “opinion” and the relevant documentation to provincial level of the SAT or the counterpart local tax bureau for Type 2 Transfer

Reduced dividend WHT not available to retained earnings accumulated prior to the Qualifying Transfer

Announcement 72 stipulates that subsequent to an “Qualifying Transfer” where “special tax treatment” has been elected, the retained earnings of the PRC entity accumulated prior to being transferred shall not be entitled to any reduction in dividend withholding tax (WHT) rate as accorded under the relevant tax treaty between China and the transferee’s (i.e. the new shareholder’s) jurisdiction if dividend is distributed after the equity transfer transaction. This measure is designed to prevent any conferment of dividend WHT advantages that may be derived from a qualifying restructuring and “codifies” what tax authorities sometimes require in practice.

KPMG observations

Announcement 72 is a welcomed development as transaction parties now have more specific guidance on qualifying for “special tax treatment” for Qualifying Transfers, although it is important to note that the timeline required for the recordal filing has been “brought forward” under Announcement 72 to within 30 days of the equity interest transfer being effected. This compares with the previous requirement under Circular 59 where the relevant recordal is upon lodgement of the PRC company’s annual CIT return (which can be 5 months after the end of the financial year).

In addition, under the Announcement 72 “recordal filing” system, an “opinion” issued by the local responsible tax bureau still appears to be required to confirm the eligibility of the “special tax treatment”. Hence it is important for taxpayers to ensure that the recordal filing is complete and thorough to support their application for ‘special tax treatment’.

Importantly, Announcement 72 specifically requires offshore merger / corporate splits resulting in an equity interest change in the PRC entity be subject to recordal. This in principle should be helpful for offshore

taxpayers carrying out “vertical” merger / corporate splits. It may even be interpreted that Announcement 72 “lowers the bar” for “horizontal” mergers / splits, and relaxes the rigid “100% shareholding” requirement for the transferor and transferee to qualify for intra-group re-organisation. The extent to which this can be interpreted as a substantive relaxation, however, remains to be clarified by the SAT.

Foreign investors should monitor the development in this aspect, and carefully evaluate the potential tax implications and exposure of any cross-border intra-group re-organisation prior to actual implementation.

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