

China Strengthens Tax Rules Relating to Share Transfers by Non-resident Enterprises

December 10, 2009

The PRC State Administration of Taxation issued the Notice on Strengthening the Management of Enterprise Income Tax Collection of Income from Share Transfers by Non-resident Enterprises, on December 10, 2009 (the "Notice").

Scope of income from share transfers

Income in the Notice is defined as income derived from share transfers of Chinese resident enterprises directly or indirectly by Non-resident enterprises. However, income derived from buying and selling shares of listed Chinese resident enterprises in the public stock exchange markets is not included within the scope of the Notice.

Calculation of share transfer income

The taxable share transfer income is defined as share transfer price minus the cost of share investment. Share transfer price refers to the consideration received by the transferor in the form of cash, non-cash assets, share, etc. Cost of share investment refers to the contribution to a Chinese resident enterprise for investment by the transferor, or the consideration paid by the transferor in order to purchase the share of the Chinese resident enterprise.

Indirect share transfer

The Notice indicates that ultimate foreign investors are required to disclose the required documents regarding indirect transfers of Chinese resident enterprises to the PRC tax authorities under the following circumstances:

- a. If an intermediate holding company transfers its share of a Chinese resident enterprise to a third party; and
- b. This intermediate holding company is located in a low tax jurisdiction or such jurisdiction exempts income tax on foreign-sourced income.

The documents to be disclosed are as follows:

- a. Share transfer contract or agreement;
- b. The relationship between the foreign investor and the intermediate holding company in terms of cash flow, operations, purchase & sales, etc.;
- c. The business operation, personnel, financial accounts, and assets of the intermediate holding company;
- d. The relationship between the intermediate holding company and the Chinese resident enterprise in terms of cash flow, operations, purchases & sales;
- e. Explanation of the reasonable business purpose for the foreign investor to set up the intermediate holding company;
- f. Other documents required by the tax authority.

Though the term "indirect transfer" is not defined in the Notice, it is presumed that indirect transfer means an intermediate holding company which is set up by a foreign investor transfers its share of a Chinese resident enterprise to a third party and

this transfer is actually implemented in favor of this foreign investor. Sometimes, the foreign investor may use many levels of intermediary holding companies in different countries to accomplish the share transfer. No matter how complicated the cases are, the disclosure shall be required for review as long as the foreign investor has a little relationship with the share being transferred.

Conclusion

The Notice has clarified the implementation details on certain issues regarding the company income tax, which are important to the tax authorities in dealing with tax treatments for cross-border share transfer. The notice come into effective 1 January 2008 retrospectively, which means the rules in the Notice can apply to the share transfer in 2008 and 2009. It will be useful for the tax authorities to handle the pending cases before the Notice.

It is estimated that the PRC tax authorities have strengthened the supervision of tax paying regarding the cross-border share transfer. They will initiate the relevant investigation or exercises on share transfers. Therefore, foreign investors which have conducted such share transfers may take more risks to enjoy the tax benefits from this kind of transactions. More attention shall be paid to the establishment of business structure for tax planning with respect to China-related transactions so as to withstand the potential challenges.