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China issues new guidelines on the taxation of the indirect offshore transfer of PRC assets

On 3 February 2015, China's State Administration of Taxation (SAT) promulgated the so-called "Announcement 7" which became effective on the same day. Announcement 7 goes beyond the previous Circular 698 that imposed 10% capital gains tax on the indirect offshore transfer of PRC equity interests. It introduces material changes which may significantly complicate future M&A deals conducted offshore that involve substantive Chinese assets. In the meantime, pending further clarification from SAT, uncertainty remains as to its applicability to historic transactions. Parties to historic transactions which may be caught by Announcement 7 should review their signed SPAs to see if any indemnity provisions may become relevant in light of this new development.

Circular 698, which was published by SAT in 2009, imposes PRC corporate income tax (effectively a 10% capital gains tax) on an offshore transaction that indirectly transfers equity interests in underlying PRC resident enterprises, where the offshore transaction falls short of a bona fide commercial purpose and where the relevant authorities consider that it was structured to avoid PRC taxes.

Like Circular 698, Announcement 7 also targets the indirect transfer of "Chinese taxable property" which falls short of having a reasonable commercial purpose and which is structured to avoid PRC taxes. That said, some of the content of Announcement 7 is materially different from Circular 698. This has created uncertainties and is likely to complicate the structuring of future M&A deals conducted offshore which involve substantive PRC assets.

Broader scope of "China Taxable Property"

Technically, the previous Circular 698 only applied to the offshore indirect transfer of equity interests in PRC resident enterprises. A broader concept of "China taxable property" (being the subject of the offshore indirect transfer) is introduced under Announcement 7, which includes not only the indirect transfer of equity interests in PRC resident enterprises, but also PRC real property and assets attributed to an offshore entity's establishment in China. The inclusion of PRC real property means that Announcement 7 will now catch the previously "grandfathered" real property holding structure that existed before July 2006, whereby an offshore entity directly acquires PRC real property as opposed to holding it through a PRC-incorporated real estate project company (which was legally required after July 2006).

Controversial withholding and penalty mechanisms

For M&A transactions, the most controversial aspect of Announcement 7 is that it imposes a withholding obligation on the buyer and associated penalty mechanisms affecting both the seller and the buyer. The mechanisms are quite complex and are summarized below.

- If an offshore transaction is subject to PRC corporate income tax according to Announcement 7, the party which, pursuant to law or contractual arrangement, makes payment to the transferor/seller (i.e. typically the buyer), will be the withholding agent of the taxes which are payable.
- If the buyer/withholding agent fails to withhold and pay the required taxes, the seller should make a tax filing with the relevant PRC tax authority and pay the taxes within 7 days from the day on which the tax payment obligation arises. According to Announcement 7, the tax payment obligation arises at the later of (i) the effective date of the SPA in relation to the transfer of equity interests in the offshore entity or (ii) the closing date of the offshore transaction.
- If neither the buyer nor the seller pays the taxes, the tax authority can go after the buyer (as the withholding agent) according to the PRC Tax Collection Administration Law and its implementing rules. The buyer may not only have to be responsible for the amount of tax due, but may also be subject to a fine of between 50% to three times of the amount of tax due. That said, if the buyer/withholding agent reports the offshore transaction to the relevant tax authority within 30 days from the signing of the SPA, its liability "may be mitigated or relieved" although what this means exactly is unclear.
- In the event that the withholding agent fails to withhold and pay the taxes in the first place, and if the seller also fails to file its tax return and pay taxes, apart from its liability to pay the unpaid taxes, the seller will be subject to a daily late payment interest of 0.05% per day on the unpaid amount. To encourage voluntary reporting of the offshore transaction to the PRC tax authority, a lower interest rate applies if the seller reports the transaction to the authority within 30 days from the signing of the SPA, as opposed to a higher interest rate which would otherwise kick in if the seller fails to report at all.

The aim of this new mechanism is to strengthen the enforcement of tax collection by SAT so as to put both the seller and the buyer "on the hook". However, this creates uncertainties among sellers and buyers. For example, their views may differ as to whether there is a reasonable commercial purpose in the target offshore entity that is being transferred, which is the key factor in determining whether the transaction would trigger the PRC corporate income tax liability. They may also have different opinions on the amount of PRC tax payable. As Announcement 7 now clearly imposes a withholding obligation on the buyer, the potential differences between the buyer and seller may create a major stumbling block to the deal. It remains to be seen whether a practical arrangement (such as joint consultation with the relevant tax authority before signing of the SPA) could be developed over time to provide the necessary comfort so that transactions will not be held up.

Retrospective effect

Another problematic aspect of Announcement 7 is its retrospective effect. The last clause of Announcement 7 states that transactions which have taken place before the date of its promulgation but which have not received "tax treatment" shall be handled in accordance with Announcement 7. The wording is vague and it is unclear as to what extent Announcement 7 applies to (i) deals that have been signed and completed before the promulgation of Announcement 7, and (ii) deals that have been signed before the promulgation of Announcement 7 but which have not yet been completed. In the latter case, it might be prudent, at least from the buyer's perspective, to report the transaction to the relevant tax authority so that if the transaction is indeed caught by Announcement 7, the buyer may still argue that it has reported the case and later (if necessary) rely on the aforementioned provision that the buyer's liability may be "mitigated" or "relieved".

In addition, it may be prudent for the parties to review their signed SPAs to see if any indemnity provision may become relevant. Further clarification by SAT of the practical implementation of Announcement 7 would be welcome to remove these uncertainties.

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This briefing aims to highlight the potential impact of Announcement 7 on M&A transactions, but does not purport to offer tax advice. Clients are recommended to consult their tax advisors regarding the specific tax implications of Announcement 7.

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This publication does not necessarily deal with every important topic or cover every aspect of the topics with which it deals. It is not designed to provide legal or other advice.

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