Corporate Alert: China's New Tax Regulation on Indirect Disposals Complicates Certain Offshore M&A Deals

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In 2009, China's State Administration of Taxation (SAT) promulgated Circular 698 to empower PRC tax authorities to re-characterize transfers by non-PRC residents of shares in offshore companies that hold equity interests in Chinese companies as direct transfers of such Chinese companies and impose a 10% capital gains tax on such transfers, if tax authorities determine that the arrangement lacks reasonable commercial purpose and is aimed at avoiding PRC tax. Since its promulgation, Circular 698 has had a wide impact on foreign investments in China via offshore intermediate holding companies, such as in the case of many private equity and venture capital investments.

On February 3, 2015, SAT issued a new regulation, Bulletin [2015] No.7 ("Bulletin 7"), which became effective on the same day. Bulletin 7, which partially supersedes Circular 698, provides more comprehensive guidelines on a number of issues relating to taxation of indirect offshore disposals of China assets. The new regulation introduces material changes which would significantly influence M&A deals conducted offshore and involving underlying assets in China. It applies retroactively to transactions that took place before February 3, 2015 but have not received tax assessment from PRC tax authorities.

Reasonable Commercial Purpose

In Bulletin 7, SAT for the first time officially provides a list of factors that should be considered in assessing "reasonable commercial purpose". Bulletin 7 calls for a comprehensive analysis following the "substance over form" principle, where all arrangements relating to an indirect transfer of PRC assets are to be considered in their totality.

Bulletin 7 further provides that certain arrangements where all of the following criteria are met shall be deemed to lack reasonable commercial purpose (without going through a more comprehensive analysis):[1]

1. 75%+ of the equity value of the offshore company being transferred is attributable to assets in China;
2. at any time during the year before the indirect transfer, 90%+ of the total assets (excluding cash) of the offshore company were comprised of investments located in China, or 90%+ of its income was sourced from China;
3. the functions performed and risks assumed by the offshore company and its subsidiaries which hold the underlying assets in China are limited and insufficient to demonstrate economic substance; and
4. the foreign taxes payable on the indirect transfer are lower than the potential PRC taxes payable on a direct transfer of the same underlying assets in China.

Withholding Obligations

With respect to offshore equity transfers involving PRC assets, the most significant and potentially controversial aspect of Bulletin 7 is that it imposes withholding obligations on buyers and also stipulates penalty mechanisms affecting both sellers and buyers. Under Bulletin 7, the party (typically the buyer) obligated to pay consideration to the transferor/seller shall be the withholding agent in a taxable transaction, regardless of whether it is a resident or not.[2] If the buyer/withholding agent fails to withhold

1 The offshore holding company structures used in many foreign PE and VC investments in Chinese businesses might arguably meet all such criteria, and as a result, transfers of the offshore holding companies in such structures might be taxable.

2 Interestingly, a tax regulation issued in 2009 (Circular [2009] No.3, which is still in effect) stipulates that if the parties to an offshore equity transfer transaction are both nonresidents, the seller shall be responsible for tax reporting and payment. This regulation was perceived by many to waive nonresident buyers' withholding obligations in such offshore equity transfers.

and pay the tax, the seller shall report and pay such tax within seven days after the date on which tax liability arises. If neither party pays the tax, PRC tax authority can hold the buyer (as withholding agent) liable and impose a penalty of 50%-300% of the unpaid tax, but such penalty can be reduced or waived if the buyer reports the transaction to tax authority within 30 days after the signing of the SPA. Bulletin 7 also provides for late payment interest which may be imposed on the seller if both parties fail to pay the tax, and the applicable interest rate will be lower if the seller reports the transaction within 30 days after the execution of the SPA.

By putting both the seller and the buyer "on the hook", the above mechanism is apparently intended to encourage tax reporting and payment by parties to a potentially taxable offshore indirect transfer. Although reporting becomes voluntary under Bulletin 7, buyers and sellers would be motivated to report transactions that are potentially taxable, with a view to mitigating their respective exposures to penalties and interest charges. This is particularly true in the case of buyers, who almost always have a very strong incentive to report the transactions in order to secure a potential exemption from or reduction in future penalties for failure to fulfill their withholding obligations.

Impact on Deal Dynamics

The new regulation will have a major impact on how offshore M&A transactions involving PRC underlying assets are to be negotiated and conducted. According to Bulletin 7, tax liability in respect of a taxable indirect transfer arises upon the effectiveness of the equity transfer agreement and the completion of the transfer, and the parties are required to pay the tax within seven days thereafter. The parties to a potentially taxable offshore transaction will need to conduct the "reasonable commercial purpose" assessment in light of the criteria stipulated in Bulletin 7, so as to determine whether the transaction is taxable. However, such self-assessment might not be totally safe. In particular, if the parties determine that the arrangement has reasonable commercial purpose and the transaction is not taxable, but the tax authority later takes a different view, the parties might be required to pay, in addition to the tax due, penalties and/or late payment interest which may amount to significant additional liabilities.

The "reasonable commercial purpose" assessment could be very complicated and subjective, and may not be an easy task for either the taxpayer or the tax authorities. The parties to a potentially taxable transaction would face a difficult situation. One of the ways to avoid the possibly significant penalties and interest charges is to pay tax shortly after the offshore equity transfer is completed, but this may be undesirable for the seller because it will likely be difficult (if not impossible) to get a refund of any overpaid tax. Another option is to hold off closing the transaction until the tax authority makes a determination. However, as Bulletin 7 does not stipulate whether, how or when the tax authority should respond to a reporting, this approach may be associated with substantial uncertainty in the timing of closing.

As the risk for buyers, as withholding agent, to be held ultimately "wrong" has become much higher under Bulleting 7, it may not be easy to align the interests of buyers and sellers. Buyers may have an incentive to make a worst-case scenario presumption on the "reasonable commercial purpose" assessment and withhold taxes in all cases where commercial substance is limited. It is therefore advisable for the seller and the buyer to work cooperatively to assess the commercial substance of the transaction structure and the taxability of the transaction. Practical arrangements, such as incorporating appropriate legal protection to cover the buyer's potential exposures (e.g., escrow, indemnity) in the transaction documents, may help the parties to reach a consensus on whether to report the transaction and/or pay taxes. Proactive communication with tax authorities to understand their practice and views is also wise and desirable.

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