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## Application of China's General Anti-Avoidance Rules (GAAR): Lessons Learned from Recent Enforcement Cases

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Will an offshore indirect sale of a China-based portfolio company continue to be shielded from PRC tax liability as it was in the past? Will investments in China through intermediate holding structures in jurisdictions having tax treaties with China automatically allow for the enjoyment of treaty benefits for dividends, royalties, interest and other income sourced from China?

This memorandum highlights the most imperative features of China's recent GAAR rules and their impact on multinational corporations and private equity or venture capital funds investing in China.

Since promulgation of the new PRC Enterprise Income Tax Law ("EIT Law") in 2008, which included GAAR principles for the first time (Art. 47), the State Administration of Taxation ("SAT") and other government authorities have issued a number of tax circulars aiming to strengthen tax collection/enforcement with respect to offshore transactions involving China-based portfolio companies.

Under these rules, the SAT has adopted "substance over form" and "reasonable commercial purpose" tests to assess offshore transactions involving China. An offshore transaction without legitimate commercial purpose or an offshore holding structure without economic substance except avoiding PRC tax may be disregarded, and PRC tax may be imposed.

Circular [2009] No. 698 is the most important. It constitutes a significant development aiming to bring the PRC's GAAR principles from concept to reality. While covering a number of issues, the provisions on "indirect" offshore share transfers are the most controversial and have generated serious concern with respect to investment in China.

Circular 698 requires a foreign seller (in a share transfer deal) to disclose an "indirect" offshore transfer of a Chinese resident company to the PRC tax authorities within 30 days after execution of the transfer agreement if the actual tax burden in the jurisdiction of the intermediate foreign holding company is less than 12.5% or if that jurisdiction exempts foreign-sourced income from tax.

A typical example would be one in which a foreign seller has an intermediate holding company or a special purpose vehicle ("SPV") outside China which in turn owns a Chinese resident company. When disposing of the ownership interest in the Chinese company, the foreign seller sells the offshore intermediate holding company instead of making a direct onshore sale of the Chinese company. If the intermediate holding company is located in a jurisdiction which exempts foreign-sourced income from tax (such as Hong Kong, the British Virgin Islands or the Cayman Islands) or has a tax rate below 12.5% (such as Singapore), the foreign seller will have a reporting obligation to the PRC tax authorities with respect to the offshore transaction.

Circular 698 places extensive disclosure burdens on the transaction parties, including disclosure of (a) the equity/share transfer agreement; (b) the relationship between the foreign seller and the intermediate holding company with respect to funding, operations, sales and purchases and other related areas; (c) information on operations, employees, bookkeeping and assets, etc. of the intermediate holding company; (d) the relationship between the intermediate holding company and the Chinese resident company with respect to funding, operations, sales and purchases, etc.; (e) the commercial purpose for the establishment of the offshore intermediate holding company; and (f) any additional disclosures required by the tax authorities.

If the tax authorities determine that the transaction structure (i.e., the intermediate holding company) lacks a "reasonable commercial purpose", involves abuse of organizational structure or is mainly for the purpose of avoiding PRC tax, the tax authorities may disregard the existence of the intermediate holding company and treat an offshore indirect transfer as an onshore direct transfer, which would result in a PRC withholding tax (usually 10%, subject to reductions under applicable treaties) being imposed on capital gains derived from the sale even if the transfer occurs at the offshore level.

To strengthen the enforcement of GAAR rules, the SAT has recently set up an administration office for non-residents under its International Tax Department. A number of enforcement actions have since been taken.

The two earliest enforcement cases occurred in Xinjiang and Chongqing in 2008. In both cases, the local tax authorities ruled that the existence of intermediate holding companies (a Barbados company and a Singapore SPV) should be disregarded because of lack of "economic substance" and that PRC withholding tax should therefore be imposed on the capital gains. However, we note that in both cases the ultimate acquirers were Chinese companies and that payment had to be made from China to overseas parties, which made the tax authorities' prior clearance unavoidable under China's foreign exchange control rules.

More recent cases include the Xuzhou case, the Jiangdu case and the investment bank case.

The Xuzhou case involved the sale by a Barbados company of its equity interest in a Chinese joint venture in Xuzhou, Jiangsu to the Chinese partner, which claimed exemption from PRC capital gains tax pursuant to the PRC/Barbados bilateral tax treaty. The local tax authority in March 2010

challenged the business substance of the Barbados company and determined that such company was merely a "conduit" and thus denied it treaty benefits.

The Jiangdu case involved the disposal by a US private equity firm of its interest in a Hong Kong holding company which in turn owned an interest in a Chinese company in Jiangdu, Jiangsu Province. In May 2010, the local tax authority decided to disregard the existence of the Hong Kong intermediate holding company because of lack of "substance", i.e., the Hong Kong holding company had no employees and no substantive operating activities, assets or liabilities other than holding an interest in the Chinese company, and concluded that the offshore transaction was solely for the purpose of avoiding PRC tax. A capital gains tax of approximately RMB100 million was imposed.

The most recent reported case involved an indirect sale by a major US investment bank of its equity interest in Shuanghui Group, a publicly listed (A-share) Chinese company, through transfer of its equity interests in multiple offshore entities (Hong Kong and the BVI). This transaction is currently being investigated by the local tax authority. If the tax authority determines that the offshore transaction had no commercial purpose other than to avoid PRC capital gains tax, the investment bank may be required to pay such PRC capital gains tax. The estimated tax due is RMB400 million. The US investment bank reportedly disagrees with the tax bureau's position and believes that imposing PRC tax on the offshore dispositions has no legal grounds.

The above enforcement actions have attracted a great deal of attention and aroused serious concern because they are likely to bring about significant change with respect to tax planning for transactions involving Chinese entities or assets. "Substance over form" and "reasonable commercial purpose" tests are the key doctrines in these cases.

General principles and criteria for the "substance" test can also be found in such tax circulars as Circular [2009] No. 81, Circular [2009] No. 124 and Circular [2009] No. 601.

Under these circulars, a "pre-approval" or "pre-filing" must be made in order to enjoy treaty benefits. Substantively, to enjoy treaty benefits for income received from a Chinese resident enterprise (including in particular dividends, royalties and interest), the recipient must meet certain conditions, including (a) it must be a tax resident of the other treaty state; and (b) it must be a "beneficial owner" of the income. Treaty benefits may be denied if the arrangement lacks "commercial substance".

The key standards for distinguishing "beneficial ownership" include (a) whether the recipient has control of the income received (or is obligated to transfer a substantial portion of the income to other entities in a relatively short period of time); (b) whether the recipient has substantial business operations other than holding the income generating property; and (c) whether the recipient has assets and staff which correspond to the income received.

Companies which are merely a "conduit" and lack "substance" may not enjoy treaty benefits. "Conduit" company status may be inferred if the company is established in a jurisdiction for the

purpose of evading or reducing PRC tax, and does not engage in any other operations, such as manufacturing, distribution, management or services, other than holding the investment in question.

While little practical guidance has been given under the rules on how to meet the "substance" test, we understand that in practice the tax authorities tend to look at the following criteria to determine whether an offshore SPV is merely a "shell" or has a "commercial purpose/substance". We do not believe that this requires the offshore SPV to engage in substantial manufacturing or distribution activities, but it will be important to demonstrate that the offshore SPV performs at least certain investment management functions to protect or enhance the value of its underlying investments in China. Some practical tips on these criteria are as follows:

- Whether the offshore SPV is merely holding a single investment in China or holding and managing multiple investments in China or elsewhere. This will help to show that the offshore SPV is not merely a "shell" for the income-generating project in China but performs management functions for other investments on a consolidated basis.
- It would be advisable for the SPV to have employees, such as a secretary and other support staff. It will be particularly helpful if the SPV also has a management team that performs actual investment management functions with respect to investments in China.
- A physical office should be considered. The office address should be reflected on business cards and office correspondence/e-mail signature blocks of the SPV personnel.
- To further demonstrate performance of management functions on portfolio investments, it is advisable that the SPV nominate/appoint directors, officers or other personnel in the portfolio companies, rather than rely on a corporate secretarial service for such functions.
- It may also be useful for the SPV management to have meetings (including in-person meetings) on a regular basis to discuss investment/management matters. Such meetings should be fully documented.
- The SPV should also have active bank accounts. It is advisable that investment funds, dividends and investment proceeds derived from investments in China be run through these bank accounts.
- To demonstrate substance, the SPV should also consider maintaining its own books and records.
- The SPV should consider avoiding the distribution of investment income immediately after receiving proceeds from its investments in China. We understand that the tax authorities also look at this criterion to assess whether the offshore SPV operates relatively independently or has control and autonomy over its income.

- In connection with management functions, the SPV should also be the entity engaging any third party service providers, such as legal counsel and accounting advisors, for its investments in China.
- Other factors to consider include whether the SPV has its own telephone/fax numbers and files individual income (salaries) tax returns for its employees.

To demonstrate "substance", appropriate documentation is critical. Simply seeking a "tax resident certificate" from a foreign jurisdiction is not sufficient for claiming treaty benefits.

In addition to the "substance" test for the SPV, the "reasonable commercial purpose" test is also important in determining whether an indirect offshore sale of an interest in a China-based company can be characterized as a legitimate transaction without incurring PRC tax liability.

While "reasonable commercial purpose" is not clearly defined under the rules, one may argue that an offshore transfer (via the existence of the intermediate holding company) has valid business reasons—such as avoidance of complicated regulatory approvals in China, business flexibility, foreign exchange convenience, centralized management and back office functions, funding, operational efficiency and synergies, and even for non-PRC tax planning. While there is no assurance that the PRC tax authorities will accept these reasons, we believe that asserting them will reduce the potential risk.

In sum, China has increasingly tightened its control over offshore transactions since the adoption of GAAR rules in 2008. An offshore transaction relating to an indirect sale of an investment or assets in China is no longer necessarily tax-free under the new GAAR rules simply because it is an offshore transaction. Tax authorities will instead look to the "substance" of the transaction to determine whether PRC tax should apply. Transactions involving an abuse of corporate form or lacking "commercial reason" are likely to be subject to closer scrutiny. Multinationals and investment funds investing in China should pay greater attention to these developments in China's tax regime and adapt their strategic planning and risk management practices accordingly.

We will continue to assist our clients in crafting innovative strategies for complex cross-border transactions to achieve the goals of both tax-efficiency and full compliance with PRC law.

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## *Authors*



## Lester Ross

PARTNER

✉ [lester.ross@wilmerhale.com](mailto:lester.ross@wilmerhale.com)

☎ +1 202 663 6000