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Indirect Transfer of PRC-situated Properties

Introduction

As ownership restrictions in the People's Republic of China (PRC) ease over time, trustees will increasingly be asked to accept properties located in the PRC within the trust structures established by PRC-based settlors. As a result, it is important for trustees to understand how recently introduced rules on indirect transfers of PRC-situated properties will affect the liabilities of a trustee in accepting and disposing of such properties otherwise than directly in the PRC.

On 3 February 2015, the State Administration of Taxation (SAT) issued Announcement 7[1] to replace and expand on the rules applicable to indirect transfer of PRC-situated properties. Previously, Circular 698[2] and Announcement 24[3] had provided for various disclosure rules applicable to the indirect transfer of PRC enterprises but the regime was incomplete and uncertain (particularly as to the consequences of a failure to report) and left many key issues unanswered. Announcement 7 aims to resolve much of the uncertainty by introducing a complete code for disclosures of indirect transfers of PRC-situated properties.

Announcement 7 applies to any transaction occurring after 3 February 2015 as well as, retrospectively, to any prior transaction yet to be reported and reviewed by the PRC tax authorities.

Scope of application

Article 1 stipulates that the Announcement targets specifically non-resident enterprises attempting to avoid (evade?) PRC taxes by indirectly transferring 'PRC Taxable Property' through arrangements lacking a *bona fide* commercial purpose. For such arrangements, the tax authorities will have the right to re-characterize the transfer as a direct transfer of the relevant properties and tax it as such.

'PRC Taxable Property' is a new concept defined at Article 1. It includes:

i. properties of establishments within the PRC;
ii. real estate situated in the PRC; and
iii. equity investment (e.g. shares) of Chinese resident enterprises.

An indirect transfer will be any transaction producing a result virtually identical to a direct transfer of a PRC Taxable Property, including any transfer of the equity or other similar interest of a non-resident enterprise ("Target") owning directly or indirectly one or more PRC Taxable Properties.

Bona fide commercial purpose

Generally, to assess whether a transaction has a *bona fide* commercial purpose, the tax authorities will consider all of the relevant circumstances but focusing in particular on[4]:

i. whether the value of the Target is directly or indirectly attributable to the value of one or more PRC Taxable Properties;
ii. whether the properties of the Target consist of direct or indirect investments in the PRC, or whether most of its income is derived directly or indirectly from the PRC;
iii. whether the functions and risks undertaken by the Target and its subsidiaries demonstrate economic substance;
iv. the age of the structure;
v. the taxes paid in other jurisdictions in connection with the transfer;
vi. the substitutability of the indirect investment or indirect transfer of the PRC Taxable Properties by a direct investment or a direct transfer;
vii. the application of tax treaties; and
viii. any other relevant factors.

However, irrespective of the above analysis, a transaction will be deemed not to have a *bona fide* commercial purpose[5] if all of the following conditions apply:

i. 75% or more of the Target's value is directly or indirectly derived from one or more PRC Taxable Properties;
ii. at any time in the year prior to the indirect transfer of PRC Taxable Properties, at least 90% of the income of the Target originated directly or indirectly from investments in the PRC;
iii. the risks and functions of the Target and its subsidiaries in the chain of ownership do not amount to economic substance; and
iv. the foreign tax payable on the transfer is less than the potential PRC tax on a direct transfer of the property.

Safe Harbor for intra group transactions

The analysis of Article 4 of Announcement 7 will also not be required where the Target is a public company; or if the proceeds of the sale can be exempted pursuant to a tax agreement[6]; or in the case of certain intra group transactions[7].

For intra group transactions, a transfer will be deemed to have a *bona fide* business purpose if:

i. The relationship between the seller and buyer is any of the following:

   - the seller owns directly or indirectly 80% or more of the buyer;
   - the buyer owns directly or indirectly 80% or more of the seller; or
   - the buyer and the seller are owned, directly or indirectly, at least 80% by the same person.

By exception, where more than 50% of the value of the Target is derived directly or indirectly from real properties in the PRC, then the relationship must be 100% instead of 80%.

For the purpose of this test, the relationship percentage is the product of the ratio of interest in the entities down the chain of ownership.

ii. After the indirect transfer, the eventual PRC tax payable on a subsequent indirect transfer involving the same PRC Taxable Property will be no less than the PRC tax payable if the first transfer had not taken place.
iii. Consideration is in the form of shares of the transferor or share of its affiliates (excluding shares of listed companies).

Filing requirements

Announcement 7 provides that reporting is ‘voluntary’ with any of the parties to the transactions or the PRC enterprises subject to the transfer (where applicable) enabled to submit the documents relevant to the transfer. Thereafter, the tax authorities may request information concerning the transfer from any of the parties as well as parties who have participated in planning the transfer, such as a third party tax planning strategies advisor.

If an indirect transfer is eventually re-characterized by the tax authorities, Announcement 7 provides for different penalties and interests based on whether the transfer had been previously reported. In addition, where a transfer should be re-characterized as a direct transfer, the tax liability will arise on the effective date of the transfer agreement and calculation of interest and penalties will start from that date (even if the transaction is re-characterized much later). It follows that what is said to be 'voluntary' is in fact strongly advisable to avoid penalties and punitive interests.

Conclusion

Announcement 7 provides for a much more comprehensive regime than that under Circular 698 and Announcement 24. There are still uncertainties (e.g. how does the cost of a PRC Taxable Property change in the books of a direct owner of the property where a transfer has been re-characterized and taxed to an entity up the chain of ownership) but, for trustees, the additional clarity of Announcement 7 is welcome as it will facilitate many transactions and will help them gauge more accurately the eventual tax liabilities arising from an indirect transfer of PRC Taxable Properties within the trust structures they administer.

1 *Announcement of SAT Concerning Several Matters Relating to the Corporate Income Tax on Indirect Transfer of Properties by Non-tax Resident Enterprises, Announcement [2015] No. 7.*

2 *Notice on Strengthening the Administration of Enterprise Income Tax from the Transfer of Shares by Nonresident Enterprises, Guoshuihan [2009] No. 698.*

3 *Announcement on Several Issues Concerning the Administration of Income Tax on Nonresident Enterprises, Announcement [2011] No. 24.*

4 *Article 3 of Announcement 7*

5 *Article 4 of Announcement 7*

6 *Article 5 of Announcement 7*

7 *Article 6 of Announcement 7*

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