



PORTCULLIS TRUSTNET

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PEOPLE’S REPUBLIC OF CHINA (“PRC”) UPDATE **Taxation of Non-Resident Enterprises** **PRC Clarifies Rules on Circular 698**

On 28 March 2011 the PRC’s State Administration of Taxation issued Bulletin [2011] No. 24 (“the Bulletin”) to provide further clarification as to Guoshuihan [2009] No. 698 (“Circular 698”) and taxation of non-resident enterprises.

The Bulletin takes effect from 01 April 2011 and will also affect transactions that occurred prior to its 01 April 2011 issuance in which relevant PRC tax matters have not been dealt with.

This eUpdate focuses on the main points of the Bulletin that seek to provide further clarification to the extent of the rules under Circular 698.

Transactions whereby consideration is paid by installment

Clause 1 of Article 6 of the Bulletin (“Clause 1”) provides that “If a non-resident enterprise transfers a PRC resident enterprise directly, and the relevant sales and purchase contract or agreement stipulates that the consideration of the sale is to be paid by installments, the recognition of income from the sale should take place on the date on which the related sales and purchase contract or agreement takes effect and upon the completion of procedures in respect of the share transfer.”

Although Clause 1 does attempt to address the issue of timing in circumstances where consideration for a direct transfer of a PRC resident enterprise by a non-resident enterprise is paid by installment, the Bulletin:-

- does not provide any clear direction as to whether such non-resident enterprises are required to report and pay Enterprise Income Tax to the tax authorities within 7 days from the date of the share transfer or receipt of consideration, whichever is earlier, per Article 2 of Circular 698; and
- does not address circumstances where the consideration may be adjusted subsequently to the effective date of the sale and purchase contracts or share transfer procedures

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Purchase and sale of listed shares in resident enterprises

Article 1 of Circular 698 excludes the transfer of shares of resident enterprises by non-resident enterprises where the shares are bought and sold by a non-resident enterprise in the public securities market.

Clause 2 of Article 6 of the Bulletin (“Clause 2”) further confirms the exclusion by providing that “Listed shares in PRC resident enterprises bought and sold over a public securities market” as referred to in Article 1 of Circular 698 are defined as those whereby the party from whom the shares are purchased, the party to whom the shares are sold, quantity of the shares and price of the shares are not determined in advance by the buyer and the seller, but are determined based on the regular trading principles of a public securities market.

Clause 2 however does not provide any further clarification on whether other types of transactions (e.g. over-the-counter trades or private placements) are included in Circular 698.

Definition of the terms “effective control”, “effective tax burden” and “does not tax income”

Article 5 of Circular 698 imposes certain reporting requirements on a foreign investor (party with “effective control”) that indirectly divests itself of shares in a resident enterprise by disposing of shares in an intermediate holding company, if:-

- the intermediate holding company is located in a jurisdiction that has an “effective tax burden” of less than 12.5%, or
- the jurisdiction “does not tax income”.

Clause 3 of Article 6 of the Bulletin (“Clause 3”) clarifies the above referenced terms in context of Article 5 by providing that Circular 698 reporting requirements apply to all foreign investors who indirectly transfer the shares of resident enterprises, regardless of whether they have majority ownership or effective control of the resident enterprise.

Clause 3 has clarified that “effective tax burden” refers to the effective tax imposed on the gains on the shares transfer transaction. Consequently it would appear that provided the gains are taxed at a rate not lower than 12.5% in the jurisdiction of the intermediary holding company, the non-resident enterprise would not be required to report under Circular 698.

In respect of the term “does not tax foreign-sourced income”, Clause 3 provides that this condition as expressed in Article 5 of Circular 698 would only apply if the foreign-sourced gains on the share transfer transaction are not taxed in the jurisdiction of the intermediary holding company.

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Transactions where two or more non-resident enterprises indirectly transfer equity in a resident enterprise

Clause 4 of Article 6 of the Bulletin confirms the provision of Article 5 of Circular 698 that where two or more non-resident enterprises were to undertake an indirect transfer of the equity in a resident enterprise, one of the non-resident enterprises could choose to undertake the Circular 698 reporting requirements on behalf of the other non-resident enterprises. The effect would be to reduce the tax compliance burden for a group of non-resident investors.

Transactions where a non-resident enterprises indirectly transfer equity in two or more resident enterprises

Clause 5 of Article 6 of the Bulletin confirms that if a non-resident enterprise were to undertake an indirect transfer of two or more resident enterprises located in different provinces (or cities), the non-resident transferor could choose any one of the PRC tax authorities in the associated provinces (cities) to comply with its Circular 698 reporting obligations.

In summary, the Bulletin has provided significant clarification for non-resident enterprises holding PRC investments via offshore holding companies in respect of their obligations under Circular 698. The Bulletin has also effectively aimed to reduce the compliance burden of such non-resident enterprises and provide more certainty in the related tax administration procedures.

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