BBD ENTERPRISES

Investing Into China – The Importance of Substance

September 2013 Issue

Background

As part of the global trend, countries in the Asia-Pacific region are intensifying their review and adjustments on tax arrangements that are considered abusive or artificial.

In China, the enforcement of anti-avoidance rules, in particular, against non-resident enterprises is one of the main priorities of PRC tax authorities in the past few years. The main focus is on combating tax avoidance and treaty shopping. As further outlined below, Chinese revenue authorities are focusing on those structures that lack substance and business purpose.

The Anti-Avoidance Rules

The main anti-avoidance rules for inbound investments are Circular 601 and 698.

Circular No 601

In accordance with No. 601, the holding company or special purpose vehicle incorporated in a low-tax jurisdiction should not be incorporated for the purposes of avoiding or reducing tax or shifting/parking profits abroad and such holding companies should engage in substantive business activities, otherwise the holding company will not be deemed as the beneficial owner of the dividends and treaty benefits will be denied. According to the guidance provided under Circular 601, the anti-avoidance rules are triggered in the following cases:

- ***The recipient is under an obligation to distribute all or the majority (i.e., 60% or above) of the China-sourced income to a resident of a third jurisdiction within a specified period (i.e., 12 months***).

- ***Other than holding the properties or rights that generate the income received, the recipient conducts little or no business activities in China.***

- ***The recipient is a corporation or another type of business entity, and the assets, size of operations and human resources of the recipient are disproportionately small relative to the income received from China.***

- **The recipient does not, or almost does not, have rights to control or dispose of the income or the properties or rights giving rise to the income, and bears little or no risks.**

- **The recipient is exempt from tax or is not subject to tax in the residence country with respect to the income received from China, or the recipient pays tax in the residence country but at an extremely low effective tax rate.**

- **With respect to interest income from a loan agreement, the recipient has a loan or deposit agreement with another party with terms (e.g., amount, interest rate, execution date) resembling those in the primary loan agreement.**

- **With respect to royalty income arising from a copyright, patent or technical know-how (collectively intellectual property or IP) transfer agreement, the recipient has an agreement with another party regarding the same IP.**

In a separate guidance note, it was made clear that certain treaty benefits should not be denied only if one of the criteria above is not met. Interestingly, revenue emphasizes the importance of substance, criteria no 2 and 3 above.

Circular No 686

Circular No 698 regulates the transfer of shares in foreign entities that directly or indirectly hold investments in China, when the foreign entities are domiciled in jurisdictions where there is no, or low, capital gains tax. Under Circular No. 698, such transfers must be reported in China, and where the revenue authorities judge there to be insufficient substance in the entity transferring the shares, they will deem the capital gain to have been made in China, and may charge a withholding tax equal to the capital gains tax.

According to law and within 30 days after signing the equity transfer agreement, the seller must submit to the competent authorities the following documents:

- **The equity transfer agreement/contract**
- **A statement describing the relationship between the seller and the intermediate holding company in the areas of finance, business and buy-sell transactions**
- **A statement describing the intermediate holding company's business operations, human resources, finance and assets**
- **A statement describing the relationship between the intermediate holding company and China resident company in the areas of finance, business and buy-sell transactions**
- **An explanation of the reasonable commercial purpose for the seller in establishing the intermediate holding company**
- **Other information as required by the in-charge tax authorities**

Similar to Circular No 601, commercial substance must also be implemented on the level of intermediate holding companies, otherwise such entities may be disregarded and the taxpayer may end up paying as much tax as if there wouldn`t be any entity incorporated offshore.

Conclusion

The message is clear: In an environment of increased scrutiny by Chinese revenue authorities, foreign investors must review their holding structures to ensure there is sufficient commercial substance (e.g., personnel, decision making activities, etc.) and appropriate and accurate documentation to support that the business purpose and substance requirements are met.

Although there are a number of cases published and despite the guidance available as mentioned above, the arguments of the tax authorities are often unclear as to why certain tax-efficient structures are challenged and more often it is unclear how authorities determine when insufficient substance is established. Hence, when planning investments into China, an even more conservative approach is recommended in order not to fall into grey areas of law.