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Newsletter

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Legal Updates

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Legal Updates

1. The Tax Man Cometh: Not Only Long Awaited “Safe Harbor” (Authors: Bing XUE, Yizi XIE)

On February 6, 2015, China’s State Administration of Taxation (“**SAT**”) released the Public Notice Regarding Certain Enterprise Income Tax Matters on Indirect Transfer of Properties by Non Tax Resident Enterprises (SAT Public Notice [2015] No.7, “**Notice No.7**”) on its official website. Notice No.7 is the specific application of the general anti-avoidance rule (“**GAAR**”) to transactions of indirect transfers of taxable properties in China (“**Indirect Transfer**”) by non-tax resident enterprises (“**Non-TRE**”), meanwhile it demonstrates China’s anti-tax avoidance efforts against Indirect Transfer swing into action. The release of the long-awaited Notice No.7 will certainly bring a profound influence on Indirect Transfer. We will share our insights and suggestions on Indirect Transfers.

Background of Notice No.7

Enterprise Income Tax Law of the People's Republic of China (“**EIT Law**”), effective on January 1, 2008, has established a comprehensive income tax regime for tax resident enterprises (“**TRE**”) and Non-TRE. It has been a popular deal structure for multinational corporations and foreign investors to interpose a Non-TRE as an intermediate holding company for their investments in China. Since the implementation of the EIT Law, SAT has strengthened its tax collection over cross-border investments by Non-TREs.

- On December 10, 2009, SAT promulgated the famous Notice on Strengthening the Administration of Enterprise Income Tax Collection Derived from Transfers of Equity Interests by Non-TREs (Guoshuihan [2009] No.698, “**Notice No.698**”). Among other things, the most eye-catching and controversial issue of Notice No.698 is the Indirect Transfer may be subject to China enterprise income tax (“**EIT**”), thus Notice No.698 had a wide-spread impact on the market.
- On March 28, 2011, SAT promulgated Notice on Several Issues of Administration of Income Tax on Non-TREs (SAT Notice [2011] No. 24, “**Notice No.24**”) to clarify certain aspects of the rules during the implementation of Notice No.698.

Notice No.698 is made effective January 1, 2008 retrospectively. Notice No.698 has definitely become a critical issue in cross-border investments. Since the implementation of Notice No.698, the increase of tax cost has caused anxiety among market participants, furthermore, uncertainties over China tax compliance and tax collection cause more anxieties in the capital markets. It is noteworthy that Notice No. 7 introduces a brand new tax collection regime that is actually a supplementary and upgraded version of Notice No.698. The mechanism of “certainty” embodied in Notice No. 7 is a tremendous positive energy to Non-TRE investors in China.

Legal Basis for Notice No.7

The legal basis for Notice No.7 is EIT Law and its implementing regulations, and Law of the People's Republic of China on the Administration of Tax Levying and its implementing measures. Pursuant to Notice No.7, relevant GAAR provisions including those set forth in the Administrative Measures for the General Anti-avoidance Rule (for Trial Implementation)" (SAT Order [2014] No.32) shall be applied if the in-charge tax authorities need to launch tax investigation and to make adjustments on Indirect Transfer of China taxable properties.

Wider Scope than Notice No.698

SAT specifies the concept of "**China Taxable Property**" and the taxation principles thereto for the first time through Notice No.7:

- (1) Substance: where a Non-TRE indirectly transfers any equity interests in a China TRE and other properties through the implementation of a scheme lacking reasonable commercial purpose and resulting in avoidance of EIT liability, the Indirect Transfer shall be re-characterized as a direct transfer of equity interests in Chinese resident enterprises and other properties in accordance with the provisions of Article 47 of the EIT Law;
- (2) China Taxable Property: shall refer to equity interests in China TREs and other properties, including properties of an establishment or place ("**E&P**") in China, real properties in China, equity investment assets in China TREs and other properties directly held by a Non-TRE and the income derived from such transfer would be subject to EIT in accordance with the provisions of PRC tax law;
- (3) Indirect Transfer of China Taxable Property: shall refer to the transaction which produces a result identical or similar substantially to direct transfer of China Taxable Property by a Non-TRE through transfer of equities and other similar interests of foreign enterprises directly or indirectly holding China Taxable Properties ("**Offshore Enterprise**", excluding offshore incorporated Chinese TREs), including the circumstances under which changes in foreign enterprises' shareholders due to restructuring of the Non-TRE occur. A Non-TRE indirectly transferring China taxable property is known as an "**Equity Transferor**".

Notice No.7 is applicable to Indirect Transfer of China Taxable Property lacking reasonable commercial purpose and resulting in avoidance of EIT liability in China, and situations that the transferred Offshore Enterprises own specific taxable properties (including E&P in China, owning real properties or real properties company in China, owning equity investment assets in China). Pursuant to Notice No.7, where the income derived from equity transfer of an Offshore Enterprise by the Equity Transferor is effectively connected with the E&P in China, Notice No.7 shall not apply.

Reasonable Commercial Purpose

The principle of “substance over form” is the fundamental criterion for Chinese tax authorities to identify reasonable commercial purpose. Notice No.7 specifies eight analytical factors for the overall consideration and comprehensive assessment of reasonable commercial purpose as follows:

- (1) whether the main value of the Offshore Enterprise’s equity is derived directly or indirectly from China Taxable Property;
- (2) whether a majority of the assets of the Offshore Enterprise comprise of direct or indirect Chinese equity investments; or whether a majority of the revenue of the Offshore Enterprise is sourced directly or indirectly from China;
- (3) whether the actual functions performed and risks assumed by the Offshore Enterprise and its subsidiaries which directly or indirectly hold China Taxable Property can substantiate the economic substance of the corporate structure;
- (4) the existence duration of the shareholders, business model of the Offshore Enterprise and relevant organizational structure;
- (5) the situation regarding overseas income tax payment for the Indirect Transfer of China Taxable Property;
- (6) whether the indirect investment or the Indirect Transfer of China Taxable Property by the Equity Transferor can be substituted by a direct investment or a direct transfer of China Taxable Property;
- (7) the condition regarding the applicability of tax treaties or tax arrangement in China to the income from indirect transfer of China Taxable Property; and
- (8) other related factors.

Long-awaited Rule of “Safe Harbor”

Notice No.7 sets forth circumstances that shall be directly deemed to lack reasonable commercial purpose and those shall be deemed to have reasonable commercial purpose in the

Indirect Transfer of China Taxable Property:

	Circumstances without Reasonable Commercial Purpose (meeting all of the following conditions)	Circumstances with Reasonable Commercial Purpose (meeting all of the following conditions)
<u>Key Provisions of</u>	➤ 75% or more of the value of the Offshore Enterprise’s equity is derived directly or indirectly from	➤ the shareholding relationship of the transaction parties shall satisfy any one

	Circumstances without Reasonable Commercial Purpose (meeting all of the following conditions)	Circumstances with Reasonable Commercial Purpose (meeting all of the following conditions)
<u>Notice No.7</u>	<p>China Taxable Property;</p> <ul style="list-style-type: none"> ➤ at any time within one year before the Indirect Transfer of China Taxable Property, 90% or more of the total assets (excluding cash) of the Offshore Enterprise comprise directly or indirectly of investments in China, or 90% or more of the revenue of the Offshore Enterprise is sourced directly or indirectly from China; ➤ although the Offshore Enterprise and its subsidiary which directly or indirectly holding China Taxable Property has registered in the country (region) where they are located in order to have the organizational form as required by law, the function they actually perform and the risks they undertake are too limited to prove the existence of their economic substance; ➤ the overseas income tax payable on the Indirect Transfer of China Taxable Property is less than the possible China tax payable on the direct transfer of China Taxable Property. 	<p>of the following conditions:</p> <ol style="list-style-type: none"> 1) the Equity Transferor holds directly or indirectly 80% or more of the equity of the transferee 2) the transferee holds directly or indirectly 80% or more of the equity of the Equity Transferor 3) 80% or more of the equity of the Equity Transferor and the transferee are held directly or indirectly by the same party <p>where more than 50% (excluding 50%) of the value of the Offshore Enterprise's equity is derived directly or indirectly from real estates situated in China, the shareholding ratio referred to in item 1), 2), 3) shall be 100%; in the case of indirect shareholding as mentioned above, the equity interest shall be calculated by multiplying the shareholding percentage at each level;</p> <ul style="list-style-type: none"> ➤ for the second Indirect Transfer incurred after this Indirect Transfer, the China income tax on it will not be less than the tax on the same or similar Indirect Transfer incurred when there is no such first Indirect Transfer; and ➤ the transferee pays all consideration for the equity transfer in equity (exclusive of equities in listed enterprises) of the transferee itself or other enterprises with holding relationship.

	Circumstances without Reasonable Commercial Purpose (meeting all of the following conditions)	Circumstances with Reasonable Commercial Purpose (meeting all of the following conditions)
<u>Han Kun Observations</u>	The aforementioned provisions regarding direct identification of situations without reasonable commercial purpose will bring tremendous risks and challenges in Chinese tax compliance to reorganization transaction including cross-border investment and financing modes such as contractual control structure of VIE.	<p>It may be deemed as having reasonable commercial purpose upon meeting all of the foregoing conditions in an Indirect Transfer of China Taxable Property, thus, Notice No.7 has substantially established a rule of “Safe Harbor” in Indirect Transfer;</p> <p><u>But it is worth-noting that</u> the aforementioned provisions specifically excludes the intra-group Indirect Transfer of China Taxable Property with purely tax-driven purposes from the Safe Harbor; and whether a transaction shall constitute an intra-group Indirect Transfer of China Taxable Property with purely tax-driven purposes shall be tested by comparing the tax results between the China tax burden on any subsequent Indirect Transfer conducted after this Indirect Transfer and the China tax burden on the same or a similar Indirect Transfer if it were conducted before this Indirect Transfer, and in any case that the former tax result may be preferential to the latter, it cannot exclude the possibility that such certain intra-group Indirect Transfer of China Taxable Property is deemed as with purely tax-driven purposes.</p> <p>Therefore, the “Safe Harbor” is not always safe in all deal arrangements and not so perfect as expected before.</p>

Upgraded Version of Notice No.698 and Notice No.24

Notice No.7 took effect on its issuance date, i.e., February 3, 2015, but will also apply to cases where their respective PRC tax treatments are not yet concluded. The relevant contents specified in Article 5 and 6 of Notice No.698 and Item 6.3, 6.4 and 6.5 of Notice No.24 were repealed at the

same time.

We will issue a series of Han Kun Tax Law to share our insights on Notice No.7 and its impacts on the Indirect Transfer related tax landscape.

2. Mainland Court's Standards for Identifying Social Public Interests When Recognizing Off-Shore Arbitration Awards (Authors: Eric LIU, Yaxing ZHANG, Yuhao LU, Delong ZOU)

Case Briefs

At the end of 2009, China Media Express Holdings Inc. ("Media Express") was listed in the U.S. through Reverse Take-Over (RTO). In January 2010, Starr Cayman Investment Co. ("Starr Co.") executed a Share Purchase Agreement and an Investor Rights Agreement with Media Express, to purchase 1,000,000 shares of convertible preferred stock at the price of \$ 30,000,000 and 1,545,455 warrants at the price of \$ 9,999,093.85. After the completion of the transaction, Starr Co. believed Cheng Zheng, as Media Express's founders, and other parties embezzled and misappropriated investment funds, as well as violated the aforesaid agreements in other ways. Starr Co. accordingly instituted arbitration in Hong Kong International Arbitration Center.

On December 19, 2012, Hong Kong International Arbitration Center gave arbitration awards HKICA/A11030 and HKICA/A11098 ("Arbitration Awards"), which ruled that Fujian Zongheng High-Speed Information Technology Co., Ltd., Fujian Focus Media Co., Ltd., and Chengzheng (collectively referred to as "Enforcees") shall be liable for damages to Starr on grounds of breach of Share Purchase Agreement and Investor Rights Agreement.

After such Arbitration Awards entered into force, according to Supreme People's Court's Arrangement for Reciprocal Enforcement of Arbitration Awards between Mainland China and Hong Kong Special Administrative Region ("Arrangement"), Starr Co. petitioned Fuzhou Intermediate People's Court ("Fuzhou Inter. Court") for enforcement of the awards. Fuzhou Inter. Court accepted the case on August 9, 2013 and rendered Enforcement Rulings (2013) Rong Zhi Zi No.511 and No 512 ("Enforcement Rulings") in accordance with laws, which ruled to freeze (allot) the Enforcees' deposits equivalent to the amount of damages or seal (seize/freeze) its property of the same value.

The Enforcees refused to accept such rulings and applied to Fuzhou Inter. Court for ordering not to enforce the Arbitration Awards in accordance with Article 7 of the Arrangement, on grounds that the enforcement of such awards may violate social public interests in Mainland China. On October 9, 2014, Fuzhou Inter. Court held a hearing about the case and finally rejected the petition of the Enforcees and rendered Ruling (2014) Rong Zhi Jian Zi No. 51 ("No.51 Ruling").

Case Analysis

The focus of disputes in this case is whether recognition and enforcement of arbitration awards involving VIE (Variable Interest Entities) structure arrangement and VAM (Valuation Adjustment Mechanism) will violate social public interests.

In disagreement with the Enforcement Rulings, Enforcees contend that VIE structure arrangement and VAM involved in arbitration breach regulations set forth under *Provisions on the Administration of Telecommunications Enterprises with Foreign Investment*¹ (*Provisions*) promulgated by State Council, *Notice on Strengthening Administration of Operation in Value-Added Telecommunications Service by Enterprises with Foreign Investment*² issued by Ministry of Information Industry and *Regulations on Implementation of Security Review System Relating to Acquisition of Domestic Enterprises by Foreign Investors*³ promulgated by Ministry of Commerce. Therefore, Enforcees believe that the court should deny to enforce the Arbitration Awards in compliance with Article 7 of the Arrangement, which prescribes that “mainland court may rule not to enforce the Hong Kong arbitration award in mainland areas if such court believes enforcement of such award shall violate public interests thereof”.

Against the claims proposed by the Enforcees, Starr Co. proposes the following counterarguments.

- (1) The court is only authorized to inspect whether the outcome of the enforcement of such arbitration award, rather than the application of laws on substantial legal issues of such arbitration award, will violate the social public interests.
- (2) The claim of Starr Co. is that the Enforcees shall pay damages arising out of its breach of the agreements, rather than to continue to perform such agreements which is in adherence to contract spirit and therefore is not in violation of social public interests.
- (3) Violation of mandatory requirements prescribed in administrative regulations and departmental rules does not necessarily constitute breach of public policies. Departmental rules are not part of basic legal system and do not fall within the scope of social public interests.

¹ Article 17 of *Provisions on the Administration of Telecommunications Enterprises with Foreign Investment* stipulates that where telecommunications enterprises with foreign investment intent to operate trans-boundary telecommunication services, such operation shall be subject to approval of departments of authorization of industry and information in State Council and shall be conducted through International Telecommunications Entrance and Exit Bureau established with approval from such competent departments.

² Article 1.1 of *Notice on Strengthening Administration of Foreign Investors' Investment and Operation in Value-Added Telecommunications Services* stipulates that, where foreign investors intent to invest in and operate telecommunications services, they shall strictly comply with requirements set forth under the *Provisions* by submitting applications for establishment of telecommunications enterprises with foreign investment and applying for corresponding operation license. Foreign investors, which fail to found such telecommunications enterprises in accordance with laws or get relevant operation license, shall be prohibited from operating telecommunications services in our country.

³ Article 9 of *Regulations on Implementation of Security Review System Relating to Acquisition of Domestic Enterprises by Foreign Investors* stipulates that, where foreign investors intent to acquire domestic enterprises, economic security review authority shall judge whether such acquisition needs security review based on the substantive facts of the transaction and actual impact caused thereby. Such foreign investors shall not substantially evade security review by any means, which include but is not limited to nominal shareholding, trust, multilevel reinvestment, lease, credit, protocol control, foreign trade, etc.

Fuzhou Inter. Court adopts the Starr Co.'s views and reasons as follows in No.51 Ruling.

- (1) Arbitration Awards given by Hong Kong International Arbitration Center demand Enforcees to pay damages to Starr Co. as a result of its breach of Share Purchase Agreement and Investor Rights Agreement, rather than require Enforcees and Starr Co. continue performing such agreements. In accordance with the provisions set forth under the Arrangement, the court ruled to enforce the Arbitration Awards by demanding Enforcees to bear liability for the breach, which complies with basic legal principles and social public interests, such as contract sanctity and good faith.
- (2) In its Reply to Haikou Intermediate People's Court's referral for Non-Recognition and Enforcement of the Arbitration Award Given by Arbitration Institute of the Stockholm Chamber of Commerce, Supreme People's Court indicates that violation of mandatory requirements prescribed in administrative regulations and departmental rules does not necessarily constitute breach of public policies. In light of such instruction, this court believes that whether the involved transaction has relation to VIE structure arrangement and VAM or whether it involves breach of departmental rules promulgated by State Council, Ministry of Information Industry and Ministry of Commerce does not necessarily determines constitution of violation of social public interests. Therefore, the claim of Enforcees that the court should reject enforcement in compliance with Article 7 is not tenable on grounds of insufficient evidence.

Our Observations

This case explains again the “standard” of people’s court for identifying public policies and social public interests in relation to recognizing and enforcing foreign arbitration awards, which indicates that “violation of public policies shall be limited to the scope that the outcome of recognition of off-shore arbitration awards violates basic legal system or damages fundamental social interests in our country”⁴.

We understand that such standard has twofold meanings. First, in identifying whether the enforcement of off-shore arbitration awards will violate public policies, it is whether the outcome of such enforcement, rather than application of laws on substantial matters of the case will breach social public interests that shall be inspected. In this case, Fuzhou Inter. Court determines that Arbitration Awards given by Hong Kong International Arbitration Center demand Enforcees to pay damages to Starr Co. as a result of its breach of Share Purchase Agreement and Investor Rights Agreement, rather than require Enforcees and enforcement applicant to continue performing such agreements. Such determination reflects that it is the outcome of enforcement that matters.

⁴ In its *Reply to Referral for Non-Recognition of Arbitration Award Tokyo No.07-11 rendered by Japan Commercial Arbitration Association*, the Supreme Court indicates that violation of public policies shall be limited to the scope that “the outcome of recognition of off-shore arbitration awards violates basic legal system or damages fundamental social interests in our country”

Second, the “standard” emphasizes that the violation of public policies means the breach of basic legal system or fundamental social interests in our country. In this case, the court does not directly comment on the legal effects of VIE structure arrangement or VAM. Nevertheless, in light of the No.51 Ruling and law application in respect of this case, even if substantive matters involved in the off-shore arbitration may violate some mandatory requirements prescribed in departmental rules, this does not necessarily constitute violation of basic legal system and fundamental social interests in our country. Hence, court shall not refuse to recognize or enforce off-shore arbitration awards merely on grounds that substantive matters involved in such arbitration breach domestic laws and regulations.

Furthermore, the results in this case have significant impacts upon protection of interests of investors in VIE structure.

Currently, there are no PRC laws and regulations explicitly stipulating on validity of VIE structure as well as VAM and therefore, relevant agreements are exposed to risks of being recognized as invalid. However, when deciding on whether a foreign arbitration award concerning “VIE structure arrangement” and VAM constitutes breach of social public interests, the court does not identify the circumstances under which recognition of off-shore arbitration award shall be denied directly with the circumstances where a contract shall be deemed as invalid. To some extent, such prudence can prevent the principle of social public interests from being abused, and facilitate the protection of investor’s rights and interests.



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