漢坤律師事務所
HAN KUN LAW OFFICES

# Newsletter


4th Edition of 2015

## Legal Updates

1. Foreign-Invested Enterprises Now Given Full Discretion to Settle Foreign Exchange to Make Domestic Equity Investments
2. The Tax Man Cometh: A New Regime of Tax Collection

# Legal Updates

## 1. Foreign-Invested Enterprises Now Given Full Discretion to Settle Foreign Exchange to Make Domestic Equity Investments (Authors: Huan WANG, Jiao MA)

On April 8th, 2015, China's State Administration of Foreign Exchange ("SAFE") released the SAFE Circular Reforming the Administration of Foreign Exchange Capital Settlement by Foreign-invested Enterprises (Hui Fa [2015] No.19) (the "Circular"). The Circular is a reflection of the reforms implemented in the SAFE Circular on Several Issues with respect to the Establishment of Pilot Projects to Reform the Administration of Foreign Exchange Capital Settlement by Foreign-Invested Enterprises in Several Areas (Hui Fa [2014] No. 36) ("SAFE Circular 36"), which was a pilot program that intended to introduce its measures nationwide. The Circular will come into effect on June 1, 2015 and will supersede the Circular of SAFE's General Affairs Department on Relevant Operating Issues Concerning the Improvement of the Administration of Payment Settlement of Foreign Exchange Capital by Foreign-Invested Enterprises (Hui Zong Fa [2008] No.142) ("SAFE Circular 142") and the Supplementary Circular of SAFE's General Affairs Department on Relevant Operating Issues Concerning the Improvement of the Administration of Payment Settlement of Foreign Exchange Capital by Foreign-Invested Enterprises (Hui Zong Fa [2011] No.88).

The Circular's specific reforms are as follows:

### 1) Foreign-invested Enterprises Given Full Discretion to Settle Foreign Exchange to Make Domestic Equity Investments

### 2) Foreign-invested Enterprises are Allowed to Settle Foreign Exchange on a Discretionary Basis

The Circular allows foreign-invested enterprises to settle foreign exchange with banks on a discretionary basis for their domestic equity investments. Following settlement, such foreign-invested enterprises may place the settled RMB funds into a settlement exchange account. Funds from such settlement exchange account may be used to for discretionary payments by the foreign-invested enterprise for their domestic equity investments.

### 3) Certain Restrictions Remain on the Use of RMB Funds Obtained through Foreign Exchange Settlement

The Circular still restricts the use of the RMB funds obtained through foreign exchange settlement in several means as set forth in SAFE Circular 142, even if the foreign-invested enterprises may have the option of the payment exchange settlement or foreign exchange settlement on a discretionary basis. Specifically, the Circular sets forth a "prohibited list." Under this list, foreign-invested

enterprises are prohibited from directly or indirectly using RMB funds obtained from foreign exchange settlement for purposes outside of its business scope, for investment in securities, to grant RMB entrusted loans, to repay inter-company debt or to purchase non-self-use real estate.

In addition, the Circular instructs banks not to conduct RMB settlement of a foreign-invested enterprise's foreign exchange on a one-time basis or to pay all RMB in the foreign exchange settlement account without receiving true copies of required certificates from such foreign-invested enterprise.

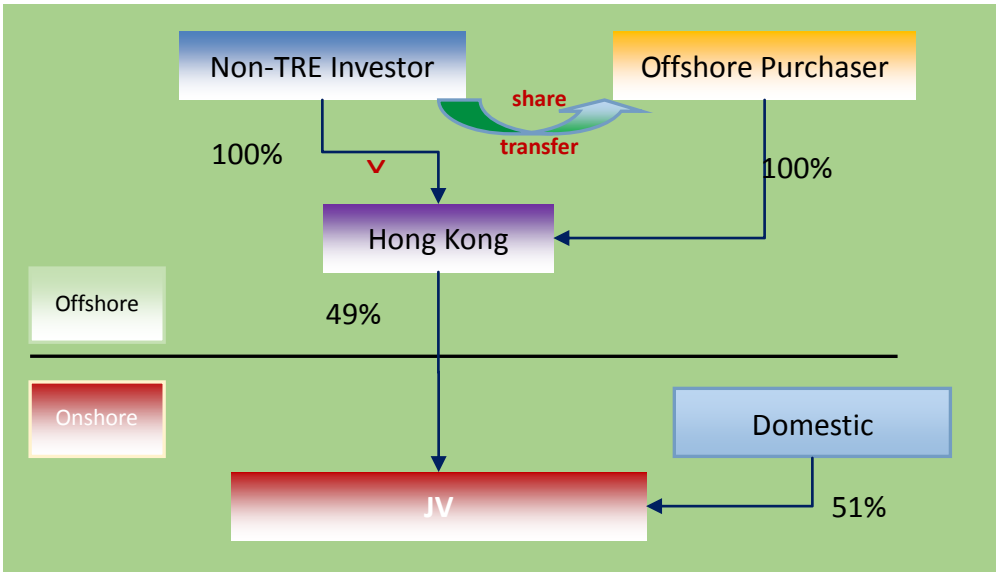
The Circular also simplifies the foreign exchange settlement and use of RMB settled funds for a foreign-invested enterprise's other investment projects. However, since local banks responsible for conducting settlement have differed in their implementation of SAFE Circular 36, it remains to be seen whether various local banks will immediately implement the terms set forth in the Circular.

## 2. The Tax Man Cometh: A New Regime of Tax Collection (Authors: Bing XUE, Yizi XIE)

As discussed in our previous legal update The Tax Man Cometh: Not Only Long Awaited "Safe Harbor", Notice No.7 is set to present a different income tax regime for non-tax resident enterprises ("**Non-TRE**"). In addition to the long awaited "Safe Harbor", it is worth-noting that Notice No.7 has introduced new measures to strengthen administration of income tax collection on Non-TRE.

### Case Study: Indirect Share Transfer

It was widely discussed whether Chinese tax authorities would take an intensive anti-avoidance action on offshore indirect share transfer when Notice No.698 was promulgated in late 2009. On June 8, 2010, a local counterpart of China's State Administration of Taxation ("SAT") in Jiangsu published on its official website a case of indirect share transfer with a total tax amount up to RMB 173 million ("Jiangsu Share Transfer Case"). There has been a heated discussion on Jiangsu Share Transfer Case. We would like to highlight the crucial points of the tax administration rules as set forth in Notice No.698 and Notice No.7 through this Case Study of the Jiangsu Share Transfer Case.




The diagram above presents the deal of Jiangsu Share Transfer Case, which constitutes a currently popular transaction mode in cross-border investment and financing in China. For the convenience of discussion, we summarize the deal structure as follows:

- **Indirect Access**: Non-TRE investors tend to establish holding companies in a country or region with loose tax environment and favorable tax planning opportunities as an intermediate access to China investment. Hong Kong is one of the most popular intermediate region for holding companies due to its special geographic advantages and the nearly most favorable tax treatment provided by arrangement of avoidance of double taxation between the mainland China and Hong Kong.

- **Indirect Exit**: Non-TRE investors may be levied on a 10% withholding tax if they exit via direct share transfer of China tax resident enterprises ("TRE") (such as the JV presented in the diagram above). Comparatively, Non-TRE investors may tend to exit via indirect share transfer of intermediate holding companies, which always take place in "tax-friendly" regions such as Hong Kong and BVI.

It has caused a long-lasting controversy in tax administration practice of Chinese tax authorities as to whether the aforementioned popular indirect exit should fall into Chinese tax authorities' jurisdiction. Chinese tax authorities have strengthened their law enforcement on Non-TRE ever since the implementation of "Enterprise Income Tax Law" ("EIT Law") and its implementing regulations in 2008. Notice No.698 and Jiangsu Share Transfer Case did echo the SAT's stringent tax approach on Non-TRE.

**A New Regime of Tax Collection with Consistency and Innovation**

With Jiangsu Share Transfer Case as an example, we set forth below the salient points of the tax regime provided under Notice No. 7 compared with that in Notice No.698.

| # | Notice No.698 | Notice No.7 | Han Kun Notes |
|---|---|---|---|
| **Nature of Jiangsu Share Transfer Case** | indirect share transfer of TRE by offshore investors | indirect share transfer of TRE by offshore investors | The jurisdiction set forth in Notice No. 7 regarding indirect share transfer is consistent with that in Notice No.698. |
| **Voluntary Report / Mandatory Report** | mandatory report | voluntary report | ➢ Notice No. 7 fails to specify who has the right to decide the direct application of the "Safe Harbor" rules. Per our understanding, if Chinese tax authorities are the competent parties to make such decisions, all transaction parties shall file supporting data with tax authorities for assessment; and under such circumstances, **it may not be the truth for a transaction to be in compliance with the "Safe Harbor" rules even if it is assessed by the transaction parties themselves to be so**.<br>➢ Notice No. 7 encourages taxpayers and withholding agents to report and provide relevant data actively by means of putting forward different legal effects on whether providing data or not in the circumstances that an indirect share transfer is subject to China enterprise income tax ("**EIT**"). |
| **Data Providers Required by Tax Authorities** | transaction parties and the target TRE of share transfer | transaction parties, the planning party and the target TRE of share transfer | During the investigation, tax authorities have a power to request parties related to the transaction to provide tax related data and such parties are obliged to cooperate |
| **Withholding Obligations of Assignees** | unclear | For income from indirect share transfer which shall be subject to EIT in accordance with Notice No.7, the unit or individual that | ➢ Notice No.7 is not the beginning of withholding agent. The chapter of "Withholding at Source" in EIT Law and its implementing regulations provides a legal basis for withholding agent. |

| # | Notice No.698 | Notice No.7 | Han Kun Notes |
|---|---|---|---|
| | | has a direct obligation to pay relevant sum to the share transferor according to relevant laws or contracts shall be the withholding agent. | ➢ But it is worth-noting that article 15 of *Interim Measures for the Administration of Remittance of Income Tax for Non-Resident Enterprise Withheld at Source* (Guoshuifa [2009] No.3, "**Measures No.3**") promulgated by SAT in 2009 and still in effect specifies that "where both parties to a share transfer transaction conducted outside China are Non-TRE, the Non-TRE that obtains the income shall, either on its own or through its entrusted agent, declare and pay taxes to the relevant competent tax authority at the place where the enterprise within China whose share has been transferred is located. The said enterprise within China shall assist the relevant tax authority in collecting tax from the Non-TRE." The understanding of deviations between Notice No.7 and Measures No.3 with regard to withholding obligations of the Non-TRE share assignee in an indirect share transfer is still subject to further clarification by SAT.<br>➢ The withholding time point of the withholding agent specified in Notice No.7 remains to be further defined, which results in uncertainty in some degree and difficulty to the business negotiation for an indirect share transfer. |
| **Legal Liability for Failure to Perform Withholding Obligations or Tax** | unclear | In the event that neither the share assignee has withheld the EIT nor the share transferor has paid the EIT on time in an indirect share transfer subject to EIT, besides chasing for the EIT payable, an interest levy on a | In accordance with relevant provisions in Law on the Administration of Tax Levying, where a withholding agent fails to withhold the amount of tax which should be withheld, it may be faced with a fine of not less than 50% but not more than 3 times the amount of tax that should have been withheld. However, in the event that the withholding agent has reported the relevant transaction to Chinese tax authorities within 30 days of signing the share transfer contract, it |

| # | Notice No.698 | Notice No.7 | Han Kun Notes |
|---|---|---|---|
| **Obligations** | | daily basis on the share transferor shall be imposed in accordance with EIT Law, and the interest levy shall be calculated on the base rate plus 5% points.<br><br>In the event that the share transferor has reported the relevant transaction to Chinese tax authorities within 30 days of signing the share transfer contract, it may be exempted from the additional interest levy. | may be relieved or exempted from the punishment. |

SAT has set up a new regime of tax collection on Non-TRE via Notice No.7. It is reasonable for us to expect that Chinese tax authorities will further strengthen its administration on offshore transaction of indirect transfer of China Taxable Property. Participants in cross-border capital transactions should further note the relevant PRC tax compliance issues.

## Important Announcement

This Newsletter has been prepared for clients and professional associates of Han Kun Law Offices. Whilst every effort has been made to ensure accuracy, no responsibility can be accepted for errors and omissions, however caused. The information contained in this publication should not be relied on as legal advice and should not be regarded as a substitute for detailed advice in individual cases.

If you have any questions regarding this publication, please contact:

## Contact Us


**Beijing Office**
Tel.: +86-10-8525 5500
Suite 906, Office Tower C1, Oriental Plaza
No. 1 East Chang An Ave.
Beijing 100738, P. R. China

**Estella CHEN Attorney-at-law**
Tel.: +86-10-8525 5541
Email: estella.chen@hankunlaw.com

**Shanghai Office**
Tel.: +86-21-6080 0909
Suite 5709, Tower 1, Plaza 66, 1266 Nanjing West Road,
Shanghai 200040, P. R. China

**Yinshi CAO Attorney-at-law**
Tel.: +86-21-6080 0980
Email: yinshi.cao@hankunlaw.com

**Shenzhen Office**
Tel.: +86-755-3680 6500
Suite 4709, Excellence Times Plaza, 4068 Yitian Road, Futian District,
Shenzhen 518048, P. R. China

**Jason WANG Attorney at-law**
Tel.: +86-755-3680 6518
Email: jason.wang@hankunlaw.com

**Hong Kong Office**
Tel.: +00852-2820 5600
Suite Rooms 2001-02, 20/F, Hutchison House, 10 Harcourt Road, Central,
Hong Kong, P. R. China

**Dafei CHEN Attorney at-law**
Tel.: +852-2820 5616
Email: dafei.chen@hankunlaw.com