



The State of Taxation Administration (“SAT”) issued a circular (Guoshuihan [2008] No.1076) to set its position on a case involving the abusive use of double tax treaty in relation to an acquisition in Xinjiang.

Background

- 1) In March 2003, a Xinjiang company and an Urumqi company jointly established another company, i.e. JV.

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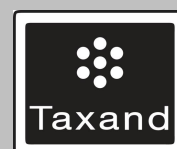
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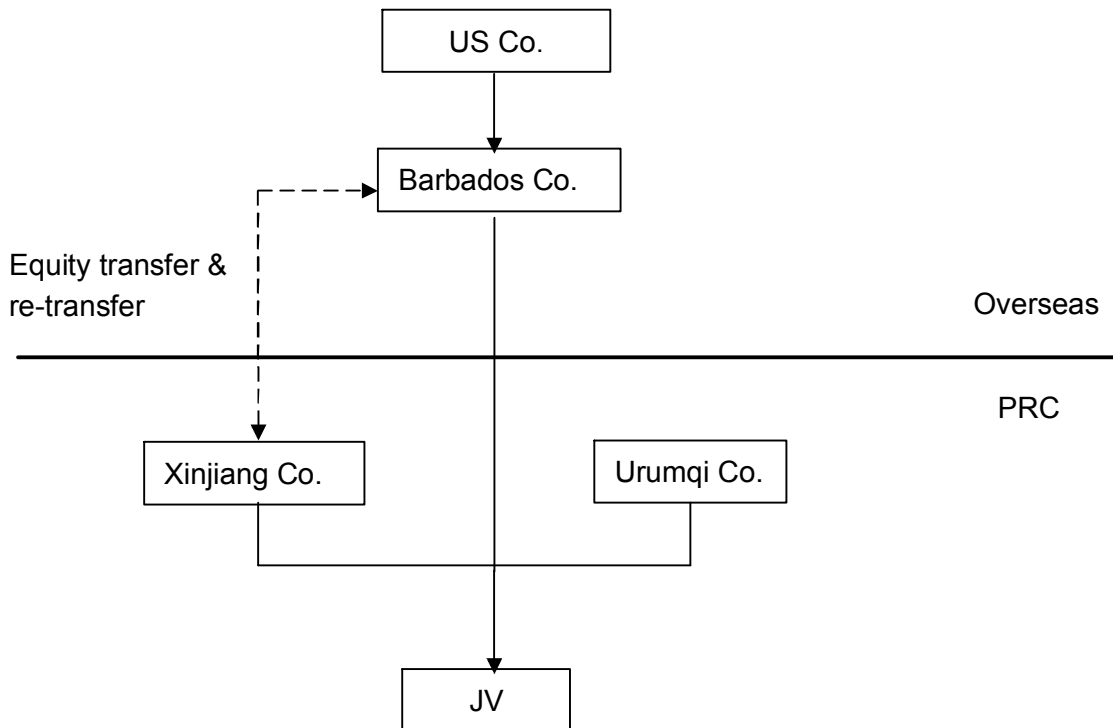
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- 2) In July 2006, a Barbados company, which was established by an American company in May 2006, acquired a one-third interest in JV from the Xinjiang Co. Just 27 days after the transaction, Xinjiang Co. increased its registered capital in JV.
- 3) In June 2007, Barbados Co. transferred all of its equity interest in JV back to Xinjiang Co. deriving a capital gain of USD12 million in less than a year.



The JV applied on behalf of Barbados Co. for the tax exemption of the capital gain under the China-Barbados tax treaty.

Position of China tax authorities

Xinjiang tax bureaus raised following concerns regarding Barbados Co.'s qualification for tax treaty benefits:

- Barbados Co. could not be treated as Barbados tax residence since it was registered in Barbados but had no place of management there and all three of its registered directors were US nationals.
- Barbados Co.'s capital gain was not derived from actual operations, but was based on a pre-agreed contractual arrangement.
- It is difficult to determine the nature of Barbados Co.'s investment in the transactions.

Thus, Xinjiang tax bureaus rejected the tax treaty application claim and PRC withholding tax of 10% should be imposed on the capital gain.

Implications

The issuance of Guoshuihan [2008] No.1076 is an example for tax authorities challenging abuse of tax treaty. Generally, foreign companies set up a special purpose vehicle in a jurisdiction (e.g. Barbados, Singapore, etc.) that has a favorable tax treaty with China to benefit from the preferential tax treatment of capital gains. Although the implications of the circular depends on whether other tax authorities will take the same position with similar parameters adopted in above case as Xinjiang tax authorities, it did influence the efficiency of the most common structure by which foreign companies hold direct investment in China.

One of the main queries raised by the tax authorities in Xinjiang case relates to the economic substance of Barbados Co.'s role and responsibilities in the transactions and the business justification for earning the capital gain. This point is intriguing in light of the General Anti-Avoidance Rules ("GAAR") introduced under the new Enterprise Income Tax Law and clarified in the Implementation Regulations for Special Tax Adjustments. Since there is a risk that the tax authorities may rely more on the GAAR to challenge transactions/structure that lack substance, it is important to do extra effort to support the business justifications of transactions/structure.

Further tax developments

In February 2009, SAT issued a notice (Guoshuihan [2009] No.81) to clarify some administrative issues for the dividend provisions contained in China's income tax treaties. It also introduces additional requirements that may restrict taxpayers' qualification to enjoy tax treaty benefits. It was endorsed that the primary purpose of transactions or arrangements cannot be to enjoy a favorable or preferential tax treaty. Otherwise, the tax authorities may make adjustments for improperly enjoying treaty benefits.

Comments

All those above endorse that China tax authorities is tightening up abusive use of double tax treaties. Foreign investors in China are recommended to review their holding structure for investments in China in light of applicability of tax treaty. In addition, taxpayers should pay attention to future development in relevant areas in China as well as in other countries. With the close cooperation of tax authorities of China and other countries, Chinese tax authorities' position in the taxing cross-border merger & acquisition transactions may be shaped. The exchange of information provision in the tax treaties and cooperation between the tax authorities and other relevant government agencies (e.g. the Ministry of Commerce, State Administration of Foreign Exchange, etc.) also facilitates the tax authorities' investigation.

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