

## Client Alert

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### New Challenges to Special Purpose Vehicles for Investing in China

The tax authorities in China are challenging the most common structure by which foreign companies hold direct investments in China: the use of a special purpose vehicle (SPV) established in a jurisdiction that has a favorable tax treaty with China.

The tax benefits of an SPV holding company are twofold. First, the SPV may benefit from preferential withholding tax rates under the treaty on dividends and other forms of passive income. For example, the tax treaties with Hong Kong, Singapore and several other jurisdictions reduce the withholding tax rate on dividends from 10% to 5%.

Second, if the foreign investor wishes to dispose of the investment in China, it may sell the shares of the SPV without paying income tax in China on the capital gain from the sale. Typically, the jurisdiction where the SPV is established will also exempt the capital gain from local taxation or levy tax at a low rate.

In regulations just issued, as well as in two tax cases reported at the end of 2008, the State Administration of Taxation (SAT) has signaled an intention to scrutinize the use of SPVs and, in some circumstances, to deny corresponding tax benefits in China.

#### 1. Regulations on the Taxation of Dividends

The SAT issued the *Notice on Issues Relevant to the Implementation of Dividend Provisions in Tax Treaties (Notice 81)* on February 20, 2009.

Notice 81 addresses the situation where the withholding tax rate on dividends under a tax treaty is lower than the 10% rate under domestic law in China. The following conditions must be met for the recipient of the dividend to enjoy the treaty benefit:

- The recipient of the dividend must be a tax resident of the other treaty jurisdiction;
- The recipient of the dividend must be the beneficial owner of the dividend;
- The dividend must qualify as a dividend under the tax law of China; and
- Other conditions that the SAT may impose.

In general, the above requirements are not at odds with international norms. A major change under Notice 81, however, is that the SAT will now require the non-resident taxpayer or the withholding agent to provide a host of documentary evidence to prove that the recipient of the dividend meets these requirements.

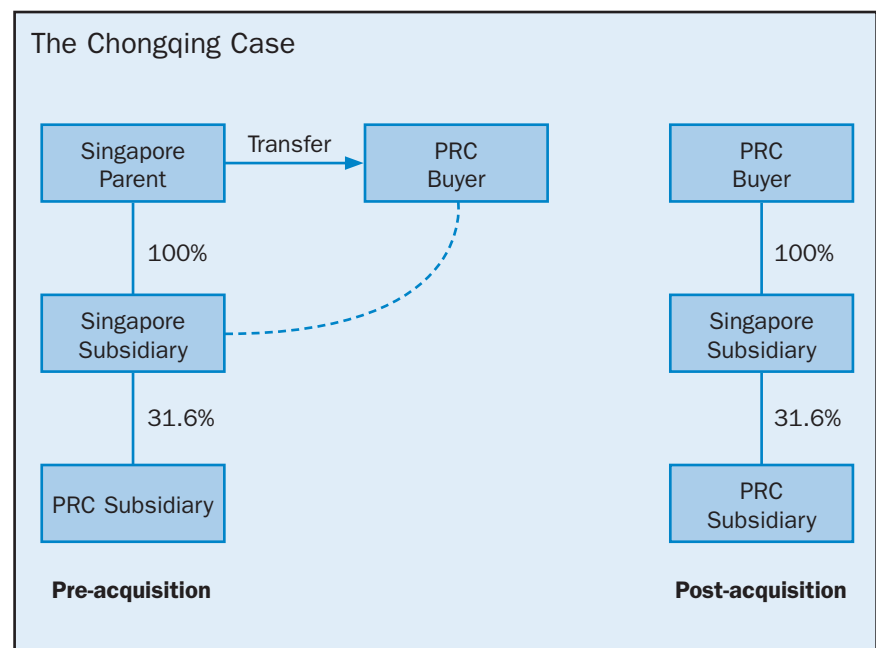
A potentially more significant provision of Notice 81 is found in Article 4, which empowers the tax bureaus in China to investigate and to deny treaty benefits where the main purpose of a transaction or an arrangement is to obtain more favorable treatment of dividends under a tax treaty. Article 4 calls into question the establishment of an SPV in a particular jurisdiction, such as Hong Kong, Singapore, Mauritius, Barbados or Ireland, if the main purpose is to obtain the lower withholding tax rate on dividends under the related tax treaty.

Notice 81 reflects the implementation of the emerging anti-avoidance principle in China that poses new challenges to the effective use of SPVs. This principle also underlies the decisions in the two tax cases discussed below.

## 2. The Chongqing Case

In the Chongqing case, the tax bureau in Chongqing disregarded the existence of an SPV established in Singapore and levied income tax on the capital gain derived by the SPV's parent company from the sale of the SPV.

As illustrated below, a Singapore parent company sold to a PRC buyer its Singapore subsidiary, which was an SPV that held a subsidiary in China. The Chongqing tax bureau disregarded the Singapore subsidiary and treated the transaction as a sale by the Singapore parent of the PRC subsidiary. Consequently, the Singapore parent had to pay income tax in China at a 10% rate on the capital gain from the sale, as if it had sold the PRC subsidiary directly.



Two key factors cited by the Chongqing tax bureau were that the Singapore subsidiary had a very small amount of capital and did not carry on any business activity other than owning the shares of the PRC subsidiary. Hence, the Singapore subsidiary lacked economic substance.

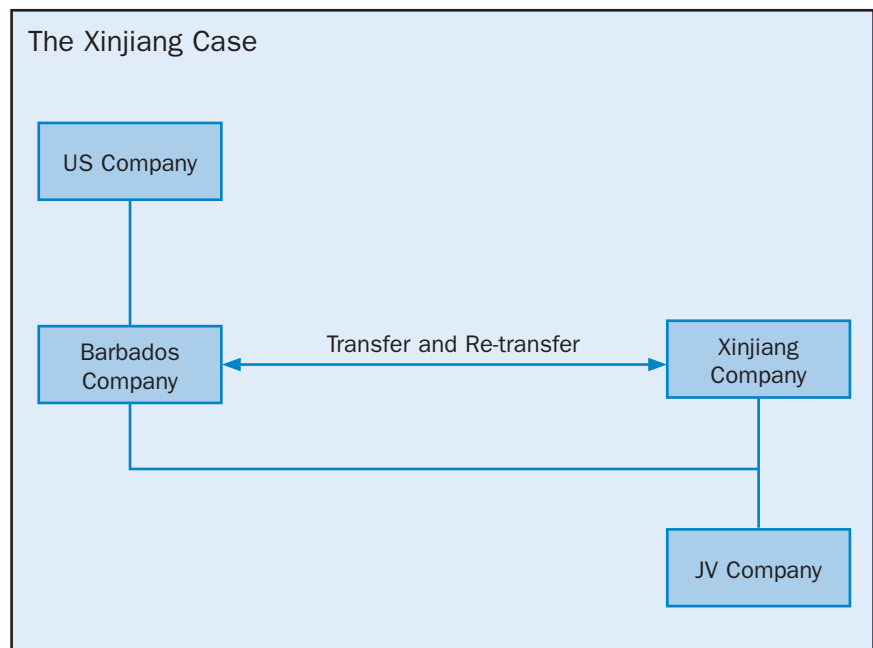
Although the Chongqing case was reported by the municipal tax bureau in Chongqing, we understand that the SAT reviewed and approved the case. Notably, the SAT has since provided a stronger regulatory basis for disregarding the existence of an SPV that lacks economic substance in the *Implementation Measures for Special Tax Adjustments (for Trial Implementation)* (**Circular 2**), issued on January 9, 2009. Among other things, Circular 2 sets out detailed rules for

the anti-avoidance principles in China's income tax legislation. Article 94 of Circular 2 specifically permits the tax authorities to disregard the existence of an enterprise that lacks economic substance, particularly one established in a tax haven, and thereby to prevent tax avoidance by both related and unrelated parties of the enterprise.

### 3. The Xinjiang Case

In the Xinjiang case, a Barbados company sold its PRC subsidiary at a gain. The tax bureau did not allow the Barbados company to enjoy the capital gains tax exemption under the tax treaty between China and Barbados. The basis for the decision appears to be that the Barbados company was not a tax resident of Barbados, but the tax bureau also cited concerns about a lack of legitimate business purpose for the transaction and abuse of the tax treaty. The case was decided by the provincial tax bureau in Xinjiang, and the SAT officially reported the case in December 2008.

As depicted below, the Xinjiang case involved the sale and buy-back of an equity interest in a joint venture company in China by a Xinjiang company and a Barbados company. The Barbados company was an SPV established by a US company. The transaction resulted in the Barbados company deriving a US\$12 million capital gain in less than a year. If the transaction had succeeded, the Barbados company would have been exempted from income tax in China under the tax treaty.



The Xinjiang tax bureau said that a consularized document from the PRC embassy in Barbados showed only that the Barbados company was registered in Barbados, but was insufficient proof of tax residency. Instead, the tax bureau relied on the exchange of information procedure under the tax treaty to obtain information from the Barbados authorities and concluded that the Barbados company was not resident in Barbados for tax purposes. On this basis, the tax bureau denied the tax exemption under the treaty.

As the transactions took place in 2006 and 2007, the anti-avoidance principles in China's current enterprise income tax legislation, which became effective on January 1, 2008, technically did not apply to the case. Nonetheless, the tax bureau took the opportunity to comment in some detail on the potential

tax avoidance and treaty abuse aspects of the transactions. Thus, the case is another example of the increased scrutiny of SPVs based on the developing anti-avoidance principles in China.

#### **4. Conclusions**

Taken together, the Chongqing case, the Xinjiang case, Notice 81 and Circular 2 indicate the intention of the tax authorities in China to develop and to implement anti-avoidance principles and, in that context, to challenge the use of SPVs in certain circumstances. At the same time, the analysis of any particular structure is highly dependent on the particular facts and circumstances. For example, both the Chongqing case and the Xinjiang case involved PRC parties, and this meant that the transactions came to the attention of the tax authorities in China because of exchange control or similar reporting requirements. The Xinjiang case also involved transactions that apparently had obvious elements of treaty abuse. More generally, as the articulation and the implementation of the anti-avoidance principles are still at an early stage, it remains uncertain how aggressively the tax authorities in China will challenge the more conventional use of SPVs.

Nonetheless, foreign investors in China will want to monitor developments in this area, as well as to evaluate their holding structures for investments in China in light of these emerging anti-avoidance principles and practices. Although SPV structures will continue to provide benefits, it may become more important than in the past for an SPV to have some degree of economic substance.

Our lawyers in Greater China would be pleased to help you in assessing the impact of the above regulations and cases on your holding structure for investments in China. For further information, please contact any of our tax partners listed in this alert.

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