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SAT updates guidance on application of capital gains article in China's tax treaties

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The State Administration of Taxation (SAT) issued guidance on 31 December 2012 (Bulletin [2012] No. 59 (Bulletin 59)) on the interpretation of the capital gains article in China's tax treaties, followed by explanatory notes outlining its position on the issues addressed in Bulletin 59. Bulletin 59 updates previous guidance relating to the applicability of benefits under the capital gains article and is effective as from the date of issuance.

Bulletin 59 mainly focuses on the interpretation of article 13(4) and article 13(5) in the China-Singapore tax treaty for which guidance was issued in 2010 (Circular 75). Article 13(4) typically provides that China has the right to tax capital gains from the alienation of shares by a resident of the other contracting state if more than 50% of the value of the shares transferred is derived directly or indirectly from immovable property situated in China. Article 13(5) allocates taxing rights to China with respect to capital gains from the alienation of shares of a Chinese company, if at any time during the 12-month period before the alienation, the recipient in the other contracting state held directly or indirectly at least 25% of the capital of the Chinese company.

Background

As noted above, Circular 75 contains detailed guidance on the interpretation of China's tax treaty with Singapore. Circular 75 has played a vital role in the general interpretation of China's treaties, because the circular also applies to any similar provisions in China's other tax treaties/agreements.

Bulletin 59 supplements and updates the guidance in Circular 75 on the applicability of benefits under the capital gains provision.

Highlights of Bulletin 59

- Scope of the term, "immovable property": Bulletin 59 confirms that the term "immovable property" as used in the capital gains article of the China-Singapore treaty and in Circular 75, shall encompass operating and non-operating building construction, land use rights and property accessory to immovable property.

- Fifty percent test for land-rich companies: Bulletin 59 addresses the interpretation of article 13(4) of the China-Singapore treaty, which allocates taxing rights to China with respect to capital gains from the alienation of shares where more than 50% of the value of the shares transferred is derived directly or indirectly from immovable property situated in China.

Circular 75 provides that, since the treaty concerned does not contain a specified timeframe for purposes of determining whether the 50% immovable property threshold is exceeded, the threshold will be deemed to be exceeded if the immovable property holding exceeded 50% at any time during the three years preceding the transfer of the shares. Bulletin 59 confirms the three-year look-back period, defining it as the 36 consecutive calendar months before the month of the share transfer (not including the month of transfer).

A frequent question that arises in practice is how often the value of the immovable property has to be measured to determine whether the 50% threshold is exceeded at "any time" during the 36-month period. If the market value of the land or land use rights has fluctuated during the three years before the alienation, does the measurement have to be made multiple times in order to ascertain whether at any time, the 50% threshold is exceeded? If so, this could increase the compliance burden for land-rich companies wishing to obtain benefits under the treaty.

Bulletin 59 further stipulates that, in applying the 50% test, the value of total assets and immovable property are to be determined according to China's accounting standards for measuring the value of assets (without taking into account debt or other liabilities of the company), but the value of land or land-use rights included in the relevant immovable property cannot be lower than the current market value of comparable property at the same or a similar location. Under China's accounting standards, the net book value (NBV) generally is used to measure the value of land and buildings. Therefore, Bulletin 59 provides unfavorable treatment for taxpayers that have a land or land-use rights NBV that is lower than the market price.

It is interesting to note that the example in the explanatory notes to Bulletin 59 suggests that, in determining the adjusted value of land or land use rights, the market value of the land or land use rights that is comparable to the land/land use rights of the Chinese company is used as the original acquisition value. An amortization is then given based on the same amortization method the company has been using for the land or land use rights for accounting purposes (e.g. straight-line method, same useful life, etc.).

The Commentary to the OECD model treaty comments on the 50% test, but not on the measures to value the immovable property.

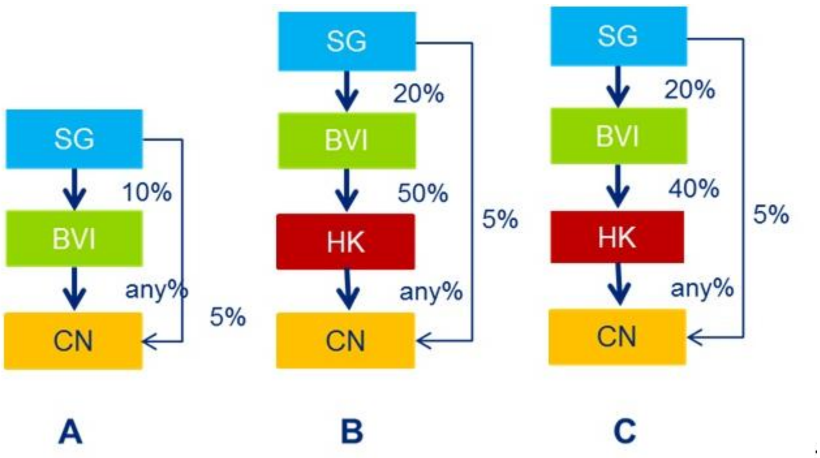
- Twenty-five percent test: Article 4 of Bulletin 59 addresses the 25% (direct or indirect) capital participation test and replaces the relevant guidance in Circular 75. Bulletin 59 includes a new "participation through a nominee" test for determining a "direct participation," establishes a threshold for determining an "indirect participation" and for the "attribution rule," revises the definition of "members of the affiliated group with which the Singapore resident has a significant economic relationship."

  There is no OECD commentary on the 25% test because the OECD model treaty does not have a comparable paragraph in article 13 regarding the taxation right with respect to a 25% or more capital participation.

  Participation through a nominee – Under Bulletin 59, where a Singapore resident participates in a Chinese resident company through a nominee (including an individual, a company or another entity) and the Singapore resident has the exclusive right to the benefits arising from the capital participation through the nominee and substantially bears risks of the capital participation, the nominee's capital participation in the Chinese resident company can be regarded as a direct capital participation held by the Singapore resident.

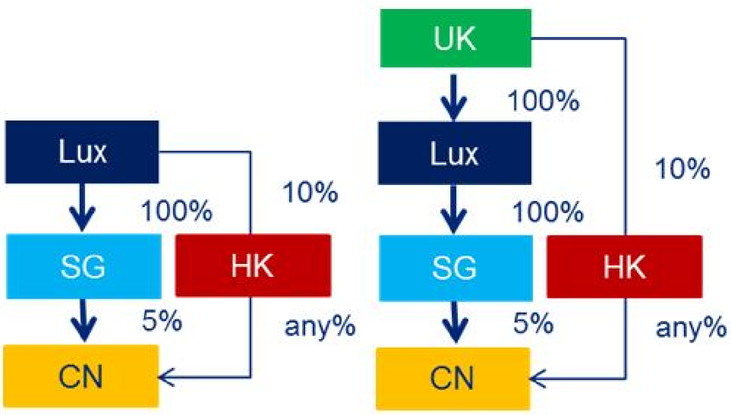
  It appears that the SAT intends to address a so-called "nominee structure" where a Singapore resident cannot invest into a Chinese company directly (mostly because of the Chinese regulatory constrains) and therefore appoints a nominee to invest in the Chinese company and to own the equity interest of the Chinese company on behalf of the Singapore resident.

  Threshold for "indirect participation" – For purposes of determining a 25% indirect participation, the indirect participation must be through single- or multiple-tier companies (or entities), with a 10% or greater direct participation requirement being met. For example, in the disposal of the direct 5% participation in a Chinese company by a Singapore company, the 25% test should include the indirect participation(s) in scenarios A and B below. For scenario C, the explanatory notes to Bulletin 59 seems to suggest that the indirect participation will not be included in the 25% test since the Singapore company's participation in the Hong Kong company (direct and indirect) is 8% (i.e. less than 10%). However, it is possible that the tax authority could take the position that such indirect participation may fall under article 4(2) of the Bulletin by its literal meaning, since the direct participation in each tier above the Hong Kong company is more than 10%. Further guidance is expected from the tax authorities on the "10% direct participation."



It should be noted the indirect participation rule does not indicate that the capital gains article will be applied to gains from an indirect disposal of the Chinese entity (if there is no treaty abuse) according to the explanatory notes.

Attribution rule – When determining the percentage of indirect participation in the Chinese company held by the Singapore resident, direct or indirect participations by other members of the affiliated group with which the Singapore resident has a significant economic relationship also should be included. Bulletin 59 revises the definition of significant economic relationship. Individuals (including where the interest is owned jointly with the individual's spouse, parents (and direct relatives above parents), children (and direct relatives below children)), companies and other entities that hold a 100% interest in the Singapore resident directly or indirectly are regarded as members of the affiliated group with which the Singapore resident has a significant economic relationship. The 10% rule also applies in these circumstances in determining the member's indirect participation in the Chinese company. For example, in the disposal of the direct 5% participation in a Chinese company by a Singapore resident company, the 25% test should include Lux and UK's indirect participation in the Chinese company.



Participation included in the 25% test

	Circular 75	Bulletin 59
Participation through a nominee	No	Yes
Indirect participation	No de minimis rule: Participation through a company that is owned by the Singapore resident	De minimis rule: Participation through a company that is at least 10% owned by the Singapore resident

Participation included in the 25% test (Continued)

	Circular 75	Bulletin 59
Attribution rule (rules on individuals are omitted in this table)	- Affiliated members' direct participation - Affiliated members include the 100% direct parent company and the parent's 100% directly or indirectly owned subsidiaries	- Affiliated members' direct and indirect participation - Affiliated members include 100% direct and indirect parent companies - 10% de minimis rule applies in determining the parent's indirect participation

Compared to Circular 75 which does not set a de minimis rule in determining the indirect participations, Bulletin 59 sets a minimum threshold, i.e. an indirect participation through a more-than-10% (including 10%) single-tier or multiple-tier participation in companies or other entities owning the Chinese company. But Bulletin 59 expands the scope of the attribution rule to include the indirect 100% parent and its 10%-owned entities.

With the introduction of Bulletin 59, foreign investors need to be more careful in assessing whether their alienation of shares/participation/other rights in the capital of a Chinese company/other legal person will be taxed in China.

Note: Contents discussed in this Tax Analysis pertains to Deloitte International Tax Services.

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