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CHINA FOCUSES ON TAX AVOIDANCE:

TREATY ABUSE FOUND BASED ON NO "LEGITIMATE" BUSINESS PURPOSE

Source: Patrice Marceau and Daniel Chan (DLA Piper, China)

If one had to define in one word (or two!) the main trend in PRC tax in the last few months, "anti avoidance" would be it. In recent months, we have seen in succession: two local tax bureau decisions attacking the integrity of treaty-based holding structures; the long-awaited circular from the State Administration for Taxation (SAT) on special adjustments, including transfer pricing; and a notice from the SAT addressing specifically anti-avoidance with respect to the payment of dividends to a tax treaty jurisdiction entity.

The trend is definite and shows that the PRC is fast catching up on tax avoidance, learning to use every tool in the box to counter what it perceives to be abusive tax planning.

THE TWO LOCAL TAX BUREAU CASES

The first case was issued on November 27, 2008. It involves the Chongqing tax bureau and the sale to a PRC purchaser of a sole purpose Singapore holding company of a PRC entity. When the PRC purchaser sought the required authorizations to transfer the purchase price abroad to the foreign seller, the tax authorities reviewed the matter and concluded that the Singapore entity should be disregarded because it lacked economic substance. On that basis, they treated the gain on the disposition of the Singapore entity as a gain on the disposition of the PRC entity itself and imposed

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withholding tax on the outbound purchase price. As justification to disregard the Singapore entity, the authorities noted specifically (i) its minimal capital and (ii) the lack of business activities other than holding the interest in the PRC entity.

The other case was officially reported on December 30, 2008¹. It deals with the PRC-Barbados tax treaty and its exemption for capital gain on the disposition of an interest in a PRC company. Barbados is one of the few remaining PRC treaties where a complete exemption is offered irrespective of the level of ownership in the PRC entity². The transaction involved the sale by a Barbados entity controlled by a U.S. parent of its interest in an entity in the PRC. Upon its request for the treaty exemption for capital gains, the Xinjiang tax bureau reviewed the transaction thoroughly, even requesting assistance from the Barbados government under the exchange of information provisions of the treaty. It eventually concluded that the Barbados seller was not eligible to treaty benefits as it was not a resident of Barbados for the purposes of the agreement. In doing so, they disregarded a "certificate of residency" endorsed by the PRC embassy in Barbados, arguing that the certificate merely established that the seller was registered in Barbados, not that it was necessarily a resident for the purposes of the treaty. As justification, the authorities expressed the view that the transaction amounted to treaty abuse given its lack of legitimate business purpose.

There is much to be concerned as a result of the two cases (and perhaps others which have yet to surface):

- Although the decisions were issued by local tax bureaus, they have undoubtedly been endorsed by the SAT and therefore they reflect the basic approach of the central authorities towards tax avoidance and tax-driven structures using treaty jurisdictions.
- The scope of the attack shows that the PRC authorities are learning the theories of high tax jurisdiction authorities around the world to attack tax-driven structures. Arguing on the basis of economic substance or legitimate business purpose are lines of argument not previously encountered from the PRC tax authorities.
- It is disturbing that the PRC authorities would frame their attack on the basis of business or economic substance even in cases involving newly negotiated treaties where, in the negotiations leading to the conclusion of the treaty, the PRC authorities eschewed the vast arsenal of anti-avoidance provisions available in the model OECD/UN treaty (the usual starting point in tax treaty negotiations).
- What do you need to have sufficient economic substance? Both cases highlighted the low capital of the entities. Would a substantial capital have changed the result? What if the entity held interests in more than one entity? Does the entity need an office? Employees? A bank account? At this stage, the required threshold is very much unclear, which leaves a high level of uncertainty in devising appropriate structures for PRC based investments.
- With government's revenues depleted by the economic crisis, offshore holding structures become a low hanging fruit for the authorities to extract additional taxes.

It is virtually certain that, in the months and years to come, we will see more and more challenges from the authorities of tax-driven treaty-based structures.

FOOTNOTES

¹ Guo Shui Han [2008] No. 1076 issued by the SAT on December 30, 2008.

² In recent PRC tax treaties, the capital gain exemption clause applies only to ownership of less than 25% of a PRC entity (e.g. the recent treaties with Hong Kong or Singapore). There are older treaties in the PRC network providing for a more generous scope of exemption (Barbados, Switzerland and, until recently, Mauritius). For Mauritius, the exemption was recently revised to bring it in line with the less-than-25% standard. If rumor has it right, it is unlikely that the total exemption currently enjoyed by Barbados will survive for much longer. Indeed, the PRC authorities have now initiated discussions for changes to the treaty and it is odds-on that the scope of the capital gain exemption offered to Barbados will be curtailed. Mauritius is a good example of how persuasive the PRC authorities can be in the context of such discussion.



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