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INDEX

INTERPRETATIONS OF THE IMPLEMENTATION OF CIVIL PROCEDURE LAW OF THE PEOPLE'S REPUBLIC OF CHINA (THE "INTERPRETATIONS") （最高人民法院关于适用《中华人民共和国民事诉讼法》的解释）, ISSUED BY THE SUPREME PEOPLE'S COURT (THE "SPC")

The Civil Procedures Law ("CPL") of the People's Republic of China was substantially amended in late 2012. The Interpretations now clarify several issues not specified in the CPL more comprehensively than any other CPL-related judicial interpretations to ensure a unified and consistent implementation of the CPL nationwide.

The Interpretations' main features regarding **civil litigation procedures** are as follows:

- They further clarify the jurisdiction of courts to hear cases, particularly regarding disputes over contracts. To reduce uncertainty when determining the place of performance of a contract under which both parties are subject to material obligations, the Interpretations state that if the parties do not agree on the place of performance, it will be where the disputed obligation is performed.

- They reestablish the principles for determining the place of performance of online purchase agreements, specifying that (1) if the object of the purchase agreement is delivered via internet, the place of performance will be the purchaser's place of residence; (2) if the object of the purchase agreement is delivered by other means, the place of performance will be the place of receipt; and (3) if the parties agree in writing on the place of performance, this agreement will prevail.

- They illustrate the principles for determining burden of proof and stipulate that the claimant will be liable if it cannot produce admissible evidence proving its claim before the judgment is issued.

- They provide a more precise definition of electronic data, which is now recognized as acceptable evidence under the CPL. Electronic data refers to information that is formulated or saved in electronic form, including emails, electronic data exchanges, online chat records, blogs, mini blogs, SMS, electronic signatures and domain names.

- They establish the procedures and timeframes for submitting evidence. The Interpretations relax the time constraints, allowing the court to accept evidence submitted after a deadline if it is considered related to the material facts of the case.

- They further clarify the status of expert in a civil proceeding, defined under the CPL as a "person with professional knowledge," and establish that the parties can appoint one or two experts to attend the hearing, who can only participate in aspects of the hearing that are related to their professional activity.

- They establish criteria for determining the probative value of evidence and stipulate that the court (1) must coordinate the parties to clarify and debate on whether —and to what extent— the presented evidence has probative value, and (2) issue its judgment based on the laws, logical reasoning and rules of thumb.

- They relax the requirements on the guarantee for preservation measures. They also allow the court to determine the amount of guarantee the applicant must provide, which previously had to equal the amount of the assets or obligations to be preserved.

The Interpretations also introduce several **arbitration-related provisions**, which we highlight below:

- The facts recognized in a binding arbitration award granted by an arbitration commission need not be proven again with evidence and can be directly adopted by the court, unless the other party provides enough evidence to rebut them.

- If, before the first hearing, the court's jurisdiction is challenged on the grounds of a valid arbitration agreement between the parties to the dispute, the court will review the issue and not accept the case where (1) the arbitration institution or another court has already upheld the validity of the arbitration agreement; (2) the parties did not challenge the validity of the arbitration agreement before the first hearing in the arbitration; or (3) the court concludes that the arbitration agreement is valid.

- The court's decision to reject the enforcement of a domestic arbitral award under the CPL cannot be challenged or reviewed. In these cases, the parties can enter into a new arbitration agreement to arbitrate the dispute again or submit their dispute to the court.

- If a court grants preservation measures requested by a party in an arbitration procedure before a foreign-related arbitration institution in China, the applicant must provide a guarantee. However, the court can exempt the applicant from providing a guarantee if it considers this unnecessary.

- To enforce a foreign arbitral award in China, the applicant must first apply for the recognition of the award (a foreign arbitral award cannot be enforced until the court acknowledges its compliance with law).

The Interpretations will prevail if any discrepancy arises regarding any other judicial interpretations issued by the SPC.

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ANNOUNCEMENT OF THE STATE ADMINISTRATION OF TAXATION ON ISSUES CONCERNING ENTERPRISE INCOME TAX ON INDIRECT PROPERTY TRANSFER BY NON-RESIDENT ENTERPRISES (ANNOUNCEMENT [2015] NO.7) (国家税务总局关于非居民企业间接转让财产企业所得税若干问题的公告)

In recent years, circular Guoshuihan [2009] No.698 ("Circular 698"), issued by the State Administration of Taxation ("SAT") in 2009, has played a crucial anti-avoidance role in regulating indirect equity transfers of Chinese enterprises.

Under Circular 698, when a foreign investor indirectly transferred its equity interest in a Chinese resident enterprise through the direct transfer of a foreign intermediate holding company, enterprise income tax ("EIT") in China was triggered if the transfer arrangement abusively used an organizational structure without reasonable commercial purposes to avoid taxes.

However, it only established a general principle, leaving considerable discretion to the local tax authorities when making their own judgments. Although SAT further issued Announcement [2011] No.24 ("Announcement 24") to clarify the matter, many aspects remained unclear.

In this context, SAT issued Announcement [2015] No.7 ("Announcement 7") on February 3, 2015, to replace the tax rules concerning offshore indirect equity transfers established under Circular 698 and Announcement 24.

Announcement 7 introduces a new regime with a wider scope, which is expected to impact multinational companies engaging in offshore merger and acquisition transactions and corporate restructuring involving China-based assets.

The features of Announcement 7 are as follows:

Wider scope

Announcement 7 applies not only to offshore indirect equity transfers targeted under Circular 698, but also to offshore indirect transfers of assets held under the establishment and place ("E&P") of a foreign company in China and real estate located in China (jointly referred to as "Chinese taxable properties").

Under article 1 of Announcement 7, any indirect transfer of Chinese taxable properties by a non-resident enterprise should be reclassified as a direct transfer of properties under article 47 of the EIT Law (general anti-avoidance rule or GAAR) if the transfer arrangement lacks reasonable commercial purposes and aims to avoid EIT in China.

Announcement 7 also extends the scope of transfers by including transfers of other similar interests, besides equity transfers and changes of shareholders of the non-resident enterprise due to corporate restructuring. This may result in the transfer of partnerships, trusts and other similar forms of interest also subject to EIT in China if the other requirements are met.

Blacklist

Under Announcement 7, an indirect transfer that meets all the following conditions will be considered not to have a reasonable commercial purpose, and no further analysis and assessment will be required:

1. At least 75% of the equity value of the foreign companies directly or indirectly derives from Chinese taxable properties.

2. At any time during the year before the transfer, at least 90% of the total assets (excluding cash) of the foreign companies are directly or indirectly composed of investment in China, or at least 90% of the foreign companies' income derives directly or indirectly from China during the year before the transfer.

3. The functions performed and the risks undertaken by the foreign companies are limited and are not enough to prove economic essence.

4. The tax burden abroad is lower than the tax burden in China in the case of direct transfer of Chinese taxable properties.

Safe harbor rules

Announcement 7 provides safe harbor rules that exclude some indirect transfers of Chinese taxable properties from being taxed in China:

- Indirect transfers of Chinese taxable properties by purchasing and selling equity of the same listed foreign company through public stock exchanges.

- Indirect transfers of Chinese taxable properties that, if directly transferred, may be exempt from EIT in China under the applicable tax treaties or arrangements.

Intra-group restructuring processes that meet all the following conditions will be considered to have reasonable commercial purposes:

1. The shareholding relationship of the parties involved is one of the following:

   - The transferor directly or indirectly owns at least 80% of the transferee's equity.
   - The transferee directly or indirectly owns at least 80% of the transferor's equity.
   - The same party owns at least 80% of the equity of the transferor and transferee.

   If over 50% of the value of a foreign company's equity derives directly or indirectly from real estate in China, the proportion in items a), b) and c) will be 100%.

2. The tax burden in China on subsequent indirect transfers will not be reduced, if compared to the same or similar indirect transfers made outside an intra-group restructuring.

3. The transferee completely settles the consideration of the transfer through its own or its subsidiaries' equity (excluding equity of listed companies).

Foreign investors will welcome these safe harbor rules, especially multinational companies engaging in qualified intra-group restructuring. However, if an indirect transfer cannot benefit from safe harbor rules, this does not mean it will be reclassified and taxed; the transfer will then be assessed under the purpose test.

Reasonable commercial purposes assessment

Circular 698 established that reasonable commercial purposes should be considered when determining whether an offshore indirect transfer should be reclassified as a direct transfer and subjected to EIT in China. However, it did not provide any clear criteria to assess those reasonable commercial purposes, so local tax authorities generally relied on economic substance as the key factor for the assessment.

One significant improvement in Announcement 7 is a list of factors to be considered in the reasonable commercial purposes assessment ("purpose assessment"), including the following:

1. Whether the main value of the equity of the foreign companies directly or indirectly derives from Chinese taxable properties.
2. Whether the foreign companies' assets are mainly composed of investment directly or indirectly made in China, or whether the foreign companies' income mainly derives directly or indirectly from China.
3. Whether the functions performed and the risks taken by the foreign companies and their subsidiaries can prove that the corporate structure has economic substance.
4. The shareholders and business model of the foreign companies, and the timeframe of the organizational structure.
5. Tax payable abroad.
6. Whether the indirect investment and indirect transfer can be substituted with a direct investment and direct transfer.
7. Applicable tax treaties or arrangements.
8. Other relevant factors.

By introducing the function and risk analysis and other factors based on tax purposes, the parties to the transaction have stronger grounds to argue the existence of reasonable commercial purposes. However, as the purposes assessment can be very subjective, without further clearer instructions, different local tax authorities are likely to reach inconsistent judgments.

Recharacterization effect – tax implications in China

Announcement 7 establishes the following tax treatments for income derived from an indirect transfer of Chinese taxable properties lacking reasonable commercial purposes and not benefiting from the safe harbor rules:

1. If the indirect transfer involves assets held under a foreign company's E&P in China, income will be treated as connected with the E&P, and subject to 25% EIT.
2. Excluding the item above, if the indirect transfer relates to real estate in China, income will be treated as derived from transferring real estate, and subject to 10% EIT.
3. Excluding the two items above, income will be treated as derived from transferring equity investment assets in China, and subject to 10% EIT.

However, where tax treaties establish other treatments or rates, the applicable tax treaties will prevail.

Announcement 7 does not address how the cost base for tax calculation purposes will be determined (including whether tax paid in a previous direct or indirect transfer of Chinese taxable properties will be considered as a tax base in any subsequent direct or indirect transfers).

If an equity transfer of the same foreign company by an equity transferor leads to the indirect transfer of at least two China taxable properties, which in turn involves at least two competent tax authorities, all related procedures must be followed with each competent tax authority.

Reporting requirements

Voluntary report

Unlike Circular 698, requiring the equity transferor to report the offshore indirect transfer to the competent tax authority of the Chinese resident enterprises, Announcement 7 provides that parties to an indirect transfer of Chinese taxable assets and the Chinese resident enterprises indirectly transferred can voluntarily report the transfer to the competent tax authorities by submitting the following documents (English versions need to attach the Chinese translation):

(1) Equity transfer agreement.

(2) Corporate shareholding structure before and after the equity transfer.

(3) Financial and accounting statements for the past two years of the foreign companies and their subsidiaries that directly or indirectly hold the Chinese taxable properties.

(4) Reasons why reclassification should not apply.

Announcement 24 allowed foreign investors to choose one competent tax authority for reporting purposes if the transfer involved two or more Chinese resident enterprises located in different provinces or cities. As Announcement 7 eliminates this provision, voluntary reports must now be submitted to the competent tax authorities in each location.

Announcement 24 also provided that if an offshore indirect equity transfer involved two or more equity transferors, either one could fulfill the reporting obligation under Circular 698. Announcement 7 also eliminates this provision, so each equity transferor must submit its own report to the competent tax authority.

Compulsory reporting

If the competent tax authorities investigate an indirect transfer of China taxable properties, both parties to the indirect transfer, advisors and the Chinese resident enterprises being indirectly transferred must submit the following documents to the competent tax authorities on request:

(1) Documents specified for voluntary reporting (unless already submitted).

(2) Information related to the decision-making and implementation of the overall arrangements.

(3) Information on production and operation, staff, accounting and properties, as well as the internal and external audit information of the foreign companies and their subsidiaries that directly or indirectly hold Chinese taxable properties.

(4) Asset appraisal report and other pricing guidelines used to determine the offshore equity transfer price.

(5) Tax payable abroad.

(6) Evidence and information related to the application of safe harbor rules.

(7) Other relevant documents.

Announcement 7 specifies that investigations must be carried out under Decree No.32 on Administrative Measures on GAAR (trial), issued in December 2014 and analyzed in our December legal flash.

Tax administration

When making an indirect transfer of assets held under an E&P subject to EIT in China, income from the indirect transfer should be included in the incomes of the E&P during the period the agreement takes effect and the transfer is completed.

When making an indirect transfer of real estate and equity interest, the equity transferee obliged to directly pay the consideration for the transfer should act as a withholding agent for the EIT payable. The withholding obligation applies regardless of whether the transferee is a resident in China.

If the withholding agent does not withhold in full the EIT payable, the equity transferor must declare the EIT payable to the competent tax authorities within seven days after the date the agreement takes effect and the transfer is completed.

If the withholding agent does not withhold and the equity transferor does not declare or pay EIT, the Chinese tax authorities can impose on the withholding agent a penalty of between 50% and three times the unpaid tax amount. However, if the withholding agent voluntarily reports the indirect transfer within 30 days after signing the equity transfer agreement, liability may be reduced or waived.

The equity transferor will be subject to daily interest calculated based on the RMB loan base interest rate published by the People's Bank of China plus a 5% mark-up. However, if the equity transferor voluntarily reports the indirect transfer within 30 days after signing the equity transfer contract or agreement, or declares or pays the EIT payable voluntarily, it will not be subject to the additional 5%.

These provisions aim to motivate the withholding agent and transferor to voluntarily report the indirect equity transfer. Therefore, equity transferors and transferees of an indirect transfer of Chinese taxable properties should agree on how to handle EIT-related matters in China and the related uncertainties.

Further remarks

Announcement 7 improves the regulation on indirect transfers of Chinese taxable properties by introducing factors that must be considered when evaluating the reasonable commercial purposes and safe harbor rules for intra-group restructuring, and standardizing the criteria that the different authorities will apply. However, many issues have not been dealt with. Specifically, it does not require the competent tax authorities to issue a formal tax assessment on the subjectivity of EIT for the transaction. Therefore, even if the transferor considers the indirect transfer has reasonable commercial purposes and submits a voluntary report to the competent tax authority, it still faces the uncertainty of the transaction being reclassified and subjected to EIT in China in the 10 years following the transaction.

Although Announcement 7 took effect on the date of issue, February 3, 2015, it also applies to unsettled offshore equity transfers taking place before that date. Considering the core legal basis is the GAAR, introduced on January 1, 2008, Announcement 7 applies to offshore indirect equity transfers taking place since January 1, 2008, and whose tax assessment has not yet been concluded by the tax authorities under Circular 698.

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