

Service permanent establishment

Recent developments in China have increasingly focused on the potential exposure to service permanent establishment (PE) status of foreign fund managers and the tax treatment of employees seconded there.

Specifically, many of the local tax authorities in China are requiring taxpayers in their respective districts to provide additional details on the activities of employees seconded from overseas parties to China. The requested details range from the number of days employees have been in China in 2008 and 2009 to the nature of the contracts entered into with overseas parties (if any), the fees payable under the contracts, and the basis of how the fees were determined. The Chinese tax authorities are also focusing on the activities of seconded employees and paying particularly close attention to whether these employees are performing services for the local Chinese entity or in fact are working for the overseas entity.

The increased scrutiny on these activities may lead to an increased risk of the Chinese tax authorities considering an employee a dependent agent of the overseas entity (for example, the management company or fund), thus creating a service PE and subjecting the income of the overseas entity to tax in China.

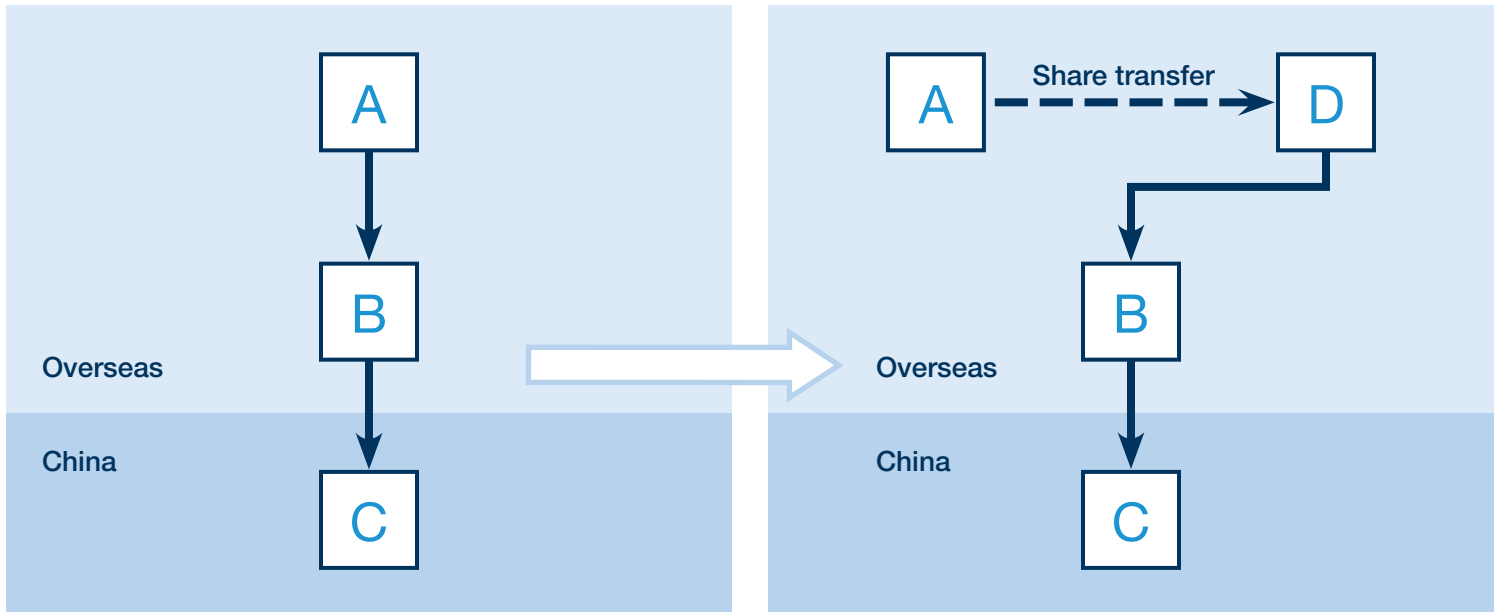
Capital gains on the indirect transfer of shares

In addition to the widely debated Chinese tax avoidance cases of Chongqing and Jiangxi last year, the Chinese State Administration of Taxation (SAT) is preparing a tax policy that covers, among other things, the “indirect transfer” of Chinese equities by non-Chinese tax resident enterprises (non-TREs) outside China. Although the policy has not yet been released, the SAT has prepared a draft of the policy to inform non-TREs of the potential tax implications of these indirect transfers. It should be noted that the policy is expected to be retroactively effective from January 1, 2008.

The draft policy states that upon the indirect transfer of Chinese equities (such as those held through a holding structure) by one non-TRE to another non-TRE, certain documents and information (including the commercial purposes of the holding company) must be provided to the SAT regarding the transfer. Such documents must be provided when the holding company location is either (1) a low-tax jurisdiction with a benchmark rate (which may be half of the standard China corporate income tax rate of 25 percent) or (2) a jurisdiction that does not tax the foreign company on the capital gains upon the transfer of the holding company’s shares.

The SAT will review the relevant information to determine if the transaction was effected to avoid Chinese withholding tax. Then the agency may invoke the general anti-abuse rules or general anti-avoidance rules (GAAR) and disregard the holding company to collect the 10 percent withholding tax.

The following diagram illustrates what the draft policy intends:



The illustration involves non-TRE[†] A, which disposes SPV B (a special purpose vehicle that is also a non-TRE), which holds China subsidiary C, to another non-TRE, D. Upon transfer of SPV B, non-TRE A is required to provide a list of requisite documents and information (including the commercial purposes for the use of SPV B) regarding the transfer. This is required only when SPV B is located in a jurisdiction that has the following specified tax features:

1. a low-tax jurisdiction with a benchmark rate (which may be half of the standard China corporate income tax rate of 25 percent), or
2. a jurisdiction that does not tax a foreign company (i.e., non-TRE A) in respect to the gains on transfer of SPV B's shares.

With the requisite documents and information, the Chinese tax authorities can examine the true nature of the transfer. Should the transfer of the China subsidiary C's equity be achieved through a transaction deemed to be "abusive use of company structure" (i.e., transfer of SPV B) to avoid China withholding income tax, then the Chinese tax authorities can invoke GAAR and disregard SPV B. Once SPV B is disregarded, then the transfer may effectively be treated as a non-TRE, SPV A, transferring China subsidiary C's equity. Accordingly, the gain may be considered China sourced and, therefore, subject to China withholding income tax.

[†] A TRE is a Chinese tax resident enterprise. A foreign entity deemed by the Chinese tax authorities to be managed and controlled from China may be considered a TRE and subject to tax in China.

The key implications of the draft policy are as follows:

- An offshore holding company structure that has been used over the past years to obtain favorable tax rates upon exit of Chinese investments may not be as effective under the new proposed policy.
- Sufficient substance is required to maintain the Chinese tax efficiency of offshore structures. Thus, appropriate documentation should be maintained to be able to provide backup information if the SAT questions the holding structure.
- If it appears likely that the holding company may be disregarded for Chinese tax purposes based on the draft policy, it may be necessary to accrue for Chinese capital gains tax under US FIN 48 principles.

The changes for seconded employees and capital gains are among several significant developments in China recently that impact the asset management industry. These developments are similar to those in other emerging markets in Asia. As such, companies should give careful consideration while structuring investments and operations into China.

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