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Foreign-registered companies face China tax scrutiny

By Sundeep Tucker and Xi Chen

Companies operating in China using foreign-registered structures to minimise onshore tax should be braced for more aggressive scrutiny from mainland authorities, tax advisers have warned.

Thousands of companies, from state-owned industrial giants to small foreign investment vehicles, which conduct most of their business in China, are registered overseas for tax reasons.

However, tax advisers who have tracked a series of rulings and guidelines issued by central and provincial authorities said foreign-registered vehicles were coming under unprecedented scrutiny as governments adopt international standards to help boost revenue.

As a result, scores of foreign private equity and hedge funds could face larger Chinese tax bills. China typically levies a 10 per cent capital gains tax on restructurings.

PwC said a trio of recent rulings by provincial tax bureaus in Chongqing, Xinjiang and Jiangxi had implications for overseas special purpose vehicles used by foreign investors. In the Xinjiang case, the tax authority ruled that a company registered in Barbados should be liable for capital gains tax for an onshore disposal because it could not prove it and its directors were based in the Caribbean country and thus could not utilise a China-Barbados double taxation exemption.

“These rulings show that even provincial tax authorities have become alert to potential abuses of the tax system,” said Danny Po, greater China tax partner for PwC. “As a general theme, China’s tax practice is drawing closer to the international practice.”

Overseas shareholders in some of China’s biggest companies also face paying a new dividend withholding tax. China’s State Administration of Taxation last month ruled that a 10 per cent dividend withholding tax would apply to all overseas-listed companies that have their major

business operations concentrated in China and whose senior management is primarily based on the mainland.

The new rules retroactively took effect on January 1 2008 and tax experts said the country's biggest companies would be affected.

CNOOC, China Netcom and Lenovo are among dozens of "red chip" companies – based in China but incorporated and listed overseas – and institutional investors will have to make special arrangements to try and avoid the tax. The withholding tax will not apply to individual investors.

The Hong Kong-listed shares of China Mobile were suspended last week for technical reasons relating to the new tax.

Analysts believe some foreign investors, such as pension funds reliant on dividend payouts, would become more cautious about investing in red chips.

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