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China Strengthens Scrutiny over Tax Treatment of Equity Transfers by Individuals
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On December 7, 2014, the State Administration of Taxation of China (SAT) promulgated the *Administrative Measures for Individual Income Tax on Equity Transfer Incomes (for Trial Implementation)* ("**Circular 67**"). Circular 67 became effective January 1, 2015.

Circular 67 establishes a basic legal guideline for individual income tax ("**IIT**") collections and reporting requirements, which would apply when individual shareholders transfer equity interests in Chinese companies to any other party. It also clarifies various regulations with respect to individual shareholders transferring equity interests, including an itemized list of equity transfer scenarios, the assessment of equity transfer income, the valuation of equity interests, and tax reporting formalities relating to these equity transfers.

Broad definition of "Equity Transfer"

For purposes of Circular 67, the term "equity transfer" refers to various scenarios of transactions relating to the transfers of equity interests, including redemptions of equity by a company, compulsory transfers of equity by judicial or administrative bodies, equity transfers in connection with non-monetary transactions, and equity transfers to offset debt. However, Circular 67 does not apply to stock transfers of companies that are listed on the Shanghai or Shenzhen Stock Exchanges, so long as those stocks are acquired from the public market.

Assessment of Equity Transfer Incomes

According to Circular 67, payments that are obtained by the transferor of equity interests, including cash, assets, rights and interests, rights to liquidated damages, and other forms of compensation are categorized as "equity transfer income". Applicable tax authorities may also determine the amount of equity transfer income upon verification in the event that the equity transfer income is declared "significantly" and "unjustifiably" low (with certain itemized definitions respectively). Circular 67 also provides methodologies in verifying and assessing taxable income derived from transactions relating to equity transfers.

Valuation of Equity Interest

Circular 67 also provides detailed methodologies for valuating equity interests in different scenarios, including stock acquired by contributions in cash or contribution in kind, stock transferred from certain parties at no cost (e.g., family members), or stock converted from capital surplus, surplus reserves or retained earnings, among other circumstances.

Tax Reporting Requirements

In addition, Circular 67 imposes pre-transfer, post-transfer, and periodic tax reporting requirements on the transferor, the transferee, and the company that the equity interests apply to.

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Circular 67, being the most recent legislative guideline in China's new round of IIT reform commencing from 2011, is anticipated to increase the tax scrutiny of personal investments of high-income individuals. Failure to report and pay such income taxes in these types of equity transfer transactions may cause a variety of post-closing liabilities on both the seller and the purchaser. It is thus particularly important for foreign parties doing business in China to consider including appropriate tax indemnification and covenants in their stock/equity purchase agreements with individual Chinese sellers in order to address and mitigate these potential risks.

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