Company to Transfer Property Title in China and Tax Implications

Description

Recently a corporate client from Canada hired us for legal advice in its attempt to transfer a piece of residential property owned by its China subsidiary entity to one of its employee under an incentive plan that has been executed some 15 years ago.

The China subsidiary bought the properties 15 years ago in Beijing and at the same time, entered into a gift contract with a key employee to the effect that if the employee would continue to work for the China business for 15 years, then the company will transfer the title of the property to the employee for free then. Now 15 years have passed, and the employee has been with the China subsidiary till now.

But the problem is now that the property value has soared 20 times more than its original purchase (up to RMB 10 million) price over the 15 years, which was definitely not foreseen at the time of the parties coming to that gift contract.

While there is a legal way for the employer to back out of the deal based on Chinese laws and the contract terms (sorry, cannot disclose the details), nonetheless, the boss of the USA parent company decided to keep its China subsidiary's promise. Good people indeed!

So what are the options for the company to transfer the property to the employee under Chinese laws? and what are the tax implications?

I. Gift

As it was initially intended, the company can execute the gift contract and transact the title transfer as a gift. In this case, the following taxes will be incurred by the company and the employee:

For the Company:

(1) Enterprise income tax. Seems pretty odds though, yes, the enterprise income tax is levied here under China Enterprise Income Tax Law where it says that gifts made by companies shall be deemed as sale, and thus subject to the income tax based on the fair value of the asset.

(2) Land Value Added Tax. This can be a huge burden on the transaction indeed. In the case of gift, land VAT is also imposed. Land VAT is only exempted in the case of gift between individuals of family members of next of kin.

(3) VAT (whose precedent is Business Tax)

The same logic applies here such gift between a company and an individual is deemed as sale, therefore VAT is levied as well.

(4) Stamp duty.

For the Employee:

(1) Deed tax: 3% of the property fair market value;

(2) Individual income tax: 20% of the property fair market value;

(3) In the future, if the employee sells the property, he may be paying another 20% of income tax, unless exempted according to tax rules, and also he will be paying VAT tax as well based on the full sale price.

So does not seem a good option indeed.

2. Paper Sale

By a paper sale, I mean a fake sale where there is no real money paid to the seller.

In this case, the seller company will be paying the same taxes as listed above and the employee buyer will benefit a lot from such an arrangement in terms of his tax burden. He will be paying deed tax only: depending on his conditions, if this is the first property he owns, then his deed tax is 1.5% of the property value;

As it is a sale, employee needs not to pay the 20% income tax. In the future, when he sells his property, he will be paying normal income tax, and the VAT tax will be based on the difference of the sale price and the purchase price (as indicated in the paper sale contract) instead of the full sale price.

Apparently, this is a good arrangement for the employee.

3. Contribution in Kind into a Company

The client apparently had some positive experience back in the States in structuring the property transfer in the form of capital in kind contribution into a company incorporated. They inquired whether this can be a good option in China.

Well, yes, it used to be but at this time of the post, sorry no.

It is true that before the tax reform of transition of business tax to VAT, when a piece of real property is contributed by an investor into a company (limited liability company) as capital in kind, both business tax (now VAT) and Land VAT were not required to be paid at the time of capital contribution. Then the shareholder who contributes the property to the company can then transfer his shares in the company whereby there are generally not many taxes at all.

But ever since the tax reform which has resulted in the repeal of the China business tax just last month (November 19), those tax benefits are taken away. Capital contribution in kind is now more often considered as a real sale whereby the investor transfers his real estate to a company in exchange for payment in the form of corporate shares. This is indeed unfair taxation on the investor. In a strict legal sense, the contribution in kind does not really transfer the ownership of the in kind capital, and the company is holding the asset title on trust for shareholders only.

However, given the recent efforts of China government to encourage private investment, favorable tax treatments are now available:

(1) just this March of 2018, China tax authority has issued a new notice exempt companies from paying deed tax when real estate properties are contributed as capital by shareholders;

(2) land VAT in the case of real estate property capital contribution into companies has been exempted till end of 2017. Though new policy has not been announced, it is very expected that this policy will be continued.

For more information on land VAT, please refer to another post.

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