

# News Flash

## China Tax and Business Advisory

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Our M&A Processes and Solutions ("MAPS") team is a leading service provider for M&A tax services in China market. Nationally our team comprises more than 100 full-time tax professionals in Beijing, Shanghai, Guangzhou, Shenzhen and Hong Kong. Throughout the deal process, MAPS team specialists could assist in performing buyer and vendor tax due diligence reviews and advising on tax efficient acquisition models. We also advise our clients on tax efficient investment holding structures and operation models. Whilst the Chinese tax authorities increasingly question the tax residency and qualification of foreign investors in claiming tax treaty benefits, our MAPS team helps our clients clarify with the Chinese tax authorities for their eligibility and perform the relevant application procedures.

## Getting Ready for the New Tax Implementation Rules for Corporate Restructuring

The Detailed Implementation Rules<sup>1</sup> ("DIR") to the China's Corporate Income Tax Law ("CIT Law") provides a general position that where an enterprise undergoes a corporate restructuring, it has to recognise the gain or loss resulting from the transfer of the relevant assets at the time of the restructuring and the tax basis of the relevant assets shall be revised according to the transaction prices, unless it is otherwise prescribed by the Ministry of Finance ("MOF") and State Administration of Taxation ("SAT"). At a first glance, this new tax rule seems to be stricter than the previous tax treatments adopted under the former tax regime before 2008. More importantly, it has been a challenge for taxpayers who have undergone corporate restructuring in 2008 to report the transactions for tax, because up to now the MOF and SAT have not issued any implementation rules on how taxable gains or losses on a corporate restructuring should be calculated or whether any concessionary treatments are available to corporate restructuring.

This Issue of our News Flash is to preview what will be the likely directions of the upcoming tax implementation rules for corporate restructuring in China.

### Recap of Former Tax Policies

Under the former China's Foreign Enterprise Income Tax ("FEIT") regime, there were a number of tax policies, such as GuoShuiFa [1997] No.71 ("Circular 71") and GuoShuiFa [1997] No.207 ("Circular 207"), addressing tax treatments for corporate restructuring. Circular 71 provided a detailed guideline on FEIT treatments with respect to corporate merger, spin-off, share restructuring and assets transfer. Circular 207 further allowed a foreign corporate investor to transfer its equity interest in a foreign investment enterprise ("FIE") to a 100% related enterprise at cost if the commercial-purpose test could be met. These two circulars were seen by many FIEs and their foreign investors as favourable tax policies. However, in principle, all these circulars and the favourable tax treatments contained therein are no longer valid when China's new CIT Law came into effect on 1 January 2008.

Besides the general position mentioned above, the DIR does not provide any further guidelines on what constitutes corporate restructuring and their tax treatments, and whether any concessionary tax treatments would be available to any qualified corporate restructuring. It simply defers all these to the implementation rules to be formulated by the MOF and SAT. However, up to now, the implementation rules still have not been released. Such rules are of vital importance to taxpayers who had undergone corporate restructuring during 2008, and are required to report these transactions in their annual CIT filing which is due by the end of May 2009 (subject to local variations).

<sup>1</sup> Article 75 of the DIR to CIT Law.

## Preview of New Tax Implementation Rules for Corporate Restructuring

We understand that the MOF and SAT have been formulating the rules since the middle of 2008. There have been several rounds of discussion drafts circulated to local-level tax bureaus, scholars, professional practitioners and some other selected groups for feedbacks and comments. We are given to understand that the rules are now in the finalisation stage and are expected to be issued in the near future.

In the final implementation rules, the following areas are likely to be covered:-

### **Types of corporate restructuring**

The types of corporate restructuring subject to the tax rules will be defined to cover the following:

- Share or assets acquisition
- Merger
- Spin-off
- Debt restructuring
- Change of legal form
- Liquidation

### **Basic tax treatments for corporate restructuring**

As a rule of thumb, gains or losses of all corporate restructuring shall be subject to CIT at the time of the transactions as per Article 75 of the DIR. Also, it is reasonable to expect that fair value needs to be used to determine the gains or losses as well as the taxation basis for the transferee who receives the shares/equity or assets. For liquidation, the profit or loss of assets distributed to the shareholders would likely be determined based on their realisable or traded values.

### **Special tax treatments for prescribed corporate restructuring**

The implementation rules would likely allow concessionary tax treatments (which may be called “special tax treatments” in the final rules) where certain prescribed conditions are met. In general, for the transferor, the realisation of the gain or loss arising from the corporate restructuring for tax purposes may be deferred wholly or partly, and the resulting tax liabilities may be effectively deferred (generally called the “tax-deferral treatment”). Correspondingly, the transferee shall assume the transferor’s original tax basis of these assets.

The conditions for qualifying for special tax treatments may include:

- The restructuring has to have reasonable commercial purpose;
- The change in the corporate structure, equity interests or assets involved has to reach certain prescribed level of significance to the transferor or transferee;
- The consideration has to be mainly share or equity and the portion of share or equity consideration has to exceed a certain prescribed percentage of the total consideration;
- No change in the original operating activities within a prescribed period of time after the restructuring;
- Share or equity acquired after the corporate restructuring shall not be transferred within a prescribed period of time.

### **Special tax treatments for cross-border corporate restructuring**

Based on our recent discussions with the SAT, we are given to understand that tax-deferral treatment for cross-border corporate restructuring may be possible but with more stringent requirements with emphasis on the shareholding relationship as well as the preservation of Chinese taxing rights.

### **Effective date of the implementation rules**

It is likely that the effective date of the new implementation rules will be retrospective to 1 January 2008, i.e., to align with the effective date of the new CIT regime. This should be a relief to those taxpayers which have undergone corporate restructuring on or after 1 January 2008 that would qualify for the special tax-deferral treatment; otherwise they would be taxable upon the restructuring as per Article 75 of the DIR.

## PwC Observations

Based on the various discussion drafts and the overall evolvement of the implementation rules, we have the following observations:

- This set of tax implementation rules comes out at an appropriate time as corporate restructuring would usually become more popular and necessary in difficult economic times. However, it should be more helpful to taxpayers if it could

have come out earlier so that the taxpayers could have more time to deal with the tax issues arising from their corporate restructuring in their annual CIT filings.

- It is apparent that the Chinese tax policy-makers have taken a significant amount of time to prepare these rules for several reasons. Firstly, the Chinese tax policy-makers realised that corporate restructuring is of vital importance to the business world, and the associated tax rules could influence corporate restructuring decision. In some cases, the deals may be called off just because of the tax implications. Secondly, corporate restructuring is in no way straight forward, and so are the associated tax treatments. Disputes between local-level tax bureaus and taxpayers could easily arise if the tax rules are not clear and comprehensive. Finally, the Chinese tax policy-makers also believe that taxpayers may undergo corporate restructuring deliberately for tax avoidance purposes. It is therefore very important for them to be extremely careful in drafting the relevant tax implementation rules.
- We note that most of the policies in the implementation rules are quite similar to widely adopted international tax practices, with some variations to suit China's particular situations.
- One of the key features of the implementation rules attracting much attention is the special tax treatments. Likely, the final version of the implementation rules would allow special tax treatments, i.e. whole or partial tax deferral, if certain prescribed conditions are fulfilled. We note that those conditions are also generally applied in international tax practices in other tax jurisdictions.
- We note that it has been a significant concern of the Chinese tax policy-makers on whether special tax treatment, i.e. tax deferral, should be granted to cross-border corporate restructuring. Some officials took the view that corporate restructuring may offer loopholes to aggressive tax avoidance planning which would shift the taxable gains, and thus source of tax to outside of China. As a compromise, the final rules would probably still allow tax deferral treatments but limiting that to only a few types of cross-border corporate restructuring, and the application would not be as lenient as the former tax policies under the FEIT regime, such as Circular 207.

It is imperative for taxpayers which have undergone or are planning a corporate restructuring to stay tune for the development of these tax implementation rules. We will closely follow the development and share with you further details and insights in due course.

In the context of this News Flash, China or the PRC refers to the People's Republic of China but excludes Hong Kong Special Administrative Region, Macao Special Administrative Region and Taiwan Region.

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