

News Flash

China Tax and Business Advisory

May 2009 | Issue 11



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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.

Promulgation of new China tax implementation rules for corporate restructuring

In general, the purposes of companies undergoing corporate restructuring are multiple, namely achieving operational efficiency, raising funding, streamlining corporate structures, enhancing business objectives, etc., and the forms of the corporate restructuring also vary. In the good times, many business expansions take place via corporate restructuring; equally in the economic downturn, corporate restructuring is also commonly used in streamlining operation to improve efficiency.

The China Corporate Income Tax ("CIT") regime has yet to provide a very comprehensive tax rules to address corporate restructuring. The Detailed Implementation Regulations ("DIR") to the China's CIT Law merely stipulates that, where an enterprise undergoes a corporate restructuring, it has to recognize 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").

We reported in the April 2009 Issue 10 of our News Flash about the upcoming set of new tax implementation rules for corporate restructuring and their likely directions. The MoF and SAT finally jointly released the rules for corporate restructuring ("Restructuring Rules") under the Notice entitled "Several Questions about CIT Treatments for Corporate Restructuring" -- Caishui [2009] No. 59, on 30 April 2009.

In this Issue, we will summarize the salient points of the Restructuring Rules, and highlight the key features of the Restructuring Rules for our clients to appreciate them and take necessary actions:

Salient points of restructuring rules

Forms of restructuring covered

As mentioned in our last News Flash, the Restructuring Rules cover and define each of the following forms of restructuring which will be subject to the tax treatments set forth in the Rules:

- **Changes in legal form** – an enterprise undertaking simple changes such as change of registered name, registration address within China and enterprise type, etc.. Generally, there will be no tax consequences. However, the Rules specifically address the situations where the registration address is changed to overseas or where the legal person status of an enterprise is changed to a non-legal person status such as a sole proprietorship enterprise or partnership enterprise. In those situations, the enterprise would be

subject to tax according to the liquidation rules¹.

- **Debt restructuring** -- a debtor being in financial difficulty and the creditor making a concession on the debt according to an agreement with the debtor or a written court ruling.
- **Equity acquisition** – an enterprise using equity or non-equity payment or a combination of both to acquire the equity of another enterprise for the purpose of controlling the latter-mentioned enterprise.
- **Asset acquisition** – an enterprise using equity or non-equity payment or a combination of both to acquire the assets of another enterprise.
- **Merger** – one or more enterprises (“enterprises being merged”) transferring its or their entire assets and liabilities to another existing enterprise or a newly established enterprise (“merged enterprise”), with the shareholders of the “enterprises being merged” obtaining the shares in the merged enterprise or non-equity payment in return, and consequently resulting in the merger of two or more enterprises.
- **Spin-off** – an enterprise (“enterprise being spun-off”) splitting and transferring its assets partially or entirely to existing or newly established enterprises (“spin-off enterprise”), with the shareholders of the “enterprise being spun-off” obtaining the shares in the spin-off enterprise or non-equity payment in return; and consequently resulting in the spin-off of the enterprise.

General tax treatments

The general principle is that enterprises undergoing corporate restructuring should recognize the gain and loss from the transfer of the relevant assets and/or equity at fair value when the transaction takes place, and the tax basis of the relevant assets in the hands of the transferee should be revised according to the transaction prices. The Restructuring Rules, based on such general principle, provide the detailed tax treatments for each of the above types of designated corporate restructuring.

In summary, the tax consequences to the parties involved in the corporate restructuring are instantly recognized.

Special tax treatments

However, the Restructuring Rules allow that if some prescribed conditions are satisfied, then it is possible for the parties involved in the corporate restructuring to opt for special tax treatments.

Prescribed conditions

The Restructuring Rules allow special tax treatments for corporate restructuring that fulfils all of the five following conditions:

1. The corporate restructuring has to have reasonable commercial reasons and the main purpose of the corporate restructuring is not for tax reduction, avoidance or postponement of tax payment;
2. The equity or assets being acquired, merged or spun-off have to reach a certain prescribed ratio to reflect the significance of the corporate restructuring. In an equity acquisition deal, the equity acquired should not be less than 75% of the total equity of the enterprise being acquired; whereas in an asset acquisition deal, the assets acquired should not be less than 75% of the total assets of the enterprise that transfers out the assets;
3. No change in the original actual business activities within 12 consecutive months after the restructuring (“compulsory operating period”);

¹ The tax rules for corporate liquidation are addressed under another MOF / SAT Notice entitled “Several Questions about CIT Treatments for Corporate Liquidation”, Caishui (2009) No. 60, on 30 April 2009.

4. The deal consideration should mainly comprise of equity (or shares) and the portion of equity-payment has to exceed 85% of the total consideration. In other words, the non-share equity (commonly known as “Boot” which includes cash, bank deposits, receivables, tradable securities, inventories, fixed assets, other assets and undertaking of liabilities, etc.) cannot exceed 15% of the total consideration; and
5. The original shareholder who received the equity-payment on the corporate restructuring has to commit not to transfer those equity received within 12 consecutive months after the corporate restructuring (“compulsory holding period”).

▪ **Special tax treatments -- tax deferral**

For a corporate restructuring that satisfies all the abovementioned conditions, the parties involved may elect for special tax treatments which are essentially a tax deferral treatment. It is important to note that this is not compulsory for the parties involved to use the special tax treatments. Rather, it is their choice.

The general principle is that the recognition of gain or loss of the transferor on the transfer of assets or equity (shares) can be deferred with respect to the equity-payment portion; and the transferee shall take over the transferor’s tax basis of the transferred assets or equity (shares).

However, the transferor still has to recognize any taxable gain or loss with respect to the Boot portion, where relevant, which is calculated as follows and with the tax basis of the relevant assets adjusted accordingly:

$$\left(\begin{array}{l} \text{Fair value of} \\ \text{transferred assets} \end{array} - \begin{array}{l} \text{Tax basis of} \\ \text{transferred assets} \end{array} \right) \times \frac{\text{The amount of Boot}}{\text{Fair value of transferred assets}}$$

In addition, under a merger or spin-off, the enterprise receiving the assets on the merger or spin-off will assume the original tax basis of these assets and liabilities of the transferor.

The rationale behind allowing special tax treatments (tax deferral by not recognizing the gains or losses at the time of the transactions) is to assist enterprises in undergoing structuring where the main consideration is equity-payment. Since it is almost a non-cash transaction, if tax is imposed upfront in the course of the corporate restructuring, the enterprises involved would have difficulty in settling the tax liabilities, and it may deter them from undergoing corporate restructuring for genuine commercial purposes. On the other hand, for corporate restructuring which involves substantial cash (or cash equivalents) payments, it is unnecessary to provide such tax concession as the parties involved should have sufficient cash for the tax payments.

Apparently, the core substance of special tax treatments is not tax exemption or any kind of preferential tax concessions by nature. The recognition of taxable gain or loss is deferred and the intrinsic tax liabilities may actually be passed over to the transferees.

▪ **Cross-border corporate restructuring**

It is good news to taxpayers that special tax treatments are also available to cross-border corporate restructuring under the Restructuring Rules. However, it is only limited to the following specific types of cross-border corporate restructuring:

Type 1. A non-tax resident enterprise (“non-TRE transferor”) transferring the equity interest in a tax resident enterprise (“TRE”) to another non-TRE (“non-TRE transferee”) which it has a 100% direct ownership. Moreover, such transfer will not result in changes in the withholding tax burden on the capital gains arising on the subsequent transfer of the equity interest of the TRE in the hands of the non-TRE transferee; and the non-TRE transferor undertakes not to transfer the equity of the non-TRE transferee within 3 years after the transfer of the TRE;

Type 2. A non-TRE transferring the equity interest in a TRE to another TRE which it has a 100% direct ownership;

Type 3. A TRE using its assets or equity investment to invest in a non-TRE which it has a 100% direct ownership, and the special tax treatment available is the allowance of spreading the gain on the transfer of assets or equity investment to taxable income over a period of 10 years. This is a tax deferral as well. However, for this Type, the Rules require the gain to be recognized upon the deal but provide a concession for the gain to be subject to tax on a prescribed deferral basis.

Type 4. Other circumstances that are approved by MOF and SAT.

It is obvious that Types 1 and 2 are for inbound-China investments, whereas Types 3 is for outbound-China investments. Type 4 is simply a “window” allowing flexibility to the authorities to address any special situations which are not considered under the current Rules. However, since approval from MOF and SAT will be required, the application process could be difficult and lengthy. Nevertheless, it should still be very helpful to many taxpayers whose corporate restructuring do not fall under any of the three specific types, to raise their particular scenarios to these authorities for consideration.

Please also note that even if the cross-border corporate restructuring falls into one of the above specific types, it still has to fulfill the five prescribed general conditions for special tax treatments mentioned above before the parties involved in the corporate restructuring can elect for special tax treatments.

Other important features

There are other important features which are worth-noting in the Restructuring Rules.

- **Treatment of tax loss and “ring-fencing rule”**

In the case of a merger not qualifying for special tax treatments, the unutilized tax losses of the enterprise(s) being merged will lapse and will not be available for use by the merged enterprise. Where the special tax treatments are available to the qualified merger, the tax losses can be carried over to the merged enterprise. In order to deter the abusive use of tax losses by acquiring and merging a “loss-rich” company by a profitable company, the “ring-fencing rule” is introduced in the Restructuring Rules to limit the utilization of losses on mergers. Under the current “ring-fencing rule”, the amount of tax losses of the enterprise(s) being merged that can be utilized by the merged enterprise in a given year is restricted by the following formula:

$$\begin{array}{l} \text{Fair value of the net} \\ \text{assets of the enterprise} \\ \text{being merged} \end{array} \quad \times \quad \begin{array}{l} \text{Interest rate of the longest term treasury} \\ \text{bonds issued by the State as at the end} \\ \text{of the year of the merger} \end{array}$$

In the case of a spin-off not qualifying for special tax treatments, the unutilized tax losses of the enterprise being spun-off have to remain in that enterprise and cannot be carried over to and utilized by the other spin-off enterprises. However, where the special tax treatments are available to the qualified spin-off, the unutilized tax losses of the enterprise being spun-off may be prorated and shared between all the spin-off enterprises according to the ratio of value of spun-off assets to the value of total assets.

- **CIT profiles / incentives of merged and spun-off enterprises**

The Restructuring Rules also address how to handle the remaining tax incentives of the restructured enterprises in a merger or spin-off. In an absorption merger or a spin-off transaction, the merged enterprise or the spin-off enterprise may continue to enjoy the remaining tax incentives brought forward from the pre-merger and pre-spin-off enterprises prior to the corporate restructuring, provided that the nature of the restructured enterprises and the conditions for enjoying the tax incentives remain unchanged. However, there are limits for such tax incentives.

- **Multiple-step corporate restructuring**

The Restructuring Rules also allow corporate restructuring with multiple-steps undertaken within a 12-month period to be assessed as one single restructuring transaction under the principle of “substance over form”. This would probably simplify the tax implications for many corporate restructuring which are rather complex and time-consuming, e.g. acquisition of a company in stages depending on the company’s earnings reaching a certain agreed amount.

- **Effective date of the restructuring rules**

The Restructuring Rules are made retrospectively to 1 January 2008, same as the effective date of the CIT Law and its DIR. This is reasonable in the sense that if the Restructuring Rules were only effective from the date on which it is promulgated, there would be a “legislative vacuum” and all corporate restructuring in that interim period would be taxable under the general principle (in accordance with Article 75 of the DIR), regardless of whether or not they qualify for special tax treatments under the Restructuring Rules.

PwC’s observations

- **Close to international practice**

The CIT Law has adopted a lot of international tax concepts, such as, controlled foreign corporations rules, thin capitalization, general anti-avoidance, etc. The Restructuring Rules are also following most of international tax practice, for instance, allowing the deferral of the recognition of gain or loss on some prescribed qualified restructuring; carry-over of the tax basis of assets transferred; treating multiple-step restructuring undertaken within a certain period as one single restructuring transaction, and having a “ring-fencing rule”.

- **Different from the former tax regimes**

The Restructuring Rules have not inherited the favourable tax treatments provided in a previous SAT Notice -- Guoshuifa [1997] No.71 which, among other things, allowed the deduction of retained earnings and reserves from the transfer consideration in calculating the gain or loss on the transfer of shares / equity interests. Hence, enterprises undergoing restructuring should consider distributing the retained earnings before the restructuring to avoid the potential double taxation, where feasible.

The Restructuring Rules also have not fully adopted the preferential tax treatments provided in another previous SAT Notice -- Guoshuifa [1997] No. 207 which allowed a foreign corporate investor to transfer its equity interest in a foreign investment enterprise to a 100% related enterprise at cost, if the commercial-purpose test could be met. Instead, the Restructuring Rules limit the special tax treatments of tax deferral on cross-border restructuring to only two scenarios, namely (Type 1) transfer of a TRE from a non-TRE to another non-TRE (Type 1); and (Type 2) transfer of a TRE from a non-TRE to another TRE which it has a 100% direct ownership. This would undoubtedly limit the commercial viability of cross-border restructuring which do not fall under these two specific types of restructuring.

- **Unclear issues**

While the Restructuring Rules have provided a clearer picture of the tax implications, there are yet a number of unclear issues for corporate restructuring. Just to name a few important ones below:

- How will “commercial reasons” and “main purpose” being one of the conditions for special tax treatments be assessed? Would it be determined on a case-by-case basis with all facts and circumstances being considered? Should the Restructuring Rules be considered under the General Anti-Avoidance Rule (“GAAR”) perspective as the main purpose test under the first condition is no different than that under the GAAR (Article 120 of the DIR)?
- One of the conditions for special tax treatments is the compulsory operating period (the continuity of original actual business activities for a period of 12 consecutive months after the restructuring). Will there be any

exception if the enterprise has to change its original business operation because of changes in market condition (valid commercial reason)?

- Is it really practical to impose the 12-month compulsory holding period for a corporate restructuring which are for the purpose of overseas IPO or private placement?
- If those prescribed conditions for special tax treatments are breached eventually, for instance the 12-month compulsory operating period and the 12-month compulsory holding period, etc., would it become taxable immediately? If so, at what value -- the prevailing fair value at the time of breach or the fair value at the original time of the restructuring transaction?

▪ **Administration**

The Restructuring Rules stipulate that enterprises which have undergone qualified restructuring and are electing special tax treatments have to submit written information to their in-charge tax bureaus for record at the time of filing their annual CIT returns. It is for the purpose of substantiating that the restructuring has met the prescribed conditions for special tax treatments; otherwise special tax treatments shall be revoked. However, the Restructuring Rules have not further elaborated on what kind of written information has to be submitted. We believe that basic information on the restructuring, such as the type of restructuring, parties involved in the restructuring, completion date of the restructuring, basic economic activities involved in the restructuring, explanation on fulfilling the conditions for special tax treatment, tax basis of the relevant assets and liabilities before and after the restructuring, etc., should be provided to the in-charge tax bureaus for record.

Moreover, the Restructuring Rules have only addressed the reporting requirements of a TRE who has to file an annual CIT return. However, it does not mention about the reporting requirements of a non-TRE who is a party to a cross-border restructuring transaction which fulfils the special tax treatment conditions and wishes to elect for special tax treatment.

It must be welcome by taxpayers, both residing in and outside China, to see further guidelines on the compliance requirements to be issued by the SAT or local-level tax bureaus as soon as practical.

▪ **Corporate restructuring completed in 2008**

The Restructuring Rules come out in the last month of the 2008 annual CIT return filing season (to be due on May 2009). We note that there were many corporate restructurings which have taken place during 2008 in the absence of the Restructuring Rules. The prevailing tax treatments adopted at that time may need to be rectified in the annual CIT return with reference to the current Restructuring Rules. This is a very practical issue to those companies which had undergone and completed restructuring in 2008.

We would suggest that companies should study the Restructuring Rules as soon as possible to re-assess the China tax implications of the restructuring completed in 2008.

They should consider whether the restructuring could qualify for special tax treatments as the Restructuring Rules were effective in 2008. If it does qualify, they should also consider whether to elect for special tax treatment which may not necessarily be beneficial. If it does not qualify, then the companies should study the general tax treatments to ensure that the tax consequences of the restructuring will be properly reported in the annual CIT return.

If there was an agreement reached with the local-level tax bureau to temporarily rely on the tax treatments under the former tax regimes until the issuance of the new Restructuring Rules, then the company should go back to discuss with the relevant local-level tax bureau on how to rectify the tax positions.

It is imperative to note that all of these have to be done by the 2008 annual CIT return filing deadline. Obviously, not much time left for the taxpayers.

Conclusion

The penultimate provision of the Restructuring Rules allows the CIT matters in a corporate restructuring which are not specifically addressed in the current Rules to be separately regulated by the MOF and SAT. It is an indication of allowing a flexibility for these authorities to come up with further policies to clarify, adjust, supplement or even change the CIT treatments as provided or not provided in the current Rules.

The new Restructuring Rules represent a milestone in the China tax development. We believe such flexibility is necessary as corporate restructuring usually involve relatively complex transactions.

No matter whether companies may have undergone corporate restructuring before the promulgation of the Restructuring Rules and hence need to rectify the tax positions in 2008 annual CIT return filing, or are about to go through a corporate restructuring, they have to stay tune for the developments of these new Restructuring Rules, not only the policies or interpretation from the MOF and SAT, but also the local implementation rules and practice.

In the next few issues of our News Flash, we will discuss the tax treatments for each type of restructurings in greater detail, and share our observations and insights drawn from these rules. In the meantime, we will be holding a webcast on the Restructuring Rules. If you are interested, please follow this link (http://www.pwchk.com/home/eng/webcast_cn_corp_reorg_may2009.html) to register for the webcast.

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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