



Mergers & Acquisitions in China: Some Current Tax Issues

By **Matthew McKee**, Senior Foreign Legal Counsel (Beijing)

Introduction

Tax considerations are a critical factor in China, as in any jurisdiction, in determining the form that mergers and acquisitions will take. Recent developments in Chinese tax law have challenged some of the traditional tax structures utilized by foreign investors for acquisitions in China. This has led to a need to review and alter some of structures adopted in the pre-2008 tax environment. The significant changes to China's tax law and regulations that impact upon M&A deals include:

1. The introduction of a general anti-avoidance rule and repeated indications by the State Administration of Taxation that they intend to aggressively utilize it to target off-shore transactions;
2. The introduction of thin capitalization rules limiting the allowable debt to equity ratio;
3. Increased requirements for transfer pricing;
4. Introduction of new specific M&A and liquidation tax rules;
5. Recent DTA interpretations by the State Administration of Taxation placing considerable doubt upon previously conceived tax benefits obtained from incorporating special purpose vehicles in particular low tax jurisdictions.

Accordingly, in the context of this environment it is timely to take a step back and undertake a cursory glance of the application of tax to M&A transactions in China.

M&A Rules

In June 2009, the Ministry of Finance and the State Administration of Taxation issued a Notice on Enterprise Income Tax Treatment of Enterprise Reorganisations (Caishui [2009] No. 59) (the "**M&A Rules**"). The M&A Rules potentially apply to any "enterprise reorganizations", which includes mergers, demergers, share acquisitions and asset acquisitions.¹ Importantly, the M&A Rules distinguish between "ordinary reorganisations" and "special reorganisations". The essential difference between an ordinary reorganization and special reorganisation is that with the latter the taxable gain or loss will generally be deferred - the M&A Rules effectively roll-over tax liability in respect of special reorganisations.

Special Reorganisations

Under the M&A Rules, a reorganisation will be a "special reorganisations" where:²

1. The reorganization has a bone fide commercial purpose and is not implemented to reduce, exempt or defer any tax.
2. The assets or equity transferred in the acquisition is above the prescribed criteria, which is 75%.³

¹ Notice of the Ministry of Finance and the State Administration of Taxation issued on Enterprise Income Tax Treatment of Enterprise Reorganisations (Caishui [2009] No. 59) (hereinafter the "M&A Rules").

² M&A Rules, Article 5.



3. The original business of the enterprise remains unchanged during the 12 month period following the reorganisation.
4. The equity consideration is at least 85% of the total consideration.⁴
5. The main shareholder receiving the equity consideration cannot transfer that equity consideration acquired within 12 months after the reorganization.

Certain cross-border transactions will be entitled to “special reorganization” relief, notwithstanding that they do not satisfy the conditions above, including:

1. where a non-resident enterprise transfers shares in a Chinese company to a 100% owned subsidiary company, regardless of whether the acquiring company is a resident company or not.⁵ In respect of a transfer to a non-resident company, the transfer must not result in a lower rate of capital gains withholding tax applying.⁶
2. A resident enterprise invests in its 100% directly owned non-resident enterprise in the form of assets or equity interests.

As can be seen, the special reorganization treatment effectively provides rollover relief for certain forms of reorganization where, in essence, the underlying owner/s has not changed. It is important to note that any non-equity portion of consideration will not be rolled over but rather a taxable gain will arise immediately in respect of that portion.⁷

Acquisitions

Like with most legal jurisdictions, foreign investors are permitted to acquire a domestic Chinese company in one of two ways; by acquiring the shares or equity in the company (a “**share deal**”) or by forming a new company and acquiring the assets of the company (an “**asset deal**”).⁸ This is subject to China’s foreign investment catalogue which prevent or restricts foreign investment in certain industries.

Share Deals

Under the Enterprise Income Tax Law⁹ (“**EITL**”) and the Implementation Rules of the Enterprise Income Tax Law¹⁰ (the “**Implementation Rules**”), the difference between the purchase price (or the

³ Ibid, Articles 6(2) & 6(3)

⁴ Ibid, Articles 6(2), 6(3), 6(4) & 6(5).

⁵ Ibid, Articles 7(1) & 7(2).

⁶ Ibid, Article 7(1)

⁷ Ibid, Article 6(6).

⁸ The Interim Provisions on the Takeover of Domestic Enterprises by Foreign Investors (Order No 10)

⁹ Enterprise Income Tax Law (promulgated by the Standing Comm. Nat’l People’s Cong., Mar. 16, 2007, effective Jan. 1, 2008) 2007 *Standing Comm. National People’s Congress Gaz No. 63* (PRC) (hereinafter “*Enterprise Income Tax Law*”),

¹⁰ The Implementation Rules of the Corporate Income Tax Law (promulgated by the Standing Comm. Nat’l People’s Cong., Dec. 6, 2007, effective Jan. 1, 2008) *State Council Gazette No. 512* (2007) [hereinafter *Implementation Rules*]



arms-length value where the consideration is something other than cash) and sale price of a share is taxable in China at the time of realization.¹¹ The M&A Rules go further and provide that the tax basis of equity or assets will be the “fair market value”.¹² Where the relevant shareholder is a foreign enterprise, the tax rate on a share transfer is 10 per cent.¹³

As with any jurisdiction, aside from tax, determining whether to pursue a buyout by way of share acquisition will be contingent upon commercial and regulatory considerations. A share deal will see a continuation of the existence of the legal entity meaning that liabilities will be inherited with the target company. Further, it will not always be possible to pursue a share acquisition because of restrictions on foreign ownership of domestic enterprises, for example, it should be noted that there are particular restrictions with respect to the acquisition of shares in listed Chinese companies. As such, tax will just be one issue amongst many in determining the appropriate approach to acquiring a business in China.

Where the conditions for “special reorganisation” are satisfied in respect of an equity purchase, the tax base of the acquired shares or equity will be same as the seller’s original tax base in the shares. Effectively, this means that no taxable gain will arise, but also that the seller’s original purchase price will be used as the tax basis for any future sale of the shares or equity. Further, the buyer inherits the seller’s tax attributes in respect of assets and liabilities.

Tax issues relevant particularly relevant to a share acquisition include:

1. The sale price of the transfer of shares is subject to Stamp Duty of 0.1%;¹⁴
2. The buyer’s acquisition expenses cannot be deducted by the target company post-purchase as there is no basis on which to allocate such expenses to the company;
3. The buyer will inherit the target company’s tax cost in any underlying asset of the company;¹⁵
4. Interest expense incurred in respect of loans taken out to acquire shares is not deductible but rather such expenses will be capitalized into the costs of the asset;¹⁶
5. A share transfer will not be subject to VAT or Business Tax; and
6. The target company’s losses may be carried forward for five years.¹⁷

The following figures provide an illustration of the different tax consequences for a share acquisition

¹¹ Enterprise Income Tax Law, Article 6(4); also see the Implementation Rules, Article 17.

¹² M&A Rules, Article 4(3)(i).

¹³ Enterprise Income Tax Law, Articles 3(3) & 27(5); Implementation Rules, Article 91.

¹⁴ Provisional Rules of the People’s Republic of China on Stamp Duty, (Order the State Council of the People’s Republic of China (No.11)), Article 2.

¹⁵ M&A Rules, Article 4(3)(ii).

¹⁶ Implementation Rules, Article 28.

¹⁷ Enterprise Income Tax Law, Article 18.



that is an ordinary reorganization and one that is a special reorganization.

Figure 1. - Share acquisition that is an ordinary reorganization

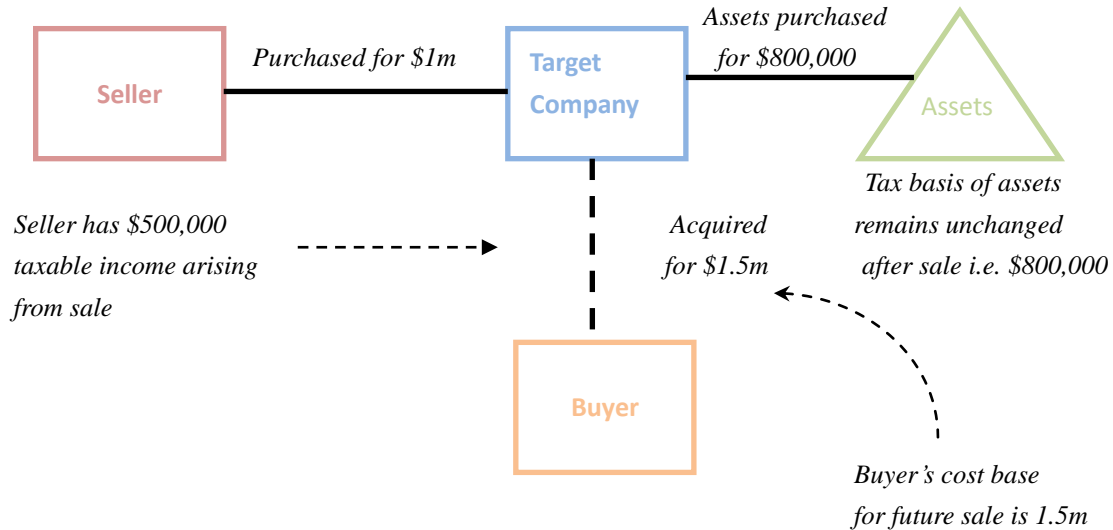
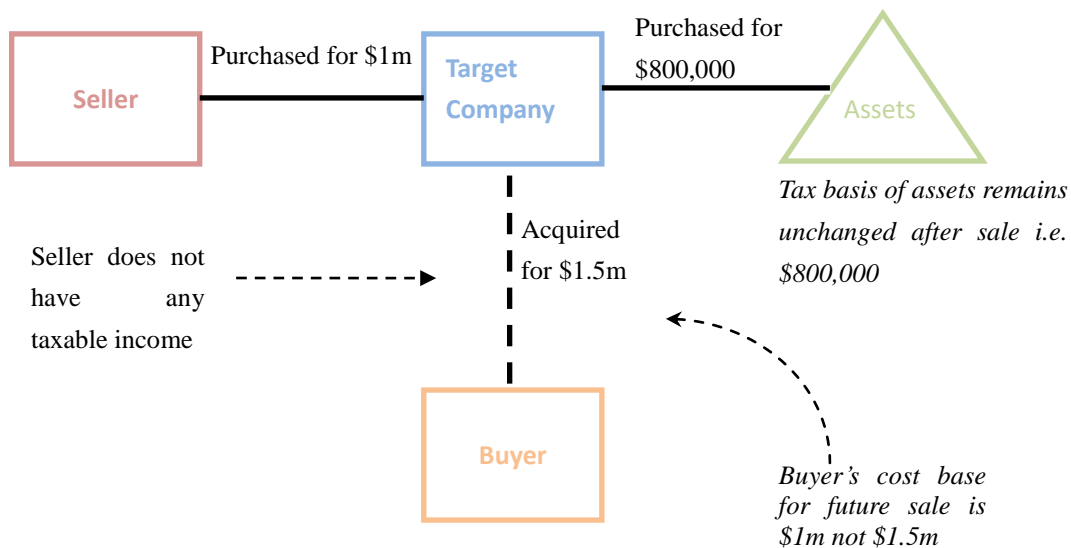


Figure 2. - Share acquisition that is a special reorganization



Asset Deals

Accretions in the value of assets are taxable at the time of realization of the asset.¹⁸ As with shares, such gains will be taxed at 10% for foreign enterprises. An asset acquisition will generally require the establishment of a PRC acquisition vehicle (New Co) as foreign companies cannot operate assets directly in China.¹⁹ As with most jurisdictions, the primary reason for an asset acquisition is the

¹⁸ Enterprise Income Tax Law, Article 6(3) and Implementation Rules, Article 16.

¹⁹ The Interim Provisions on the Takeover of Domestic Enterprises by Foreign Investors (Order No 10)



minimization of risk as liabilities of the target company will not generally follow the assets, except where such liabilities are attached to assets.

Where the conditions for “special reorganisation” are satisfied in respect of an asset acquisition, the asset transferor’s tax basis in the equity or shares of the asset receiver will remain the same of transferor’s original tax basis in the assets transferred.²⁰ The asset receiver’s tax basis in the assets will remain the same as transferor’s original tax basis in those assets.²¹

Tax issues relevant to an asset acquisition include:

1. The sale price of the transfer of assets is subject to Stamp Duty of between 0.03% to 0.05%.²² The sale of land or real estate is subject to Deed Tax of between 3% to 5%.²³
2. Any interest expenses incurred by New Co in relation to the acquisition of the assets will be capitalized and depreciated over the life of the assets.²⁴
3. The sale of fixed assets will usually be subject to VAT at the rate of 17%²⁵ and intangible assets will usually be subject to business tax of 5%.²⁶ Land Appreciation Tax will also be applicable the assets are land.
4. The buyer will not be able to utilize the losses of the target company.
5. The tax cost of the asset will be the purchase price of the assets.

The additional burden of VAT, Business Tax, Land Appreciation Tax etc seems to suggest that share deals will be preferred from a tax perspective. However, this issue is largely a question of circumstances. In many cases, an asset deal will involve lower costs because of the need to obtain regulatory approval for a share deal. Regulatory approval for an acquisition of equity in a domestic company can take anywhere between 3 weeks to 3 months. Further, where the target company leases its operating premises and does not hold any intangible property, the transactional tax burden may not be significant. Finally, from a commercial perspective, an asset deal will generally require less legal due diligence because liability will usually be limited to the target company.

Mergers

²⁰ M&A Rules, Article 6(3)(i)

²¹ M&A Rules, Article 6(3)(ii)

²² Provisional Rules of the People's Republic of China on Stamp Duty, (Order the State Council of the People's Republic of China (No.11)), Article 2.

²³ Provisional Regulations of the People's Republic of China concerning Title Deed Taxes (Issued on April 23, 1997 and adopted at the 55th Executive Meeting of the State Council on April 23, 1997), Article 3.

²⁴ Enterprise Income Tax Law, Articles 11 & 12; Implementation Rules, Article 28.

²⁵ The Interim Regulation of the People's Republic of China on Value Added Tax (Order of the State Council of the People's Republic of China (No. 538), Article 2.

²⁶ The Interim Regulation of the People's Republic of China on Business Tax as adopted at the 34th executive meeting of the State Council on November 5, 2008 (Order of the State Council of the People's Republic of China (No. 540)), Annexure 1.



A merger is defined under the M&A Rules to refer to a transaction where one or more enterprises (“**merged enterprise**”) transfer all their assets and liabilities to another enterprise (“**merging enterprise**”) so as to achieve a legal merger of the two or more enterprises.²⁷ A merger is distinguished from an acquisition in that the two parties agree to form a single company rather than remain separately owned and operated. Under Chinese law, a merger may occur by way of absorption in an existing enterprise or by establishment of a new enterprise.²⁸ In respect of the former, the distinction between a merger and an assets acquisition will be very marginal in practice and may simply be a question of labeling. Despite this fine distinction, there may be different tax consequences if the transaction is regarded as merger.

A merger that is an “ordinary reorganization” will essentially receive the same tax treatment as an asset acquisition. The merging enterprise’s tax basis of assets and liabilities received from the merged enterprise will be determined according to “fair market value”.²⁹ The tax treatment of the merged enterprise is determined by China’s tax rules relating to enterprise liquidations.³⁰ The tax basis of the merged enterprise’s assets is the realisable value or transaction price.³¹ Importantly, in respect of an ordinary reorganization, the merged enterprise’s tax losses cannot be carried over to the merging enterprise.³²

In respect of a merger that is a “special reorganization, the tax basis of the assets received from the merged enterprise shall be the same as the merged enterprise’s original tax basis in those assets and liabilities.³³ Once again this effectively means that no taxable gain will arise, but also that the seller’s original purchase price will be used as the tax basis for any future sale of those assets. Further, the merging enterprise will inherit the seller’s tax attributes in respect of the assets and liabilities.³⁴ The losses of the merged enterprise may be carried forward, but may only be utilised to an amount equal to the net operating loss (“NOL”).³⁵ The NOL is the amount equal to the fair market value of the merged enterprises assets multiplied by the bond yield of the government bond with the longest maturity term at the end of year that the merger occurred. Finally, in the case of a merger by absorption, any enduring tax incentives of the surviving enterprise may be carried over after the merger. The amount of the incentive is effectively limited to the amount that enterprise would have been entitled to in the year prior to the merger.³⁶

It can be seen then that in respect of a “special reorganisation” it may be preferable, from a tax perspective, to characterise a transaction as a merger rather than an asset acquisition where the target company has significant losses. It would be advisable to utilize a merger by absorption where one of

²⁷ M&A Rules, Article 1(5).

²⁸ Company Law of the People’s Republic of China as amended 1 January 2006 (Order No 42 [2005]), Article 173.

²⁹ M&A Rules, Article 4(4)(i).

³⁰ M&A Rules, Article 4(4)(ii).

³¹ “Notice of the Ministry of Finance and the State Administration of Taxation on Enterprise Income Tax Treatment of Enterprise Liquidation” (Caishui [2009] No. 60, Article 3(1).

³² M&A Rules, Article 4(4)(iii).

³³ M&A Rules, Article 6(4)(i).

³⁴ M&A Rules, Article 6(4)(ii).

³⁵ M&A Rules, Article 6(4)(iii).

³⁶ M&A Rules, Article 9.



the enterprises.

Special Purpose Vehicles

Traditionally, investment has been undertaken in China by interposing an off-shore company or special purpose vehicle (SPV), usually incorporated in a tax haven. Several tax benefits have been ascribed to such a structure. One such tax advantage was that no Chinese tax liability would traditionally have arisen from the sale of an SPV by a foreign enterprise. A further benefit could be obtained if the jurisdiction in which the enterprise was incorporated provided had entered into a double taxation agreement (DTA) with China containing a favourable withholding tax rate, for example the China withholding tax rate for dividends, royalties and interest paid to companies incorporated in Hong Kong is less than most other jurisdictions.

However, recent events have challenged the conventional wisdom in using an SPV as part of a China M&A strategy. The EITL contains a general anti-tax avoidance rule at Article 47 which empowers the SAT to make a tax adjustment where an enterprise enters into an arrangement that has no reasonable business purpose. In a case from late last year, the Chongqing tax authorities, relying on Article 47, disregarded an SPV and taxed the Singaporean parent company for the sale of the SPV, finding that the sale was effectively a direct sale of the Chinese enterprise. A similar finding was made by the Xinjiang tax authorities in an unrelated case with respect to a Barbados SPV. On 9 January 2009, the SAT issued the Implementation Measures for Special Tax Adjustments (for Trial Implementation) (Guoshuifa [2009] No. 2) (“**Circular No. 2**”). Article 94 of Circular No. 2 permits the tax authorities to disregard an enterprise that has no economic substance, and makes specific reference to enterprises established in tax havens. Furthermore, on 27 October 2009 the SAT issued a ‘Notice on How to Understand “Beneficial Owners” in Tax Agreements’ (Guo Shui Han [2009] 601) “Circular 601”) in which it is suggested that it will look-through interposed companies to see who receives the true benefits of income for purpose of determining which DTA, and withholding tax rate, is applicable.

These events suggest that utilization of an SPV may no longer be sufficient to enable an equity transfer to be immune from Chinese tax liability. Further, it seems that entitlement to favourable withholding tax rates under relevant DTAs may no longer be relied upon.

Tax Due Diligence

In any jurisdiction, the due diligence of a transaction is where local factors will be central. Accordingly, it is critical to obtain local counsel to undertake any tax diligence as they will be aware of the issues and practices prevalent. Two of the more current pertinent tax diligence issues in China are as follows:

1. **The existence of two sets of books** – it is unfortunately still not uncommon for companies in China to maintain two sets of books for the purpose of under reporting of profits. Financial considerations aside, this can create tax compliance issues which may be inherited in respect of a share acquisition or merger. This can result in income tax and customs compliance issues for the buyer.
2. **Transfer pricing** – China has recently undertaken a radical revision of its transfer pricing rules.



As such, arrangements which traditionally have been tax compliant may no longer be appropriate. Importantly, China's tax authorities are able to review related party transactions for ten years from the date the transaction occurred.

Financing

Appropriate financing strategies can produce significant tax benefits for a company. The tax efficiency of such strategies are limited in China by the thin capitalisation rules in Article 46 of the EITL which prohibits the deduction of interest payments to a related party where the debt-to-equity ratio exceeds the "prescribed standards. The Notice on the Tax Deductibility of Interest Expense Paid to Related Parties (Caishui [2008] No. 121), provides two prescribed debt to equity ratios; for financial entities the acceptable limit is 5:1 and for non-financial enterprises the acceptable limit is 2:1.

It should be noted that Article 89 of Circular No. 2 appears³⁷ to make provision for the allowance of a deduction if the debt to equity ratio is exceeded, where the taxpayer can demonstrate that the transaction is otherwise consistent with arms length principles. Any financing strategies should take into account the limits created by the thin capitalisation rules.

Conclusion

The above has attempted to provide a cursory examination of the more relevant practical tax considerations commonly found in an M&A deal in China. What should, at the very least, be taken from the paper is that the form or manner of a merger or acquisition may result in significantly different tax consequences. Finally, it is critical to note that the M&A environment in China is being shaped by the radical reform occurring to China's taxation system. Structuring and acquisition options need to reflect these changes.

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For more information on the topics discussed in this briefing paper, please contact our International Tax Services team.

Hwuason Law Firm

Suite 1505, Tower B, Jianwai SOHO,
No 39, East 3rd Ring Road,
Chaoyang District, Beijing
100022, PRC
Tel: 8610-58697282
Fax: 8610-58697292
E-mail: china@hwuason.com
Website: www.hwuason.com

³⁷ Article 89 itself does not explicitly establish such a right. However, it is certainly implicit in the Article that such a right exists. Although, neither the Enterprise Income Tax Law nor the Implementation Rules explicitly create such a right.