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Mergers and Acquisitions in China: Some Current Tax Issues

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Tax considerations are critical 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 used 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 affect M&A deals include:

- the introduction of a general antiavoidance rule and repeated indications by the State Administration of Taxation (SAT) that it intends to aggressively use the GAAR to target offshore transactions;
- the introduction of thin capitalization rules limiting the allowable debt-to-equity ratio;
- increased requirements for transfer pricing;
- introduction of specific M&A and liquidation tax rules; and
- recent treaty interpretations by the SAT placing considerable doubt on previously conceived tax benefits obtained from incorporating special purpose vehicles (SPVs) in particular low-tax jurisdictions.

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

M&A Rules

In June 2009 the Ministry of Finance and the SAT issued 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 reorganizations and special reorganizations. The essential difference between an ordinary reorganization and special reorganization is that with the latter the taxable gain or loss will generally be deferred — the M&A rules effectively roll over tax liability regarding special reorganizations.

Special Reorganizations

Under the M&A rules, a reorganization will be a special reorganization in the following situations:[2]

- the reorganization has a bona fide commercial purpose and is not implemented to reduce, exempt, or defer any tax;
- the assets or equity transferred in the acquisition is above the prescribed criterion, which is 75 percent[3];
- the original business of the enterprise remains unchanged during the 12-month period following the reorganization;

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

[2]M&A rules, article 5.

[3]*Id.*, articles 6(2) and 6(3).

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- the equity consideration is at least 85 percent of the total consideration[4]; and
- the main shareholder receiving the equity consideration cannot transfer that equity consideration acquired within 12 months after the reorganization.

Some cross-border transactions will be entitled to special reorganization relief, even if they do not satisfy the above-mentioned conditions:

- Special reorganization relief is available when a nonresident enterprise transfers shares in a Chinese company to a 100-percent-owned subsidiary company, regardless of whether the acquiring company is a resident company.[5] Regarding a transfer to a nonresident company, the transfer must not result in a lower rate of capital gains withholding tax applying.[6]
- Special reorganization relief is also available when a resident enterprise invests in its 100-percent-directly-owned nonresident enterprise in the form of assets or equity interests.

The special reorganization treatment effectively provides rollover relief for some forms of reorganization when, in essence, the underlying owner has not changed. Any nonequity portion of consideration will not be rolled over but rather a taxable gain will arise immediately regarding that portion.[7]

Acquisitions

As 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 prevents or restricts foreign investment in specific industries.

Share Deals

Under the Enterprise Income Tax Law[9] (EITL) and the Implementation Rules of the Enterprise Income Tax Law[10] (the implementation rules), the difference between the purchase price (or the arm's-length value when 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] When the relevant shareholder is a foreign enterprise, the tax rate on a share transfer is 10 percent.[13]

As with any jurisdiction, aside from tax, determining whether to pursue a buyout via a share acquisition will be contingent on 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, there are particular restrictions regarding the acquisition of shares in listed Chinese companies. As such, tax will just be one issue among many in determining the appropriate approach to acquiring a business in China.

When the conditions for a special reorganization are satisfied regarding 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 regarding assets and liabilities.

Tax issues relevant to a share acquisition include:

- the sale price of the transfer of shares is subject to stamp duty of 0.1 percent[14];
- the buyer's acquisition expenses cannot be deducted by the target company postpurchase, as there is no basis on which to allocate such expenses to the company;
- the buyer will inherit the target company's tax cost in any underlying asset of the company[15];

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[4] *Id.*, articles 6(2), 6(3), 6(4), and 6(5).

[5] *Id.*, articles 7(1) and 7(2).

[6] *Id.*, article 7(1).

[7] *Id.*, article 6(6).

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

[9] Enterprise Income Tax Law 2007 (promulgated by the Standing Comm. Nat'l People's Cong., Mar. 16, 2007, effective Jan. 1, 2008), *Standing Comm. National People's Congress Gaz. No. 63* (P.R.C.).

[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).

[11] EITL, article 6(4); *see also* implementation rules, article 17.

[12] M&A rules, article 4(3)(i).

[13] EITL, articles 3(3) and 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 (the stamp duty rules).

[15] M&A rules, article 4(3)(ii).

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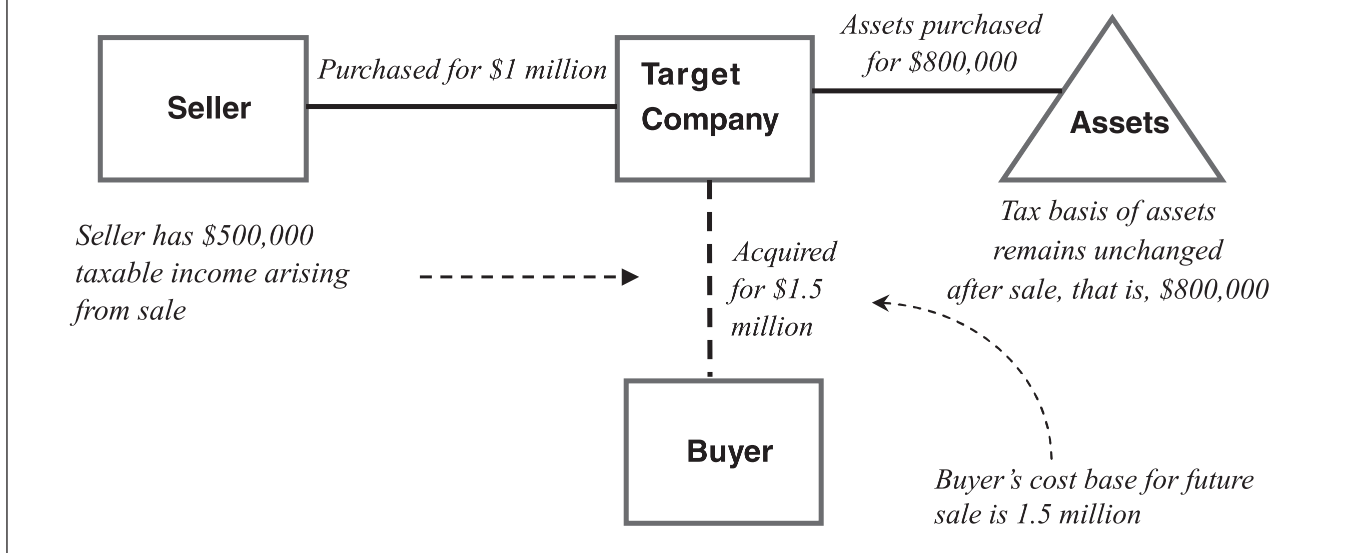

- interest expense incurred regarding loans taken out to acquire shares is not deductible but rather such expenses will be capitalized into the costs of the asset[16];
- a share transfer will not be subject to VAT or business tax; and
- the target company's losses may be carried forward for five years.[17]

The figures provide an illustration of the different tax consequences for a share acquisition that is an ordinary reorganization (Figure 1) and one that is a special reorganization (Figure 2).

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 percent for foreign enterprises. An asset acquisition will generally require the establishment of a P.R.C. 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 minimization of risk because liabilities of the target company will not generally follow the assets, except when such liabilities are attached to assets.

When the conditions for a special reorganization are satisfied regarding an asset acquisition, the asset transferor's tax basis in the equity or shares of the asset receiver will remain the same as 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:

- The sale price of the transfer of assets is subject to stamp duty of 0.03 percent to 0.05 percent.[22] The sale of land or real estate is subject to deed tax of 3 percent to 5 percent.
- 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.[23]
- The sale of fixed assets will usually be subject to VAT at the rate of 17 percent,[24] and intangible assets will usually be subject to business tax of 5 percent.[25] Land appreciation tax will also be applicable when the assets are land.

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[16]Implementation rules, article 28.

[17]EITL, article 18.

[18]*Id.*, article 6(3); implementation rules, article 16.

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

[20]M&A rules, article 6(3)(i).

[21]*Id.*, article 6(3)(ii).

[22]Stamp duty rules, article 2.

[23]EITL, articles 11 and 12; implementation rules, article 28.

[24]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.

[25]The Interim Regulation of the People's Republic of China on Business Tax as adopted at the 34th executive meeting of the

(Footnote continued on next page.)

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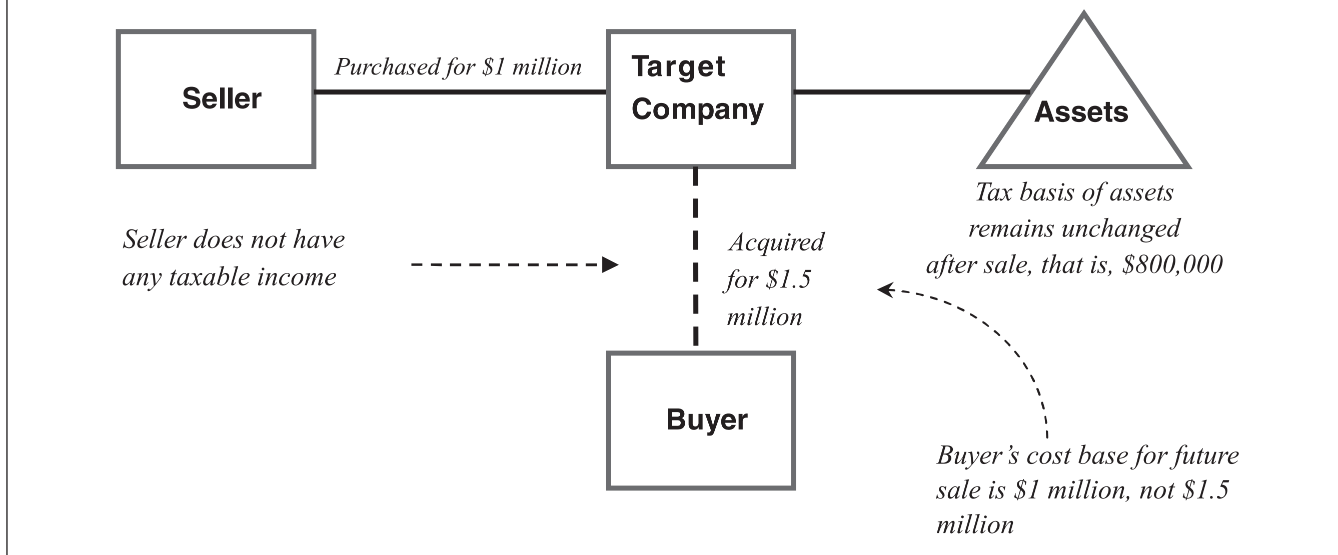

- The buyer will not be able to use the losses of the target company.
- The tax cost of the asset will be the purchase price of the assets.

The additional burden of VAT, business tax, or land appreciation tax 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 from three weeks to three months. Further, when 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

A merger is defined under the M&A rules to refer to a transaction in which 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.[26] 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.[27] Regarding 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 a 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 the fair market value.[28] The tax treatment of the merged enterprise is determined by China's tax rules relating to enterprise liquidations.[29] The tax basis of the merged enterprise's assets is the realizable value or transaction price.[30] Importantly, regarding an ordinary reorganization, the merged enterprise's tax losses cannot be carried over to the merging enterprise.[31]

Regarding a merger that is a special reorganization, the tax basis of the assets received from the merged

State Council on November 5, 2008 (Order of the State Council of the People's Republic of China (No. 540)), Annex 1.

[26]M&A rules, article 1(5).

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

[28]M&A rules, article 4(4)(i).

[29]*Id.*, article 4(4)(ii).

[30]"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).

[31]M&A rules, article 4(4)(iii).

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enterprise will be the same as the merged enterprise's original tax basis in those assets and liabilities.[32] 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 regarding the assets and liabilities.[33] The losses of the merged enterprise may be carried forward, but may only be used in an amount equal to the net operating loss.[34] 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, for 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 before the merger.[35]

For a special reorganization it may be preferable, from a tax perspective, to characterize a transaction as a merger rather than an asset acquisition when the target company has significant losses. It would be advisable to use a merger by absorption when one of the enterprises has a retained entitlement to tax incentives.

Special Purpose Vehicles

Traditionally, investment has been undertaken in China by interposing an offshore company or 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 had entered into an income tax treaty with China containing a favorable withholding tax rate.

However, recent events have challenged the conventional wisdom of using an SPV as part of a China M&A strategy. The EITL contains a general antiavoidance rule at article 47 that empowers the SAT to make a tax adjustment when 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 regarding a Barbadian SPV. On January 9, 2009, the SAT issued ''Implementation Measures for Special Tax Adjustments'' (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 reference to enterprises established in tax havens. Further, on October 27, 2009, the SAT issued ''Notice on How to Understand 'Beneficial Owners' in Tax Agreements'' (Guo Shui Han [2009] 601) (Circular 601), in which it suggested that it will look through interposed companies to see who receives the true benefits of income for purposes of determining which treaty, and withholding tax rate, is applicable.

Then, on December 11, 2009, the SAT issued ''Notice on Strengthening the Management of Enterprise Income Tax Collection of Proceeds from Equity Transfers by Nonresident Enterprises'' (Guo Shui Han [2009] 698) (Circular 698). Circular 698 requires foreign entities to disclose the indirect sale of Chinese enterprises — that is, when a SPV that owns a Chinese enterprise is sold. Notice of such a transfer (and stipulated documentation regarding the transfer) must be given to the Chinese tax authorities within 30 days of the agreement being signed. When the authorities determine that the manner of transaction has no reasonable business purpose, they are empowered to impose tax on the transfer as if it was a direct transfer of the Chinese enterprise.

These events suggest that using 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 favorable withholding tax rates under relevant treaties may no longer be relied on.

Tax Due Diligence

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

- **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 underreporting profits. Financial considerations aside, this can create tax compliance issues that may be inherited regarding a share acquisition or merger. This can result in income tax and customs compliance issues for the buyer.
- **Transfer pricing.** China has recently undertaken a radical revision of its transfer pricing rules. As such, arrangements that traditionally have been tax compliant may no longer be. Importantly, China's tax authorities are able to review related-party transactions for 10 years from the date the transaction occurred.

[32] *Id.*, article 6(4)(i).

[33] *Id.*, article 6(4)(ii).

[34] *Id.*, article 6(4)(iii).

[35] *Id.*, article 9.

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Financing

Appropriate financing strategies can produce significant tax benefits for a company. The tax efficiency of such strategies is limited in China by the thin capitalization rules in article 46 of the EITL, which prohibits the deduction of interest payments to a related party when 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 to 1, and for nonfinancial enterprises the acceptable limit is 2 to 1.

Note that article 89 of Circular No. 2 appears[36] to make provision for the allowance of a deduction if the debt-to-equity ratio is exceeded, when the taxpayer can demonstrate that the transaction is otherwise consistent with arm's-length principles. Any financing strategies should take into account the limits created by the thin capitalization rules.

Conclusion

This article 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 this article 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 of China's tax system. Structuring and acquisition options need to reflect these changes. ◆

[36]Article 89 does not explicitly establish such a right. However, it is implicit in the article that such a right exists (although neither the EITL nor the implementation rules explicitly create such a right).

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