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China Legal Focus

China Issues New Tax Circular
Regarding Corporate Income Tax
Treatment of Enterprise Restructuring

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Background

Since the enactment of the new PRC Corporate Income Tax Law ("CIT Law") on 1 January 2008, the old tax circulars regarding enterprise restructuring issued under the previous tax regime could no longer provide reliable guidance on the tax implications of restructuring. Thus on 30 April 2009, the State Administration of Taxation ("SAT") and the Ministry of Finance ("MOF") jointly promulgated the tax circular Caishui [2009] No. 59, entitled Several Questions concerning CIT Treatments of Enterprise Restructuring ("Restructuring Rules").

According to Article 75 of the Implementing Rules of the CIT Law, unless otherwise stipulated by the MOF and SAT, enterprises must recognise the gains or losses derived from the transfer of the relevant assets at the time of restructuring. Correspondingly, the tax basis for the relevant assets must be revised according to the transaction prices. The Restructuring Rules were issued to further implement the above-mentioned Article 75.

Types of Restructuring

The Restructuring Rules cover the following types of restructuring:

Type of restructuring	Definition
Changes in legal form	An enterprise makes simple changes to its registered name, registered address or form of enterprise.
Debt restructuring	A debtor in financial difficulties reaches a settlement with the creditor(s) according to a written agreement or court ruling.
Share acquisition	By means of payment in the form of shares, non-share payment or a combination of both, an enterprise acquires the shares of another enterprise in order to control the latter.
Asset acquisition	By means of payment in the form of shares, non-share payment or a combination of both, an enterprise acquires the main operational assets of another enterprise
Merger	One or more enterprises ("enterprises being merged") transfer their entire assets or liabilities to another existing or newly established enterprise ("merged enterprise") to achieve a merger of two or more enterprises. The shareholders of the enterprises being merged receive shares in the merged enterprise, non-share payments or a combination of both.
Spin-off	An enterprise ("spin-off enterprise") transfers part or all of its assets to another existing or newly established enterprise ("enterprise being spun-off"). The shareholders of the spin-off enterprise receive shares in the enterprise being spun off or non-share payments.

General Rules

According to the Restructuring Rules, unless the restructuring qualifies for special tax treatment, the general rules apply. In principle, the general rules require enterprises to immediately recognise the relevant gains and losses related to the restructuring and do not allow deferral of tax liabilities. The details are as follows:

Type of restructuring	General tax treatment
Changes in legal form	<p>If an enterprise is transformed from a legal person to a non-legal person such as a sole-proprietorship enterprise or a partnership enterprise, or its registered address is changed to an overseas address, such restructuring is regarded as liquidation of the old enterprise, distribution of the remaining assets to the shareholders and establishment of a new enterprise by the shareholders.</p> <p>For other changes of legal form, there are no tax implications and only an amendment of the tax registration is required. The CIT status of the enterprise remains unchanged unless the change of registered address removes the enterprise's entitlement to certain tax incentives based on location.</p>
Debt restructuring	<p>In the event of repayment of debts by means of non-monetary assets, such restructuring is regarded as two transactions, i.e. (i) transfer of non-monetary assets at fair market value and (ii) repayment of debts according to the fair market value of the transferred assets.</p> <p>In the event of debts being converted into shares, such restructuring is regarded as two transactions, i.e. (i) repayment of the debts and (ii) share investment by the creditor.</p> <p>The relevant gains or losses occurring during debt restructuring must be recognised.</p>
Share and asset acquisition	<p>The seller must recognise the relevant gains or losses arising from the share or asset transfer.</p> <p>The buyer must use the fair market value of the shares or assets as the tax basis for the shares or assets. As a general principle, the CIT status of the enterprise being acquired remains unchanged.</p>
Merger	<p>The merged enterprise must use the fair market value of the assets and liabilities transferred from the enterprise being merged as the tax basis for these assets and liabilities.</p> <p>The enterprise being merged and its shareholders are regarded as entering into liquidation, i.e. the enterprise being merged must recognise the relevant gains or losses arising from the transfer of the assets and liabilities. The shareholders are regarded as (i) receiving dividends from the enterprise (retained earnings) and (ii) disposing of their investment, and consequently the gains or losses arising from the disposal must be calculated and taxed.</p> <p>The pre-merger tax losses of the enterprises being merged cannot be utilised by the merged enterprise.</p>

Type of restructuring	General tax treatment
Spin-off	<p>The spin-off enterprise must recognise gains or losses arising from the transfer of the assets based on fair market value.</p> <p>The enterprise being spun off must use the fair market value of the assets as the tax basis.</p> <p>If the spin-off enterprise continues to exist, the payments received by its shareholders are regarded as distributions made by the spin-off enterprise.</p> <p>If the spin-off enterprise is dissolved, the spin-off enterprise and its shareholders are regarded as entering into liquidation.</p> <p>The pre-spin-off tax losses of the spin-off enterprise cannot be utilised by the enterprise being spun-off.</p>

The harsh tax treatment under the general rules will obviously deter enterprises from carrying out restructuring in order to achieve operational efficiency or streamline corporate structures, etc. Therefore, the Restructuring Rules also provide for special tax treatment (mainly tax payment deferral) for qualifying restructuring. The details are as follows:

Special Rules

Conditions for qualifying restructuring

In order to count as a "qualifying restructuring", the following five conditions must be met:

- (1) The restructuring must have a reasonable commercial purpose and not be conducted mainly to reduce, avoid or postpone tax payments.
- (2) The shares and assets that are acquired, merged or spun off must reach a certain prescribed ratio. In a share acquisition, the shares being acquired must not comprise less than 75% of the total shares of the enterprise being acquired. In an asset acquisition, the assets being acquired must not comprise less than 75% of the total assets of the enterprise transferring the assets.
- (3) The assets involved in the restructuring must be used to continue the original actual business activities within 12 months after completion of the restructuring ("continuation of business").

- (4) The consideration for the transaction must mainly consist of payment in the form of shares and the portion of such share payment must exceed 85% of the total consideration. In other words, the non-share payment, e.g. cash, bank deposits, inventories, receivables, etc. must not exceed 15% of the total consideration. Thus to be eligible for special tax treatment, the restructuring must principally be a non-cash transaction.
- (5) The original shareholder receiving payment in the form of shares during restructuring must not transfer the shares received within 12 months after completion of the restructuring ("continuation of share ownership").

In addition to the above conditions, a cross-border share acquisition or asset acquisition must fall into one of the following four categories to be a qualifying restructuring:

- (1) A non-tax resident enterprise ("non-TRE") transfers its shares in a tax resident enterprise ("TRE") to another non-TRE which is 100% directly held by the former non-TRE. Such transfer does not affect the withholding tax burden relating to gains from future transfer of the TRE shares by the non-TRE transferee. The non-TRE transferor must also undertake in writing that it will not transfer its shares in the non-TRE transferee within the next three years. In this category, the share transfer is eligible for special tax treatment for share acquisition as described in table 3 below.

- (2) A non-TRE transfers its shares in a TRE to another TRE. The non-TRE is 100% directly held by the transferee TRE, or vice versa. In this category, the share transfer is eligible for special tax treatment for share acquisition as described in table 3 below.
- (3) A TRE uses its assets or share investment to invest in a non-TRE which is 100% directly held by the TRE. In this category, if the TRE chooses to utilise the special tax treatment the relevant gains from the transfer of shares or assets can be added to taxable income over a period of 10 years, i.e. although the gain must be recognised upon restructuring, the tax burden is spread over 10 years.
- (4) Other circumstances approved by the MOF and SAT.

Special tax treatments – tax deferral

In the case of qualifying restructuring, the parties can choose (i.e. it is not mandatory) the special tax treatment provided for by the Restructuring Rules. Such special tax treatment is tax deferral treatment, rather than tax exemption or reduction.

The essence of the special tax treatment is that the transferor is allowed not to recognise (upon restructuring) the relevant

gains or losses from the transfer of shares or assets in respect of the portion relating to the share payment. Thus the transferee must take over the tax basis for the transferred shares or assets.

If there are gains from the transfer of shares and assets, it is normally beneficial to opt for special tax treatment in order to postpone recognition of the gains. If there are losses from the transfer of shares and assets, it is normally beneficial to opt for the general rules and recognise the losses upon restructuring. However, the whole tax picture needs to be taken into consideration to decide whether to opt for special tax treatment. In some cases, it may be beneficial to recognise the relevant gains upon restructuring in order to utilise carried-forward tax losses before they expire.

With regard to the non-share payment portion, the transferor still needs to recognise the relevant gains or losses from the transfer of the shares or assets according to the following formula:

$$(\text{Fair market value of transferred assets} - \text{tax basis for the transferred assets}) \times \text{Amount of the non-share payment} / \text{Fair market value of the transferred assets}$$

Details of the special tax treatment are summarised in the following table:

Type of restructuring	Special tax treatment
Debt restructuring	<p>Debtor: If the recognised gains from debt restructuring exceed 50% of the taxable income of the enterprise in the year, the gains can be added to taxable income and spread evenly over a period of five years.</p> <p>Creditor: If the debts are converted into shares, the tax basis for the debts becomes the tax basis for the shares.</p>
Share acquisition	<p>Transferor: If the transferor receives shares in the transferee company as consideration for the transferred shares, the original tax basis for the transferred shares is used to determine the tax basis for the shares received by the transferor.</p> <p>Transferee: The original tax basis for the transferred shares is used to determine the tax basis for the shares acquired by the transferee.</p> <p>The tax basis for the original assets and liabilities of the transferee and transferred enterprise remains the same.</p>

Type of restructuring	Special tax treatment
Asset acquisition	<p>Seller: The original tax basis for the assets transferred is used to determine the tax basis for the shares received by the seller.</p> <p>Buyer: The original tax basis for the assets acquired is used to determine the new tax basis for the assets acquired.</p>
Merger	<p>Merged enterprise: The original tax basis for the assets and liabilities transferred to the merged enterprise is used to determine their new tax basis.</p> <p>Enterprise being merged: The CIT status is inherited by the merged enterprise, e.g. the tax holidays of the enterprise being merged can be inherited by the merged enterprise if the conditions for the tax holiday are met.</p> <p>Shareholders of enterprise being merged: The original tax basis for the shares in the enterprise being merged is used to determine the tax basis for shares in the merged enterprise.</p> <p>Pre-merger tax losses: The tax losses carried forward by the enterprise being merged can be utilised by the merged enterprise within the limit calculated by the following formula:</p> <p>Fair market value of the net assets of the enterprise being merged x Interest rate of the longest term treasury bonds issued by the state as at the end of the year in which the merger takes place</p> <p>It is not clear whether the above limit is an annual limit or a total limit, however, from the context the interpretation as annual limit seems to be more reasonable.</p> <p>Pre-merger tax incentive: In a merger by absorption, the merged enterprise may continue to use its pre-merger tax incentives up to a limited amount if the nature of the enterprise and conditions for enjoying the tax incentives remain unchanged.</p>
Spin-off	<p>Spin-off enterprise: Such enterprises do not need to recognise the gains or losses for the spun-off assets.</p> <p>Enterprise being spun off: The original tax basis is used to determine the new tax basis for the spun-off assets and liabilities. The CIT status relating to the assets and liabilities spun off is inherited by the enterprise being spun off, e.g. tax holidays relating to the spun-off business.</p> <p>Pre-spin-off tax losses: The non-utilised tax losses of the enterprise being spun off can be shared between the enterprise being spun off and the spin-off enterprise according to the ratio of the value of spun-off assets to the value of total assets.</p>

Type of restructuring

Special tax treatment

Shareholders of spin-off enterprise: If shareholders need to assign their shares in the spin-off enterprise ("old shares") in order to obtain shares in the enterprise being spun off ("new shares"), the tax basis for the old shares assigned is used to determine the tax basis for the new shares. If the shareholders do not need to assign old shares in order to obtain new shares, the tax basis for the new shares can either be set at zero or determined by allocating part of the tax basis for the old shares to the new shares based on the ratio of the value of spun-off net assets to the value of total net assets.

Pre-spin-off tax incentive: The spin-off enterprise may continue to use its pre-spin-off tax incentives up to a certain amount if the nature of the enterprise and conditions for enjoying the tax incentives remain unchanged.

Other Issues

Effective date of the Restructuring Rules

The Restructuring Rules were issued on 30 April 2009 but took effect retroactively from 1 January 2008, i.e. the same date on which the new CIT Law and its Implementing Rules took effect. This is unfortunate because certain details of the Restructuring Rules came as a surprise.

Tax administration

According to the Restructuring Rules, any restructuring eligible for special tax treatment must be reported to the competent tax authority for recordal. Such recordal must be made during the annual CIT declaration, i.e. qualifying restructurings conducted in 2008 must be registered with the tax authority before 31 May 2009. If they are not, the tax authority may revoke the special tax treatment. However, the Restructuring Rules do not specify the information to be provided to the tax authority. We assume that basic details of the restructuring and the reasons why the restructuring is eligible for special tax treatment must be provided.

Previous tax circulars issued under the old tax regime

Under the old tax regime, according to the tax circular Guoshuifa (1997) No. 207, transfer of shares in a foreign investment enterprise ("FIE") to a 100% affiliated enterprise could be made at cost, i.e. zero profit would be realised during the transfer. Under the Restructuring Rules, this concept of "share transfer at cost" no longer exists. If both the share transferor and transferee are non-TREs, it is now only possible not to recognise the gains if the transferee is 100% directly held by the transferor and the five conditions for qualifying restructuring are met.

Under the old tax regime, if there was a transfer of shares in an FIE, the attributable retained earnings and reserves could be deducted when calculating the gains from the share transfer. This tax treatment is not mentioned in the Restructuring Rules. To avoid double taxation, therefore, enterprises may need to make a dividend distribution before conducting the share transfer.

Comments

Enterprises that carried out restructuring in 2008 without the guidance of the Restructuring Rules must re-assess the tax implications of the restructuring according to the Restructuring Rules. Adjustments may be necessary for the 2008 CIT annual declaration to factor in the Restructuring Rules. If the restructuring qualifies for special tax treatment, it must be registered with the tax authority in order to be eligible for the treatment. Since the 2008 CIT annual declaration must be completed by 31 May 2009, there is little time left for such enterprises to act.

Restructurings yet to be carried out or in the process of being carried out after 2008 must take into account the Restructuring Rules and attention should be paid to future developments in this area in terms of policies and practice in order to adjust restructuring strategies in a tax-efficient way.

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