SHEPPARD MULLIN
SHEPPARD MULLIN RICHTER & HAMPTON LLP

China Law Update BLOG
For the Latest Developments in China Law

China Law Update

Posted at 12:26 PM on March 18, 2010 by Sheppard Mullin

China M&A Tax Issues - Installment 3: Mergers and Special Purpose Vehicles

Mergers

A merger involves two or more enterprises forming a single legal entity (either existing or new) through combining their assets and liabilities. In China, the two methods through which a merger can be transacted are the absorption of an existing company or the creation of a new entity. Though the former resembles an acquisition, different tax rules apply if the transaction is recognized as a merger.

Tax Basis. For a merger that is considered an ordinary reorganization, the tax basis of assets and liabilities being transferred is the fair market value. If a merger is considered a special reorganization, assets transferred will have the same tax basis as the pre-transaction tax basis of the merged enterprise's assets and liabilities. As with acquisitions, taxable gain will not arise and the original purchase price will be the tax basis for future sales of the transferred assets in a merger that is considered a special reorganization.

Loss Carryover. Losses of the enterprise whose assets and liabilities were transferred (the merged enterprise) cannot be carried over to the enterprise to which assets and liabilities were transferred (the merging enterprise) unless the merger is considered a special reorganization. However, the maximum amount that can be used must be equal to the net operating loss, which is equal to the fair market value of the transferred assets multiplied by the yield of the treasury bond with the longest maturity term by the end of the year that the merger occurred.1[1]

Continued Tax Incentives. If the structure and business nature of the merging enterprise, as well as conditions that allow it to enjoy preferential tax treatments after the merger, remain the same as those of the merged enterprise, then it can continue to receive such tax incentives for the remaining period allotted to the merged enterprise. The preferential amount is calculated as the taxable income of the merged enterprise (losses are deemed as zero) multiplied by the ratio of the total assets of the merging enterprise to the total assets of the merged enterprise.2[2]

Liquidation of Merged Enterprise. The merged enterprise is treated as a liquidated entity and subject to China's tax rules for enterprise liquidation outlined in the "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 4 of this notice stipulates that the difference between the transaction price or realizable value and the tax basis is used to determine the taxable amount of the assets, as well as clearing fees and gain/loss after debt settlement.3[3]

In summary, if a transaction can satisfy the requirements of a special reorganization, it might be more tax efficient to structure it as a merger rather than an asset acquisition, since the losses of the merged enterprise can be carried forward in a merger that is considered a special reorganization whereas they cannot be carried forward in an asset acquisition that is a special reorganization.

Special Purpose Vehicles

A Special Purpose Vehicle (SPV) is a subsidiary entity of an enterprise established to achieve specific objectives such as isolating the parent company from risk or accumulating tax benefits as a result of treaties between China, in this case, and the SPV's jurisdiction of incorporation.

In China, no tax liabilities result from the sale of an SPV by its foreign parent; however, the General Anti-Avoidance Rule in the EITL enables the SAT to remove these tax benefits if it considers a transaction as having no reasonable commercial objective. Thus, recent changes in the Chinese tax regulations may cause SPVs to lose their attractiveness as tax efficient instruments for equity transfers.

Additional Note

As a final note, even though the M&A rules were promulgated in April of 2009, its effects are retroactive to January 1, 2008. Therefore, deals that were executed between January 2008 and April 2009 may be subject to additional tax burdens or refunds.

Authored By:

Jennifer Ding
jding@sheppardmullin.com

4[1] "The Interim Provisions on the Takeover of domestic Enterprises by Foreign Investors (No. 10 [2006])," Article 4; "Notice of the Ministry of Finance and the State Administration of

Taxation on Several Issues Concerning the Enterprise Income Tax Treatment on Enterprise Reorganization
(No.59 [2009] of the Ministry of Finance)", "M&A rules", Article 6.

5[2] M&A rules, Article 9.

6[3] "Notice of the Ministry of Finance and the State Administration of Taxation on Enterprise Income Tax Treatment of Enterprise Liquidation (No.60[2009], Article 4.