China Law Update

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China M&A Tax Issues - Installment I: Changes in Tax Rules

China's new tax law went into effect in January of 2008. This development has had important effects on tax structures used by foreign investors doing mergers and acquisitions in China. It has influenced the strategies firms employ in pursuing "enterprise reorganization" projects involving domestic Chinese enterprises, including mergers, share acquisitions, and asset acquisitions among other transaction types. In April of 2009, China's Ministry of Finance and State Administration of Taxation ("SAT") issued Caishui [2009] No. 59 (the "M&A Rules"). Some of the most significant aspects of these new rules are described below.

General Anti-Avoidance Rule ("GAAR")

The introduction of the GAAR, which the SAT is expected to use to target offshore transactions, is contained in three documents: the Enterprise Income Tax Law ("EITL"), the EITL Implementing Regulations, and the Notice of the State Administration of Taxation on Issuing the Measures for the Implementation of Special Tax Adjustments (for Trial Implementation) ("Measures No. 2").

Article 47 of the EITL empowers the SAT to make a tax adjustment where a transaction results in a reduction in taxable income or has no reasonable business purpose, as defined by Article 120 of the Implementing Regulations of the EITL, where the main purpose of a transaction is to reduce, be exempt from, or defer the payment of taxes.

Anti-avoidance investigations, according to Article 92 of Measures No. 2, will target the following offenses:

1. Abusing tax preferences;
2. Abusing a tax agreement;
3. Abusing the corporate organizational form;
4. Avoiding tax through a tax haven; and
5. Any other arrangement without a reasonable business purpose.

Investigations will follow the principle of "substance prevails over form," which is outlined in Article 93 of Measures No. 2 and requires that the following issues be considered:

1. The form and substance of an arrangement;

2. The time of conclusion and the period of execution of an arrangement;
3. The manners for realizing an arrangement;
4. The connections between different steps or components of an arrangement;
5. The changes of financial status of each party involved in an arrangement; and
6. The tax results of an arrangement.

Articles 94, 95, 96 and 97 of Measures No. 2 elaborate on the methods through which investigations are conducted and tax benefits are canceled, and on other detailed issues.

Thin Capitalization Rules

The Ministry of Finance and the SAT issued a Notice on the Tax Deductibility of Related Party Interest Payments, known as Caishui [2008] No. 121 ("Circular 121") on September 19, 2008. The Circular 121 introduces "thin capitalization rules" limit the debt-to-equity ratio allowable for tax deductions for excessive interest expenses incurred by an enterprise from related party debt financing. Specifically, a prescribed debt-to-equity ratio cannot exceed 2:1 for non-financial enterprises and 5:1 for financial institutions. If an enterprise engages in both financial and non-financial services, it must separately account for interest paid to related parties. If it does not, then a 2:1 ratio for non-financial enterprises will be applied to the entire amount of the interest.

There are two exceptions to this rule regarding the tax deductibility of interest expense. The debt-to-equity ratio may exceed the stipulated threshold when 1) the underlying financing is on arm's length terms or 2) the effective tax burden of the borrower is not higher than that of the domestic entity receiving the interest payment.

Any disqualified interest income received by a related party is subject to the Enterprise Income Tax.

These "thin capitalization rules" have three immediate effects. First, they reduce the tax efficiency of debt push-downs. Second, they are likely to encourage a shift to local funding sought by foreign enterprises intending to establish an entity in China or to expand operations in China. Third, compliance with these rules will be thwarted by their lack of consistency with the Company Law of the PRC. Specifically regarding the third effect, for foreign corporations with an operating entity in China, the Company Law of the PRC stipulates debt-to-equity ratio requirements as set forth below:

Total Investment	Ratio of Registered Capital to Total Investment	Registered Capital as a % of Total Investment
<= US$3 million	At least 7 : 10	70%
US$3M to < $10M	At least 1 : 2	Higher of 50% or US$2.1m

US$10M to < $30M	At least 2 : 5	Higher of 40% or US$5m
>US$30M	At least 1 : 3	Higher of 33.33% or US$12m

Under these rules, interest payments related to inter-company loans would be tax-deductible. Under Circular 121, however, if the debt-to-equity ratio is not below 2:1 (or 5:1 for financial enterprises) the tax deductions may be violating the thin capitalization rules. Thus, foreign companies with operations in China should seek clarification of these inconsistencies.

Stricter Requirements for Transfer Pricing

An enterprise may be targeted for a transfer pricing audit if it possesses any of the following characteristics:

- It conducts a significant number of related party transactions or many types of related party transactions;
- It has long-term losses or marginal or fluctuating profits;
- Its rofit level is lower than industry norm or other group members;
- It engages in transactions with related parties located in tax havens;
- It fails to properly report related party transactions;
- It fails to prepare required contemporaneous documentation;
- It fails to adhere to arm's length principles.

On inter-company transactions, tax authorities may apply any of the following methods for tax adjustments:

- Comparable Controlled Price (CUP);
- Resale Price Method (RPM);
- Cost Plus Method (CPM);
- Transactional Net Margin Method (TNMM);
- Profit Split Method (PSM);
- Any other method in compliance with the arm's length principle.

The method deemed most reliable or reasonable will be used, and tax authorities have up to 10 years to make adjustments if transactions do not conform to arm's length standards. Those enterprises subject to transfer pricing audit adjustments will be placed under a 5-year supervision period, during which compliance with contemporaneous documentation requirements, changes to operations, operating results, and related party transactions will be monitored. Interest will be imposed on unpaid tax resulting from transfer pricing adjustments. It includes non-deductible interest and interest calculated on the RMB loan base rate published by the People's Bank of China for the relevant period plus 5%.

Ordinary vs. Special Reorganizations

Caishui [2009] No. 59 distinguishes between ordinary reorganizations and special reorganizations. Special reorganizations enjoy roll-over tax liability when the underlying owner has not changed (although the nonequity portion of the transaction will not be rolled-over but rather subject to taxable gain). The following are considered special reorganizations:

- 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 75% criterion;
- The original business of the enterprise remains unchanged during the 12-month period following the reorganization;
- The equity consideration is at least 85% of the total consideration;
- The main shareholder receiving the equity consideration cannot transfer that equity consideration acquired within 12 months after the reorganization.

Special reorganization tax relief is available to cross-border transactions that do not satisfy the above conditions but occur under the below circumstances:

- When a nonresident enterprise transfers shares in a Chinese company to a wholly-owned subsidiary company, regardless of whether the acquiring company is a resident company. If a transfer is to a nonresident company, it must not result in a lower rate of capital gains withholding tax;
- When a resident enterprise invests in its wholly-owned, nonresident enterprise in the form of assets or equity interests.

In addition to the above concepts, the new tax law also outlines specific M&A and liquidation tax rules and places doubt on previously conceived tax benefits from incorporating SPVs in some low-tax jurisdictions.

The next installment will explain the difference in tax treatment between ordinary reorganizations and special reorganizations.

Authored By:

Jennifer Ding
jding@sheppardmullin.com