SHEPPARD MULLIN
SHEPPARD MULLIN RICHTER & HAMPTON LLP
China Law Update BLOG
For the Latest Developments in China Law

China Law Update

Posted at 1:00 PM on May 21, 2009 by Sheppard Mullin

Taxation of Corporate Restructuring （II）

On April 30, 2009 the PRC Ministry of Finance ("MOF") and the State Administration of Taxation ("SAT") jointly issued *Notice of Some Issues Associated with Income Tax Treatment of Enterprise Restructuring* (Cai Shui [2009] No. 59) ("Notice 59") relating to China's tax treatment of certain corporate restructuring transactions. The rules introduced in Notice 59 have retroactive effect to January 1, 2008.

Background

Under China's pre-2008 foreign enterprise income tax ("FEIT") regime, SAT issued *Guo Shui Fa* [1997]. No 71 ("Circular 71") and *Guo Shui Han Fa* [1997]. No 207 ("Notice 207"). Circular 71 set forth detailed guidelines on the tax treatment of enterprise restructuring transactions, while Notice 207 permitted foreign investors to transfer their equity interests in a Chinese enterprise to a 100% related enterprise at cost, provided a commercial-purpose test was satisfied. The guidance provided in Circular 71 and Notice 207 was interpreted by many foreign investors as indicating preferential tax policies under the FEIT regime.

However, such preferential tax policies became uncertain once the Implementation Rules to the Enterprise Income Tax Law ("the Rules") were issued on January 1, 2008. Article 75 of the Rules requires an enterprise that undergoes a corporate restructuring to realize gain or loss on the transfer of related assets at the time the transaction is conducted, and requires the corresponding tax basis to be determined in accordance with the transaction price. In order to guide enterprises that are nearing the deadline to report their corporate restructurings in the annual income tax filing, MOF and SAT formulated Notice 59 on May 7, 2009 with thirteen articles that cover some significant issues.

Details

As anticipated, Notice 59 provides a definition of enterprise restructuring and lists six specific types – namely, an equity acquisition, asset acquisition, merger, spin-off, change in legal form and debt restructuring. Additionally, it provides that either "general" or "special" tax treatment can be elected for such enterprise restructurings. The general treatment is the basic tax recognition rule provided under Article 75 of the Rules. Conversely, if certain criteria are met, a party to a restructuring can elect special non-recognition treatment.

Below are the basic requirements for both foreign and domestic investors to elect special tax treatment:

- The restructuring transaction must accomplish reasonable commercial purposes, and cannot be conducted primarily to decrease, avoid or defer tax payments.

- For equity acquisitions, no less than 75% of the total equity of the target company must be acquired; and for asset acquisitions, no less than 75% of the total assets of the target company must be acquired.

- Within the twelve months following the restructuring, there can be no change in the original business operation of the target company, and there can be no re-transfer of the acquired stock.

- At least 85% of the total consideration received by the transferor must consist of the acquirer's stock.

- The shareholders who receive equity in the restructuring must continue to hold such equity for a period of one year following the restructuring.

Special tax treatment is also available for the following specific types of cross-border restructurings that otherwise satisfy the above five criteria:

- Transfer by a non-resident enterprise of its equity interest in a resident enterprise to another resident enterprise that is wholly-owned by the transferring non-resident transferor.

- Investment by a resident enterprise of its assets or equity in a wholly-owned non-resident enterprise. The gain resulting from such a transfer must be amortized into taxable income over the ten year period following the transfer.

- Transfer by a non-resident enterprise of its equity interest in a resident enterprise to another non-resident enterprise that is wholly-owned by the non-resident transferor. Such transfer will not result in any change to the withholding tax burden of the non-resident transferee relating to any capital gains arising out of a subsequent transfer of the entity interest in the resident enterprise. However, the non-resident transferor must not transfer its equity interest in the wholly-owned transferee within 3 years after the transfer.

- Other transactions approved by MOF and SAT.

Notice 59 allows restructurings that occur in multiple steps to be considered as one restructuring, provided all steps are completed within a 12-month period. The special non-recognition treatment will only apply with respect to the equity consideration received on the restructuring. Taxable gain or loss will still be recognized on the receipt of any "boot" consideration (including cash, receivables and other assets). If a resident enterprise undergoing a restructuring satisfies all of the above requirements and intends to elect special tax treatment, it must submit written information to its supervising tax bureau, along with its annual income tax filing, showing that the requirements were satisfied.

Authored By:

Raymond Tan

86.21.2321.6053

rtan@sheppardmullin.com