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# New Tax Rules Regarding M&A Transactions in China

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**OVERVIEW**

On May 7, 2009, China's Ministry of Finance (the "MoF") and State Administration of Taxation ("SAT") jointly issued the long-awaited Notice on Several Enterprise Income Tax Issues Relating to Enterprise Reorganization Activities, Caishui [2009] No. 59 (the "New Reorganization Tax Rules"), and the Notice on Several Enterprise Income Tax Issues Relating to Enterprise Liquidation Activities, Caishui [2009] No. 60 (the "New Liquidation Tax Rules"), both dated April 20, 2008, and effective retroactive to January 1, 2008. These rules mark a milestone in China's tax reform: for the first time, China now has a set of rules providing for so-called "tax-free" (actually tax-deferred) corporate reorganizations.

Before the promulgation of these new rules, corporate reorganizations were governed by one of two series of SAT circulars, one pertaining to domestic companies and the other to foreign-invested enterprises ("FIEs"). The series for FIEs consisted of Guoshuifa [1997] No. 71 ("Circular 71") and Guoshuifa [1997] No. 207 ("Circular 207"). Circular 71 was intended to be a comprehensive guideline on tax treatment of four types of M&A transactions: merger, division, equity restructuring, and asset transfer. Circular 207 specifically allowed a foreign investor to transfer its equity interest in an FIE to a 100% owned subsidiary at cost (thus realizing zero gain), provided that the transaction was motivated by a reasonable business purpose. Under those Circulars, many foreign investors were able to reorganize their China operations without significant tax consequences. However, the new Enterprise Income Tax Law, which unified the previously separate tax regimes for domestic enterprises and FIEs, effectively repealed those Circulars as of January 1, 2008.

A remarkable difference between the New Reorganization Tax Rules and the previous patchwork of SAT circulars is that the new rules are based on the same fundamental principles as the U.S. tax rules regarding corporate reorganizations. They also recognize a broader range of M&A and debt-restructuring transactions already common outside of China. The New Reorganization Tax Rules are also designed to address all tax issues involved in corporate reorganizations—there are provisions on the treatment of tax attributes, several provisions are introduced to guard the new freedom against abuse, and certain loopholes are closed. The only major issues related to reorganizations that are not addressed in the New Reorganization Tax Rules are those that are technically post-reorganization issues in taxable acquisitions, and they are covered by the New

Liquidation Tax Rules.

**SUMMARY AND ANALYSIS**

The New Reorganization Tax Rules address six types of reorganizations and prescribe two types of tax treatment for them. The six transaction types include four types of M&A transactions—equity acquisition, asset acquisition, merger, and division—along with change of legal form and debt restructuring. A reorganization of each of these types is a taxable transaction unless it meets the requirements for a tax-free transaction. This report focuses on M&A transactions.

**Taxable Transactions**. In a taxable M&A transaction, the target must recognize gain or loss from the transfer of assets or the target shareholders must recognize gain or loss from the transfer of their shares, and the purchaser takes the fair market value (in most cases the purchase price) as its tax basis in the equity or assets. Net operating losses ("NOLs") may not be carried over to the purchaser (to offset its own tax liability). Surviving parties can continue to enjoy their pre-existing tax holidays (subject to proportional reduction in the case of a division), provided that they separately meet the qualification criteria.

**Tax-Free Reorganizations**. When a transaction qualifies as a tax-free transaction, recognition of gain or loss from the transaction (other than gain allocable to "boot") is deferred until a future recognition event. The deferral (rather than permanent exemption) is preserved through the concept of "substituted basis." For example, in a stock-for-stock deal (a tax-free equity acquisition), the basis in the purchaser's stock which the target's shareholders receive is the same as their basis in the target's stock transferred; this type of substituted basis is called "exchanged basis." At the same time, the purchaser's basis in the target's stock acquired is the same as the stock's basis in the hands of the target's shareholders; this type of substituted basis is called "transferred basis." Similarly, in a stock-for-assets deal (a tax-free asset acquisition), the target takes an exchanged basis in the purchaser's stock which it receives, and the purchaser takes a transferred basis in the target's assets received. Tax-free mergers and divisions are treated the same way. By imposing substituted bases, the rules make sure that the built-in gain in the equity and assets will be taxed when the new owners make a taxable disposition in the future. It is in this sense that the commonly used term "tax-free" is inaccurate. Finally, the last benefit of tax-free treatment in tax-free mergers and divisions is that NOLs can be carried over to the new owner, subject to certain limitations. [I did not understand the reference to ring fencing.] Treatment of tax holidays is subject to the same rules as govern taxable reorganizations.

**Criteria for Tax-Free Reorganizations**. The criteria for tax-free treatment are essentially the same as the combined criteria contained in the Internal Revenue Code and case law of the U.S., such as business purpose, continuity of business enterprise ("COBE"), continuity of shareholder interests, the "all or substantially all" requirement, and limitation on boot. Specifically, the transaction must have a bona fide business purpose, 75% or more of the target's total equity or assets must be transferred, the original core operations of the transferred assets must continue for at least 12 months after the transfer, any nonequity payment (defined to include cash, bank deposits, accounts receivable, marketable securities, inventory, fixed assets, other assets, assumption of liabilities, etc., together commonly referred to as "boot") must be less than 15% of the total purchase price, and target shareholders may not transfer purchaser's equity which they receive until 12 months after the transfer. The principle underlying these requirements is, according to Assistant Professor Jiguang Zhai of China University of Political Science and Law, one of the drafters of the New Reorganization Tax Rules, that a corporate reorganization should not trigger tax liability to the parties as long as they have not cashed out their stakes in the business operations. Finally, to qualify for tax-free treatment, parties to reorganizations must report the transactions when filing their annual tax returns for the year in which the transactions are completed.

**Cross-Border Reorganizations**. Cross-border transactions are subject to additional restrictions or adjusted tax-deferred treatment. The New Reorganization Tax Rules enumerate three types of crossborder equity or asset acquisitions that are eligible for tax-free treatment: transfer of equity interest in a resident enterprise by a non-resident enterprise to its 100% non-resident enterprise subsidiary ("foreign Co-to-foreign Sub"), transfer of equity interest in a resident enterprise by a non-resident enterprise to its 100% resident enterprise subsidiary ("foreign Co-to-domestic Sub"), and transfer of equity or assets by a resident enterprise to its 100% non-resident enterprise subsidiary ("domestic Co-to-foreign Sub"). Other types of cross-border transactions are not eligible for tax-free treatment unless otherwise approved by the MoF or SAT. For domestic Co-to-foreign sub transactions, the favorable tax treatment is a 10-year concession rather than an open-ended deferral: gain realized must be recognized over a 10-year period using a straight-line method. For foreign Co-to-foreign Sub transactions, two additional requirements must be met: (1) the Chinese capital gains withholding rates applicable to the transferee and the transferor must be the same (which will depend on the terms of any applicable income tax treaties), and (2) the transferor must undertake in writing to the governing tax bureau that it will not transfer its interest in the transferee for three years after the transfer. Presumably, these additional requirements are designed to discourage treaty shopping.

**Initial Reactions**. Although business and tax professionals generally welcome these new rules, some are already concerned about the potential impact of certain provisions that are less favorable than previous rules. During the period from January 1, 2008 to May 7, 2009, many overseas holding companies transferred their interests in PRC operating companies to Hong Kong intermediate holding companies with the goal of taking advantage of the lower dividend withholding rate under the PRC-Hong Kong tax arrangement. Many such transactions were entered into on the assumption that Circular 207 remained in effect until it was officially repealed. As the New Reorganization Tax Rules are effective retroactive to January 1, 2008, those companies now must prove that their transactions qualify for tax-free treatment under the above requirements. This may be a challenge if the Hong Kong company does not perform substantive functions or its functions are not supported by adequate documentation.

Another point of concern is the rigidity of the additional restrictions for cross-border transactions. The policy underlying the additional restrictions presumably is to prevent tax leakage through sham outbound transactions, but these restrictions can also impose additional barriers and costs on legitimate intragroup consolidations. For example, suppose a multinational corporation wants to consolidate two of its PRC operating companies, one held through a Hong Kong holding company and the other through a Cayman holding company, by having the Cayman company transfer its equity interest in its WFOE to the Hong Kong company in exchange for the Hong Kong company's stock. Even if this transaction is motivated by legitimate business reasons, it will not qualify for tax-free treatment because it does not fit under any of the three enumerated forms. To achieve its business goal on a tax-free basis, the multinational must take the additional step of first transferring its equity interest in the Hong Kong company to the Cayman company, so that the Hong Kong company becomes a 100% subsidiary of the Cayman company. Then, when the Cayman company transfers its WFOE to the Hong Kong company, the transaction can be eligible for tax-free treatment. In contrast, Circular 207 would have allowed one-step restructuring, as it allowed tax-free equity transfers not only to 100% subsidiaries, but also to sister companies under 100% common control.

**CONCLUSION**

The new rules reflect the Chinese government's growing sophistication and familiarity with international tax and corporate practices. In the past, the bulk of tax planning techniques used by parties to enhance deal value were useless in China. These new rules will change that and, as the government has intended, facilitate bona fide M&A activity.

The new rules will also present new challenges to both the government and taxpayers. Given the brevity of these rules and the broad range of transactions governed by them, they are vulnerable to abuse. The New Reorganization Tax Rules introduce the step-transaction doctrine, which authorizes tax bureaus to treat multiple transactions taking place within a 12-month period as a single transaction based on the substance-over-form principle. Together with the business-purpose requirement, this rule will prove to be a powerful anti-avoidance device. However, sophisticated techniques could be used to plan not only direct tax consequences but also tax attributes, and we have yet to see if the existing anti-avoidance rules will be sufficient.

From the taxpayer's perspective, many key issues, such as the criteria for reasonable business purpose, the determination of fair market value, and the specifics of COBE, remain vague. Much of the vagueness is probably intentional, since certain issues—such as the step-transaction doctrine and the reasonable business purpose requirement—are by their nature much better addressed by a "facts and circumstances" approach than by a set of codified criteria. As a result, we are likely to see communications between tax bureaus and taxpayers becoming a more important part of tax practice. Although currently there are no formal procedures for obtaining rulings from the Chinese tax authorities, some national tax bureaus at provincial or municipal levels are prepared to provide verbal guidance upon request. Some issues, however, can be clarified by administrative guidance. For example, what are the details of the COBE requirement—does a purchaser have to continue the historical business of the target, or can the purchaser use the acquired assets to operate a similar business? These questions can determine the feasibility of a deal, and companies will welcome guidance when contemplating M&A transactions.

## *Authors*

## Lester Ross

**PARTNER**

Partner-in-Charge, Beijing Office

lester.ross@wilmerhale.com

+86 10 5901 6588

## Kenneth Zhou

**PARTNER**

kenneth.zhou@wilmerhale.com

+86 10 5901 6588