China Law Update

Posted at 11:35 AM on March 18, 2010 by Sheppard Mullin

China M&A Tax Issues - Installment 2: Ordinary versus Special Reorganizations in Share Deals and Asset Deals

The M&A rules recognize a deal as either an ordinary reorganization or a special reorganization, and different tax treatments apply accordingly. In terms of acquisitions, the major difference in tax treatment between ordinary and special reorganizations is the tax basis used for calculating the gain/loss from the transaction and the time point at which this gain/loss is recognized. Furthermore, according to Article 7 of the M&A rules, an acquisition between a domestic Chinese enterprise and a foreign enterprise (which in this case includes those domiciled in Hong Kong, Macao, and Taiwan) must meet one of the additional conditions below in order to qualify as a special reorganization1[1]:

- The foreign enterprise transfers its equity in domestic enterprise to its wholly-owned subsidiary (also a foreign enterprise), the income withholding tax burden is not changed by the transaction and the transferor promises in writing to the relevant tax authority that it will not change its equity holdings in its said wholly-owned subsidiary for 3 years.
- The foreign enterprise transfers its equity in a domestic enterprise to its wholly-owned subsidiary that is also a domestic enterprise.
- The domestic enterprise that is a wholly-owned subsidiary of a foreign enterprise invests its assets/equity in its parent. In this case, the domestic enterprise can allocate its taxable income from the transaction over 10 years.
- If the acquisition satisfies none of the above three conditions, approval must be obtained from the Ministry of Finance and the SAT in order to enjoy tax treatments given to special reorganizations.

Equity Acquisitions

One of the two typical methods in which foreign investors can acquire a domestic non-foreign-invested Chinese enterprise is through an equity deal, which involves buying the equity of the target company or increasing the capital of the target company in order to transform it into a foreign-invested company and establish control (the foreign investor must contribute more than 25% of the registered capital of the domestic enterprise in order to take advantage of special treatments only given to foreign-invested enterprises in China).2[2] Liabilities will be inherited with the target company in an equity acquisition since the legal entity remains unchanged.

In terms of the tax issues involved in an equity deal that is considered an ordinary reorganization, the M&A rules require that the post-transaction fair market value be the tax basis of the equity or assets transferred. If the shareholder is a foreign enterprise, then the tax rate on an equity transfer is 10%. For special reorganizations, however, the tax basis of the acquired equity or assets is the seller's pre-transaction tax basis in these equity or assets. For example, if the seller originally purchased the target company for $2 million, and the buyer presently acquires the target company from the seller for $3 million, then the buyer's tax basis is $3 million in an ordinary reorganization but only $2 million in a special reorganization. This difference in tax treatment for special reorganizations prevents any taxable gain from arising and allows the seller's original purchase price to remain as the tax basis for further sales of the equity or assets.

The EITL dictates that accretions or dilutions in the value of equity or assets are recognized at the time of execution for an ordinary reorganization. The amount recognized is that between the fair market value and the pre-transaction tax basis of the equity and assets transferred. In a special reorganization, the acquirer can defer the gain or loss derived from the transaction except for those related to non-equity payments, which is calculated as the difference between the fair market value and the pre-transaction tax basis of the equity/assets multiplied by the proportion of the fair market value of equity/assets that is non-equity.3[3]

Lastly, VAT or business tax will not be levied on an equity transfer. China's rules on stamp duty, however, require a 0.1% stamp duty on the sale price of the share transfer.4[4] After a transaction is completed, the acquirer's acquisition expenses cannot be deducted by the target company. These include interest expenses incurred for loans used for the acquisition, which will be capitalized into the costs of the asset according to the EITL Implementation rules. The target company's losses are permitted to be carried forward for up to 5 years.5[5] Furthermore, the tax basis of assets of the target company remains unchanged after the deal.

Asset Acquisitions

The other way in which many foreign investors take over domestic Chinese enterprises is through an asset deal, which involves the formation of a new foreign-invested legal entity in China through which the foreign investor buys and operates the assets of a domestic enterprise, or the purchase of the assets of a domestic enterprise, which are then used to create a foreign-invested enterprise in China.6[6]

The asset acquirer in deals that are considered special reorganizations also enjoy the advantage of being subject to the pre-transaction tax basis in those assets. The differences in timing of the recognition of gain or loss from the transaction between ordinary and special reorganizations are the same as those in equity deals.

The tax cost of the assets is their purchase price. Foreign enterprises are subject to a 10% tax. VAT on fixed assets is at 17%, while business tax on intangible assets is at 5%. Deed tax of 3%-5% is levied on the sale of land or real estate. Stamp duty is 0.03%-0.05% of the sale price of the assets transferred. Unlike in equity deals, the losses of the target company in an asset deal cannot be carried forward. Finally, interest expenses incurred during the asset acquisition and by the newly established entity will be capitalized and depreciated over the life of the assets.

Conclusions

Choosing a deal structure to achieve tax efficiency thus depends on the particular set of circumstances surrounding the acquisition. For example, the tax burden in an asset deal may not be excessive if the target company does not hold a large amount of real estate and thus is not subject to the deed tax. Furthermore, in maximizing tax saving opportunities, deductions on interest expense or other tax benefits associated with different financing structures should also be taken into consideration. Of course, it also must be taken into consideration that in China, certain restrictions on foreign ownership of domestic companies in industries such as mining, pharmaceuticals, and insurance prevent equity deals from being transacted.

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7[1] "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)" (the M&A rules), Article 7.

8[2] "The Interim Provisions on the Takeover of Domestic Enterprises by Foreign Investors (No. 10 [2006])," Articles 2 and 9.

9[3] "China Mergers, Acquisitions and Reorganization Tax Guide," Deloitte China Practice, 2009, http://www.deloitte.com/assets/Dcom-China/Local%20Assets/Documents/Services/Tax/cn_tax_ChinaMARTaxGuide_040609(1).pdf.

10[4] “Provisional Rules of the People’s Republic of China on Stamp Duty (Order of the State Council of the People’s Republic of China (No. 11),” Article 2.

11[5] “Enterprise Income Tax Law of the People’s Republic of China (Adopted at the 5th Session of the 10th National People’s Congress of the People’s Republic of China on March 16, 2007)” (EITL), Article 18.

12[6] “The Interim Provisions on the Takeover of Domestic Enterprises by Foreign Investors (No. 10 [2006]),” Article 2.