NEWSLETTER

China Tax Update

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Planning a Restructuring in China: A Legal and Tax Overview

In recent years many multinational companies have grown quickly in the Chinese market. But the flipside of many success stories is that the structures, systems and organization could not keep pace with this extraordinary growth. More and more foreign investors are realizing that their presence in China has reached a size which requires the restructuring or reorganization of their China operations. Various transactions may be necessary like adding-in or spinning-off certain business operations, exiting existing joint ventures, replacing production lines, setting up holding structures etc. And when implemented, these activities may trigger various tax consequences.

In 2009 China's State Administration of Taxation ("SAT") issued the **Circular concerning Several Issues on Enterprise Income Tax of Enterprise Restructuring**[1] ("Circular 59") which defines a restructuring as:

A transaction outside an enterprise's daily business operation but which has caused significant changes to an enterprise's legal structure or business structure, including 1) change in legal form; 2) debt restructuring; 3) share acquisition; 4) asset acquisition; 5) merger; and 6) split.

Circular 59 provides a restructuring with the options of general treatment ("General EIT Treatment") and special tax treatment ("Special EIT Treatment") in dealing with enterprise income tax ("EIT"). General EIT

[1] Circular Cai Shui (2009) No. 59

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Treatment imposes EIT on the fair market value ("FMV") of the shares or assets transferred in the restructuring. Special EIT Treatment allows parties to perform the transaction at book values, which in effect means that tax effects are deferred if certain conditions are fulfilled.

The restructuring parties should not only focus on EIT but also consider other taxes arising from the restructuring and the relevant legal implications. This article addresses some general concerns in the planning of some types of restructuring involving foreign investors or foreign invested enterprises ("FIEs") in China.

Share Transfer

Generally speaking, the transfer of shares in a FIE is subject to the approval by the Ministry of Commerce or its local counterparts ("MOC"). According to the Company Law and subject to the company's articles of association, if a shareholder in a company intends to transfer its shares to a third party, it must obtain consent from over half of the original shareholders of this company who have the first right of refusal. However, if the company is a Chinese-foreign equity or cooperative joint venture ("EJV" or "CJV"), which has at least one Chinese party and one foreign party, the share transfer is subject to specific restrictions: it must have unanimous approval from the original shareholders of the EJV or CJV. In this case the other parties (e.g. the Chinese party) to the EJV or CJV has deciding power on the share transfer.

The EIT implication of the share transfer depends on which tax treatment it applies.

	Major Preconditions	Major EIT Consequences
General EIT Treatment		■ The transferor must recognize a gain or loss from the share transfer; ■ The transferee must book the FMV of shares transferred as their tax basis.
Special EIT Treatment	■ The shares transferred are at least 75% of the total shares of the target company; ■ The transferee pays at least 85% of the total	■ The transferee must book the tax basis of the shares transferred as their original tax basis; ■ The transferor must book the tax basis of the Share

	Major Preconditions	Major EIT Consequences
	transfer price by shares ("Share Consideration").	Consideration as the original tax basis of the shares transferred.

A cross-border share transfer to which Special EIT Treatment is applied is subject to further restrictions. For example, a foreign company that transfers the shares of a Chinese subsidiary to another 100% owned foreign subsidiary (for instance a holding company) may only enjoy Special Treatment if it complies with two additional preconditions.

- The EIT to be withheld by the Chinese tax authorities is not affected by the restructuring;
- The transferor must commit to the tax authority that it will not transfer the shares of the transferee for at least three years after the restructuring.

A foreign investor should also be aware of the legal difficulties that exist for a share swap between a Chinese company and a foreign company. The restrictions in the approval procedure with the MOC and the foreign exchange authority could bring additional risks to a deal. Currently share swaps between two FIEs are still very difficult to implement[2]. However, China has established a relatively mature procedure for the split and merger of FIEs, which could make the Special EIT Treatment legally possible.

Asset Transfer

An asset transfer does not normally require unanimous approval from shareholders unless the articles of association of the target company state otherwise.

Under Chinese tax rules[3] the assets under Special EIT Treatment refer to assets directly relevant to the business operation of the relevant enterprise, including intangible assets, account receivables, and

[2] MOC on 4 May 2011 publicized a draft of the **Administration Rules on Equity Contribution related to Foreign Invested Enterprises** to solicit public opinions. These rules are anticipated to set up a framework for a foreign investor to contribute its equities in a Chinese subsidiary to another company in China.

[3] SAT's No. 4 Public Notice of 2010

investment. In this sense, the transfer of single assets might not qualify for Special EIT Treatment.

	Major Preconditions	Major EIT Consequences
General EIT Treatment		■ The seller must recognize a gain or loss from the asset transfer; ■ The buyer must book the FMV of asset transferred as their tax basis.
Special EIT Treatment	■ The transferred assets are at least 75% of the total assets of the seller; ■ The buyer pays for the assets by Share Consideration which is at least 85% of the total transfer price.	■ The transferee must book the tax basis of the assets transferred as their original tax basis; ■ The transferor must book the tax basis of the Share Consideration as the original tax basis of the assets transferred.

On the other hand, a cross border asset transfer that enjoys Special EIT Treatment under tax rules may not be workable under China's legal regime because a foreign company cannot legally "own" any operational asset in China.

Further, the transfer of real estate or intangible assets (e.g. patent and trademarks) may attract BT. In 2002 the SAT issued Circular 165[4] which states that an enterprise is not subject to BT for an overall transfer of assets, rights, debts and employees. But local tax authority may not approve an asset transfer to enjoy this exemption if the target company continues to exist after the restructuring.

VAT is normally applied to a sale of tangible assets (excluding real estate). But the SAT No. 13 Public Notice ("Notice 13")[5] clarifies that a company is not subject to VAT if it transfers part or all of its assets - with related rights, debts and employees - to another entity or other people during a restructuring whether as a merger, split, sale, or asset swap. So the tax authority may still impose VAT on the asset transfer if the relevant tangible and intangible assets and personnel are not transferred together at the same time.

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[4] Circular Guo Shui Han [2002] 165
[5] issued in February 2011

Merger

"European Law Firm of the Year" 2010, *The Lawyer*

"Law Firm of the Year: France" 2010, *The Lawyer*

A foreign investor may choose to merge two or more of its Chinese subsidiaries during a restructuring. Under Chinese law, a company merger can be an absorbing merger in which a company absorbs one or more companies, causing the latter to be dissolved; or it can be a new establishment merger in which two or more companies merge into a new company while dissolving themselves. The merger between FIEs is subject to MOC approval[6].

Chinese law requires the post merger company to assume all the rights and obligations of the pre-merger companies. However tax rules restrict the inheritance of tax treatment under the merger. For example, in case of an absorbing merger between a profitable company (i.e. post-merger company) and a loss-making company (i.e. merged company), tax consequences under the different tax treatments are as follows:

	Major Preconditions	Major EIT Consequences
General EIT Treatment		■ The post-merger company must book the FMV of the assets and liabilities of the merged company as their tax basis; ■ The merged company must be dissolved; both the merged company and its shareholders must pay EIT calculated by the tax rules for dissolution; ■ With certain exceptions, the post-merger company cannot continue to enjoy the EIT incentives of the merged company; ■ The profit and losses of the two companies under the merger CANNOT be set off.
Special EIT Treatment	■ At least 85% of the total consideration is Share Consideration; or no consideration if the merger is under common control.	■ The post-merger company must use the original tax basis of the assets and liabilities of the pre-merger company as their tax basis; ■ The post-merger company may, subject to limitation, inherit the

[6] The merger may not be approved by the approval authority unless the investors of merging parties has paid up registered capital of the FIEs and the FIEs has began to run actual operation.

	Major Preconditions	Major EIT Consequences
		EIT treatment of the pre-merger company, e.g. loss deduction, revenue recognition, EIT incentive; ▪ The profit and losses of the post-merger company and the merged company can be set off, subject to limitation.

The merger may attempt to obtain BT and VAT exemption pursuant to Circular 165 and Notice 13. But other taxes (such as land appreciation tax and deed tax) might still need to be paid because the tax rules and practice are unclear.

Split

Subject MOC approval, an FIE (if it is a company as opposed to a few FIEs who are not companies) may be split into two or more companies[7].

The split can either be a surviving split in which the original company survives, and one or more new companies are set-up. Or it could be a new establishment split in which the original company dissolves and two or more new companies are set up. Chinese law requires pre and post-split companies to have joint liability, unless a debt repayment agreement has between signed with the creditors of the pre-split company. Below are the EIT consequences of a surviving split under different tax treatments:

	Major Preconditions	Major EIT Consequences
General EIT Treatment		▪ The surviving company must calculate tax income from the assets split-off according to their FMV; ▪ The split company should book the assets split-off at FMV; ▪ The shareholder of the surviving company must pay EIT as if the consideration it received is

[7] The approval authority may not approve the split unless the investor(s) of a pre-split company has paid-up its registered capital and this company has began to run actual operation.

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	Major Preconditions	Major EIT Consequences
		distributed from the surviving company; ■ The surviving company and the split company cannot set-off their profit and loss.
Special EIT Treatment	■ The shareholding ratio of the shareholders in the surviving company remains unchanged in the split company; ■ Both the surviving company and the split company do not change substantial business after the split; ■ At least 85% of the consideration paid to the shareholder(s) of the surviving company is Share Consideration.	■ The split company must use the original tax basis of the assets and liabilities split-off as their tax basis; ■ The split company must, subject to limitation, inherit the EIT treatment related to the split-off assets, e.g. loss deduction, revenue recognition, tax incentive; ■ The accumulative losses relating to the split-off assets can be allocated to the split company to offset its future profit; ■ The shareholder of the split company must book the tax basis of its new shares in the split company as the tax basis of its original shares in the surviving company, or other value according to Circular 59.

As with a merger, if tangible assets (excluding real estate) are split off, Notice 13 allows the split not be subject to VAT .But other taxes such as BT may still be imposed on these intangible assets (and real estate) because the tax rules and practice are unclear.

Debt Restructuring

Circular 59 defines a debt restructuring as a matter in which a creditor makes concession to its debtor, pursuant to a written agreement or court judgment, when the debtor is in financial difficulties. Chinese law does not specifically regulate debt restructuring, but does require MOC approval for debt-to-capital conversions.

In principle, a debt restructuring under General EIT Treatment should be handled in two steps to calculate taxable income: for a debt-to-capital conversion - 1) repayment of debt and 2) capital investment; and for payment of debt by assets -1) transfer of assets and 2) repayment of debts at FMV of the assets.

If it qualifies for Special EIT Treatment, the taxable income from the debt restructuring can be allocated over a period of 5 years and the debt-equity conversion may enjoy another type of EIT payment deferral.

Conclusion

Successful restructuring planning requires comprehensive assessment of various legal and tax issues under a specific situation. The legal and tax intricacies always create challenges for professionals. In reality, hardly a single planning case can be applied to another. So, a certain level of due-diligence is recommended before planning work starts, and consultation with various authorities is an indispensible part of work.

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