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# Tax on Inbound Investment

in 33 jurisdictions worldwide

Contributing editors: Peter Maher and Lew Steinberg

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# China

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## Acquisitions (from the buyer's perspective)

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### 1 Tax treatment of different acquisitions

What are the differences in tax treatment between an acquisition of stock in a company and the acquisition of business assets and liabilities?

The PRC Enterprise Income Tax Law sets out the general principles for the taxation of corporate profits and transactions. Under the general principles, companies undergoing restructuring including restructuring via M&A should recognise the gain or loss resulting from the transfer of the relevant stocks or assets at the fair value at the time of the restructuring.

In 2009, the Chinese State Administration of Taxation issued the Notice on Several Enterprise Income Tax Issues Relating to Enterprise Restructuring Activities, Caishui [2009] No. 59 (Rule No. 59). Rule No. 59 deals with a number of tax issues associated with stock and asset acquisitions, as well as restructuring and spin-offs.

#### Advantages and disadvantages on tax in stock acquisitions

One major advantage for stock acquisitions, is the avoidance of deed tax, business tax, land appreciation tax and VAT. Further, in accordance with Rule No. 59, if the consideration received by the shareholders of the target company is not less than 85 per cent of the total consideration for the acquisition, the acquisition may qualify for 'special tax treatment' regarding the carrying over of net operating losses.

One major disadvantage, which is very important in China, is that the new shareholders will be liable for the tax debts of the target company – in many cases, it is not possible to adequately assess the tax liabilities through due diligence in China.

#### Advantages and disadvantages on tax in assets acquisitions

There is little tax risk for the acquirer when the acquisition is made by asset purchase, which is one reason why this type of transaction is very popular in China. The tax due diligence associated with an asset acquisition will generally be much simpler and less risky and less costly. Further, the VAT input invoices associated with assets that are acquired, can be carried out to the new owner allowing for significant export tax rebates in some instances.

The target company generally will need to pay higher taxes in an asset acquisition assuming that the book values of its assets are lower than the consideration for the assets. Further, asset acquisitions attract business tax, land appreciation tax and VAT tax implications for the target company.

Further, if some assets owned by the target company were imported into China for self-use on a duty free basis, when such assets are transferred to the purchaser within the customs supervision period (eight years for boats and planes; six years for vehicles; five years for other goods – under the PRC Rules for the Administration

of the Levying of Duties on Imported and Exported Goods), the target company will generally be required to make a supplementary duty payment before the asset transfer takes place, in accordance with the Administrative Measures of the Customs of the PRC for the Tax Reductions and Exemptions for Imported and Exported Goods, Decree No. 179 of the General Administration of Customs, issued by it on 29 December 2008 and commencing operation on 1 February 2009.

#### Deferral of tax liabilities

Rule No. 59 provides for special tax treatment in both types of transactions, allowing for the deferral of tax liabilities, in certain cases involving 'restructurings'. Deferral is possible when all of the following conditions are satisfied:

- the restructuring is based on reasonable commercial reasons, but not for the purpose of tax reduction, avoidance or deferral;
- the stocks or assets being acquired, merged or spun-off reach the required ratio – not less than 75 per cent of the stock or assets are transferred within 12 months of the restructuring;
- the original substantial business activities are not changed within 12 consecutive months after the restructuring takes place;
- the portion of stock payment is not less than 85 per cent of the total transaction price; and
- the original main shareholders obtained stock payment will not transfer their stocks within 12 consecutive months after the restructuring.

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### 2 Step-up in basis

In what circumstances does a purchaser get a step-up in basis in the business assets of the target company? Can goodwill and other intangibles be depreciated for tax purposes in the event of the purchase of those assets, and the purchase of stock in a company owning those assets?

No provisions exist under the Chinese tax regulations for the allowance of a step-up in basis for business assets of a target company.

Intangible property can generally be amortised over a 10-year period using a straight-line method, and this does not change when an acquisition occurs. For acquired intangibles, if the useful life is provided in the applicable laws and regulations or the agreement, that useful life can be used as an amortisation period. The payment for purchased goodwill, however, can only be deducted at the time of either the transfer or liquidation of the enterprise. Prior to the new PRC Enterprise Income Tax Law being enacted in 2007, the goodwill as a result of an asset purchase by a foreign invested enterprise, could be amortised for 10 years. The new rule disallows such amortisation and therefore increases the amount of taxable income associated with acquiring a business.

### 3 Domicile of acquisition company

Is it preferable for an acquisition to be executed by an acquisition company established in or out of your jurisdiction?

It is preferable for an acquisition to be executed by an acquisition company established in China, if local finance and security is sought. From a tax perspective, little advantages or disadvantages exist for either method. The use of Hong Kong investment entities for acquiring stock in a Chinese entity remains popular – the main reasons are tax-based, including reduced withholding tax rates (5 per cent) and lower corporate income tax rates (17.5 per cent) for Hong Kong enterprises.

### 4 Company mergers and share exchanges

Are company mergers or share exchanges common forms of acquisition?

Company mergers are common forms of acquisition in China – under a merger, the company receiving the assets will assume the original tax basis of the assets transferred. Under the special tax treatment provisions discussed above, if the portion of stock payment is not less than 85 per cent of the total transaction price, the tax liabilities may be deferred.

Pure share exchanges are not so common in China, since the Chinese government authorities review these transactions more strictly and often with suspicion. Having said that, the Chinese M&A regulations clearly allow for share exchange M&A transactions.

### 5 Tax benefits in issuing stock

Is there a tax benefit to the acquirer in issuing stock as consideration rather than cash?

No, there is not a tax benefit to the acquirer in issuing stock as consideration rather than cash. But as mentioned above, if the portion of stock payment is not less than 85 per cent of the total transaction price, the tax may be deferred, under the special tax treatment, in accordance with Rule No. 59.

### 6 Transaction taxes

Are documentary taxes payable on the acquisition of stock or business assets and, if so, what are the rates and who is accountable? Are any other transaction taxes payable?

Stamp duty is payable on the acquisition of stock or business assets under the PRC Interim Regulations on Stamp Duty, issued by the State Council on 6 August 1988 and commencing operation on 1 October 1988. The rate of stamp duty is 0.05 per cent. Both parties are accountable. Further, deed tax at a rate of 3 per cent is payable on any assets acquired but not payable on a stock acquisition. Only the purchaser is accountable for deed tax under Chinese law.

VAT is payable on an assets acquired but not payable when a stock acquisition is used. Only the target company is accountable for the VAT liabilities under Chinese law.

### 7 Net operating losses, other tax attributes and insolvency proceedings

Are net operating losses, tax credits or other types of deferred tax asset subject to any limitations after a change of control of the target or in any other circumstances? If not, are there techniques for preserving them? Are acquisitions or reorganisations of bankrupt or insolvent companies subject to any special rules or tax regimes?

Net operating losses, tax credits or deferred tax assets cannot be applied if the main shareholders assign their shares obtained from the acquisition within 12 consecutive months after the acquisition, in accordance with the Rule No. 59.

Special tax rules apply to the reorganisation of bankrupt/insolvent companies; they include: (i) in the case that where a debt-to-equity swap occurs, the income or loss resulting from the debt settlement and equity investment can be deferred; and (ii) if the taxable income confirmed in the debt restructuring is more than 50 per cent of that year's taxable income of the bankrupt/insolvent company, the corresponding tax can be paid averaged over five years.

### 8 Interest relief

Does an acquisition company get interest relief for borrowings to acquire the target? Are there restrictions on deductibility where the lender is foreign, a related party, or both? Can withholding taxes on interest payments be easily avoided? Is debt pushdown easily achieved? In particular, are there capitalisation rules that prevent the pushdown of excessive debt?

An acquisition company gets interest relief for borrowings to acquire the target, since the interest can be deducted as costs before tax under certain conditions. However, there are restrictions on deductibility where the lender is a related party in accordance with the Notice Concerning Taxation Policies for the Standards for Pre-Tax Deduction of Interest Payments Made to Related Parties issued, Rules [2008] No. 121 of the Ministry of Finance and the State Administration of Taxation on 19 September 2008. According to the Rules No. 121, a company may deduct interest actually paid to related parties within the permitted debt-to-equity ratio. It appears that the deduction should be on an actual payment basis. Accrued but unpaid related-party interest expenses are not deductible. The Notice provides for a related-party debt-to-equity ratio of 5:1 for financial companies and 2:1 for other companies. The related-party debt includes not only direct loans from a related party but also a back-to-back loan where a related party provides, through an unrelated party, an unrelated-party loan guaranteed by a related party or secured by the assets of a related party, and other investment in the nature of a debt indirectly obtained from a related party. The interest on related-party debt exceeding the permitted amount will not be deductible when computing taxable income for corporate income tax purposes in the current year or future periods.

In accordance with the PRC Enterprise Income Tax Law and its Implementation Rules, the borrower is obligated to withhold tax when interest is paid or due and payable to a non-resident company. 'Due and payable' means the amount of interest payable that should be accounted for by the taxpayer on an accrual basis. For this reason, there is a risk that a borrower would need to withhold and pay the withholding tax on the accrued interest payable to a related party while no tax deduction is permitted.

### 9 Protections for acquisitions

What forms of protection are generally sought for stock and business asset acquisitions? How are they documented? How are any payments made following a claim under a warranty or indemnity treated from a tax perspective? Are they subject to withholding taxes or taxable in the hands of the recipient?

Tax warranties and indemnities are generally sought by the acquisition company, considering the risks brought by information asymmetry, and after a stock acquisition the acquired company's tax obligations and the legal liabilities resulting from these will be inherited by the new shareholders. Such warranties and indemnities are generally included in the share purchase or asset acquisition agreement. Often a provision is included in a warranty to the effect that any payment made for breach of the tax warranty or indemnity may be regarded as a reduction in the purchase price, under the relevant tax warranty and/or indemnity provision. Deeds of tax covenants are not common.

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**Post-acquisition planning**
**10 Restructuring**

What post-acquisition restructuring, if any, is typically carried out and why?

Typical post-acquisition restructuring includes assets restructuring and finance restructuring in China.

Divestiture, namely asset sales is often carried out so as to enhance the post-acquisition company's core strengths, improve the company's competitiveness and market value of its assets, and reduce the degree of diversification. Sometimes the divestiture is required by the PRC Anti-monopoly Bureau, which reviewed the acquisition and approved it with certain conditions. If the Anti-monopoly Bureau believes the post-acquisition company would cause excessive monopoly or control in some market and undermine fair competition, it will require the company to strip part of its assets or operations, in accordance with the PRC Anti-monopoly Law, Rules of the President No. 68, issued on 30 August 2007 and commencing operation on 1 August 2008.

Finance restructuring mainly includes debt restructuring and equity restructuring. The debt restructuring is carried out through the any or all following means:

- to repay all or part of the debt by non-cash means;
- to repay all or part of the debt by modifying the conditions of liability, such as extension of the repayment period, reduction of interest rates, exemption of interest and reduction of principal amount; and
- to repay all or part of the debt by issuing equity securities, based on the satisfaction of specific conditions under the Company Law. Further, equity structure and capital structure may also be rearranged (ie, stock repurchase – reducing the outstanding common stock so as to reduce the threat of takeover).

**11 Spin-offs**

Can tax neutral spin-offs of businesses be executed and, if so, can the net operating losses of the spun-off business be preserved? Is it possible to achieve a spin-off without triggering transfer taxes?

In accordance with Rule No. 59, tax neutral spin-offs of businesses can be executed when any and all of the following conditions are met:

- all the shareholders of the pre-spin-off company obtain the stock of the spun-off company as per their original stock ratio;
- both the pre-spin-off company and the spun-off company do not change the original substantial business activities; and
- the stock payment obtained by the shareholders of the pre-spin-off company at the time of spin-off is not less than 85 per cent of the total payment.

If tax neutral spin-off is executed, the net operating losses of the pre-spin-off company within the statutory time limit for coverage may be allocated to the spun-off company as per the ratio of the pre-spin-off assets.

**12 Migration of residence**

Is it possible to migrate the residence of the acquisition company or target company from your jurisdiction without tax consequences?

It is impossible to migrate the residence of the acquisition company or target company from China without tax consequences.

**13 Interest and dividend payments**

Are interest and dividend payments made out of your jurisdiction subject to withholding taxes and, if so, at what rates? Are there domestic exemptions from these withholdings or are they treaty-dependent?

Interest and dividend payments made out of China are subject to withholding tax, in accordance with the Enterprise Income Tax Law. Further, besides interest and dividend payments, royalties paid to non-residents also are subject to withholding taxes. The applied rate of withholding tax is 10 per cent – the general rate of withholding tax levied on non-residents is 2 per cent under the Enterprise Income Tax Law, however, the general rate is reduced to 10 per cent under the Implementing Regulations and bilateral tax agreements. For Hong Kong, the rate is generally 5 or 7 per cent.

**14 Tax-efficient extraction of profits**

What other tax-efficient means are adopted for extracting profits from your jurisdiction?

Royalties and service fees are generally adopted for extracting profits from China – the applicable withholding tax rate is generally 10 per cent.

For royalties, the applicable withholding tax rate may be reduced to 7 per cent or even 5 per cent, in accordance with the double tax treaties. It is worth noting that royalties paid abroad are subject to 5 per cent Chinese business tax. The business tax can be exempted for the transfer and development of patents and technologies in the field of natural sciences (but not social sciences) and consulting and services related to these.

Service fees paid abroad are subject to 5 per cent Chinese business tax, regardless of the whether the service is provided within the borders of China or abroad, in accordance with the Implementing Regulations of the PRC Business Tax Law. Further, it should be noted that new rules allow for China to impose enterprise income tax on a foreign company in some cases – for example, if an employee of a foreign company is sent to China to provide services for more than six months, then the foreign company may be deemed to have a permanent establishment in China.

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**Disposals (from the seller's perspective)**
**15 Disposals**

How are disposals most commonly carried out – a disposal of the business assets, the stock in the local company or stock in the foreign holding company?

A disposal of the stock in the foreign holding company is most commonly carried out in China, since the indirect change of ownership of a Chinese company instead of the direct change of ownership will generally not trigger any Chinese tax consequence. However, it is noteworthy that the State Administration of Taxation released a Notice on Strengthening the Administration of Enterprise Income Tax on Non-resident Enterprises' Equity Transfer Income ('Notice No. 698') on 10 December 2009, which expressly states that if the overseas investor indirectly transfers the stock of a Chinese resident enterprise 'using improper arrangements', without reasonable commercial purpose, but for the purpose of tax avoidance, the Chinese tax authority is entitled to levy enterprise income tax on the overseas investor.

From a tax-efficient perspective, a disposal of the stock in the local company is more commonly carried out than a disposal of the business assets. In accordance with Rule No. 59, a disposal of the stock is subject to a 10 per cent enterprise income tax under the ordinary tax treatment; the tax may be free or deferred under the special tax treatment provisions described above. Besides, a 0.05 per cent of stamp duty is also applicable.

**16 Disposals of stock**

Where the disposal is of stock in the local company by a non-resident company, will gains on disposal be exempt from tax? Are there special rules dealing with the disposal of stock in real property, energy and natural resource companies?

As discussed above, a non-resident company is generally subject to 10 per cent withholding tax under the ordinary tax treatment provisions, but the tax may be free or deferred under the special tax treatment, in accordance with Rule No. 59.

There are no special rules dealing with the disposal of stock in real property, energy and natural resource companies. Rule No. 59, as a general rule, is applied to all kinds of disposals of stock.

**17 Avoiding and deferring tax**

If a gain is taxable on the disposal either of the shares in the local company or of the business assets by the local company, are there any methods for deferring or avoiding the tax?

In accordance with the Rule No. 59, tax can essentially be deferred under the special tax treatment provisions. The special tax treatment provisions are applied when all of the following conditions are satisfied:

- the restructuring is based on reasonable commercial reasons, but not for the purpose of tax reduction, avoidance or deferral;
- the stocks or assets being acquired, merged or spun-off reach the required ratio – not less than 75 per cent stocks or assets are transferred within 12 months;
- the original substantial business activities are not changed within 12 consecutive months after the restructuring;
- the portion of stock payment is not less than 85 per cent of the total transaction price; and
- the original main shareholders obtained stock payment will not transfer their stocks within 12 consecutive months after the restructuring.

**Update and trends**

The revised PRC Enterprise Income Tax Law, which came into operation in 2007/8, includes several anti-avoidance rules. Such anti-avoidance provisions permit the Chinese tax authorities to make adjustments when enterprises enter into business arrangements that give rise to a reduction of taxable income and are not supported by a reasonable business purpose. Under Rule No. 59, the inbound investment must be based on reasonable commercial reasons, but not for the purpose of tax reduction, avoidance or deferral. The Chinese tax authorities are entitled to make adjustments to certain transactions, deny tax benefits, or disregard legal entities that are considered to lack substance, under these powerful anti-avoidance rules. These rules are also used to examine back-to-back loan or financing structures made by non-resident investment funds.

The special tax treatment provisions can also be applied to cross-border restructuring when the following additional conditions are satisfied:

- the non-resident enterprise transfers the stock in a resident enterprise to another wholly owned non-resident enterprise. Such transfer will not result in a change in the withholding tax rate on the capital gains arising on the subsequent transfer of the stocks of the resident enterprise. The transferring party promises to the tax authority not to transfer the stock of the transferee within three years after the transfer of the resident enterprise;
- the non-resident enterprise transfers the stock in a resident enterprise to another wholly owned resident enterprise; and
- the resident enterprise uses its assets or stocks to invest in another wholly owned non-resident enterprise.

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