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Acquisitions (from the buyer's perspective)

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?

On 7 May 2009, China's Ministry of Finance (MOF) and the State Administration of Taxation (SAT) jointly issued the 'Notice on Several Enterprise Income Tax Issues Relating to Enterprise Reorganisation Activities', Caishui No. 59 (2009) and the 'Notice on Several Enterprise Income Tax Issues Relating to Enterprise Liquidation Activities', Caishui No. 60 (2009). Both circulars are dated 20 April 2008 and are effective retroactive from 1 January 2008. These rules now provide for tax deferred corporate reorganisations.

Closely modelled on the on the US tax rules governing corporate reorganisations, the new reorganisation tax rules address six types of reorganisation: equity acquisition, asset acquisition, merger, division, change of legal form and debt restructuring. Each of these types of reorganisation will be considered to be a taxable transaction unless it meets the requirements for a 'tax free' (ie, tax deferred) transaction.

Ordinary reorganisations

As a general rule, both parties to an ordinary reorganisation should recognise gain or loss at the time of a transaction. Unless the special rules apply, the target company must recognise gain or loss from the transfer of assets or the target shareholder must recognise gain or loss from the transfer of their shares, and the purchaser takes the assets or equity shares with a tax basis equal to fair market value.

Change of legal form of an enterprise

For simple legal-form changes such as change of address, change of registered name or form of organisation, the enterprise only needs to update its tax registration and unless otherwise provided, the tax attributes of the original enterprise will normally be inherited by the changed enterprise. When the enterprise changes its legal form from a legal person to a sole proprietorship, partnership, or other non-legal person form, the enterprise shall be deemed to be liquidated, with all of its assets distributed to the owners of the enterprise, and the owners shall be deemed to have set up a new enterprise by contributing the assets. The tax basis of the assets of the new enterprise will be determined according to fair market value.

Acquisition of assets or equity

In a reorganisation involving the transfer of assets or equity stock, the transferor or seller recognises gain or loss on the transfer. The purchaser takes the assets or equity stock with a basis equal to fair market value.

Mergers

In a taxable merger, the assets and liabilities are treated as sold at fair market value by the merged enterprise and then as a liquidation of the merged enterprise. The enterprise recognises gain or loss on the deemed sale and the shareholders recognised gain or loss on the deemed liquidation. The surviving enterprise takes both assets and liabilities at fair market value. China's tax law does not allow the surviving enterprise to use the merged enterprise's net operating losses (NOLs). The NOLs of a merged enterprise are permanently lost.

Special reorganisations

The Notice on Several Enterprise Income Tax Issues Relating to Enterprise Reorganisation Activities, Caishui No. 59 (2009) allows for a 'tax free' (actually tax deferred) transaction in which the gain or loss from the transaction is deferred until a future recognition event. The tax deferral is achieved through the concept of 'substituted basis'. Tax deferrals for stock-for-stock and stock-for-asset transactions are discussed in more detail below.

Requirements for 'tax free' special reorganisation

To qualify for tax free (tax deferred) treatment, a transaction must meet all of the following requirements:

- the reorganisation must have a business purpose and the main purpose must not be to avoid or defer tax payment;
- 75 per cent or more of the target's total equity or assets must be transferred;
- there must not be substantial change in the business activities within 12 months of the reorganisation;
- the payment in stock as a percentage of total consideration for the transaction must be no less than 85 per cent. Therefore, cash, accounts receivable, marketable securities, fixed assets, other assets, inventory, and other 'boot' cannot be more than 15 per cent of the total consideration for the transaction; and
- the party receiving the stock cannot transfer the stock within 12 months of the transaction.

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?

Current Chinese tax rules do not allow for a step-up in basis in a share acquisition deal.

Acquired goodwill cannot be amortised and can be deducted only when the entire assets of a company are transferred or a company is liquidated.

Other intangible assets can be amortised for no less than 10 years in general or a shorter lifetime stipulated by law or the transfer agreement.

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?

Under the ordinary rules, from a tax perspective, there is little difference between an acquisition of assets by an onshore company and an acquisition of assets by an offshore company. In both cases, the seller of the assets will pay either 5 to 20 per cent in capital gains tax or 25 per cent corporate income tax plus VAT on the recognised gain or loss, depending on the type of asset sold. However, under the special reorganisation rules, tax deferral may be possible if the conditions in question 1 are met as well as one of the following:

- a non-resident company transfers equity stock of a resident company to another 100 per cent directly controlled non-resident company. The transferor must promise to the tax authorities in writing, that it will not transfer the shares of the non-resident company for three years. In addition, the transfer must not result in a change in withholding tax;
- a non-resident company transfers equity stock of a resident company to another 100 per cent directly controlled company;
- a resident company transfers equity stock or assets to a 100 per cent directly controlled non-resident company as an investment and in such case, the resident company can recognise gain on the transfer over a 10-year period; or
- other situations as approved by the Ministry of Finance or the State Administration of Taxation.

However, if the assets acquired are the equity shares of a company incorporated in China, it will, as a general rule, be more tax-efficient when the shares are disposed of, to purchase and hold the assets via an offshore holding company. Please see questions 15 and 16.

4 Company mergers and share exchanges

Are company mergers or share exchanges common forms of acquisition?

As discussed above, in a taxable merger, the assets and liabilities are treated as sold at fair market value by the merged enterprise and then as a liquidation of the merged enterprise. The enterprise recognises gain or loss on the deemed sale and the shareholders' recognised gain or loss on the deemed liquidation. The surviving enterprise takes both assets and liabilities at fair market value. Chinese tax law does not allow the surviving enterprise to use the merged enterprise's net operating losses. The NOLs of a merged enterprise are permanently lost.

However, if the stock consideration received by the shareholders of the merged enterprise is not less than 85 per cent of the total consideration for the transaction, or if no consideration is paid because of common control, the merger can be deemed to be a special reorganisation and may qualify for tax deferred treatment. If the special rules apply, the merged companies and their shareholders may not recognise gain or loss on the stock consideration. The tax basis in the assets and liabilities of the surviving enterprise will be equal to the basis of the assets and liabilities in the hands of the merged companies immediately before the transfer. The shareholders' tax basis in the stock of the merged company should be equal to the shareholders' tax basis in the stock originally held. While NOLs in a taxable merger are permanently lost, the NOLs in a 'tax free' merger can survive the merger subject to limitations.

5 Tax benefits in issuing stock

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

There is no tax benefit to the acquirer in issuing stock as consideration rather than cash. However, if the consideration is stock or equity interest, a tax deferral treatment may be available to the seller under the Notice on Several Enterprise Income Tax Issues Relating to Enterprise Reorganisation Activities.

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 the one documentary tax that applies to both share transfers and asset transfers. Under the PRC Provisional Rules on Stamp Duty, each contract party (the acquirer and the seller) is subject to stamp duty on the total value of a transfer contract. Generally speaking, the stamp duty rate applicable to a share or asset transfer contract is 0.05 per cent. If inventories are included in an asset transfer, the applicable tax rate for the inventories will be 0.03 per cent instead of 0.05 per cent. Please note that each party is required to pay the stamp duty at the above rate.

There is no transaction tax applicable to a share transfer. In an asset transfer, different transaction taxes are levied on different types of asset transfer.

Immoveable properties

In general, the seller is subject to a 5 per cent business tax (BT) on the transfer price of an immoveable property that includes a building or a land use right. If the building was previously acquired by the seller, the cost of acquisition is allowed to be deducted from the transfer price, that is, only the net is subject to the BT.

The seller is also subject to land value appreciation tax, which is imposed at progressive rates ranging from 30 per cent to 60 per cent on the gains from the sale of land-use rights and buildings. This is often viewed as a quasi-additional capital gains tax as it is a tax on the gains, not on the gross receipt.

The buyer is subject to 3 to 5 per cent deed tax on the transfer price of a building or land-use right.

Inventory and fixed assets

The sale of inventory is subject to 17 per cent VAT. The seller collects the VAT from the buyer and pays it to the tax authorities. The buyer can credit the VAT paid to the seller against the VAT collected from its own customers. Certain goods are subject to VAT at 13 per cent.

From 1 January 2009, where a taxpayer sells any fixed asset used by itself (hereinafter referred to as the 'used fixed asset'), the VAT shall be collected in light of the following different circumstances:

- if the taxpayer sells a used fixed asset which was purchased or produced by itself after 1 January 2009, it shall pay the VAT at the applicable tax rate;
- if the taxpayer who had not been brought into the pilot enlargement of the VAT deduction scope before 31 December 2008, sells a used fixed asset which was purchased or produced by itself before 31 December 2008, the taxpayer shall pay the VAT at the half rate of 4 per cent; and
- if the taxpayer who had been brought into the pilot enlargement of the VAT deduction scope before 31 December 2008 sells a used fixed asset which was purchased or produced by itself before the pilot enlargement of the VAT deduction scope in the area where it is located, it shall pay the VAT at the half rate of 4 per cent; if it sells a used fixed asset that was purchased or produced by itself after the pilot enlargement of the VAT deduction scope in the area where it is located, it shall pay the VAT at the applicable tax rate.

Intangible assets

The seller is subject to business tax at 5 per cent on the transfer price of such intangible assets.

7 Net operating losses, other tax attributes and insolvency proceedings

Are net operating losses or other tax attributes 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 (NOLs) can be carried forward for five years and can survive a change in control of the target if it is a share acquisition where all the tax attributes of the target company are preserved. That said, if the sole or main purpose of the acquisition is to utilise the NOLs, the benefit may be denied under the new Enterprise Income Tax (EIT) Law (2007) anti-avoidance rules.

In an assets acquisition deal, the NOLs of the target will be lost and there is no way to preserve them.

In a taxable merger deal, under the Notice on Several Enterprise Income Tax Issues Relating to Enterprise Reorganisation Activities, the NOLs of the company that doesn't survive after the merger will also be lost. However, the NOLs of the surviving company may be capable of being preserved.

In a tax-free merger deal, based on the Notice on Several Enterprise Income Tax Issues Relating to Enterprise Reorganisation Activities, the NOLs of the company that doesn't survive can be preserved but is subject to a limit. The limit is the fair market net value of the assets of the company multiplied by the interest rate of the treasury bond that is issued by the central government in the same year as the merger takes place and has the longest maturity period.

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?

Under the EIT Law, any reasonable expenses that are necessary and normal expenses incurred in the normal course of business and are directly connected to the generation of income can be deducted. Therefore, an acquisition company should generally be able to deduct interest for loans used to acquire assets.

However, in the case of a share acquisition, since dividends received by a Chinese company from a Chinese subsidiary are exempt from EIT (although the EIT Law is not 100 per cent clear on this point), the interest on loans used to acquire shares should not be deductible.

Where the lender is a foreign company, under the EIT Law, the interest rate shall not exceed the normal commercial rate used by the financial institutions in China.

If the lender is a related party, the interest deductibility is also subject to the debt-to-equity ratio rule under the new EIT Law.

According to a recent tax circular issued in September 2008, interest for loans from related parties can be deducted if the debt-equity ratio is within 5:1 (applicable to financial institutions) or 2:1 (applicable to all other companies). Excessive interest can only be deducted if a company can provide documents proving that the borrowing is at arm's length, if such interest is paid to a related Chinese company, and the effective tax rate of that entity is not lower than that of the interest paying company.

If the lender is a non-resident, the interest paid to the lender is subject to 5 per cent business tax and 10 per cent withholding tax. There is no exemption of withholding tax on interest payments except for qualified interest paid to an international financial institution such as the International Monetary Fund (IMF) or the World Bank. Certain double tax treaties provide for a withholding tax exemption on interests if the lender is a government or wholly government-owned financial institution. In addition, under several treaties such as the Hong Kong-China tax treaty, the Chinese withholding tax on interest is reduced to 7 per cent.

A debt pushdown in a share acquisition is not possible in China.

9 Protections for acquisitions

What forms of protection are generally sought for stock and business asset acquisitions? How are they documented?

In both stock and asset acquisitions in China, warranties and indemnity are commonly sought. Tax warranties are usually included in the transfer agreement and the target company generally warrants that it is in compliance with tax laws and regulations and that its total tax liability as of a certain date has been or will be fully settled. Tax compliance is still a major problem in China and Chinese companies routinely engage in tax evasion. Tax warranties and indemnity are extremely important to a potential buyer, especially in a share acquisition in which the buyer assumes all liabilities of the target company.

Post-acquisition planning

10 Restructuring

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

Post-acquisition restructuring is typically driven by business integration and the streamlining of a controlled groups operations and lines of control. In some cases, tax concerns may drive the restructuring, in order to take advantage of more favourable tax treaties or avoiding the 5 per cent business tax on inter-company service charges.

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?

Generally, the spin-off of a business will be treated as a sale of assets for fair market value by the original enterprise, with the original enterprise recognising gain or loss on the transaction. Under the general rules, NOLs of one enterprise may not be used by another enterprise and are retained in the original company.

The Notice on Several Enterprise Income Tax Issues Relating to Enterprise Reorganisation Activities, Caishui No. 59 (2009) allows for tax-neutral spin-offs if certain conditions are met and allows for a partial transfer of NOLs to the spun-off business.

For a spin-off to qualify as a 'tax free' special reorganisation, all of the conditions below must be met:

- all shareholders of the original enterprise must receive stock in the spun-off enterprise in proportion to their original ownership in the original enterprise;
- both the original enterprise and the spin-off enterprise shall not substantially change their respective business operations; and
- the stock of the spun-off enterprise received by the shareholders of the original enterprise shall not be less than 85 per cent of the total transaction consideration.

If the transaction is treated as a special reorganisation and the original enterprise has unexpired NOLs immediately before the spin-off, a portion of the NOLs may be allocated to the spun-off enterprise based on the percentage of pre-spin-off assets it received from the original company.

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 not possible to migrate the residence of a Chinese company to a foreign jurisdiction without tax consequences. A company incorporated in China is always considered to be a Chinese resident, even if it is managed outside China. Furthermore, article 3 of the Enterprise Income Tax Law (2007) provides that non-resident enterprises with no place of business or permanent establishment in China are taxed on their China-sourced income at 10 per cent.

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?

Under the EIT Law, both interest and dividend payments paid to a non-resident are subject to a 10 per cent withholding tax. Certain tax treaties reduce the withholding tax rate applicable to dividends from 10 per cent to 7 or 5 per cent, and to interest from 10 per cent to 7 per cent.

In addition, an additional 5 per cent business tax may also be levied on interest paid to a non-resident, depending on the individual policies of the local tax bureau across China. The State Administration of Taxation (SAT) has not issued a definitive ruling on this and has allowed its local branches to interpret the rule locally.

14 Tax-efficient extraction of profits

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

The primary means of profit repatriation from China include interest, royalties, service fees, and dividends.

Interest, royalties and service fees are generally tax-deductible in China against the payers' 25 per cent enterprise income tax (EIT). Generally, there is a 10 per cent withholding tax payable by the recipients of interest, royalties, and service fees. Unless an exemption is obtained, royalties derived by non-resident enterprises are also subject to an additional 5 per cent business tax. If an applicable double tax treaty applies, the withholding rates on interest, royalties, and dividends may be as low as 5 per cent.

Based on the revised Business Tax Regulations, effective from 1 January 2009, a 5 per cent business tax is imposed on service fees payable by a Chinese entity to a non-Chinese entity, regardless of the location where services are rendered. In addition, China's EIT may be levied on service fees depending on whether the recipient of the service fee is considered to be a permanent establishment (PE) in China. If the foreign enterprise does not create a PE in China, the service fees shall be exempt from the China EIT. On the other hand, if a PE is deemed to be set up in China, service fees shall be subject to EIT.

The Chinese tax authorities usually apply a deemed profit rate to assess the taxable profit of the foreign company instead of requesting a detailed breakdown of the actual revenue, costs and expenses in connection with service rendered. A deemed profit rate of 10 per cent to 15 per cent is commonly applied to management fees and related services. It may also be feasible to negotiate with the local branches of the SAT to fully exempt 'offshore services', which are wholly rendered outside China. It should be noted that management fees should correspond to an actual service provided to the China-related company. General management fees for a parent company's general stewardship functions are not deductible for China's EIT purposes.

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?

The most tax-efficient exit strategy is the disposal of the stock in a foreign holding company, which holds ownership in the foreign invested enterprise in China. Such a transaction will not involve the direct change of ownership in the Chinese entity and therefore will attract no Chinese tax.

A less tax-efficient exit strategy would be to directly dispose of the shares in the Chinese company. If the special reorganisation rules do not apply, a 10 per cent capital gains tax would generally apply. Double tax treaties may allow for a lower capital gains rate. If the special reorganisation rules apply, taxation may be deferred. Please see questions 1, 2 and 3. In addition, both the buyer and seller must pay 0.05 per cent stamp duty.

The least cost-efficient exit strategy involves the foreign investor selling off the company's assets and then de-registering the company. Gains on the sale of company assets would be taxed at the normal 25 per cent EIT rate. In addition, VAT of various rates would also apply to various assets. After the assets have been sold, the company would then be required to go through a lengthy and often expensive process of tax-deregistration and company deregistration.

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?

A non-resident is subject to withholding tax of 10 per cent on capital gains realised on the disposal of investment or transfer of assets on the excess of the proceeds over the net value of the assets transferred, unless exempted by an applicable double tax treaty. If the special

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reorganisation rules apply, taxation may be deferred. Please see questions 1, 2 and 3.

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?

Special reorganisations

The Notice on Several Enterprise Income Tax Issues Relating to Enterprise Reorganisation Activities, Caishui No. 59 (2009) allows for a 'tax free' (actually tax deferred) transaction in which the gain or loss from the transaction is deferred until a future recognition event. The tax deferral is achieved through the concept of 'substituted basis'. Tax deferrals for stock-for-stock and stock-for-asset transactions are discussed in more detail below.

Requirements for 'tax free' special reorganisation

To qualify for tax free (tax deferred) treatment, a transaction must meet all of the following requirements:

- the reorganisation must have a business purpose and the main purpose must not be to avoid or defer tax payment;
- 75 per cent or more of the targets total equity or assets must be transferred;
- there must not be substantial change in the business activities within 12 months of the reorganisation;
- the payment in stock as a percentage of total consideration for the transaction must be no less than 85 per cent. Therefore, cash, accounts receivable, marketable securities, fixed assets, other assets, inventory, and other 'boot' cannot be more than 15 per cent of the total consideration for the transaction; and
- the party receiving the stock cannot transfer the stock within 12 months of the transaction.

In addition to each of the items above, for the special reorganisation rules to apply to a cross-border transaction, one of the below must also apply:

- a non-resident company transfers equity stock of a resident company to another 100 per cent directly controlled non-resident company. The transferor must promise to the tax authorities, in writing, that it will not transfer the shares of the non-resident company for three years. In addition, the transfer must not result in a change in withholding tax;
- a non-resident company transfers equity stock of a resident company to another 100 per cent directly controlled company;
- a resident company transfer equity stock or assets to a 100 per cent directly controlled non-resident company as an investment and in such case, the resident company can recognise gain on the transfer over a 10-year period; or
- other situations as approved by the Ministry of Finance or the State Administration of Taxation.

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