
CHINA

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1. Introduction

1.1 General Comments on M&A in People's Republic of China

This chapter details the main issues that are relevant to both purchasers and sellers on a transfer of ownership of a company in People's Republic of China (PRC or China). It is generally assumed that all sellers are PRC companies and that all purchases are made either by a foreign enterprise (FE) or through a foreign-invested enterprise (FIE) in PRC, unless otherwise indicated. A transfer of ownership of a PRC company may take the form of a disposal of shares or assets.

The relevant taxes to be considered in the context of a M&A transaction are detailed as follows.

1.2 Corporate Tax

Foreign Enterprise Income Tax (FEIT): Generally, PRC companies are taxed on a stand-alone basis. FEIT taxes the profits earned by a company at a tax rate of 33%.

1.3 Withholding Tax (WHT)

A FE which has no permanent establishment, or place of business, in China but derives profit, interest and other income from sources in China is subject to WHT at the rate of 10% on such income.

1.4 Turnover Taxes

Value Added Tax (VAT): This is a sales tax where up to 17% is added to the sales price charged for goods (except for certain categories of sales which are exempt from or outside the scope of VAT).

Business Tax (BT): Generally, BT of 5% is imposed on any transfer of immovable assets (e.g. land and real estate) and intangible assets (e.g. trademarks, patents and copyrights). In addition, a FE that derives interest income from China is also subject to BT at the rate of 5%.

Consumption Tax (CT): CT is imposed on 11 categories of goods, including cigarettes, alcoholic beverages and certain luxury items.

1.5 Stamp Tax

This tax is payable by both the purchaser and seller at rates ranging from 0.03% to 0.05% on the value of equity or asset transferred.

1.6 Other Relevant Taxes

Land Appreciation Tax is imposed on the seller upon the transfer of land use rights and building and is assessed at progressive rates from 30% to 60% of the appreciated amount of the land use right and building.

Deed Tax is payable by a purchaser at the rates ranging from 3% to 5% on the purchase price of land use right or building.

2. Acquisitions

According to the Provisional Measure for Merger and Acquisition of Domestic Enterprises by Foreign Investors (the Provisional Measure) effective from 12th April 2003 and issued by the Ministry of Foreign Trade and Economic Co-operation which is part of the Ministry of Commerce (MOC), the State Administration of Taxation (SAT), the State Administration of Industry and Commerce (SAIC), and the State Administration of Foreign Exchange (SAFE), foreign investors are now allowed to acquire PRC companies in one of the following ways:

- an acquisition of the equity or share holdings of a non-FIE by a foreign investor. This acquisition, subsequently, converts the target entity into a FIE (hereinafter referred to as a stock deal);
- an acquisition of the assets of a non-FIE by an existing FIE or by a foreign investor through the formation of a new FIE (hereinafter referred to as an asset deal).

In light of the above, special rules and regulations apply if foreign investors acquire stock in listed Chinese companies (see section 2.2.1).

2.1 The Preference of Purchasers: Stock vs. Assets Deal

The adoption of an asset deal or a stock deal for an acquisition in China largely depends on the regulatory situations, as well as the commercial and tax objectives of the investors. For example, in some cases, an asset deal may be the only option for acquiring businesses from Chinese domestic enterprises.

2.2 Stock Deal

According to the Provisional Measure, under a stock acquisition, the Target Company remains as a going concern subject to its originally approved operating period. The acquirer also inherits the business risk and hidden or contingent liabilities, if any, of the Target Company. Accordingly, this risk should be addressed by performing a due diligence on the target, through adjusting the purchase price and/or obtaining contractual warranty from the Target Company's prior shareholders, where commercially viable.

Under a stock deal, there is no change in the legal existence or disruption to the attributes of the acquired PRC Company. Thus, the Target Company may not re-value its asset basis for Chinese tax purposes.

The transfer of a stock interest in a Chinese entity is subject to Stamp Tax on the transfer price. Such Stamp Tax is payable by both the buyer and the seller. Any acquisition expense incurred by the buyer may not be allocated to the Target Company and, therefore, such expense generally incurred by the offshore buyer may not be claimed as a tax deduction in China.

Generally, tax losses of the Target Company arising prior to the acquisition may continue to be carried forward after the stock acquisition for any period remaining within the five-year limit (see section 6.2 for details).

2.2.1 Acquisition of Stock in Listed Chinese Companies

The stock of domestic Chinese companies may be listed on one of China's two stock exchanges located in Shanghai and Shenzhen. Two classes of shares are tradable on these stock exchanges:

- Class A shares that are restricted to domestic traders and qualified institutional foreign investors (QFII); and
- Class B shares that are restricted to foreign investors and individual Chinese investors.

There are also two classes of shares that are not tradable. These two classes are:

- state-owned shares that are owned directly by the State; and
- legal person shares that are owned by another company or institution with a legal person status.

The legal person shares may be owned indirectly by the State if the shareholders of the legal person shares are state-owned enterprises (SOEs). These non-tradable shares jointly account for 60% or more of the total issued shares of a listed company.

- Acquisition of Tradable Stock

Foreign investors have long been allowed to acquire Class B shares in the Chinese market. However, Class A shares, which had previously been reserved for domestic investors, became available to foreign investors at the end of 2002 under the QFII rules jointly issued by the China Securities Regulatory Commission (CSRC) and the People's Bank of China.

The term "QFII" refers to foreign funds management companies, insurance companies, securities companies and other asset management institutions approved by the CSRC to invest in the PRC securities market within the limitations set by the SAFE.

A QFII is able to invest in Class A shares, government bonds, convertible bonds and corporate bonds listed on China's securities exchanges. However, for an investment in Class A shares, each QFII is allowed to hold less than 10% of particular listed company's total issued shares. All QFIIs together are allowed to hold in total more than 20% of particular listed company's total issued shares. Also, a QFII's domestic investment activities should comply with the requirements set out in the Guidance for Foreign Investment in Various Industries. Therefore, the QFII rules offer only limited possibilities for merger and acquisition activities in China.

- Acquisition of Non-Tradable Stock

Before 2003, non-tradable shares of listed Chinese companies may be transferred between the State and Chinese legal persons but were off-limits to foreign buyers. On 1st November 2002, the CSRC, the Ministry of Finance and the State Economic and Trade Commission jointly issued the Notice on Relevant Issues Concerning the Transfer to Foreign Investors of Listed Company State-Owned Shares and Legal Person Shares (the State-Owned Share Notice). This State-Owned Share Notice, effective from 1st January 2003, addresses the direct sale of both state-owned and legal person shares to foreign investors.

According to the State-Owned Share Notice, in principle, non-tradable shares may be sold by public bid. In the case of crucial items (which have not been defined), the sale must be submitted to the State Council (the highest governmental administrative authority of China) for approval. In addition, a share transfer to a foreign investor is subject to the Foreign Investment Guideline prohibitions and limitations on foreign investment in specified economic sectors.

Therefore, if, as a result of the proposed share acquisition, the foreign-owned interest exceeds the limitations set out in the Foreign Investment Guideline, the transaction may not be approved.

Furthermore, a listed Chinese company that transfers its shares to a foreign investor, even if the amount of shares transferred resulted in the foreign investor having control over the company, the said company will not qualify as a FIE and, thus, it may not enjoy the various preferential tax treatments granted to FIEs.

On 4th September 2005, the CSRC issued the Measures for the Administration of Share Capital Segregation Reform of Listed Companies which stipulated that any sale of non-tradable shares would require approval by at least two-thirds of all voting shareholders. It also emphasised the need to compensate the holders of tradable shares for any significant falls, if any, in value of the shares as a result of the said sale transaction.

There are still a number of ambiguities as to how the State-Owned Share Notice will be implemented. Therefore, foreign investments under this rule will have to be negotiated not only with the Chinese Target Company but also with several Chinese government authorities.

2.3 Asset Deal

In general, an asset acquisition involves the formation of a new company for the purpose of acquiring the assets, liabilities and business of a Target Company. However, it should be noted that the formation of a new company requires certain approval.

An asset deal is typically used in order to leave behind some of the inherent risks associated with the Target Company. An asset acquisition helps to restrict the risks to the specific assets, liabilities and businesses being acquired. Thus, the acquirer generally does not assume any contingent or hidden liabilities of the Target Company. However, in certain specific situations, an asset deal is not immune from the inherent risks related to the assets acquired. For example, if there is any default on the Target Company's part of import duty and VAT on the assets acquired, PRC Customs may pursue the assets, notwithstanding that they have been sold. The seller is required to pay PRC taxes in respect of the transfer of the following assets:

| Nature of assets acquired | Relevant tax |
|---|---------------------|
| Land, building and intangibles | Business tax 5% |
| Inventory | VAT 17% |
| Inventory – Category of goods subject to CT | CT at various rates |
| Used equipment sold above original cost | VAT 2% |
| Motor vehicles sold higher than the original cost | VAT 2% |

Generally, the seller and buyer may only retain and carry forward their respective tax losses and may not transfer the tax losses to the other party through the transfer of their assets and business operations to the other party.

2.4 Transaction Costs for Purchasers

2.4.1 Turnover Taxes

- Stock Purchase

In general, stock transfers are not subject to VAT or BT.

- Asset Purchase

From the purchaser's perspective, if the purchaser is subject to the VAT regime and is obliged to charge VAT on its sales (output VAT), the purchaser may recover VAT paid by it on the purchases (input VAT) of inventory from the seller. A purchase of inventory (excluding fixed asset) on which VAT has been charged by the seller is regarded as an input for the buyer. Therefore, VAT charged by the seller may be recovered by the buyer.

Note that in some situations, depending on certain VAT related characteristics of the purchaser, the input VAT may not always be recoverable in full. Hence, to the extent to which the VAT paid may not be recovered, such non-recoverable VAT would be a real cost to the purchaser.

For certain types of inventory, the CT paid for the purchase of inventory could be offset against the CT liabilities for a manufacturing purchaser if the said inventory is used for the production of another product that is also subject to CT. Otherwise, the CT paid would be a real cost to the purchaser.

2.4.2 Stamp Tax and Other Relevant Taxes

- Stock Purchase

Stamp Tax of 0.05% is payable by both the purchaser and the seller on the amount of consideration or value of the transfer of stock, whichever is higher.

- Asset Purchase

Deed Tax of 3% to 5% of the amount or value of the transfer consideration is payable by the purchaser on transactions related to land or real estate properties in the PRC.

In addition, under an asset deal, the sale of inventory and fixed assets is subject to a Stamp Tax at the rate of 0.03% on the value set out in the relevant sales contracts. Stamp Tax at 0.05% would be applied on the transfer of immovable or intangible assets. This Stamp Tax is imposed on both the seller and the buyer.

2.4.3 Concessions Relating to M&As

According to the latest notice issued by the SAT, Deed Tax will not be payable if the transfer of land or real estate ownership is caused by a SOE's restructuring (e.g. conversion to a limited liability company) during the period from 1st October 2003 to 31st December 2005. However, it is unclear whether the above preferential tax policy will be extended to 31st December 2008 (as regulated in the latest circular Cai Shui [2006] No. 41).

2.4.4 Tax Deductibility of Transaction Costs

The PRC tax laws and regulations do not provide clear stipulations on the deductibility of transaction costs. In general, FIEs are not allowed to take deductions for expenses related to feasibility studies, interest expense on investment loans, management expenses and other investment-related expenses for FEIT purposes. Nevertheless, if a FIE uses non-cash assets (e.g. tangible and intangible assets) to acquire stock or assets, the difference between the original book value of the non-cash assets and the purchasing price of the acquired stock or assets is taxable profit or deductible loss of the seller in the taxable period of the transaction.

3. Basis of Taxation Following Asset or Stock Acquisition

3.1 Stock Deal

Stock purchased should be recorded by the purchaser in its books at the acquisition cost. No adjustment to the basis of the underlying assets of the company is allowed for PRC tax purposes. Where adjustments have been made for accounting purposes (usually through revaluation) and the relevant depreciation and amortisation is based on such adjusted values (hereinafter referred to as accounting adjustment), the taxable income of the acquired company is required to be adjusted in the annual FEIT filing. The following are methods that may be adopted to account for such tax adjustment:

- actual annual adjustment method (Profit & Loss approach) - the annual taxable income is adjusted by the actual increase or decrease in the relevant cost or expense resulting from the accounting adjustment for each specific asset item; and
- consolidated adjustment method (Balance Sheet approach) - all of the balance sheet adjustments for the revalued assets are consolidated (i.e. netted off against each other) and spread evenly over a 10-year period for tax adjustment purposes.

The FIE should apply for approval from the relevant tax authority before adopting either of the above adjustment methods.

3.2 Asset Deal

Each asset purchased should be recorded on the buyer's books at its actual purchase price. In the case where a lump sum purchase price is paid for numerous assets or together with goodwill or business operations and cannot be specifically allocated to each asset, the buyer should record as the cost of each asset the corresponding net value on the seller's books before the transfer. The balance of the purchase consideration after offsetting against the net book value of the assets is regarded as the purchase price for goodwill or business operations and should be recorded as intangible assets on the buyer's books. The balance recorded may then be evenly amortised over the shorter of 10 years or the remaining operation term of the buyer.

4. Financing of Acquisitions

4.1 Thin Capitalisation

According to the prevailing PRC FIE laws and regulations, a FIE should comply with the following debt-to-equity ratio (i.e. the difference between the total investment and registered capital may be financed by debt).

| Total investment (TI) (USD) | Minimum registered capital |
|-----------------------------|---------------------------------------|
| Less than 3 million | 70 % of TI |
| Between 3 and 10 million | Higher of 2.1 million or 50 % of TI |
| Between 10 and 30 million | Higher of 5 million or 40 % of TI |
| More than 30 million | Higher of 12 million or 33 1/3% of TI |

4.2 Deductibility of Interest

4.2.1 Stock Deal

For FIEs, interest expenses incurred in respect of loan used to acquire an investment are not deductible from taxable income.

4.2.2 Asset Deal

As indicated in section 2.3, an asset deal generally involves the formation of a new company to acquire the relevant assets. In respect of a new company which is a FIE, interest incurred to acquire the relevant assets shall be capitalised and depreciated over the useful life of the assets for FEIT purposes.

5. Merger

5.1 Legal Forms

In China, a merger refers to the combination of two or more enterprises into one enterprise. Such a combination may take the form of an absorption merger or a new company merger.

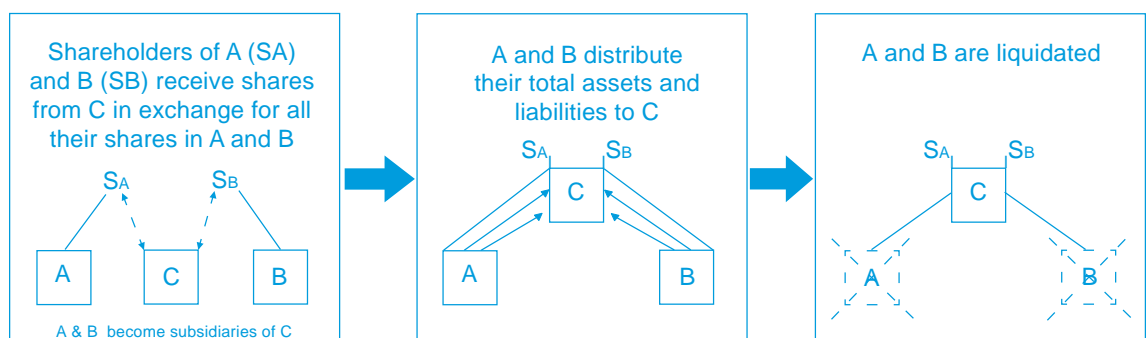
An absorption merger is a merger where one party continues to exist while other parties to the merger are dissolved.

A new company merger is a merger where all the parties to the merger are dissolved, and a new enterprise is established to take over the merged business.

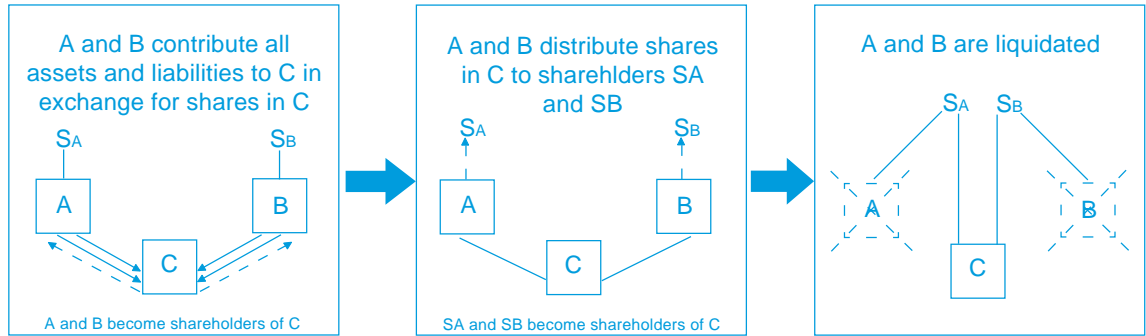
5.2 Typical Scenarios of Merger

- New Company Merger

Scenario 1:

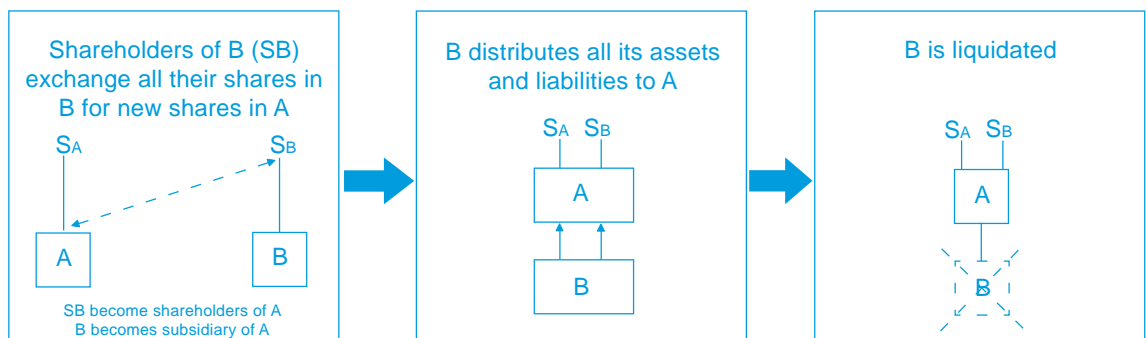


Scenario 2:

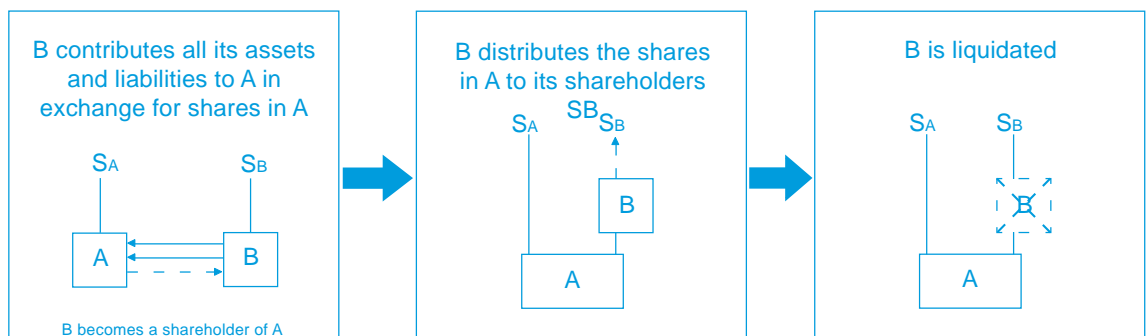


- Absorption Merger

Scenario 1:



Scenario 2:



6. Other Structuring and Post-Deal Issues

6.1 Repatriation of Profits

Any after-tax profit remitted by a FIE to its foreign investors is exempt from PRC taxes. However, before a FIE may distribute dividends to its foreign investor, the FIE must meet the following conditions:

- the registered capital has been duly paid up in accordance with the provisions of its articles of association;
- the company has begun to make profits (i.e. show profits after covering the accumulated tax losses from prior years, if any);
- PRC FEIT has been paid by the FIE or the company is in a tax exemption period; and
- the statutory after-tax reserve funds (see below) have been provided for.

According to the PRC Equity Joint Venture Law, a foreign equity joint venture company is required to contribute its after-tax profit to statutory reserve funds before any after-tax profit may be distributed to its shareholders as dividend. Components of the statutory reserve funds include the general reserve fund (GRF), staff benefit and welfare fund (SBWF) and enterprise development fund (EDF). The contribution rate to the SBWF and EDF is at the discretion of the FIE. However, the company must contribute at least 10% of its after-tax profits to the GRF until the cumulative amount represents 50% of the registered capital.

A wholly foreign-owned enterprise (WFOE) is only required to provide GRF and SBWF, and not EDF.

In addition, a FIE is allowed to repatriate its after-tax profits as dividend payments in foreign currency upon the presentation of the following documents/certificates:

- the Board of Directors' resolution on distribution of profits;
- audit report issued by a Chinese CPA certifying the amount of distributable profits; and
- relevant tax payment certificates.

Generally, profit remittances as dividend payments do not need the approval of the SAFE but may be made by the remitters through their basic foreign exchange accounts in a bank. The remittance amount may also be purchased from designated foreign exchange banks or swap centers by presenting the above documents and certificates.

6.2 Losses Carried Forward and Applicable Tax Rate

Tax losses arising in pre-merger periods may continue to be carried forward by the surviving entity for not more than five years.

The FEIT rates applicable to different operations of the surviving entity are determined according to the locality and industrial nature of the actual business activities of such operations.

Where different tax holiday treatments or tax rates are applicable to different operations of the surviving entity, an apportionment of taxable income is required for FEIT purposes. Losses carried forward from operations entitled to different tax treatments, for example, tax holiday concessionary rate (hereinafter referred to as tax operations), may be offset only against the corresponding apportioned taxable income of the surviving entity.

Where different tax rates apply, the taxable income of the surviving entity is apportioned based on the rules below:

- Actual Basis

Where different tax operations are maintained by the surviving entity and separate accounting books are kept to record the activities of each tax operation, taxable income may be apportioned on an actual basis (i.e. based on each operation's own accounting records). The resulting apportionment should still be accurate and reasonable.

- Deemed Ratio

Where the surviving entity does not maintain different tax operations or when the surviving entity maintains different tax operations but is unable to compute the respective taxable income on an accurate and reasonable basis, the surviving entity should apportion its total taxable income among the tax operations based on certain financial ratios (e.g. annual turnover, cost, expense, assets, number of employees, wages and salaries). The taxpayer may use one or a weighted average of all such ratios subject to the tax authority's agreement. Where the relevant ratios for the year of merger are difficult to determine, the records for the last complete tax year before the merger may be used.

Specifically, when the surviving entity has a net profit or loss, income tax should be levied at the rates applicable to the profit making operations. For the operations which have been sustaining losses but turn profitable in a later year, special rules apply in determining the tax rate.

6.3 Continuation of Tax Incentives

6.3.1 Change of FIE Status

Unless otherwise stipulated, when the ratio of foreign investment in a FIE falls below 25% of the total registered capital after an acquisition, merger or de-merger, the PRC FEIT laws and regulations applicable to FIEs no longer apply to that reorganised entity. Instead, the reorganised entity is treated as a domestic enterprise (as opposed to a FIE) for tax purposes. As a result, any FEIT exemption or reduction already enjoyed by the original FIE during its FEIT holidays should be treated as follows:

- Foreign Investment Remains

If all of the foreign investments in the FIE still remain in the reorganised entity, no clawback of the exempted or reduced FEIT will be required regardless of the actual operating term of the reorganised entity.

- Foreign Investment Withdrawn

If all or some of the foreign investments in the FIE have withdrawn or transferred to domestic investors during the reorganisation and the operating term of the reorganised entity does not meet the FEIT holiday requirement (normally 10 years), a clawback is required for the previously exempted or reduced FEIT amounts.

6.3.2 Tax Holiday

If the surviving entity still meets the requirements for a tax holiday, the surviving entity should continue to enjoy the tax holidays to which A and B were entitled before the merger. Specifically, the following rules apply;

- if the tax holiday has already expired before the merger, no renewal of the tax holiday is allowed for the surviving entity.
- if the tax holiday has not been used up by the time of the merger and the remaining holiday periods for A and B are the same, the surviving entity should continue to enjoy the relevant tax holiday until expiration of the remaining holiday period. For instance, if both A and B are entitled to a two-year exemption and a three-year 50% reduction for FEIT purposes and both have enjoyed the benefit of two holiday years before the merger, the surviving entity can only obtain the benefit of the remaining three-year 50% reduction holiday period; and
- if the remaining holiday periods for A and B are different or if one entity was not entitled to any tax holiday, the taxable income of the surviving entity should be apportioned for FEIT purposes (see section 6.2 for details). After such apportionment, the surviving entity should continue to receive the benefit of the relevant tax holiday for the taxable income attributable to the tax operation entitled to the remaining tax holiday. However, tax holiday treatment will not apply for any remaining taxable income that is not attributable to such tax operation.

6.4 Group Relief

China has a separate entity basis of taxation for FIEs. Therefore, tax groupings are not applicable for FIEs in China.

7. Disposals

7.1 The Preference of Sellers: Stock vs. Assets Deal

As explained in section 2.1, the adoption of an asset deal or a stock deal for an acquisition in China largely depends on the regulatory situations, as well as the commercial and tax objectives of the investors. In some cases, an asset deal may be the only option for selling the businesses by the seller (especially for SOEs) due to regulatory restrictions.

7.2 Stock Disposal

7.2.1 Profit on Stock Disposal

Gains on the disposal of stock of a Chinese company are regarded as being sourced in China (China-sourced). Therefore, China's tax authorities have the right to tax such gains. When the proceeds are then repatriated to the locality in which the investor is a tax resident, the local tax authorities may impose further taxes on those same amounts. Depending on the law of such locality. Where there is double taxation, relief may be provided by local tax provisions or a double tax treaty (DTT) if that locality has concluded a DTT with China.

The following table provides an overview of the PRC tax treatment for a stock disposal by different types of investors.

Stock Investment – Tax on Disposal Gain

| Type of investor | Taxes | Shares in non-listed company | Shares in listed company | | |
|-----------------------------------|-------|------------------------------|--|----------|--|
| | | | A Share | B Share | Non-tradable share |
| QFII | WHT | N/A | Not stipulated in current laws and regulations (may be taxable at 10%) | N/A | N/A |
| FE (other than QFII) | WHT | 10% on net transfer gain | N/A | Exempted | Not stipulated in current laws and regulations (may be taxable at 10%) |
| Foreign individual | WHT | N/A | N/A | Exempted | N/A |
| Domestic investor (including FIE) | FEIT | 33% on net transfer gain | 33% on net trade gain | N/A | 33% on net transfer gain |
| Domestic individual | IIT | 20% on net transfer gain | Exempted | Exempted | N/A |

7.2.2 Distribution of Profits

- Companies

Pursuant to the PRC FEIT laws and regulations, any FE which does not have an establishment or place in China but derives profit, interest and other income from sources in China, is subject to a WHT at the rate of 10% on such income. However, a FE that receives dividends or derives trading gains from B shares is provisionally exempt from WHT. Please note that a QFII would not benefit from this exemption as a QFII is only allowed to invest in A shares.

Gains and losses on the disposition of stock realised by FIEs are generally subject to FEIT and should be included in the profit or loss of the FIE in the taxable period incurred. Please see section 8.4 for more details.

- Individuals

Foreign individual investors receive the same treatment as FEs regarding their stock disposals (i.e. exempt from WHT for trading gains derived from B shares).

7.3 Asset Disposal (Companies Only)

7.3.1 Profit on Asset Disposal

A valuation for state-owned assets is required for any PRC company involved in an asset transfer, exchange or mortgage procedure. The valuation should be adopted as the pricing basis for the asset disposal (see section 9.2).

Gain arising from the sale of assets is included as taxable income for the seller and is subject to FEIT. There is no PRC tax exposure on the transfer of liabilities.

In addition, some of the fixed assets of the seller may have been imported into China free of import duty. For these import duty free assets, the Customs Office imposes a supervising period (generally, a period of five years). In the event that these assets are sold within the supervising period, the relevant portion of the import VAT and duty based on the asset's depreciated value would be required to be paid back before these assets can be sold.

7.3.2 Distribution of Profits

The tax treatment for distribution of profits as asset disposal is the same as share disposal as explained in section 7.2.2.

8. Transaction Costs for Seller

8.1 Turnover Taxes

- Stock Disposal

Disposal of stock is exempt from VAT and BT.

- Asset Disposal

Generally, the sale of tangible goods (including machinery and equipment, etc.) is subject to VAT (plus CT if tangible goods are one of the 11 categories of goods taxable for CT) at 17% normally which is payable by the seller. However, VAT is temporarily exempted on the sale or transfer of used fixed assets if the following criteria are satisfied:

- the tangible goods are included in the Fixed Assets List of the seller;
- the tangible goods are managed and have been used as fixed assets; and
- the sales price does not exceed the original purchase value.

If all the above criteria are satisfied and approval is received by the in-charge tax bureau, the transferred fixed assets may be exempted from the VAT. If only the first two criteria are satisfied, the excess of the sales price over the original purchase value is subject to VAT at the effective rate of 2%, without any input VAT deduction.

For the sale of intangible assets (e.g. patent, land use right and goodwill) and immovable assets (e.g. real estate properties), BT at a rate of 5% of the transaction value is imposed on the seller.

8.2 Stamp Tax and Other Relevant Taxes

- Stock Disposal

Stamp Tax is payable by both buyers and sellers on the disposal of shares (see first point of section 2.4.2).

- Asset Disposal

Stamp Tax is payable by both buyers and sellers on the disposal of certain assets (see second point of section 2.4.2).

Land Appreciation Tax is imposed on the seller upon the transfer of land use rights and building and is assessed at a progressive rate from 30% to 60% of the appreciated amount of the land use right and building.

8.3 Concessions Relating to M&As

A foreign investor may transfer its ownership in a PRC FIE at cost (i.e. no capital gain) to another investor, provided that the following conditions are met:

- the transfer of share interest is connected with a corporate reorganisation of the group for genuine business purposes; and either
- the transfer is conducted between an FE/FIE and its 100%-owned subsidiary (i.e. a company directly or indirectly wholly owned by the FE/FIE); or
- the transfer is conducted between an FE/FIE and another FE/FIE which is 100%-owned by a common parent.

8.4 Tax Deductibility of Transaction Costs

- Determination of Gains or Losses

Gains or losses from an exchange or transfer are determined as follows:

$$\text{Transfer Gain or Loss} = \text{Transfer Value} - \text{Transfer Cost}$$

$$\text{(Where) Transfer Value} = \text{Transfer Price} - \text{Allowable Exclusion}$$

Transfer cost refers to the original book value or actual purchase value of the investment being transferred.

Transfer price refers to the gross receipts from the investment transfer, including all cash and in-kind items (e.g. non-cash assets and ownership equity).

Allowable exclusion refers to the value of the undistributed retained earnings and reserves (URER) to be transferred. The URER value should not exceed the total book value of the URER to which the transferor is entitled.

Therefore, the formulas can be consolidated as follows:

$$\text{Transfer Gain or Loss} = \text{Transfer Price} - \text{Allowable Exclusion} - \text{Transfer Cost}$$

- FEIT Treatment of Gains

Gains derived from an exchange or transfer by a FIE or FE is subject to FEIT or WHT. However, as illustrated in the above formula, the transfer price attributable to URER is excluded for FEIT purposes. The reason for the exclusion is that under the FEIT law for a FIE and FE, undistributed retained earnings are not subject to further taxes when distributed.

- FEIT Treatment of Losses

Similarly, losses incurred during a transfer by a Chinese entity (including FIEs) are deductible for FEIT purposes. However, it is not clear at the moment whether the allowable exclusion can create a loss. For instance, in the case where the transfer price is equivalent to or less than the transfer cost, the authorities are unlikely to allow the exclusion of the URER value (stated in the transfer agreement).

9. Preparation of Target for Sale

9.1 Pre-deal Planning

A foreign investor should view preliminary targets based on the following aspects before taking the first step to conduct the actual tax and regulatory due diligence review.

- Regulatory efficacy: Restrictions of the proposed investment under the current PRC laws and regulations.
- Funding options: Capital contribution requirement and financing options for the proposed investment project.
- Investment evaluation: Tax attributes and the possible business scope to be approved for the proposed investment.
- Exit strategy: Options for future disposal of the China investment and the related tax and regulatory considerations.

9.2 State-owned Assets Valuation

A valuation for the state-owned assets for the entities involved would be required in any of the following situations:

- an entity or a part of an entity is restructured into a limited liability company or company limited by shares;
- the use of non-cash assets for investment purposes;
- a merger, division or liquidation;
- a change in the equity holding percentage of the original investors (except for listed companies);
- a transfer of all or a part of the ownership or equity of a company (except for listed companies); or
- an asset transfer, exchange or mortgage.

The entities required to obtain a valuation for the state-owned assets should engage specialised valuation agencies with relevant qualifications.

In addition, the entities conducting the transactions that require a valuation should use such valuation as the basis for pricing such transaction. In case the actual price has a difference of more than 10% compared to the valuation result, such entities should provide a written explanation for such price difference to the in-charge financial authorities (or the group company and other relevant authorities).

9.3 Anti-trust Review

The Provisional Measure has anti-trust implications, although the term itself is not used. Investors are required to report an acquisition of shares or assets in certain circumstances. The authorities may prohibit the acquisition if they believe it would create an obstacle to future market competition, or would be harmful to consumers' interest. However, the lack of definitions for many terms (e.g. market) suggests that many of the requirements may be difficult to apply.

10. De-mergers

In China, a de-merger refers to the split of one entity (referred to as A below) into two (or more) entities (referred to as the surviving entities) according to the relevant PRC laws and regulations.

10.1 Split-off De-merger and Spin-off De-merger

De-mergers can be separated into the following two categories:

- Split-off De-merger

The shareholders of A receive shares of newly established surviving entities in exchange for all of their shares in A. A then distributes all of its assets and liabilities to the surviving entities and liquidates afterwards. Alternatively, A may contribute all of its assets and liabilities to the surviving entities in exchange for shares in the latter. A then distributes the shares of the surviving entities to the shareholders of A and is liquidated afterwards.

- Spin-off De-merger

The shareholders of A receive shares of the newly established surviving entity B (or entities) in exchange for newly issued shares or for part of their shares in A. A then distributes the corresponding portion of its assets and liabilities to the new surviving entity. A split-up of A and B occurs when the distribution is in exchange for the newly issued shares or a part of the shares in A. Alternatively, A may contribute a part of its assets and liabilities to the new surviving entity B in exchange for shares in the latter. A then distributes the shares in the new surviving entity to its shareholders.

A continues to exist (as a surviving entity) after the de-merger.

For both types of de-mergers, the following applies:

- for split-off de-mergers, A does not need to be liquidated for tax purposes;
- the shareholders of A may decide to hold shares in all or some of the surviving entities (including A after the de-merger); and
- all of the assets and liabilities of A should be transferred to or partially remain in the surviving entities after the de-merger according to the statutory procedures and stipulations in the de-merger agreement. The relevant shareholders should be able to determine the split ratio for assets and liabilities in the de-merger agreement.

10.2 Tax Consequences

Business operations of the surviving entities should be treated as a continuation of the business operation of A before the de-merger for tax purposes. If the surviving entity qualifies as a FIE, the relevant FEIT treatment discussed below would apply. Otherwise, please refer to section 6.3.1 for details.

- Revaluation (Step Up Value)

The rules are similar to those discussed in section 3.1.

- FEIT Preferential Treatments

The FEIT treatment (including rates, continuation of tax holiday, etc.) applicable to each surviving entity should be determined based on its locality and business nature according to the relevant provisions in the FEIT law and its detailed rules and regulations.

In areas pertaining to a tax holiday, the following rules should be observed:

- Business nature remains the same: If the surviving entities assume the same business nature (as that of A) for tax purposes, it should continue to enjoy tax holidays applicable to A in the remaining holiday period. No renewal of tax holidays is allowed for the surviving entities.
- Business nature changes: In the case where the tax holidays applicable to A no longer apply to one of the surviving entities due to its business nature, that surviving entity would not continue to enjoy the relevant treatments. That surviving entity may, however, continue to enjoy the tax holidays (starting from the first profit making year of the original entity A) in the remaining holiday years after the de-merger if it qualifies for the tax holidays. For instance, if the new business nature allows the surviving entity to enjoy a two-year exemption and three-year 50% reduction, and the original entity began to make profits two years before the de-merger, the surviving entity may only enjoy the remaining three-year 50% reduction holiday period from the year of de-merger.

- Losses Carried Forward

Tax losses arising prior to the de-merger should be split among the surviving entities according to the de-merger agreement. Each surviving entity may then carry forward its own portion of the above losses within the five-year limit. Agreement for the appropriate split of losses should be obtained from the tax bureau.

11. Listing/Initial Public Offer (IPO)

The tax status of a company being listed and its subsidiaries is generally unaffected by listing/IPO.

11.1 Issue of New Stock by Listed Company

The issue of new stock by the listed company would result in a capital increase and would, therefore, trigger a stamp tax at the rate of 0.05% of the increased capital.

11.2 Disposal of Stock by Existing Shareholders

If the listing/IPO involves the disposal of stock by existing shareholders, the tax position for those shareholders is as outlined in section 7.2.

