

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 the 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

Corporate Income Tax (CIT): Generally, PRC companies are taxed on a stand-alone basis. Previously, taxation of a FIE was governed by the Foreign Enterprise Income Tax (FEIT) Law to separate from domestic enterprises, but is now covered by a unified new CIT Law effective 1 January 2008. The profits earned by a company are taxed at the CIT rate of 25% (or lower where tax incentives apply).

1.3 Withholding Tax

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 Withholding Tax (WHT) at the rate of 20% on such income with a possibility of exemption or reduction. The Withholding Tax rate is reduced to 10% by the Detailed Regulations for the Implementation of China's new CIT Law.

1.4 Turnover taxes

Value Added Tax (VAT): 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 or charge at lower VAT rate).

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 received interest income from China is also subject to BT at the rate of 5%.

Consumption Tax (CT): is imposed on 14 categories of goods, including cigarettes, alcoholic beverages and certain luxury items.

1.5 Stamp Tax

Stamp Tax (ST) is payable by both the purchaser and seller at rates ranging from 0.03% to 0.05% on the value of equity or assets transferred.

1.6 Other relevant taxes

Land Appreciation Tax is imposed on the seller upon the transfer of land use rights and buildings 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 rates ranging from 3% to 5% on the purchase price of land use right or building.

2. Acquisitions

According to the Provisions on Acquisition of Domestic Enterprises by Foreign Investors (Order No. 10) effective from 8th September 2006 issued by the Ministry of Commerce (MOC), State-owned Assets Supervision and Administration Commission of the State Council (SASAC), the State Administration of Taxation (SAT), the State Administration of Industry and Commerce (SAIC), China Securities Regulatory Commission (CSRC) 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).

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 asset deal

The adoption of an asset 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.

Order No. 10 is the first PRC regulation legally endorsing and setting out the regulatory framework for a cross-border share swap as a form of payment for foreign investors to acquire shares of domestic enterprises. Domestic enterprises must engage a M&A advisor to perform a due diligence review on the foreign investor. The M&A advisor, which should be a reputable agency registered in China, has to issue a report to set out its professional opinion on the financial status of the foreign investor.

2.2 Stock deal

According to Order No. 10, 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 a contractual warranty from the target company's 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. 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 no more than 20% of a 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 are not able to be acquired by foreign buyers. On 1 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 1 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.

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 4 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 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 approvals.

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 and buildings	LAT at various rates from 30% to 60% business tax 5%
Intangibles	Business tax 5%
Inventory	VAT 17% (general VAT payer) / 3% (small-scale VAT payer)
Inventory — category of goods subject to CT	CT at various rates
Equipment	VAT 17% / 2% (Please refer to section 7.2 for more details)
Transfer contracts	ST at 0.03% on contracted value on transfer of inventory, and 0.05% on other assets

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 purchaser's perspective, if the purchaser is subject to VAT and is obliged to charge VAT on its sales (output VAT), the purchaser may recover VAT paid by it on purchases (input VAT) of inventory and production-related equipment from the seller. A purchase of inventory and production-related equipment on which VAT has been charged by the seller is regarded as input VAT 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 can be offset against the CT liabilities for a manufacturing purchaser if the inventory is used for the production of another product that is also subject to CT. Otherwise the CT paid is 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 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 are 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. Stamp Tax is imposed on both the seller and the buyer.

2.4.3 Concessions relating to M&As

According to the notices issued by the SAT and MOF (Caishui [2008] No. 175 and Guoshuifa [2009] No.89), the following Deed Tax concessions relating to M&As:

- In an equity transfer, Deed Tax will not be payable if there is no transfer of ownership of land and real estate;
- In a merger, two or more enterprises combine to one enterprise with the original shareholders continuing to exist, the merged enterprise taking over the land and real estate from the original parties shall be exempted from Deed Tax; and
- In a spin-off, Deed Tax will not be payable if the shareholders of the spin-off enterprise remain the same as the original shareholders of the enterprise being spun-off.

The above preferential tax policy will be extended from 1 January 2009 to 31 December 2011.

2.4.4 Tax deductibility of transaction costs

The new CIT Law does not provide clear rules on the deductibility of transaction costs. Under the old FEIT law, FIEs were explicitly 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 purchase price of the acquired stock or assets is a taxable profit or deductible loss of the seller in the taxable period of the transaction.

The new CIT law also impose new deduction restrictions on intangible assets, where goodwill arising from the acquisition would not be an amortisable item. This goodwill would only be deductible when the acquired entity is subsequently disposed of or liquidated.

3. Tax treatment following asset, stock acquisition, merger and spin-off

The Detailed Implementation Rules (DIR) to the new CIT law, provides a general rule that where an enterprise undergoes a corporate restructuring, it has to recognise a gain or loss resulting from the transfer of the relevant assets at the time of the restructuring, and the tax basis of the relevant assets shall be revised according to the transaction prices, unless it is otherwise prescribed by the MOF, and SAT. The MOF and SAT finally jointly released the rules for corporate restructuring under the Notice entitled “Several Questions about CIT Treatments for Corporate Restructuring” (Caishui [2009] No. 59) which indicates the basis of taxation following an asset or stock acquisition in “General Restructuring” and “Special Restructuring” respectively.

3.1 General tax treatments

The general principle is that enterprises undergoing corporate restructuring should recognise the gain or loss from the transfer of the relevant assets and / or equity at fair value when the transaction takes place, and the tax basis of the relevant assets in the hands of the transferee should be revised according to the transaction prices. In summary, the tax consequences to the parties involved in the corporate restructuring are instantly recognised.

3.1.1 Share acquisition and asset acquisition

When an enterprise undergoes a restructuring transaction in the form of a share acquisition or an asset acquisition, the relevant transactions shall be treated in the following ways:

- a. The transferor shall recognise the gain or loss for the shares and assets transferred;
- b. The tax basis of the shares of assets acquired by the transferee shall be determined according to the fair value;
- c. The income tax matters of the target company shall, in principle, remain unchanged.

3.1.2 Mergers

In a merger of enterprises, the parties involved shall treat the transaction as follows:

- a. The merged enterprise shall determine the tax basis of the items of assets and liabilities received from the enterprise being merged based on the fair value;
- b. The enterprise being merged and its shareholders shall treat the transaction as a liquidation for income tax purpose.

3.1.3 Spin-off

In the spin-off of an enterprise, the parties involved shall treat the transaction as follows:

- a. The enterprise being spun-off shall determine the gain or loss of the assets transferred based on their fair value;
- b. The spin-off enterprise shall determine the tax basis of the assets received based on their fair value;
- c. Where the enterprise being spun-off continues to exist, the consideration received by its shareholders shall be treated as a distribution received from the enterprise being spun-off;
- d. Where the enterprise being spun-off no longer exists, the enterprise being spun-off and its shareholders shall treat the transaction as a liquidation for income tax purpose.

3.2 Special tax treatments

However, the Restructuring Rules allow that if prescribed conditions are satisfied, then it is possible for the parties involved in the corporate restructuring to choose a special tax treatment.

3.2.1 Prescribed conditions

The Restructuring Rules allow special tax treatments for corporate restructuring that fulfil all of the five following conditions:

- a. The corporate restructuring has to have reasonable commercial reason and the main purpose of the corporate restructuring is not for tax reduction, avoidance or postponement of tax payment;
- b. The equity or assets being acquired, merged or spun-off have to reach a certain prescribed ratio to reflect the significance of the corporate restructuring. In an equity acquisition deal, the equity acquired should not be less than 75% of the total equity of the enterprise being acquired; whereas in an asset acquisition deal, the assets acquired should not be less than 75% of the total assets of the enterprise that transfers the assets;
- c. No change in the original actual business activities within 12 consecutive months after the restructuring (“compulsory operating period”);
- d. The deal consideration should mainly comprise of equity (or shares) and the portion of equity-payment has to exceed 85% of the total consideration. In other words, the non-share equity (commonly known as “Boot” which includes cash, bank deposits, receivables, tradable securities, inventories, fixed assets, other assets and undertaking of liabilities, etc.) cannot exceed 15% of the total consideration; and
- e. The original shareholder who received the equity-payment on the corporate restructuring has to commit not to transfer the shares received within 12 months after the corporate restructuring (“compulsory holding period”).

For corporate restructuring that satisfies the conditions above, the parties involved may elect the following special tax treatments with respect to the equity payment:

3.2.2 Share acquisition

In an equity acquisition transaction, the parties involved may elect to adopt the following treatment, provided that the acquiring enterprise acquires not less than 75% of the shares of the acquired enterprise, and the amount of equity payment settled at the time the equity acquisition takes place is not less than 85% of the total consideration for the transaction:

- a. The tax basis of the equity of the acquiring enterprise received by the shareholders of the acquired enterprise shall be determined according to the original tax basis of the equity of the acquired enterprise;
- b. The tax basis of the equity of the acquired enterprise received by the acquiring enterprise shall be determined according to the original tax basis of the shares of the acquired enterprise;
- c. The tax basis of all the original assets and liabilities and other income tax matters of both the acquiring enterprise and the acquired enterprise shall remain unchanged.

3.2.3 Assets acquisition

In an asset acquisition, the parties involved may elect to adopt the following treatment provided that the transferee enterprise acquires not less than 75% of the assets of the transferor enterprise and the amount of the equity payment settled at the time the asset acquisition takes place is not less than 85% of the total consideration for the transaction:

- a. The tax basis of the equity of the transferee enterprise received by the transferor enterprise shall be determined according to the original tax basis of the assets transferred;
- b. The tax basis of the assets received by the transferee enterprise from the transferor enterprise shall be determined according to the original tax basis of the assets transferred.

3.2.4 Mergers

In a merger, the parties involved may elect to adopt the following treatment, provided the amount of equity payment received by the shareholders at the time the merger takes place is not less than 85% of the total consideration of the transaction; or where the enterprises being merged and the merged enterprise are under common control, and consideration is not needed to be paid:

- a. The tax basis of the assets and liabilities received by the merged enterprise from the enterprise being merged shall be determined according to their original tax basis to the enterprises being merged;
- b. The merged enterprise shall inherit the relevant pre-merger income tax matters of the enterprises being merged;
- c. The limit of the amount of losses of the enterprises being merged that may be utilised by the merged enterprise = Fair value of the net assets of the enterprises being absorbed x the Interest rate of the State bonds with the longest term issued by the State as of the end of the year during which the merger takes place;
- d. The tax basis of the equity of the merged enterprise received by the shareholders of the enterprises being merged shall be determined according to the original tax basis of equity of the enterprises being merged.

3.2.5 Spin-off

In a spin-off transaction, the parties involved may elect to adopt the following treatment, provided that the ratio of shareholding in the spin-off enterprises received by all shareholders of the enterprise being spun-off is the same as the original ratio of shareholding in the enterprise being spun-off; the spin-off enterprises and the enterprise being spun-off do not alter the original actual business operation; and the equity payment received by the shareholders of the enterprise being spun-off at the time the spin-off taking place is not less than 85% of the total consideration of the transaction:

- a. The tax basis of the assets and liabilities received by the spin-off enterprises from the enterprise being spun-off shall be determined according to their original tax basis to the enterprise being spun-off;
- b. The income tax matters related to the spun-off assets of the enterprise being spun-off shall be inherited by the spin-off enterprises;

- c. The unexpired loss of the enterprise being spun-off may be pro-rated and shared according to the ratio of the value of spun-off assets to the value of the total assets and continue to be utilised by the spin-off enterprises;
- d. The tax basis of the equity of the spin-off enterprises received by the shareholders of the enterprise being spun-off (hereinafter referred to as “new shares”) shall be determined according to the original tax basis of the shares of the enterprise being spun-off (hereinafter referred to as “old shares”) that have been given up if the old shares have to be partially or entirely given up. If the old shares do not have to be given up, the tax basis of the new shares may be determined according to either of the following two methods: the tax basis of the new shares to be determined as zero; or the tax basis of the old shares to be reduced according to the ratio of the spun-off net assets against the total net assets of the enterprise being spun-off and the amount of reduction to be evenly allocated to the new shares.

Where the parties involved in the restructuring do not have to recognise the gain or loss from the relevant assets transfer corresponding to the equity payment temporarily, the gain or loss arising from the assets transferred corresponding to the non-equity payment shall still be recognised in the transaction period, and the tax basis of the relevant assets shall be adjusted accordingly.

Gain or loss arising from assets transferred corresponding to the non-equity payment = (Fair value of assets being transferred – Tax basis of assets being transferred) x (Non-equity payment / Fair value of assets being transferred).

4. Financing of acquisitions

4.1 Thin capitalisation

According to the prevailing PRC FIE laws and regulations, an FIE should comply with the following minimum registered capital, which is expressed as a percentage of the total investment. This relationship between the total investment and registered capital is often referred to as the debt-to-equity ratio.

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

Moreover, the new CIT law contains a specific “thin capitalisation” rule to disallow interest deductions on borrowings from related companies if the interest-bearing loans of the enterprise exceed certain prescribed “safe-harbour” debt-equity ratios, which have been jointly addressed by the “MOF” and “SAT” of Caishui [2008] No.121.

The salient points of Circular 121 can be summarised as below:

- a. There are two prescribed debt / equity ratios—one for enterprises in the financial industry and the other one for non-financial enterprises. The former is set at 5:1, while the latter at 2:1. Where the ratio of debt from related parties to the equity exceeds the certain prescribed debt / equity ratio in a year, the interest expense pertaining to the debt from related parties shall not be deductible in that year (and no carry-forward to future years), except in situations where the criteria set out in Point (b) below is met. The prescribed ratio for enterprises in the financial industry is higher than that for non-financial enterprises as financial arrangements in finance industry have their particular features;
- b. The excessive interest expense may still be deductible if an enterprise can provide documentation to support that the inter-company financing arrangements comply with the arm's length principle; or if the effective tax rate of the borrowing enterprise is not higher than that of the domestic lending enterprise;
- c. If an enterprise carries on both financial business and non-financial business, it has to segregate the related party interest expenses between the two businesses on a reasonable basis; otherwise, it has to follow the prescribed debt / equity ratio for non-finance industry, i.e., the 2:1 ratio, in calculating its deduction threshold for related party interest expense;
- d. The lending enterprise shall be subject to CIT on the full amount of interest income (including the non-deductible portion of the borrowing enterprise) in accordance with the relevant tax regulations.

4.2 Deductibility of interest

4.2.1 Stock deal

Under the new CIT law, an interest expense incurred in respect of a loan used to acquire an investment or stock shall be capitalised and is not deductible for tax purposes.

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, interest incurred to acquire the relevant assets prior to the company commencing business should be capitalised and depreciated over the useful life of the assets for CIT purposes. Generally, once the relevant assets are put into use, any subsequent interest incurred is deductible.

5. Other structuring and post-deal issues

5.1 Repatriation of profits

Any after-tax profit remitted by a FIE to its foreign investors is subject to PRC withholding tax at 20% but with a possibility of exemption or reduction. The detailed implementation rule confirms that the withholding tax rate is reduced to 10%.

However, before an 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 makes profits (i.e. profits after covering the accumulated tax losses from prior years, if any);
- the company has paid PRC CIT, unless 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 a 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, GRF and EDF is at the discretion of the board.

A wholly foreign-owned enterprise (WFOE) is only required to provide GRF and SBWF, and not EDF. However, the WFOE must contribute at least 10% of its after-tax profits to the GRF until the cumulative amount represents 50% of the registered capital.

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 remitted as a dividend payment does not require the approval of 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 centres by presenting the above documents and certificates.

5.2 Losses carried forward

Under the circular Caishui [2009] No.59, there are new restrictions for losses carried forward in M&A transactions:

- In the case of a merger not qualifying for special tax treatment, the unutilised tax losses of the enterprise(s) being merged will lapse and will not be available for use by the merged enterprise. Where special tax treatment is available to the qualified merger, the tax losses can be carried over to the merged enterprise. In order to deter the abusive use of tax losses by acquiring and merging a “loss-rich” company by a profitable company, a “ring-fencing rule” is included in the Restructuring Rules to limit the utilisation of losses on merger. Under the current “ring-fencing rule”, the amount of tax losses of the enterprise(s) being merged that can be utilised by the merged enterprise in a given year is restricted by the following formula:

Fair value of the net assets of the enterprise being merged	×	Interest rate of the longest term treasury bonds issued by the State as at the end of the year of the merger
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- In the case of a spin-off not qualifying for special tax treatment, the unutilised tax losses of the enterprise being spun-off have to remain in that enterprise and cannot be carried over to and utilised by the other spin-off enterprises. However, where the special tax treatment is available to the qualified spin-off, the unutilised tax losses of the enterprise being spun-off may be prorated and shared between all the spin-off enterprises according to the ratio of value of spun-off assets to the value of total value and used within the original expiry period.

5.3 Continuation of tax incentives

5.3.1 Phase-in of tax incentives and grandfathering of tax holidays

Per Guofa [2007] No.39, the new CIT regime no longer provides tax incentives based on investment status, location of registration / operation, etc. Instead, tax incentives are granted based on industry (i.e. high-tech) and available to both FIEs and domestic companies. Due to this, tax incentives granted under the old regimes (e.g. foreign investment) are to be passed out unless the company qualifies for tax incentives under the new CIT regime. Beginning 1 January 2008, companies which are currently enjoying an income tax rate of lower than 25% (the new statutory rate) under the old regimes will be raised to 25% gradually over five years as follows:

FEIT regime	CIT regime	Phasing-in of CIT rate
24%	25%	Change will take place on 1 Jan 2008
15%	25%	The rate will gradually increase in the following manner: 2008 18% 2009 20% 2010 22% 2011 24% 2012 25%

The above transition will not apply if the company obtains special status or is in special industry which qualifies for special CIT incentives under the new CIT regime.

Circular 39 also addresses the grandfathering treatment of unutilised tax holidays of the old regimes. For those companies which have already commenced their tax holidays before 2008, they can continue to enjoy the remaining unutilised tax holidays until expiry. For those companies which have not commenced their tax holidays before 2008 due to losses, their tax holidays are deemed to commence in 2008 and can be utilised until expiry.

For sake of clarity, Circular 39 has an appendix showing the types of tax incentives under the old regimes which qualify for the grandfathering treatment.

5.3.2 Tax holidays of merged and spun-off enterprises

Circular Caishui [2009] No.59 also addresses the treatment of the remaining tax incentives of the restructured enterprises in a merger or spin-off.

In an absorption merger, the surviving enterprise can continue to enjoy the unutilised preferential tax treatments brought forward prior to the merger provided that its entity nature and conditions for preferential treatments have not changed. The amount of tax benefits shall be based on the taxable income in the year prior to the merger. It will be zero if the enterprise was incurring losses.

With respect to the unutilised tax preferential treatment available to the enterprises prior to the spin-off, the surviving enterprise may continue enjoying its unutilised tax preferential treatment. However, the amount of tax benefit is limited to the multiple of the taxable income in the year prior to the spin-off and the ratio of assets of the surviving enterprise after the spin-off to the total assets prior to the spin off.

5.4 Group relief

China CIT applies on a separate legal entity basis. Unless otherwise approved tax groupings are not possible for companies in China.

6. Disposals

6.1 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 regulatory issues, 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.

6.2 Stock disposal

6.2.1 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 income 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 the 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	Not stipulated in current laws and regulations (may be taxable at 10%)	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)	CIT	25% on net transfer gain	25% on net transfer gain	N/A	25% on net transfer gain
Domestic individual	IIT	20% on net transfer gain	Exempted	Exempted	N/A

According to the PRC CIT law and detailed implementation rules, capital gain subjected to tax is calculated as follows:

$$\text{Sales proceeds} - (\text{cost at acquisition} + \text{relevant taxes paid at the time of acquisition})$$

The major change from the old FEIT regime is that retained earnings in the entity being disposed is no longer a deductible item. Therefore, tax planning becomes important when acquiring and disposing investments.

6.2.2 Distribution of profits

Companies

Pursuant to the new CIT law 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 WHT generally at the rate of 10% (may be lower than 10% if eligible for tax treaty rate) on such income.

The Circular Guoshuihan [2008] No.897 addresses the WHT treatment on dividends derived from H-shares:

- The Chinese listed companies issuing H-shares have to withhold WHT at the rate of 10% on the distribution of dividends for 2008 and beyond to foreign corporate investors of H-shares; and
- If the foreign corporate investor is eligible for tax treaty rate (usually lower than 10%), it is allowed to apply for a refund on the overpaid WHT upon application and approval by the Chinese tax authorities.

The Circular Guoshuihan [2009] No.47 addressing the WHT treatment on dividends, bonus profits and interest derived by QFIs from A-shares:

- The Chinese listed companies issuing A-shares have to withhold WHT at the rate of 10% on the payment of dividends (also bonus profits and interest) to QFI for 2008 and beyond;
- If the QFI is eligible for tax treaty rate (usually lower than 10%), it is allowed to apply for a refund on the overpaid WHT upon application and approval by the Chinese tax authorities.

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).

6.3 Asset disposal (companies only)

6.3.1 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).

Any gain arising from the sale of assets is included as taxable income for the seller and is subject to CIT. There is no PRC tax implications on the transfer of liabilities.

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

6.3.2 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.

7. Transaction costs for seller

7.1 Corporate income tax

With respect to CIT, tax basis of transactions for the seller under a general reorganisation and special reorganisation is discussed in section 3.

7.2 Turnover taxes

- Stock disposal

The disposal of stock is not subject to VAT and BT.

- Asset disposal

Under the new VAT regime, in general the disposal of assets, other than land, buildings and certain intangibles, is subject to VAT at 17% for general VAT payers and 3% for small-scale VAT payers. However, for used equipment that was acquired by the seller before 1 January 2009 and not subject to VAT input credit at the time of purchase, an effective VAT rate of 2% is applicable on the transfer value.

There could also be BT of 5% payable on the transfer of land, buildings or intangible assets such as technical know-how, trademarks etc.

7.3 Stamp Tax and other relevant taxes

- Stock disposal

Stamp Tax is payable by both buyers and sellers on the disposal of shares (refer to section 2.4.2).

- Asset disposal

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

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

7.4 Concessions relating to M&As

Before the CIT regime, where a foreign corporate investor transferred its equity interest in a FIE to a 100% related enterprise, it was allowed to do so at cost for tax purposes, if the commercial-purpose test could be met under the former STA Notice-Guoshuifa [1997] No.207. The Chinese tax authorities would not challenge the transfer from a transfer pricing perspective; such virtually tax-exemption treatment facilitated the offshore disposal of the underlying Chinese business without any China tax implications. However, from 2008 this is no longer available under the new CIT regime.

Unlike the former tax regime, Special Tax Treatments are available only to the three specific types of cross-border corporate restructuring, unless otherwise specifically approved by MOF and STA. Out of the three specific types, there are only two relevant to foreign investors and FIEs, and they are both related to equity acquisitions only namely:

- Equity acquisition between non tax resident enterprise (“non-TREs”); and
- Equity acquisition between a non-TRE and a TRE.

Special Tax Treatments in the form of tax deferral rather than tax exemption, is available for the transfer of an equity interest in a FIE by a non-TRE (“non-TRE transferor”) to another non-TRE (“non-TRE transferee”). In addition to the prescribed 5 conditions in section 3, additional requirements are imposed on such cross-border equity acquisitions according to the Restructuring Rules, including:

- The non-TRE transferor should have a 100% direct ownership of the non-TRE transferee;
- The transfer should not result in changes in the withholding tax burden on the capital gains arising from the disposal of the TRE in the hands of the non-TRE transferee, as compared to that of the non-TRE transferor; and
- The non-TRE transferor undertakes not to transfer the equity interest of the non-TRE transferee within 4 years subsequent to the transfer of the FIE.

The restructuring rules impose much more restrictive criteria on cross-border equity acquisitions when compared to the usual tax-exemption treatment available under Circular 207.

8. Preparation of target for sale

8.1 Pre-deal planning

A foreign investor should view preliminary targets based on the following aspects before taking the first step to conducting a 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.

8.2 State-owned assets valuation

A valuation for the state-owned assets for the entities involved is 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 the transaction. In case the actual price has a difference of more than 10% compared to the valuation result, the entities should provide a written explanation for the price difference to the in-charge financial authorities (or the group company and other relevant authorities).

8.3 Anti-trust review

Investors are required to report an acquisition of shares or assets in certain circumstances. If an acquisition either

- involves strategic important industries;
- has or may have impact on state economic safety; or
- causes a transfer of actual controlling rights of a domestic enterprise which owns well-known trademarks or Chinese traditional brand names, the transaction must be reported to the authorities.

The authorities could deem the transaction invalid either if the relevant parties fail to report the transaction or they consider the transaction places a material impact on state's economic safety.

9. Listing / initial public offering (IPO)

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

9.1 Issue of new stock by listed company

The issue of new stock by the listed company results in a capital increase and therefore triggers stamp tax at the rate of 0.05% of the increased capital.

9.2 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.

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