



The Ministry of Finance and the State of Taxation Administration (“SAT”) jointly issued a circular (Caishui [2009] No.59) to address the special tax treatment of certain cooperate restructuring transactions, which takes effective retroactively as from 1 January 2008.

Background

Previously, there was a tax-free treatment regarding group reorganization, i.e. the transaction was permitted to be undertaken at cost, without the recognition of taxable gain or loss (Guoshuihan [1997] No. 207).

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Since China's new Enterprise Income Tax ("EIT") Law and its Implementation Rules that became effective on 1 January 2008 do not address the tax treatment of certain cooperate restructuring transactions, the effect of this rule became unclear. The new cooperate reorganization rule (Caishui [2009] No. 59) services as a starting point in filling the regulatory gaps in this area. Under the new rule, qualified taxpayer may elect special tax treatment to defer the EIT for gain or loss on certain transactions

Forms of Reorganization

The new rule contemplates the following types of company reorganization:

- Change of legal form
- Debt restructuring.
- Equity acquisition
- Asset acquisition
- Merger
- Split

Eligibility Requirements for Special Tax Treatment

For company reorganization transactions meeting the following conditions, the special tax treatment is applicable:

- Reasonable business purpose
The primary of the transaction must not be to reduce, avoid or defer tax payments.
- Prescribed ratios on amount of assets or equity transferred
 - At least 75% of the total equity (of the target company) is transferred in an equity acquisition; or
 - At least 75% of the total assets (of the transferor) are transferred in an asset acquisition.
- Continuity of business operations
No change in the original business operating activities of the target company for 12 months after the reorganization.
- Continuity of ownership
The major transferor must not transfer the acquired stock for 12 months after the acquisition.

For cross-border reorganizations, following conditions should also be met in addition to those aforementioned requirements:

- A transfer of a PRC company equity from a non-resident company to its 100%-owned non-resident subsidiary

- The PRC capital gains withholding tax rate for transferee post-transaction is the same as the rate for transferor pre-transaction.
 - The transferor should not transfer the shares of the transferee non-resident company within 3 years of the transfer.
- A transfer of a PRC company equity from a non-resident company to its 100%-owned PRC subsidiary
 - A transfer of assets / equity by a PRC company to its 100%-owned non-resident subsidiary
 - Others authorized by the Ministry of Finance and SAT

Regular Tax Treatment V.S. Special Tax Treatment

Under regular tax treatment, company reorganizations will lead to immediate EIT of the recognized gains or losses, which are measured by the differences between the fair market value and the tax bases of the assets involved.

Under the special tax treatment, qualified company reorganizations can defer the EIT for gains or losses on the transfer of assets and liabilities.

The main differences between regular and special tax treatment are as following:

	Regular Tax Treatment	Special Tax Treatment
Determination of tax basis	Step-up to Fair Market Value ("FMV")	Carryover basis of assets or shares (Any gain / loss with respect to the non-equity consideration will be recognized and added to the transaction)
Timing of gain / loss recognition	At the time of transaction	Temporary deferral (Any gain / loss with respect to the non-equity consideration will be recognized at the time of transaction)
Calculation of taxable gain / loss	Recognize any realized gain / loss arising from transfer of assets / equity	(FMV of transferred assets – Tax basis of transferred assets) x (Non-equity payment / FMV of transferred assets)
Tax loss and attribute carryover (applicable to Merger and Split)	Carryover is not allowed	Carryover is allowed with limitation (Note)

Note:

Limitation for losses can be carried over:

In the case of a merger: FMV of net assets of merged company x Interest rate of longest term

government bond at end of the year in which merger occurred

In the case of a split: Value of assets acquired by each company / Total value of assets

Documentation Requirement Regarding Special Tax Treatment

If the taxpayer elects the special tax treatment for certain reorganization transactions, both the transferor and the transferee are required to submit relevant supporting documents to the tax authorities together with the annual tax return filing for the year in which the reorganization is completed. Failure to make the proper filing will result in the disallowance of special tax treatment.

Comments

The new rule provides an opportunity for qualified taxpayer to elect special tax treatment regarding certain reorganization transactions, but it is insufficient to deal with all reorganization scenarios in practice. In addition, there were a number of uncertainty exist. For example, the eligible requirements will be a difficult task for both the tax authorities and the taxpayers in practice and the relevant documentation requirement also need to be specified. Thus, further clarifications and implementations are expected in the future.

Hendersen will keep an eye on any updates on regulations and rules as well as tax authorities' practice. Please contact us if you need any help regarding this.

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Contact Us

International Tax

Dennis Xu
dennis.xu@hendersen.com

Transaction Service

Thomas Ge
thomas.ge@hendersen.com

Corporate Tax

Eddie Wang
eddie.wang@hendersen.com

Transfer Pricing

Joyce Zhang
joyce.zhang@hendersen.com

Human Capital Service

Kevin Wang
kevin.wang@hendersen.com

Outsourcing

Grace Chen
grace.chen@hendersen.com



Hendersen
T a x a n d

www.hendersen.com

Hendersen Taxand

Unit 1003-1004, the Exchange
No. 299 TongRen Road
Shanghai 200040, PRC
Tel: +86 (21) 6447 7878
Fax: +86 (21) 3360 7100



www.taxand.com