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CIT Impact on Chinese Mergers and Acquisitions

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There have been important tax developments in Chinese mergers and acquisitions in recent years. Taxpayers should be aware of the potential pitfalls if planning a reorganization in China.

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The foundation of the current PRC tax regulatory framework for mergers and acquisitions ("M&A") is laid out in Bulletin 59 (Caishui 2009-59),jointly issued by the Chinese Ministry of Finance and the Chinese State Administration of Taxation ("SAT").

In Bulletin 59, the Chinese Government offered parties in a M&A transaction the so-called "special tax treatment" for corporate income tax ("CIT") purposes and prescribed stringent qualification criteria. The special tax treatment, in simple terms, means rollover CIT relief to the qualified participants. Assets recipients receive carry-over CIT basis for the assets received while exchanging shareholders receive substituted CIT basis for equity interests received, as adjusted for gains recognized due to the use of nonqualified considerations in the transaction. Through this tax basis rule, some or all gains realized by the transacting parties are exempted from current taxation.

In the last few years, we have seen important tax developments in the Chinese M&A area. During this period, the SAT has issued several new circulars to interpret the original rules in Bulletin 59, adding a new type of reorganization called "asset assignment", adjusting the qualification criteria, and revising the filing procedures. Despite the unprecedented level of regulatory details, Chinese tax reorganization is a thorny field with a number of uncertainties and inconsistencies both in theory and in practice. Under the newly revised procedural rules, after a taxpayer takes a tax return position for special tax treatment, it usually cannot seek confirmation from the tax authorities to verify the latter's concurrence to the position and therefore will not know whether such a tax position will be accepted until an official challenge from the tax authorities is raised during audit. This puts all the pressure on the taxpayers to clear up potential ambiguities and controversies beforehand, taking into account both technical merits and local practices.

The primary types of M&A transactions considered in this article are asset acquisitions, equity transfer, and merger/demergers. The category of Chinese tax addressed is Chinese CIT only. Other Chinese taxes such as VAT, land appreciation tax, deed tax and stamp duty, may also apply during a reorganization, and are out of the scope of this article.

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Overview

Before delving into the details, it is useful to recapture the basic requirements that a M&A transaction should satisfy to obtain special tax treatment in China. In general, a domestic M&A transaction should meet five general criteria simultaneously:

(1) it must have business purpose;

(2) 85 percent of the consideration should be "qualified";

(3) the buyer must acquire a minimum percentage of the total assets or equity interests of the target;

(4) some recipients of "qualified considerations" should hold on to them for at least 12 months after the M&A transaction is completed; and

(5) the substantive business operations underlying the assets or equity interests being transferred should remain unchanged for at least 12 months following the consummation of the M&A transaction.

If any of these five conditions is not met, a M&A transaction would be treated like a regular sale and the transacting parties will be subject to immediate Chinese CIT on their realized gains.

Chinese tax rules on cross-border reorganizations are more restrictive compared with domestic reorganizations, due to China's concern that multinational companies (MNCs) may utilize tax rollover relief to move profits out of the Chinese tax net if presented with such opportunities. In order to qualify for special tax treatment, a cross-border tax reorganization not only needs to satisfy all the five general conditions above, but also has to meet additional requirements.

For inbound investments into China from foreign investors, only two types of tax reorganizations are permitted to receive special tax treatment and they are limited to internal restructuring situations. The first type is the transfer of a Chinese subsidiary from a foreign parent to a directly and wholly owned foreign subsidiary (Type I). In a Type I equity transfer, the foreign transferor must retain equity interest received from the transaction for at least three years (instead of the normal 12 months). Due to the change in equity ownership, the governing income tax treaty between the foreign shareholder and China may be different before and afterwards. Bulletin 59 and the subsequent Bulletin 72 (SAT Announcement 2013-72) contain anti-abuse rules to ensure that the restructuring parties do not derive greater tax benefits from the new treaty than the old treaty, with respect to future capital gains from any subsequent transfer of the Chinese subsidiary by the foreign transferee, or with respect to future China-sourced dividend that the Chinese subsidiary may distribute to the foreign transferee out of historical earnings accumulated before the transaction.

The second type involves the transfer of a Chinese subsidiary by a foreign parent to another Chinese subsidiary that is directly and wholly owned by the foreign transferor (Type II). Beyond these two types, the SAT has not agreed to grant special tax treatment to any other cross-border M&A transactions undertaken by foreign investors when a Chinese target is directly transferred.

Transacting Parties

Bulletin 59 describes equity transfer as "one enterprise acquires the shares of a target enterprise to achieve the control of the latter," and defines asset transfer as "one enterprise acquires the substantive operating assets of a target enterprise." What the language implies is that in both asset and equity transfer transactions, there can be only one acquiring party. If there are multiple acquirers forming an acquisition group acting in unison, the tax authorities will likely view it as multiple acquisitions instead of one, and assess their qualifications for CIT rollover relief on an individual basis. While there can be only one buyer, Bulletin 59 does allow multiple sellers to exist in an equity transfer for the purpose of granting CIT rollover relief.

There is no restriction as to how many parties can participate in a merger/de-merger and having more than two parties participate would not exclude the transaction from special tax treatment. This is supported by practice. For example, in a 2012 case, five commercial banks in Hubei Province were merged into one newly created local bank. The Hubei provincial state tax bureau officially confirmed that the merger was entitled to special tax treatment.

The income tax relief provide under Bulletin 59 was intended for corporate participants only. In reality, some shareholders in M&A deals may be individuals. Previously there was a concern on whether the presence of individual shareholders in a reorganization would disqualify the transaction from special tax treatment entirely. In Bulletin 48 issued in 2015 (SAT Announcement 2015-48), the SAT confirmed that this would not be the case. Although Bulletin 59 does not grant income tax rollover relief to individuals, the qualification of the corporate participants for special tax treatment would not be negatively affected due to the involvement of individual shareholders. By similar rationale, the same could be said if some shareholders are partnerships or trusts. This should be confirmed with the local tax authorities as it is not explicitly covered by the current regulations.

Considerations Received

The considerations received in a Chinese tax reorganization must satisfy the "qualified consideration" requirements in order to receive rollover relief. Bulletin 59 specifies that an exchanging shareholder must receive a "substantial percentage " of considerations in the form of qualified equity interest during the reorganization and any major exchanging shareholder must hold on to the qualified considerations received for at least 12 months after the reorganization is completed. The purpose is to ensure that after the reorganization, the transferring shareholder(s) will retain a continuance of proprietary interests in the assets transferred, indirectly through the qualified equity interests received. This way the transaction is distinguished from a outright sale which would require current taxation. The "12 month retention" criterion is a mechanical test and precludes any need to assess whether any preconceived plan to dispose of the qualified considerations is present at the time of reorganization. To qualify for special tax treatment, a "substantial percentage" means at least 85 percent. If the percentage of non-qualified consideration, such as cash, unqualified equity interests or other assets of value, exceeds 15 percent of the total transaction value, special tax treatment will not be available.

Qualified Equity Interest

Bulletin 59 defines qualified equity interest as equity holdings in the acquiring entity or its "controlling entity." While it was expected that a "controlling entity" of the acquirer refers to a company that holds a controlling interest in the acquirer directly and/or indirectly as in the case of a triangular reorganization, Bulletin 4 (SAT Announcement 2010-4), which was issued by the SAT to clarify Bulletin 59, surprisingly states that a "controlling entity" of the acquirer means an entity that the acquirer owns directly. Under this interpretation, either the shareholding of the acquirer or its subsidiary would serve as qualified equity interests. While this interpretation makes a M&A transaction qualify for special tax treatment more easily, a "continuity of interest" principle inherently behind the tax deferral treatment is violated if the equity interests of the acquirer's subsidiary are used as compensation. Some Chinese tax officials have commented in unofficial situations that the interpretation in Bulletin 4 was not appropriate and should be modified. So far no amendment has been issued in official form. In addition, Bulletin 59 and Bulletin 4 do not indicate whether equity interests in the acquiring entity and its "controlling entity" could be used in combination in a reorganization. The answer is likely yes but it should preferably be verified with the local tax bureau beforehand.

Debt Assumption

A buyer's assumption debt owed by the seller in a Chinese tax reorganization is generally considered non-qualified consideration. In some asset transfer transactions, the acquiring company will buy the business assets plus debts of the transferring entity in an overall package. A question arises as to whether this assumed debt as a part of the business asset package represents a payment of non-qualified consideration from the buyer. If the debt being transferred is a closely related to the business assets that make up the former operation of the transferor entity, it can be argued that the debt assumption represents an integral part of the asset package being transferred and should not be viewed as separate consideration. In practice, some local tax authorities challenged taxpayers on this. If an asset transfer involves assumption by the acquiring party of debt that has been accrued by the transferring party, regardless of whether the debt is contingent or not, the parties are recommended to seek alignment from the in-charge tax authorities. If the local tax authorities take a conservative view, the transaction should be restructured to mitigate tax risks.

Contingent Payment

In some M&A transactions, the transacting parties agree upon a contingent provision in the agreement under which the exchanging shareholders will receive additional considerations if the target company meets certain pre-set financial goals in a specified future period. If such additional considerations will not be in the form of qualified equity interests, the parties need to examine whether their future payment would cause a violation of the 85 percent threshold on qualified considerations for the overall transaction.

Multiple Sellers

Where there are multiple sellers in an equity reorganization, the regulation doesn't say whether the "85% qualified consideration" requirement can be met on an aggregate level or must be satisfied on an individual selling shareholder's level. If some shareholders receive more than 85 percent while others receive less than 85 percent but the total amount of qualified equity interests received by the selling shareholders exceeds 85 percent of the transaction value, it is uncertain whether this would disqualify the whole transaction from special tax treatment. This could happen if selling shareholders have different levels of preference on cash versus equity as compensation. Clarifications with the local tax authorities are recommended.

Assets or Shares Acquired

To qualify for special tax treatment under the Chinese tax reorganization rules, the buying party must obtain a substantial part of the assets or shares from the target company (substantiality test) so that the acquiring company either inherits the core operation of the target company or achieves control of the target company through equity ownership. The percentage threshold used to be 75 percent under Bulletin 59 but has been lowered to 50 percent in Bulletin 109 (Caishui 2014-109) so that potentially more M&A transactions could satisfy this requirement.

It is unclear whether the 50 percent substantiality test refers to the end-state after the consummation of the M&A transaction, or represents the amount of assets or equity to be acquired from the M&A transaction only. Based on a literal reading of the language, the tax authorities will likely take the latter interpretation. This means that in a share acquisition transaction, if the acquirer has already possessed 51 percent of equity interest in the target company from prior acquisitions, it would not be in a position to acquire another 50 percent of the target and therefore would fail the substantiality test. The acquiring entity may attempt to sell 1 percent of the target to the seller beforehand and buy back the 1 percent plus the remaining 49 percent during the reorganization. When doing this, taxpayers should be aware that the Chinese Government follows a step transaction doctrine and has the right to aggregate transactions that happen within 12 months of the reorganization. If the disposition of 1 percent occurs right before the main transaction, the tax authorities can argue that the disposal and the buy-back of the 1 percent should be ignored due to the transitory nature and in substance the buying entity only acquires 49 percent in the reorganization. This step transaction doctrine can also apply in asset acquisitions.

For an asset reorganization to qualify for special tax treatment, the buying entity is required not to change

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the substantive business activities conducted by the selling entity within the 12 months after the acquisition. This requirement also serves to distinguish an asset reorganization from an asset sales. If the acquiring party disposes of key assets soon after the acquisition instead of using them in the same line of operation that has been conducted by the selling entity, the Chinese tax authorities would think that the acquisition resembles a sale rather than a reorganization. This is a mechanical test and any preconceived plan to dispose of assets by the acquiring entity beyond 12 months from the reorganization would likely not be viewed as damaging evidence against the transacting parties.

Business Purpose

For many tax reorganizations, a major hurdle to obtain special tax treatment is to fulfill the business purpose requirement, which dictates that the primary objective of a reorganization is not to reduce, eliminate, or defer Chinese income tax liabilities. This business purpose test is less objective compared with the other requirements and gives the Chinese tax authorities flexibilities in determining whether income tax deferral should be granted. When judging whether a reorganization has business purpose, the Chinese tax authorities often use the tax outcome to deduce the intention of the parties. For example, while a taxpayer may claim solid business reasoning behind a restructuring and produce comprehensive documentary support substantiating the business benefits to be expected from a reorganization, the tax bureau may get fixated on whether the company stands to gain any tax advantages from the restructuring and use that tax outcome to rebut the taxpayer's claim.

In a tax reorganization case, a Japanese multinational company planned to restructure its operations in China by transferring the equity interests in its four Chinese operating subsidiaries (four targets) into a wholly-owned China holding company ("CHC"). All the objective criteria in Bulletin 59 were satisfied and the transaction as a cross-border reorganization was sanctioned by Bulletin 59. When evaluating whether business purpose existed for the transaction, the government looked at whether the MNC's CIT situation in China would be improved after the restructuring. The four targets had accumulated earnings before the restructuring and could distribute them as dividend to whoever their parent company was. The tax authorities figured that, without the restructuring, dividend distributed from the four targets would go straight to the Japanese parent and would be subject to 10 percent Chinese withholding tax. With the restructuring, such dividend distribution would flow into the CHC and under the Chinese CIT law would be exempt from Chinese CIT. Although any further distribution from the CHC to the Japanese parent would be still subject to 10 percent Chinese withholding, this deferral in dividend withholding tax was considered a tax benefit created by the restructuring and caused considerable concern for the tax authorities.

Eventually the tax officials recognized the fact that CHC was a special corporate regime in China and one of its purported functions was to:

(i) hold Chinese subsidiaries under its umbrella;
(ii) centralize corporate functions;
(iii) create a uniform market image;
(iv) receive China-sourced dividends without paying CIT; and
(v) reinvest the earnings in China.

Consolidating the Chinese operations underneath the CHC by the Japanese MNC was to make the CHC do what it was supposed to accomplish. Therefore the tax authorities did not use the withholding tax deferral outcome as a factor against the taxpayer, and accepted the business purpose. Not every Chinese tax reorganization was as fortunate as this one. Taxpayers should be aware of this mind-set and approach of the tax authorities when preparing to answer their inquiries, and aim to prove that the business and financial impact of the reorganization will far exceed any tax benefits that may be derived.

Sometimes special tax treatment for a reorganization that meets all the objective tests has difficulty of getting accepted by the tax authorities because it impacts the tax revenues of the local government negatively. Even if the reorganization happens in a domestic setting, if the restructuring causes a permanent loss of tax revenue to a local tax jurisdiction in China, that creates a strong practical disincentive for that local tax bureau to grant special tax treatment. For example, in a merger situation where one local company is absorbed into another company from outside the province, or into a company located in the same province but administered by a different tax bureau system, taxing the asset transfer by the disappearing entity as a sale could represent the last major source of tax revenue for the local tax authorities in charge. Such a merger transaction would have a better chance of being blessed by the local tax authorities if the two entities are located in the same local tax jurisdiction and the total tax revenue of the local district is not affected by the reorganization.

Asset Assignment

In Bulletin 40 issued in 2015 (SAT Announcement 2015-40), the SAT added a new type of reorganization called "asset assignment" that may qualify for special tax treatment and prescribed its conditions. Asset assignment refers to transfers of assets or equity interests among domestic companies that are in a 100 percent directly controlled relationship. The transferor may directly own 100 percent of the transferee or vice versa. Alternatively both the transferor and the transferee can be directly and wholly owned by another domestic company or the same group of domestic companies. Other than ownership requirements for the transacting parties, the qualifying criteria for asset assignment are generally consistent with those described before. However, Bulletin 40 specifies detailed and stringent accounting treatment that must be followed by the transacting parties in order to obtain special tax treatment for this asset assignment category. Some MNCs have encountered difficulties in applying this new category of reorganization, because their accounting treatments as determined by GAAP differed from the entries prescribed by the tax authorities. Furthermore, the fact that the transacting parties are Chinese entities means that this new tax reorganization does little to relax the current restrictions that foreign invested MNCs face when conducting inbound cross-border reorganizations.

Cross-border Reorganizations

A recent court decision further illustrates the application of the Chinese tax reorganization rules in the cross-border setting. In this particular case, one Italian subsidiary holding the equity interest in a Chinese operating company was merged into its Italian parent company, and the disappearance of the Italian subsidiary caused an ownership change with respect to the Chinese operating company. The Chinese tax authorities believed that because the transaction led to a change of shareholder for the Chinese operating company, it represented a transfer of the Chinese equity interest from the Italian subsidiary to the Italian parent and the gains realized should be subject to 10 percent Chinese withholding tax. The taxpayer argued that even if the transaction were recast as a transfer of equity interest, any capital gains would be deferred based on the tax reorganization rules in Bulletin 59. The government responded that although the transaction might have qualified for tax rollover relief under Bulletin 59 if the transferor and transferee were Chinese entities, it was a cross-border transaction and did not fall under either Type I or Type II, which were the only two types of inbound M&A transactions approved by Bulletin 59 to receive special tax treatment.

The taxpayer then argued that the more restrictive rules in Bulletin 59 on cross-border tax reorganization were biased against foreign taxpayers and violated the nondiscrimination provisions in the income tax treaty as well as the investment treaty between China and Italy. The local tax authorities counter-argued that it was customary for countries to stipulate different tax rules and policies based on whether a taxpayer was domestic or foreign, and because the cross-border tax reorganization rules in Bulletin 59 applied to all foreign taxpayers rather than just taxpayers from Italy, the special restrictions placed by Bulletin 59 on cross-border tax reorganizations did not constitute tax discrimination. The case went through administrative review within the tax authorities and was subsequently litigated in the local district court and the appellate court in Shandong province. The courts upheld the decision by the tax authorities. In this case the taxpayer would have a much better chance of winning if the Italian parent company directly owned the Chinese subsidiary before the transaction and was merged into the Italian subsidiary, as the fact pattern in this alternative scenario would fit into the Type I cross-border tax reorganization.

Foreign restructuring transactions without involving Chinese targets directly may still have Chinese tax implications. In the previous example, if the Italian subsidiary holds the Chinese target indirectly through another foreign holding vehicle, merging the Italian subsidiary into the Italian parent would be viewed as transferring the foreign holding vehicle directly, and hence transferring the Chinese target indirectly. This transaction therefore fall under the Chinese indirect transfer rules in Circular 7 (SAT Announcement 2015-7), which was issued by the SAT in 2015. In such a case, if the Chinese tax authorities believe that the positioning of the foreign holding vehicle in the structure has insufficient business purpose, they would disregard the existence of the foreign holding vehicle and the same tax results as in the litigated case would be reached. Fortunately, Circular 7 contains a new exception for qualified internal reorganization. If the Italian parent owns at least 80 percent of the Italian subsidiary, the application of the indirect transfer rules can normally be excepted unless the Chinese subsidiary derives more than 50 percent of its value from Chinese real estate (land rich). If the Chinese subsidiary is land rich, the Italian parent must own 100 percent of the Italian subsidiary in order for the indirect transfer rules not to apply.

Tax Attributes Carryover

In a merger situation, one of the key objectives is to ensure that valuable tax attributes, most notably net operating loss ("NOL"), from the transacting parties are carried over to the surviving entity. If the disappearing entity has NOL prior to a merger, Bulletin 59 limits how much of the disappearing entity's historic NOL can be utilized by the surviving entity every year after the merger for CIT purposes. The annual limit = the fair market value of the merged entity times the contemporary interest rate of the government bonds of the longest term in China. As NOL can be carried forward for only five years in China, this annual limitation on the surviving entity may cause a significant portion of the disappearing entity's NOL to expire before being utilized. A planning alternative is to consider merging the profitable entity into the company that has unutilized NOL. The current tax M&A regulations in China are silent as to whether any annual limitation applies to this scenario and the primary hurdle is whether the business purpose requirement can be met if the merger transaction is structured this way. The parties need to prove that the selection of surviving entity in the merger is not driven by tax motives, and the business necessity for doing so outweigh any ancillary tax advantages.

Conclusion

China has issued important new tax rules in the reorganization area in recent years. These new rules, while addressing many unanswered questions, often create new uncertainties. Although the national rules issued by the SAT should be implemented uniformly across the country, we have seen differing practices and interpretations by tax bureaus in local enforcement.

While tax litigations are expected to happen more frequently in the future, given the lack of expertise in tax areas by the court system, the most effective channel to resolve and prevent tax controversy remains to be direct communications with the tax authorities at different levels in most situations.

When planning for a tax reorganization, taxpayers should analyze the transaction steps in the context of the tax reorganization rules, identify potential areas of controversy and ambiguity, and seek clarity and agreement with the in-charge tax officials on a discretionary basis. When negotiating with the local tax authorities, taxpayers should focus on presenting the business rationale for structuring the reorganization in a specific manner, introducing the industry common practices, emphasizing the policy intent behind the current Chinese tax rules, and explaining international tax standards applicable to the uncertain areas that require clarification. Such consultation and negotiation with the tax authorities will allow companies to sidestep potential pitfalls during the execution of reorganization plan, and adjust the restructuring steps where necessary to mitigate the chance of future tax disputes.

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