

CHINA

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Special tax treatment of enterprise reorganisations



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Taxation of enterprise reorganisation is a current focus of PRC tax authorities. The *Circular on Several Issues Concerning the Enterprise Income Tax Treatment of Enterprise Reorganisations* (Circular 59), issued on 30 April 2009 and retroactive from 1 January 2008, outlines the tax treatment of equity transfers in connection with an enterprise reorganisation. It distinguishes between a deal where capital gains are subject to tax at the time of the transaction, and one where the tax is deferred.

Under Circular 59, an “enterprise reorganisation” is a transaction occurring outside an enterprise’s normal course of business that results in a material change to its legal or economic structure. This includes an equity acquisition; namely, a transaction in which one enterprise (the acquirer) acquires equity of another (the takeover target) and thereby gains control of the takeover target.

Generally speaking, an enterprise recognises any gain or loss from assets in the course of reorganisation when the transaction takes place, and the tax basis of the assets is calculated using the transaction price. Under this “general treatment” approach, Circular 59 qualifies that the transaction price be determined according to the fair value of the assets. As such, the equity transfer gain is the difference between the actual equity transaction price and the equity cost price, and the resultant capital gain is subject to PRC enterprise income tax.

Circular 59 allows the application of “special treatment” provisions when an enterprise reorganisation, by means of equity acquisition, satisfies the following conditions:

- (1) the transaction has a bona fide business purpose and the primary purpose of the transaction is not to reduce, avoid or defer tax payments;
- (2) at least 75% of the total equity (of the target) is transferred;
- (3) in the case of a cross-border equity acquisition with a non-resident transferor, the acquirer is a 100% subsidiary of the transferor;
- (4) there is no change in the original business operating activities of the takeover target (i.e., the re-organised assets) for 12 months after the reorganisation;

- (5) at least 85% of the total consideration received by the transferor consists of equity in the acquirer; and
- (6) the major transferor who obtained payment in the form of equity does not transfer the acquired equity for at least 12 months after the acquisition.

If these conditions are met, Circular 59 alters the “general treatment” by allowing any capital gain to be deferred, rather than payable at the time of transaction.

Thus, parties may provoke special tax treatment in respect of equity transfer in accordance with the following provisions:

- the tax basis of the acquirer’s equity obtained by the shareholder of the takeover target is based on the original tax basis of the acquired equity;
- the tax basis of the takeover target’s equity obtained by the acquirer is based on the original tax basis of the acquired equity; and
- the original tax basis of the assets and liabilities of the acquirer and the takeover target and other relevant income tax attributes remain unchanged.

“Original tax basis” as mentioned above refers to the original cost of the investment assets (equity) in question. When the assets are acquired with cash, the purchase price is the cost. But when the assets are exchanged for something else, the cost is the fair value of the assets and related taxes and charges paid.

If the equity transfer qualifies for – and the relevant parties select – special tax treatment, materials must be submitted to the competent tax authority to show that the transfer satisfies the conditions specified for a special reorganisation and that it was approved by the provincial-level tax authority. Because Circular 59 is still rather new and the relevant implementing rules have not yet been issued, local tax officials may assess its applicability very differently. Thus, if companies are considering a reorganisation, we strongly recommend they contact the relevant PRC tax authorities regarding how capital gains from the transaction will be calculated and when the tax will be due.

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