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### **Tax rules on enterprise reorganization published**

The Ministry of Finance (MOF) and the State Administration of Taxation (SAT) published a Notice, "Certain issues regarding the enterprise income tax treatment of enterprise reorganization", on 7 May 2009 (Notice [2009] No.59) by reference to Art. 20 of the Enterprise Income Tax Law of the People's Republic of China and Art. 75 of the Implementation Regulations of the Enterprise Income Tax Law of the People's Republic of China. The Notice, which applies retroactively from 1 January 2008, is summarized below.

#### *Definitions*

A "corporate reorganization" refers to a transaction altering the legal or economic structure of an enterprise, which is not in the normal course of business operation. It includes a change in the legal form of an enterprise, debt restructuring, share acquisition, asset acquisition, merger and division, etc.

The term "change in the legal form of an enterprise" refers to a simple change in the registered name, address and organizational structure of an enterprise. The change is excluded from this category if it falls within other types of reorganizations specified in the Notice.

The term "debt restructuring" refers to an event in which, when a debtor is in financial difficulty, the debts are waived by virtue of entering a written agreement between the debtor and creditor or a court order.

The term "share acquisition" refers to a purchase of shares in an enterprise (the acquired enterprise) by another enterprise (the acquiring enterprise) in order to establish control over the acquired enterprise. The consideration paid by the acquiring enterprise may include payments in shares, other payments or a combination of the two.

The term "asset acquisition" refers to a purchase of assets of an enterprise (the transferee) by another enterprise (the transferor). The consideration paid by the transferor may include payments in shares, other payments or a combination of the two.

The term "merger" refers to a situation in which one or more enterprises transfer(s) all assets and debts to an existing or a newly established enterprise (the receiving enterprise) in exchange for payments in shares or other payments from the target enterprise.

The term "division" refers to a division of enterprises whereby one enterprise splits up and transfers all or part of its assets to an existing or a newly established enterprise in exchange for payments in shares or other payments.

The term "payment in shares" in the Notice refers to the means of payment whereby an enterprise uses its own shares or shares in its holding company as consideration for a purchase or exchange of assets with the other enterprise. Cash, bank deposits, receivables, securities, inventories, fixed assets, other assets, debt guarantees etc., are referred to as "other payments".

#### *Tax treatment of enterprise reorganization*

Subject to the different conditions the tax treatment of enterprise reorganization is divided into the general and special tax treatment.

##### (a) General tax treatment

Unless the special tax treatment contained in the Notice applies, an enterprise reorganization is treated as follows:

(i) Simple change

A conversion from a legal person into an unincorporated organization such as a sole proprietorship enterprise, partnership etc., or relocating the enterprise's registration outside China (including Hong Kong, Macau and Taiwan) must be treated as liquidation, distribution or establishment of a new enterprise by shareholders. All the assets of the enterprise and the shareholder's capital contributions are to be valued on the basis of the fair market value and form the new tax base.

Enterprises undergoing other simple changes in legal forms may directly register the changes with the authorities. The tax position for the purpose of enterprise income tax remains unchanged after the modification (also in respect of carrying forward losses or tax incentives etc.), except in the situation where an enterprise no longer satisfies the requirements for tax incentives on account of relocation.

(ii) Debt restructuring

Transactions relating to debt restructuring must be treated as follows:

- If a debt is paid off with non-monetary assets, the transaction must be split up into the disposal of non-monetary assets and the settlement of debts by non-monetary assets at the fair market value. The gains and losses on these transactions are treated separately and taxed accordingly.
- If a debt is converted into capital during the debt restructuring, the transaction has to be divided into debts settlement and capital contribution in determining the income or losses arising from the debt settlement.
- The creditor has to recognize the income on the difference between the amount received and the original book value of the debt. The debtor has to recognize the losses on the difference between the paid-off amount and the original book value of the debt.
- In principle, a debt restructuring does not bring about changes to the carry-over of losses and tax incentives, etc.

(iii) Acquisition of shares or assets

Transactions relating to acquisitions of shares or assets must be treated as follows:

- The transfer must recognize the gains or losses on the transfer of the shares or assets.
- The shares or assets acquired by the purchaser must be valued at the fair market value (FMV).
- The tax position of the target enterprise remains unchanged.

(iv) Merger

A merger must be treated as follows:

- The receiving enterprise must value all the assets and liabilities of the merged enterprise at the FMV.
- The target enterprise must be regarded as being liquidated and recognize income or losses on the transfer of all the assets.
- The shareholders of the merged enterprise recognize the income or losses on their shareholding or transfer of shares as if the merged enterprise has been liquidated.
- The losses of the merged enterprise cannot be carried over to the receiving enterprise.

(v) Division

A division must be treated as follows:

- The divided enterprise must recognize the income or losses on the transfer of the assets at the FMV.

- The receiving enterprise must value the acquired assets at the FMV.
- In cases where the divided enterprise continues to exist, the consideration received by its shareholders must be treated as a distribution of the divided enterprise.
- In cases where the divided enterprise ceases to exist, the divided enterprise and its shareholders must be treated in the same way as in liquidation.
- The losses of the divided enterprise cannot be carried over to the post-division enterprise.

(b) Special tax treatment

(i) Requirements

Special tax treatment applies to reorganization if all the following conditions are satisfied:

- The reorganization has a reasonable commercial purpose and its primary purpose is not the reduction, exemption or deferment of taxes.
- The proportions of purchased, merged or spin-off assets or shareholding must meet the percentages prescribed by the Notice.
- The original substantive business operations of the restructured assets remain the same in the 12 consecutive months after the corporate reorganization.
- The payments in shares in respect of the reorganization must meet the proportions prescribed by the Notice.
- The original and main shareholders receiving payments in shares must promise not to transfer the acquired shares within 12 consecutive months after the enterprise reorganization.

(ii) Payments in shares

If an enterprise reorganization satisfies the conditions mentioned in Art. 5 of the Notice, the special tax treatment applies to the portion of the transaction which is carried out by way of payments in shares:

- If the amount of taxable income arising from a debt restructuring accounts for more than 50% of the taxable income of the current year, it may be allocated over a maximum 5 tax years. In the case of a conversion of debts into capital, the debt settlement and capital contribution may not result in income or losses on the debt settlement. The value of the capital contributed may be set at the value of the original debts. Other positions on tax matters remain unchanged.
- If the acquired shares in an acquisition of shares account for more than 75% of the total shares of the acquired enterprise and the payments in shares are more than 85% of the total payments for the transaction: (i) the book value of the acquired shares may be set at the original value of the acquired enterprise; (ii) the original value of the shares of the acquired enterprise may be retained by the receiving enterprise; and (iii) the values of all other assets and liabilities of the acquiring and acquired enterprises and the positions on other tax matters remain unchanged.
- If the acquired assets in an acquisition of assets account for more than 75% of the total assets of the transferor and the payments in shares are more than 85% of the total payments for the transaction: (i) the value of the shares acquired by the transferor may be set at the original value of the assets transferred; and (ii) the value of the assets received by the transferee may be set at the original value of the assets transferred.
- In a merger (including a merger of enterprises under common control), if the payments in shares received by the shareholders of the merged enterprise account for more than 85% of the total payments for the transaction: (i) the value of all the assets and liabilities of the merged enterprise may be set at the original value of the merged enterprise prior to the merger; (ii) the tax rights and liabilities of the merged enterprise prior to the merger should be assumed by the receiving enterprise; (iii) the losses of the merged enterprise eligible for carrying-forward by the receiving enterprise = FMV of the net assets of the merged enterprise x the rate of the state bonds with the longest term at the end of the year in which the merger is completed; (iv) the value of the shares acquired by the shareholders of the merged enterprise may be set at the original value of the merged enterprise prior to the merger.

In a division, if: (i) the shareholders of the divided enterprise acquire the shares of the spin-off

enterprise according to the proportion prior to the division; (ii) neither the divided enterprise nor the spin-off enterprise changes its original substantive business activities; and (iii) the payments in shares received by the shareholders of the spin-off enterprise account for more than 85% of the total payments for the transaction, the following tax treatment applies:

- The value of the assets and liabilities of the divided enterprise received by the acquiring enterprise may be set at the original value of the divided enterprise.
- The tax rights and liabilities in respect of the divided assets of the divided enterprise should be assumed by the acquiring enterprise.
- The amount of losses of the divided enterprise which are still within the statutory time limit for the deduction of losses may be carried over to the acquiring enterprise according to the ratio of the transferred assets and the total assets of the divided enterprise.
- If the shareholders of the divided enterprise have to wholly or partly surrender their shares in the divided enterprise (old shares) to acquire the shares in the new enterprise (new shares), the value of the new shares must be determined on the basis of the value of the old shares surrendered. Where it is not necessary to surrender the old shares for the acquisition of the new shares, there are two options to determine the value of the new shares: (i) the value of the new shares are valued at zero; or (ii) the value of the old shares is reduced on the basis of the ratio of the net value of the transferred assets and the total assets of the divided enterprise. The reduced value calculated must be equally added to the value of the new shares.
- If, in accordance with the Notice, an asset transfer is paid for in shares and the gains or losses are temporarily allowed not to be recognized, the gains or losses in respect of the proportion of the assets transfer which is paid in non-equity payments must be recognized in the current period and that proportion of the transferred assets must be adjusted in value accordingly. The formula used is:

Gains or losses of transferred assets paid with non-equity payments = (FMV – Book value, BV) x (non-equity payments / FMV)

#### (iii) Cross-border reorganizations

The following cross-border acquisitions of shares or assets (including from Hong Kong, Macau and Taiwan) qualify for the special tax treatment provided that they also meet the conditions contained in Art. 5 of the Notice:

- A non-resident enterprise transfers its shareholding in a resident enterprise to another 100% directly owned non-resident enterprise (the non-resident transferee), provided that the transaction does not lead to a change in the withholding tax on this transfer of shares and the non-resident transferor makes a written commitment to the competent tax authority not to transfer its shares in the non-resident transferee within 3 years (including the third year).
- A non-resident enterprise transfers its shares in a resident enterprise to another 100% directly-owned resident enterprise.
- A resident enterprise uses its own assets or shares to invest in a 100% directly-owned non-resident enterprise.
- Other cases approved by the MOF and the SAT.

#### (iv) Resident enterprises investing overseas

Where a resident enterprise uses its shares or assets to invest in a 100% directly-owned non-resident enterprise (see (iii) Cross-border reorganizations, above) the income arising from the transfer of shares or assets may be allocated equally over the next 10 tax years provided that the enterprise elects to apply the special tax treatment.

#### (v) Tax incentives post-reorganization

In the case of a merger (including absorption or merger into a newly established enterprise), tax incentives granted prior to the merger may continue to apply to the post-merger enterprise for the remaining period if there are no changes in the enterprise's nature and the conditions for the

application of the tax incentives. The amount of the incentives must be calculated by reference to the taxable income of the post-merger enterprise derived in the last year preceding the merger (a loss counts as zero).

In the case of a spin-off division, the tax incentives granted prior to the division may continue to apply to the post-division enterprises for the remaining period if there are no changes in the enterprise's nature and the conditions for the application of the tax incentives. The amount of incentives must be calculated as follows:

$A \times B$

where:

A = the taxable income derived in the last year preceding the division by the spin-off enterprise (a loss counts a zero)

B = the ratio of the total assets of the enterprise prior to the division and the assets of the spin-off enterprise after the division.

(vi) Transactions pre- and post-reorganization

All transactions on transfers of shares or assets which take place within a period of 12 consecutive months before and after the reorganization should be regarded as one integral reorganization transaction by reference to the substance-over-form principle.

(vii) Documentation requirement

The enterprise applying the special tax treatment is required to submit the written documentation on the reorganization to the relevant tax authority along with the annual enterprise income tax return to prove the satisfaction of the conditions for the special tax treatment. Otherwise the enterprise is not allowed to apply the special tax treatment.

Reference: *AP:CN.*; *CHI:CN.*

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