China

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General

1. What are recent tax developments in your country which are relevant for M&A deals?

A couple of tax circulars have been released by the State Administration of Taxation (SAT) aiming to tackle with various conceptual and practical issues arising with the implementation of the notice on several issues relating to treatment of corporate income tax pertaining to enterprise restructurings (Circular 59) and the notice on strengthening the administration of enterprise income tax on share transfer gains derived by non-resident enterprises (circular 698) in 2009.

Circular 698 is known for its significant impact on the deal structure involving the so-called "indirect transfer" of a Chinese entity(ies). Circular 698 in principle adopts the "reasonable commercial purposes" criteria in the assessment of share transfer transactions. The SAT released a supplemental tax circular, announcement on several issues relating to enterprise income tax on transfer of assets between non-resident enterprises (Circular 7), which provides a much more extensive scope of 'taxable properties' which are potentially subject to the indirect transfer assessment to also include certain assets and real properties, as well as further elaboration on the assessment criteria of "reasonable commercial purposes". Circular 7 also provides "safe harbor rules" and a new reporting and tax withholding mechanism.

Also issued in 2009, Circular 59 has been acting as the pillar of the enterprise reorganisation tax system. The SAT issued several tax circulars which provide more specific guidance on certain topics addressed in Circular 59, primarily:

- Circular on corporate income tax treatments to encourage corporate restructuring (Circular 109), which lowers the threshold to enjoy the special restructuring treatment in a share or asset acquisition with respect to the ratio limit, and provides additional circumstances which can enjoy the special restructuring treatment
- Announcement of several issues relating to administration of levying and collection of enterprise income tax on restructuring of enterprises (SAT announcement 2015 No. 48), which provides more detailed guidance from implementation perspectives.

2. What is the general approach of your jurisdiction regarding the implementation of OECD BEPS actions (action Plan 6 specifically) and, if applicable, the amendments to the EU Parent-Subsidiary Directive?

China has been actively participating in the BEPS project as a G20 member and a cooperative partner of OECD. Shortly after the OECD released the final package, on October 10, 2015 the SAT published via its official website the Chinese translation of the BEPS 2015 Final Reports, showing a strong urge of the Chinese government to keep up with the development of international tax system. The SAT also addressed a general plan of actions including but not limited to refining the prevailing tax legislative framework to incorporate the BEPS actions with consideration of practical situation, building up risk management mechanism, etc. It is foreseeable that the BEPS project will have profound influence on the Chinese international tax system in the next few years.

3. What are the main differences among acquisitions made through a share deal versus an asset deal in your country?

a. Share deal

- Historical tax risks will be inherited by the buyer under share deal
- The seller to the transaction would be the holding company of the Chinese target entity.
- A share deal might trigger income tax implications for the seller.

b. Asset deal

- Historical tax risks are not inherited by the buyer under an asset deal.
- The seller to the transaction would be the Chinese target entity.
- Various turnover taxes and the enterprise income tax would be potentially triggered in an asset deal, as it is treated as the sale of assets of the Chinese target entity.

Buy-side

4. What strategies are in place, if any, to step up the value of the tangible and intangible assets in case of share deals?

In a share deal the fair value of the net assets of the target entity shall be adopted. Expected that as the asset appreciation is recognised at the target entity level and reasonably allocated to each asset items, the step-up of the value of the tangible and intangible assets of the target cannot be achieved.

5. What are the particular rules of depreciation of goodwill in your country?

China tax regulations do not allow goodwill to be depreciated.

6. Are there any limitations to the deductibility of interest on borrowings?

Financial costs engaged during the usual course of business are deductible if they are not to be capitalised.

- Interest on loans granted to persons other than shareholders is deductible if :

(i) the borrowing and lending are genuine; and

(ii) the enterprise and individual have concluded a loan contract.

- Interest deductibility is limited to the market rate on similar loans
- Interest paid to a related company is deductible if the debt/equity ratios are observed:

5:1 for financial service enterprises; and

2:1 for non-financial enterprises.

Those ratios do not apply if a company can prove that:

- the loan is at arm's length; or
- the effective tax rate of the borrowing enterprise is not higher than that of the lending enterprise within China.

Interest on the debts in excess of the ratios will be non-deductible.

Non-deductible interest (i) cannot be carried forward and (ii) will be re-characterised as dividends subject to corporate income tax.

7. What are usual strategies to push-down the debt on acquisitions?

Due to the foreign exchange control and in accordance with relevant tax regulations, onshore and/or offshore related and 3rd party loans can be considered but with certain limitations, i.e., offshore loans would be subject to the foreign loan quota, while related party financing is subject to thin-capitalisation rules.

Other traditional debt push down techniques might also be considered, such as setting up a new China entity, funded with debt, to acquire the trade and assets of an existing China entity; acquiring another Chinese entity from the non-Chinese holding entity, or through transfer pricing arrangement, etc., while relevant tax costs under each scenarios shall be considered.

8. Are losses of the target company(ies) available after an acquisition is made?

Yes, the losses remain valid at the target entity level after the share deal. The target's tax losses cannot be utilised by the holding entity.

9. Is there any indirect tax on transfer of shares (stamp duty, transfer tax, etc.)?

Yes, both parties to the agreement would be subject to the stamp duty at 0.05%.

10. Are there any restrictions on the deductibility of acquisition costs?

Acquisition costs shall be capitalised and are thus not deductible until the investment is disposed. Costs and expenditures incurred associated with the transaction that do not qualify for capitalisation can be recognised in the respective tax period for the income tax purposes.

11. Can VAT (if applicable) be recovered on acquisition costs?

VAT would only be triggered in an asset deal as it is treated as a sale of assets to the buyer. If the buyer has obtained the general VAT taxpayer status, the VAT incurred on the purchase of assets and substantiated with a special VAT invoice can be credited against the output VAT incurred on taxable income of the buyer. The tax regulations also provide certain circumstances where the input VAT credit cannot be claim, which shall be assessed based on the asset list and prior to the transaction.

12. Are there any particular issues to consider in the acquisition by foreign companies? *(for example non-resident taxation rules/substance rules and tax efficient exit routes)*

No specific tax concern for buyer, while, from legal side, certain application with China authorities is required before a China legal entity is invested into overseas.

13. Can the group reorganise after the acquisition in a tax neutral environment through mergers or a tax group?

The tax neutral will normally require a lock-up period for the investor's shareholding. The period could be 1 year or 3 years depending on different kind of restructuring case.

China in principle does not have a group tax reporting mechanism.

14. Is there any particular issue to consider in case of companies of which main assets are real estate?

In a share deal, no specific tax issue solely applying to real estate. However, if the tax authorities assess the share transfer to be solely for the purpose of transfer of real properties, relevant land appreciation tax implication might be triggered.

In an asset deal, the transfer of real properties would be subject to the land appreciation tax, business tax (which might be converted to the VAT shortly), deed tax, as well as other collections associated with the real estate transactions.

Sell-side

15. How are capital gains taxed in your country? Is there any participation exemption regime available?

Capital gains are taxed at 10% for non-residents, and 25% for residents. Some preferential treatments on exemption of capital gain tax are available in Circular 59:

Article 5 Where enterprise restructuring complies with the following conditions simultaneously, special tax process provisions shall apply:

1. It has reasonable commercial purpose, and reduction, exemption or delay in tax payment is not its primary purposes.
2. The proportion of acquired, merged or separated assets or equities conforms to that stipulated herein.
3. The original real operating activities of the restructured assets are not changed in the consecutive 12 months after the enterprise restructuring.
4. The equity payment amount involved in the transaction consideration of the restructuring conforms to the proportion stipulated herein.
5. The original major shareholders to whom the equities are paid in enterprise restructuring may not transfer its equities obtained in the consecutive 12 months after the restructuring.

Article 7 In the event that the enterprise engages in equity and asset acquisition transaction between within and beyond the borders of China (including Hong Kong, Macau and Taiwan regions), special tax process may not be applied unless the following conditions are met, in addition to the conditions stipulated in Article 5 hereof:

1. When a non-resident enterprise transfers resident enterprise equity in its possession to another non-resident enterprise with 100% of its direct holdings, no change in income withholding tax of the future transfer of such equity is caused thereby, and the transferring non-resident enterprise undertakes to the competent taxation authority in writing that it will transfer equities it possesses of the transferred non-resident enterprise within 3 years (including 3 years);
2. A non-resident enterprise transfers to a resident enterprise with 100% of its direct holdings equities it possesses of another resident enterprise;
3. A resident enterprise invests in a non-resident enterprise with 100% of its direct holdings with the assets and equities in its possession; and
4. Other cases approved by the Ministry of Finance and the State Administration of Taxation.

16. Is there any fiscal advantage if the proceeds from the sale are reinvested?

Before 2007, there was some preferential treatment on reinvestment of the dividends. However, no current effective tax policy is to date available.

17. Are there any local substance requirements for holding/finance companies?

Business substance is not required to set up a holding structure. However, the business substance would be essential in the beneficial owner test in the application for tax treaty treatment.

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