A new era of corporate restructuring in China

New rules may offer opportunities for businesses

By Danny Po and Kenise Chan

During an economic downturn, companies often undergo corporate restructuring to improve operational efficiency and profitability, raise funds and re-align corporate strategies.

The Ministry of Finance and the State Administration of Taxation jointly released corporate restructuring rules entitled: “Several Questions about Corporate Income Tax Treatments for Corporate Restructuring” (Caishui [2009] No. 59) at the end of April. The restructuring rules, which are retrospective to 1 January 2008, define types of corporate restructuring and lay down the prescribed conditions when the parties involved can opt for special tax treatments. The rules not only provide guidelines on the compliance requirements for corporate restructuring, but may also offer an opportunity for companies to achieve the above business objectives in a tax neutral manner.

Under the restructuring rules, corporate restructuring covers change of legal form, debt restructuring, equity and asset acquisition, merger and spin-off. The simple change of legal form generally will not trigger any tax consequence. Other than that, as a general principle, companies undergoing corporate restructuring should recognize the gain or loss resulting from the transfer of the relevant assets or equity at fair value at the time of the restructuring. The tax basis of the relevant assets should be revised according to the transaction prices. The rules provide detailed tax treatments for all of the different forms of corporate restructuring based on this general principle.

On the other hand, the restructuring rules allow special tax treatments – essentially tax deferral – for corporate restructuring that fulfils all of the following five conditions:

• The corporate restructuring must have reasonable commercial reasons – the main purpose cannot be for tax reduction, avoidance or postponement of tax payment.
• The equity or assets being acquired, merged or spun-off must reach a prescribed ratio to reflect the significance of the corporate restructuring – at least 75 percent equity or assets transferred within 12 months.
• Original business continues for at least 12 consecutive months (compulsory operating period).
• The deal consideration should mainly be comprised of equity or shares and the portion of equity payment must reach at least 85 percent of the total consideration.
• Original shareholding continues for at least 12 consecutive months, with three years in a particular cross-border transaction (compulsory holding period).

It is important to note that adoption of special tax treatments for the parties involved is not compulsory. For qualified corporate restructuring, the recognition of gain or loss of the transferor on the transfer of assets or equity can generally be deferred with respect to the equity payment portion; the transferee shall take over the transferor’s tax basis of the transferred assets or equity.

However, the transferor still has to recognize any taxable gain or loss with respect to the non-equity payment portion and adjust the tax basis of the relevant assets with reference to the formula prescribed in the restructuring rules. Under a merger or spin-off, the company receiving the assets will assume the original tax basis of the transferor.

Special tax treatments are also available to cross-border corporate restructuring under the new rules, but are only limited to the following types of restructuring:

Type one: A non-tax resident enterprise (the transferor) transferring the equity interest in a tax resident enterprise to another wholly owned non-tax resident enterprise (the transferee). Such transfer will not result in a change in the withholding tax rate on the capital gains arising on the subsequent transfer of the equity interest of the tax resident enterprise in the hands of the transferee. The transferor undertakes not to transfer the equity of the transferee within three years after the transfer of the tax resident enterprise.

Type two: A non-tax resident enterprise transferring the equity interest in a tax resident enterprise to another wholly owned tax resident enterprise.
Companies are recommended to study the restructuring rules as soon as possible to re-assess whether any restructuring completed last year could qualify for special tax treatments and if it does, whether they would want to opt for such a treatment.

Type three: A tax resident enterprise using its assets or equity investment to invest in another wholly owned non-tax resident enterprise.

Type four: Other circumstances that are approved by the Ministry of Finance and the State Administration of Taxation.

The restructuring rules allow the gain recognized under type three to be spread over 10 years for corporate income tax reporting purposes. Type four is simply a window allowing the authorities flexibility to address special situations not considered under the current rules. Even if the cross-border corporate restructuring falls into one of the four specific types, it still has to fulfil the five conditions listed earlier before the transferor involved in the corporate restructuring can opt for special tax treatments.

Companies that have undergone qualified restructuring and are electing special tax treatments have to submit written information to their in-charge tax bureaus for their records at the time of filing their annual corporate income tax returns. The restructuring rules, however, are unclear about what kind of written information has to be submitted and do not mention the reporting requirements for a non-tax resident enterprise that is a party to a qualified cross-border restructuring and wishes to opt for special tax treatment.

Some other important features, such as the treatment of multiple-step restructuring undertaken within a certain period as a single restructuring transaction and the introduction of a “ring-fencing” rule to limit the utilization of tax losses in a merger and spin-off, are included in the restructuring rules. Despite the improved features, a number of unclear issues still linger. For example, how will “commercial reasons” and “main purpose” — being conditions for special tax treatments — be assessed? Will there be any exception for the compulsory operating period if the company has to change its original business because of changes in market conditions? How should fair value be determined when the prescribed conditions for special tax treatments are breached eventually, assuming it should be taxable immediately (at the time of breach or at the original time of the restructuring transaction)?

There are also practicality issues to imposing the 12-month compulsory holding period for a corporate restructuring for an overseas initial public offering or private placement. In addition, many corporate restructurings took place last year in the absence of the restructuring rules and the prevailing tax treatments adopted at that time may need to be rectified in the 2008 annual corporate income tax return with reference to the rules. Companies are recommended to study the restructuring rules as soon as possible to re-assess whether any restructuring completed last year could qualify for special tax treatments and if it does, whether they would want to opt for such a treatment. Otherwise, the companies should study the general tax treatments to ensure the tax consequences of the restructuring will be properly reported in the annual corporate tax income return.

If the company has reached an agreement with the local tax bureau to temporarily rely on the tax treatments under the former tax regimes until the issuance of the restructuring rules, the company should discuss with the relevant local tax bureau on how to rectify their tax positions.

The restructuring rules represent a milestone in China’s tax development. Companies that underwent corporate restructuring before the rules were implemented, and need to rectify their tax positions in the 2008 annual corporate income tax return filing, or companies that are about to go through corporate restructuring should stay tuned for the latest developments of the rules.

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