



JONES DAY
COMMENTARY

CHINA ISSUES NEW TAX RULES ON ENTERPRISE REORGANIZATIONS

On April 30, 2009, the Ministry of Finance and the State Administration of Taxation jointly issued the Notice on Certain Issues of Corporate Income Tax Treatment of Enterprise Reorganizations (the "Notice"), Caishui (2009) No. 59. The Notice prescribes Corporate Income Tax ("CIT") treatment for various types of reorganizations, including debt restructurings, acquisitions of equity, acquisitions of assets, mergers, and de-mergers.

BACKGROUND

Prior to January 1, 2008, various tax reliefs were available for enterprise reorganizations under the old income tax regimes applicable to domestic enterprises, foreign-invested enterprises, and foreign enterprises. On January 1, 2008, the new Corporate Income Tax Law (the "CIT Law") came into effect, unifying the two systems. However, the new tax law is silent on the tax treatment of enterprise reorganizations. Article 75 of the Implementation Rules of the Corporate Income Tax

Law provides that unless otherwise prescribed by the State Council departments in charge of finance and taxation, an enterprise shall recognize, at the time the transactions take place, gains or losses that arise out of transfers of assets in the course of reorganization.

The CIT Law and its Implementation Rules basically authorized the Ministry of Finance and the State Administration of Taxation to issue long-awaited tax circulars concerning CIT treatment of enterprise reorganizations; compared with the reorganization rules issued under the old tax law and regulations, the guidance provided by the Notice is much more detailed.

CLASSIFICATION OF ENTERPRISE REORGANIZATIONS

The Notice classifies enterprise reorganizations into Ordinary Reorganizations and Special Reorganizations. An Ordinary Reorganization is a taxable transaction in which the CIT rules governing

normal asset transfers should apply. A Special Reorganization is a tax-free reorganization in which recognition of gain or loss will be fully or partially deferred. An enterprise organization will be treated as an Ordinary Reorganization unless the transaction meets specific requirements for one or more types of Special Reorganizations and the parties elect to avail the transaction of the Special Reorganization rules.

ORDINARY REORGANIZATIONS

As a general rule, each party to an Ordinary Reorganization should recognize gain or loss at the time of the transaction. The Notice provides the following guidance regarding specific taxable reorganizations.

Change of the Legal Forms of Enterprise. When an enterprise changes its legal form from a legal person to a sole proprietorship, partnership, or other nonlegal-person organization or moves its place of registration overseas from China (including to Hong Kong or Macao), the enterprise shall be deemed to have been liquidated, with all assets distributed to the owners of the enterprise, and the owners shall be deemed to have set up a new enterprise by contributing the assets. The tax basis of the assets of the new enterprise and the tax basis of the owners of the investment are determined according to fair market value. For other types of simple legal-form changes (the change of its registered name, address, or form of organization), the enterprise needs only to update its tax registration; unless otherwise provided, the tax attributes of the original enterprise generally will be inherited by the changed enterprise.

Enterprise Debt Restructurings. Debt restructuring is a concession made by a creditor based on a written agreement between the debtor and the creditor or on a court decision where the debtor enterprise is in financial difficulties. If an enterprise settles its debt with noncash assets, the debtor enterprise is treated to sell the assets at fair market value and then pay the debt. The enterprise will recognize gain or loss on the deemed asset sale and then gain or loss on the debt settlement. If the creditor converts its debt into equity of the debtor, the conversion is treated first as payment of the debt by the debtor and then as an investment by the creditor. In such a deemed debt repayment, the debtor enterprise

should recognize gain or loss on the settlement. The Notice does not provide how the gain or loss should be computed. Presumably, the deemed cash repayment should be the fair market value of the equity issued to the creditor. Accordingly, if an insolvent enterprise converts debt into equity, the enterprise may need to recognize gain on the debt settlement. The enterprise may have sufficient loss carryovers to shelter such gain. If the debtor pays less than the full amount of debt in a debt restructuring, the debtor should recognize gains on the difference between its tax basis in the debt and the amount paid; the creditor should recognize losses on the difference between its tax basis in the debt and the amount received.

Acquisitions of Stock or Assets. In an enterprise reorganization involving the transfer of stock or assets, the transferor/seller should recognize gain or loss on the transfer; the tax basis in the stock or assets received by the transferee should be determined according to the fair market value of the stock or assets.

Mergers. A taxable merger is treated as a sale of assets and liabilities at fair market value by the merged enterprise and then as a liquidation of the merged enterprise. In the deemed sale, the merged enterprise will recognize gain or loss. In the deemed liquidation, the shareholders of the merged enterprise will recognize gain or loss. The tax basis of the surviving enterprise in the assets and liabilities transferred from the merged enterprise should be determined according to fair market value. The tax losses of the merged enterprise cannot be used by the surviving enterprise.

De-Mergers. The separation of two or more existing businesses formerly operated by a single enterprise (the “original enterprise”) will be treated as a sale of assets at fair market value by the original enterprise; the original enterprise should recognize gain or loss on the deemed sale. The tax basis of the new enterprise in its assets is equal to the deemed purchase price (*i.e.*, the fair market value) of the assets. If the original enterprise continues to exist, the consideration received by the shareholders of the original enterprise is treated as a distribution. The Notice does not address the character of the deemed distribution. Presumably, if the original enterprise shareholders receive shares of the new enterprise, the value of the shares should be treated as dividends to the extent of accumulated earnings and profits (including

the gains on the deemed sale) of the original enterprise; the value in excess of the retained earnings logically would be treated as a return of capital. If the original enterprise ceases to exist, it is treated as having been liquidated. The Notice provides that the loss of an enterprise cannot be used by another enterprise. It is not clear how this rule will apply to a de-merger. As the de-merger is considered a sale of assets, logically the tax losses of the original enterprise should be retained in the original enterprise. If so, the rule probably means that the new enterprise cannot use the losses of the original enterprise.

SPECIAL REORGANIZATIONS

Common Requirements. A Special Reorganization must meet all of the following requirements:

1. The reorganization must have a business purpose, and its main purpose is not to avoid or defer tax payment.
2. The assets or stock transferred in the acquisition, merger, or de-merger must satisfy the ratio prescribed by the Notice.
3. There is no substantial change in business activities within 12 months of the reorganization.
4. The payment in stock as a percentage of total consideration for the transaction must be within the ratio prescribed by the Notice.
5. The party receiving the stock cannot transfer the stock within 12 months of the transaction.

Enterprise Debt Restructurings. If a debt restructuring satisfies the requirements for a Special Reorganization and the taxable income recognized as a result of the debt restructuring is more than 50 percent of the current year's taxable income, the debt-restructuring income can be recognized in equal installments for five years. However, for a conversion of debt into equity, gain or loss on debt settlement and investment may not be recognized; the tax basis of the original creditor in the stock received should be equal to its tax basis in the debt so exchanged and cancelled.

Stock to Stock. If an acquiring enterprise acquires 75 percent or more of the stock of the acquired enterprise and the payment in stock is not less than 85 percent of the total consideration for the acquisition, then the following tax treatment can be elected:

1. The shareholders of the acquired enterprise do not recognize gain or loss on the stock exchange; their tax basis in the stock received should be equal to their tax basis in the stock surrendered.
2. The tax basis of the acquiring enterprise in the stock of the acquired enterprise should be the same as the original tax basis of the acquired enterprise stock.
3. The tax basis of the assets of both enterprises remains unchanged.

The Notice defines the stock used as payment as the stock of the acquiring enterprise or the stock of its controlled enterprise. It appears that the acquiring enterprise can use its controlled subsidiary's stock. It is not clear, however, whether the stock of the acquiring enterprise's parent company can be used in a Special Reorganization.

Stock for Assets. If an acquiring enterprise acquires 75 percent or more of the assets of a transferor enterprise by paying stock that is not less than 85 percent of the total consideration, the transferor may elect not to recognize gain or loss on the stock received. In such a case, the tax basis of the transferor in the stock received should be equal to its tax basis in the assets transferred; the tax basis of the acquiring enterprise in the assets received should be equal to the original tax basis of the transferor in these assets. Again, it is not clear whether the acquiring enterprise can use the stock of its parent company for the acquisition. Furthermore, as a result of the stock-for-assets exchange, the transferor enterprise will become a shareholder of the acquiring enterprise. Although it is not specifically stated, the Notice does not seem to allow the acquiring enterprise to issue shares to the shareholders of the transferor enterprise for the assets of the transferor.

Mergers. One or more enterprises (the "merged enterprises") transfer their entire assets and liabilities to another enterprise (the "surviving enterprise"), and the shareholders

of the merged enterprises receive the stock of the surviving enterprise and other consideration. The surviving enterprise can be an existing enterprise or a newly established one. In such a merger, if the stock consideration received by the shareholders of the merged enterprises is not less than 85 percent of the total consideration, or if no consideration is paid because of common control, then the transaction can be deemed to be a Special Reorganization. In such a case, the merged enterprises and their shareholders may not recognize gain or loss with respect to the stock consideration, the tax basis of the surviving enterprise in the assets and liabilities received should be equal to the tax basis of those assets and liabilities at the hand of the merged enterprises immediately before the transfer, the surviving enterprise will assume the tax attributes of the merged enterprises, and the tax basis of the shareholders of the merged enterprises in the stock of the surviving enterprise received should be determined according to the stock of the merged enterprises originally held. However, the use of loss carryovers of the merged enterprises by the surviving enterprise is subject to a limitation. The limitation is an amount equal to the fair market value of the net assets of the merged enterprises, multiplied by the interest rate of the longest-term treasury bond issued at the end of the year in which the merger takes place. The Notice does not provide whether the amount calculated under this formula is an annual limitation or the total limitation. Presumably, this should be an annual limitation subject to the five-year carryover period for tax losses.

De-Mergers. A de-merger is a transaction in which one enterprise (the “de-merged enterprise”) transfers all or a portion of its assets to one or more existing or newly established enterprises (the “spinoff enterprises”) and the shareholders of the de-merged enterprise receive the stock of the spinoff enterprises. For a de-merger to qualify as a Special Reorganization, (1) all shareholders of the de-merged enterprise must receive stocks of the spinoff enterprises in proportion to their original ownership in the de-merged enterprise; (2) both the de-merged enterprise and the spinoff enterprises shall not substantially change their respective business operations; and (3) the stock of the spinoff enterprises received by the shareholders of the de-merged enterprise shall not be less than 85 percent of the total consideration. If a de-merger satisfies those requirements, the following Special Reorganization treatment can be elected:

1. The tax basis of the spinoff enterprises in the assets and liabilities received from the de-merged enterprise shall be determined according to the original tax basis of the de-merged enterprise in those assets and liabilities.
2. The spinoff enterprises assume the tax attributes in relation to the assets received.
3. If the de-merged enterprise has an unexpired tax-loss carryover immediately before the de-merger, a portion of the loss carryover can be allocated to the spinoff enterprises. Such allocation is based on the percentage of total pre-merge assets received by the spinoff enterprises.
4. The tax basis of shareholders of the de-merged enterprise in the stock of the spinoff enterprises (the “new shares”) depends on whether the shareholders need to surrender all or a portion of their stock in the de-merged enterprise (the “old shares”). If the shareholders surrender their old shares in exchange for new shares, their tax basis in the new shares shall be determined according to their basis in the old shares surrendered. If the shareholders do not need to surrender the old shares, they can elect either (1) to have a zero basis in the new shares, or (2) to allocate their original basis in the old shares between the old shares and the new shares according to the percentage of total pre-transaction net assets that each enterprise owns immediately after the transaction.

Boot. In most of the Special Reorganizations above, non-stock consideration of not more than 15 percent of the total considered is permitted. Such nonstock consideration includes cash, bank deposits, receivables, securities other than the acquiring enterprise stock or its controlled entity’s stock, inventories, fixed assets, other assets, and the assumption of liabilities. Gain or loss should be recognized with respect to the nonstock consideration. The relevant tax basis should be adjusted accordingly. The gain or loss should be calculated using the following formula:

$$\text{Gain or loss on asset transfer} = (\text{fair market value of the transferred assets} - \text{tax basis in the transferred assets}) \times (\text{nonstock consideration} / \text{fair market value of the transferred assets})$$

Cross-Border Transactions. The acquisition of stock or assets between China and an overseas destination (including Hong Kong and Macao) generally will not qualify as a Special Reorganization unless the transaction satisfies all of the common requirements for Special Reorganizations as discussed above and meets one of the following conditions:

1. A nonresident enterprise transfers shares of a resident enterprise to another 100 percent directly controlled nonresident enterprise. The transfer must not result in a change of withholding tax, and the transferor must promise in writing to the tax authority in charge that it will not transfer the shares of the nonresident enterprise for three years.
2. A nonresident enterprise transfers shares of a resident enterprise to another 100 percent directly controlled resident enterprise.
3. A resident enterprise transfers assets or stock owned to a 100 percent directly controlled nonresident enterprise as an investment. In such a case, the resident enterprise can recognize gain on the transfer over a 10-year period.
4. Other situations confirmed by the Ministry of Finance and the State Administration of Taxation.

Treatment of Existing Tax Incentives. In a merger by absorption, if there is no change in the nature of the enterprise and the conditions for tax incentives, the surviving enterprise can continue to enjoy the pre-merger tax incentives of the surviving enterprise for the remaining incentive period. The tax incentive amount is based on the taxable income of the enterprise for the year prior to the merger; if the enterprise had a loss that year, the taxable income is considered to be zero. For example, let's assume A was merged into B on December 31, Y2; both A and B would have had the tax incentive of a 50 percent reduction in the tax rate for three years (Y3, Y4, and Y5) if there had been no merger. According to the Notice, it appears that B could enjoy the reduced tax rate for Y3, Y4, and Y5; the reduced rate would apply only to the amount of taxable income equal to that for Y1; if B had a loss in Y1, the reduced rate would not be available for B for Y3, Y4, and Y5. Furthermore, it appears that the tax incentives of A cannot be assumed by B with respect to A's business. If

this is the intention of the Notice, some enterprises would be penalized as a result of a merger.

The Notice provides a similar rule for de-mergers. If Y is spun off from X, it appears that only X can continue the tax incentives if X enjoyed tax incentives prior to the de-merger and there is no change in business and conditions for the incentives; the amount of incentive should be based on the taxable income of X in the year prior to the de-merger, multiplied by the percentage of pre-transaction assets remaining with X. If the taxable income for the prior year is negative, X would not be able to enjoy tax incentives after the de-merger.

Step Transactions. The Notice states the principle of "substance over form." If stock or assets were transferred in several steps before or after the reorganization within a 12-month period, those transactions would be treated as a single transaction.

Filing Requirement. If a transaction satisfies the requirements for a Special Reorganization and the parties elect Special Reorganization tax treatments, the parties must file documentation to prove that the transaction meets the requirements. The documentation must be filed at the time of filing of the annual income tax return for the year in which the reorganization is completed.

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