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CHINA CLARIFIES TAX RULES FOR ENTERPRISE REORGANIZATIONS

On April 30, 2009, the Ministry of Finance and the State Administration of Taxation (the "SAT") jointly issued the Notice on Certain Issues of Corporate Income Tax Treatment of Enterprise Reorganizations (the "Notice"), Cai Shui (2009) No. 59. The Notice provides corporate income tax treatment of various types of reorganizations including debt restructurings, acquisitions of equity, acquisitions of assets, mergers, and de-mergers. On July 26, 2010, the SAT issued the Measures on Administration of Corporate Income Tax Concerning Enterprise Reorganizations (the "Measures"), SAT Public Notice [2010] No. 4. The Measures are implemented from January 1, 2010, and they have clarified some tax rules provided in the Notice and set forth guidance for documentation and filings for reorganization. This *Commentary* outlines a few of the clarifications.

DATE OF REORGANIZATION

A gain or loss generally is recognized on the date of reorganization in an ordinary (taxable) reorganization. For a special (tax-free) reorganization, the date of reorganization determines the time of reporting for the reorganization. According to the Measures, the date of reorganization is:

- The effective date of the debt restructuring agreement, for debt restructurings.
- The date that the share transfer agreement is effective and the registration of ownership change has been completed, for share acquisitions.
- The date that the asset purchase agreement is effective and the actual closing has taken place, for asset acquisitions.

- The date that the surviving enterprise has obtained the ownership of the assets of the merged enterprise and the business registration has been completed, for mergers.

- The date that the spin-off enterprise has obtained the ownership of the assets of the de-merged enterprise and the business registration has been completed, for de-mergers.

VALUATION OF ASSETS OR SHARES TRANSFERRED

If an enterprise acquires the assets or shares of another enterprise in a special reorganization, the parties should submit to the tax authorities a valuation report issued by a PRC-licensed appraiser with respect to the fair market value of the assets or shares acquired. This valuation report is also required for a taxable merger and de-merger.

For an acquisition of assets or shares in a taxable reorganization, the parties are required to have valid evidence of the fair market value of assets or shares transferred. The Measures do not specify what constitutes "valid evidence." It appears that the valuation report is not a must; however, we recommend that such report be prepared for related party transfers whose price is not available in the market. While the taxpayer is not required to submit this evidence to the tax authorities, it must be available for their inspection.

BUSINESS PURPOSE

A *bona fide* business purpose is required for all special reorganizations. According to the Measures, when an enterprise makes filings for a special reorganization, it should explain the business purpose in the following areas:

- The method of reorganization. The enterprise should specify the forms of reorganization, the background of the transaction, the time of the transaction, and the operation models before and after the reorganization.

- Form and substance. The enterprise should explain the legal right and obligation as a result of the reorganization as well as the final actual and commercial result of the transaction.

- The possible changes of tax status of parties to the reorganization as a result of the transaction.

- The changes of financial status of parties to the reorganization as a result of the transaction.

- Whether the reorganization results in any economic benefits or potential obligations to the parties that otherwise would not be obtained under free market principle.

- The information of nonresidents' participation in the reorganization.

LIMITATION ON USE OF NET OPERATING LOSSES IN MERGERS

For a merger in a special reorganization, the Notice provides a limitation on the use of loss carryovers of a merged enterprise by a surviving enterprise. The limitation is an amount equal to the fair market value of the net assets of the merged enterprise, multiplied by the interest rate of the longest-term treasury bond that has been issued by the end of the year in which the merger takes place. The Measures clarify that this is an annual limitation and that the surviving enterprise can use the tax loss carryovers of the merged enterprise up to the limitation amount each year for the remaining loss carryover period of such losses.

FILING AND CONFIRMATION

The Measures clarify the filing requirements, including specific documents for each type of reorganization. If a reorganization is elected to be treated as a special reorganization, all parties to the reorganization must take the same elected position. If the parties need a confirmation from the tax authorities on the special reorganization treatment, the parties may have the lead party file an application for the confirmation with the tax bureau in charge; the tax bureau should then forward the application to the provincial level of tax bureau for the confirmation. If the lead party and other parties are not in the same province, municipality, or autonomous region, the provincial tax authority in charge of the lead party should send a copy of the application materials to the relevant tax authorities in the other province, municipality, or autonomous region. The lead party in a special reorganization is the debtor in a debt restructuring, the transferor in a share or asset acquisition, the surviving enterprise in a merger by absorption, the enterprise that owned majority assets in a merger where the surviving company is a newly established enterprise, or the de-merged or spin-off enterprise in a de-merger.

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