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Acquisitions (from the buyer's perspective)

1 Tax treatment of different acquisitions

What are the differences in tax treatment between an acquisition of stock in a company and the acquisition of business assets and liabilities?

PRC tax law distinguishes between acquisition of shares and acquisition of business assets and liabilities. Under both scenarios, as a general rule, gains shall be recognised and taxed upon acquisition. Generally speaking, for the seller, a share deal is often more tax-efficient than an asset deal.

In the case of acquisition of shares in a company, the corporate income tax (CIT) issues of the target company will remain intact. The capital gains or losses realised by the share transferor shall be calculated based on the difference between the fair market value of the shares and the original investment costs. If the share transferor is an individual tax resident, 20 per cent individual income tax (IIT) on the gains (if any) shall be paid by the share transferor. If the share transferor is a Chinese tax-resident enterprise (TRE), the gains or losses shall be included into its overall taxable income subject to 25 per cent CIT. If the share transferor is a non-PRC-resident enterprise (non-TRE), 10 per cent withholding tax on the gains (if any) shall be paid in China. If the share transferor is a foreign individual or entity, PRC income tax may be waived if the applicable double taxation treaty stipulates that China does not have the taxation right over the gains.

In the case of acquisition of business assets and liabilities, the target company shall recognise its gains/losses derived from the asset deal. Such gains and losses shall be included in the overall taxable income of the target company subject to 25 per cent CIT. After the asset deal, if the shareholders of the target company liquidate the target company, the shareholders shall recognise their gains from disposing the investment. Such gains are subject to 20 per cent IIT (in case of individual shareholders) or 25 per cent CIT (if the shareholder is a TRE) or 10 per cent withholding tax (if the shareholder is a non-TRE). PRC income tax on the capital gains of the foreign shareholders may be waived if the applicable double taxation treaty so provides. Upon liquidation, the retained earnings of the target company are deemed as distributed as dividends. Consequently, its shareholders are also requested to pay income tax for the 'dividends'. In addition to the above income tax implications, an asset deal may also trigger various transaction taxes when the assets are transferred from the target company to the acquisition company.

Under certain circumstances, if the relevant conditions are met so that special tax rules apply, it is possible to conduct a share deal or asset deal in a tax neutral manner without triggering income tax.

2 Step-up in basis

In what circumstances does a purchaser get a step-up in basis in the business assets of the target company? Can goodwill and other intangibles be depreciated for tax purposes in the event of the purchase of those assets, and the purchase of stock in a company owning those assets?

In the case of acquisition of shares in a target company, the tax basis of the business assets of the target company will not be affected by the acquisition. That is, no step-up in basis will occur. Goodwill does not occur in the case of acquisition of shares. The acquisition costs of the shares cannot be amortised or deducted for CIT purposes until the acquired shares are further disposed of.

In the case of acquisition of business assets and liabilities in a target company, unless the special tax rules apply, the tax basis of the acquired assets is stepped up to the then fair market value. If the total purchase price is larger than the fair market value of the acquired assets and liabilities (on a stand-alone basis), the surplus shall be recognised as goodwill. Such goodwill cannot be amortised for tax purposes and can only be deducted when the acquired business is disposed of.

3 Domicile of acquisition company

Is it preferable for an acquisition to be executed by an acquisition company established in or out of your jurisdiction?

In order to use a local acquisition company to execute an acquisition, the acquisition company can be established in the form of a 'holding company' subject to certain requirements (among others, for foreign-invested holding companies, a registered capital of US$30 million is required, which can only be used for new investment). A foreign-invested enterprise (other than a holding company) cannot use its registered capital to make acquisitions, but can only finance them from their profits and cashflow.

In the case of acquisition of shares in a target company, whether it is preferable to establish an acquisition company in China depends on the following factors:

- under PRC Company Law, dividends can be paid out only after a company has set aside 10 per cent of its after-tax profits as statutory reserve fund. As such, where a Chinese acquisition company is used to hold shares in the target company, the problem of dual reserve fund allocation will occur, which will reduce the dividend distribution capacity to the ultimate foreign shareholder;
- when the target company distributes dividends to the Chinese acquisition company, such dividend income of the Chinese acquisition company is exempted from CIT, which means dividend distribution to the ultimate foreign shareholder via a Chinese acquisition company has no tax disadvantages. If reinvestment of the dividends from the target company is intended, having a Chinese acquisition company has its tax advantages, because dividends declared to a foreign company will immediately trigger withholding tax even if such dividends are reinvested in China; and

- resale of the acquired shares in the target company by a Chinese acquisition company is generally not tax-efficient, because the capital gains will be included in the overall taxable income of the Chinese acquisition company that is subject to CIT at 25 per cent and when the gains are distributed as dividends there will be withholding tax. However, the ultimate foreign shareholder may choose to sell its shares in the Chinese acquisition company to avoid the 25 per cent CIT on the gains. China-sourced capital gains realised by a foreign company are only subject to 10 per cent withholding tax. Under some tax treaties concluded by China with other tax jurisdictions (eg, Switzerland), China may not have the taxation right over such capital gains from the share transfer.

4 Company mergers and share exchanges

Are company mergers or share exchanges common forms of acquisition?

Company mergers and share exchange are often used for intra-group restructurings. In case of transactions with non-affiliated parties, if the seller remains involved in the business or a combination of businesses is intended, such forms of acquisition are also used in practice.

A merger has the tax benefits of not triggering transactional taxes (VAT, business tax, etc). If certain requirements are met for special tax rules, the transfer of assets during a merger is not taxable and the previous losses of the disappearing company can be utilised by the surviving company with certain limitation. These conditions are:

- the merger must have a reasonable commercial purpose and not be conducted mainly to reduce, avoid or postpone tax payments;
- the assets that are transferred during the merger must reach 75 per cent of the assets owned by the enterprise being merged;
- the assets involved in the merger must be used to continue the original actual business activities within 12 months after completion of the merger;
- the consideration received by the original shareholder of the enterprise being merged must mainly consist of payment in the form of shares and the portion of such share payment must exceed 85 per cent of the total consideration; and
- the original shareholder receiving payment in the form of shares (in the surviving enterprise) during the merger must not transfer such shares received within 12 months after completion of the merger.

Share exchange, ie, acquisition of shares in the target company in exchange for new shares in the buyer, is a precondition for the share acquisition to be non-taxable under special tax rules. The following conditions shall be met in order to make the share acquisition non-taxable, ie, the CIT payable by the share transferor is exempted by rolling the tax basis to the share transferee:

- the share transfer has business reasons and is not conducted mainly for the purpose of reducing, avoiding or postponing tax payments;
- no less than 75 per cent of the shares in the target company are transferred;
- the target company will continue its original substantial business operation within 12 months after the share transfer;
- the buyer issues new shares to the seller as the main consideration (above 85 per cent of the share price) for acquiring the shares in the target company;
- the main original shareholder of the target company will not transfer the shares received from the buyer (as a consideration for transferring shares in the target company) within 12 months after the share transfer;
- if a non-tax resident enterprise (non-TRE) transfers its shares in a TRE to another non-TRE:
  - the non-TRE transferee must be 100 per cent directly owned by the non-TRE transferor;
  - the share transfer must not change the withholding tax burden when the shares are later resold; and
  - the non-TRE transferor must commit not to transfer its shares in the non-TRE transferee within three years after the transaction; and
- if a non-TRE transfers its shares in a TRE to another TRE, the transferee TRE must be 100 per cent directly owned by the non-TRE.

5 Tax benefits in issuing stock

Is there a tax benefit to the acquirer in issuing stock as consideration rather than cash?

Among other requirements, in order for the acquisition to be qualified for special tax rules where the target company and its shareholder do not need to pay income tax, the shareholder of the target company must receive new shares in the acquirer as the main consideration (above 85 per cent). That is, issuing new shares by the acquirer may avoid income tax for the target company and its shareholder. However, the acquirers will generally not have tax benefits from the special tax rules with the exception of a qualified merger where utilisation of pre-merger losses of the merged company may be possible under special tax rules.

6 Transaction taxes

Are documentary taxes payable on the acquisition of stock or business assets and, if so, what are the rates and who is accountable? Are any other transaction taxes payable?

In the case of acquisition of shares, each party (buyer and seller) shall pay stamp duty at 0.05 per cent of the share price. There are no other transactional taxes for a share transfer.

In the case of acquisition by merger, no transactional taxes will be triggered when the assets are transferred from the merged company to the surviving company. The input VAT balance of the merged company can be further credited in the surviving company.

In the case of acquisition of business assets, various transactional taxes may occur. For transfer of tangible moveable assets and some intangible assets, VAT (standard rate is 17 per cent for tangible moveable assets and 6 per cent for intangible assets) is payable by the target company. Business Tax (BT) at 5 per cent is payable by the seller for transfer of other intangible assets and immoveable properties. VAT is generally neutral as the buyer can claim a credit. However, BT costs are not recoverable due to the lack of an input-output credit system. Where VAT or BT is paid, various surcharges shall also be paid at around 10 per cent of the VAT or BT amount. However, if during the asset deal, the relevant liabilities, receivables and employees connected with the acquired business are also transferred, the asset deal is not subject to VAT or BT. For transfer of land-use rights and buildings, the buyer shall pay Deed Tax at 3 to 5 per cent and the seller shall pay Land Appreciation Tax at progressive rates from 30 to 60 per cent of the 'appreciated amount' of such properties. Stamp duty shall also be paid by each party for transfer of properties at 0.03 per cent or 0.05 per cent as the case may be.

7 Net operating losses, other tax attributes and insolvency proceedings

Are net operating losses, tax credits or other types of deferred tax asset subject to any limitations after a change of control of the target or in any other circumstances? If not, are there techniques for preserving them? Are acquisitions or reorganisations of bankrupt or insolvent companies subject to any special rules or tax regimes?

The target's net operating losses, tax credits or other types of deferred tax assets are not affected by a change of control of the target. There are no techniques for preserving them. There are no special rules or tax regime for acquisitions or reorganisations of bankrupt or insolvent companies.

8 Interest relief

Does an acquisition company get interest relief for borrowings to acquire the target? Are there restrictions on deductibility where the lender is foreign, a related party, or both? Can withholding taxes on interest payments be easily avoided? Is debt pushdown easily achieved? In particular, are there capitalisation rules that prevent the pushdown of excessive debt?

An acquisition company gets interest tax relief for borrowings to acquire the target, ie, the relevant interest can generally be deducted before tax. However, if the acquisition company's registered capital has not been fully contributed, deduction of interest for borrowings will be restricted. There are no specific restrictions where the lender is foreign.

However, if the lender is a related party, the general transfer pricing rule of arm's-length principle shall be followed. The portion of the interest paid to a related party exceeding the arm's-length principle is not tax-deductible. Further, deduction of interest paid to related parties are restricted by thin capitalisation rules. In case the loans are directly or indirectly provided or guaranteed by related parties ('loans from affiliates'), the following thin capitalisation rule shall apply:

- If loans from affiliates exceed a certain ratio of the equity investment in the borrower, the interest expenses corresponding to the exceeding amount of debts are generally not deductible before tax. The standard affiliated loan-equity ratio is 2:1 and 5:1 respectively for non-financial institutions and financial institutions.
- There is an exception to the above thin capitalisation rule: although the standard ratio is exceeded, if the borrower can prove to the tax authority that the interest rate is based on an arm's-length principle, the interest expenses corresponding to the excessive loans from affiliates may still be deductible. However, the documentation task in this respect is quite burdensome.

Payment of interest abroad is subject to PRC withholding tax at 10 per cent and business tax at 5 per cent plus surcharges of around 10 per cent of the business tax. Such withholding taxes on interest payments cannot be easily avoided. However, if the applicable double taxation treaty provides a lower withholding tax rate, the lower treaty rate shall prevail.

9 Protections for acquisitions

What forms of protection are generally sought for stock and business asset acquisitions? How are they documented? How are any payments made following a claim under a warranty or indemnity treated from a tax perspective? Are they subject to withholding taxes or taxable in the hands of the recipient?

Protections in the forms of representations and warranties are commonly used for stock and business asset acquisitions. They are normally documented in the relevant purchase contract. Also, often for the payment of the purchase price, an escrow account arrangement is used. For an escrow account arrangement, a separate agreement must be concluded between the buyer, the seller and the escrow bank. Payments made following a claim under a warranty or indemnity are taxable in the hands of the recipient, if the recipient is a Chinese tax resident. If the payments are made to a foreign tax resident, the PRC tax law does not provide clear rules on whether PRC withholding tax shall apply. In practice, it is very likely that withholding tax is levied.

Post-acquisition planning

10 Restructuring

What post-acquisition restructuring, if any, is typically carried out and why?

There are no typical post-acquisition restructurings. Whether any post-acquisition restructuring will take place depends on the needs of the new shareholder which may not be driven by tax reasons, although a restructuring inevitably will have certain tax consequences.

11 Spin-offs

Can tax neutral spin-offs of businesses be executed and, if so, can the net operating losses of the spun-off business be preserved? Is it possible to achieve a spin-off without triggering transfer taxes?

It is possible to execute tax neutral spin-offs with the net operating losses of the spun-off business being preserved, provided that all the required conditions are met. These conditions include:

- the spin-off has business reasons and is not conducted mainly for the purpose of reducing, avoiding or postponing tax payments;
- the assets involved in the restructuring will be used to continue its original substantial business operation within 12 months after the spin-off; and
- the spin-off is basically a non-cash transaction (ie, above 85 per cent of the transaction).

12 Migration of residence

Is it possible to migrate the residence of the acquisition company or target company from your jurisdiction without tax consequences?

Under PRC Corporate Income Tax Law, PRC tax-resident enterprises include companies incorporated in China (Chinese companies) and foreign companies with their effective management institutions located in China.

A Chinese company remains to be PRC tax-resident even if its management institution is moved outside China. In this case, it is possible that the foreign country where the company's management institution is moved to also treats it as tax-resident. It is possible then under the relevant double taxation treaty, China makes a concession and no longer treats it as PRC tax -resident. A foreign company (with its management institution in China) can cancel its PRC tax residence by moving the management institution outside China.

Where a company ceases to be PRC tax-resident, it is regarded as conducting liquidation from a tax point of view. Consequently, the difference between the fair market value of its assets and their book value becomes taxable. Further, its shareholders are regarded as receiving dividends (corresponding to the company's retained earnings) and realising capital gains from disposing the investment, which will trigger income tax for the shareholders.

13 Interest and dividend payments

Are interest and dividend payments made out of your jurisdiction subject to withholding taxes and, if so, at what rates? Are there domestic exemptions from these withholdings or are they treaty-dependent?

Interest and dividend payments made out of China are subject to 10 per cent withholding tax. In addition, interest payment is subject to 5 per cent business tax plus various surcharges at around 10 per cent of the business tax. Domestic exemptions from these withholdings are generally not available. However, dividends paid out of pre-2008 profits are exempted from withholding tax. Further, until now, dividends paid by foreign-invested enterprises to their foreign individual shareholders are still exempt from Chinese income tax. Tax exemptions or reductions may be available depending on treaty clauses.

14 Tax-efficient extraction of profits

What other tax-efficient means are adopted for extracting profits from your jurisdiction?

The commonly used means of profit extraction is dividends paid out of after-tax profits. However, 10 per cent withholding tax (or a lower rate provided by an applicable tax treaty) will be triggered if the shareholder is a foreign entity.

Update and trends

In recent years, the PRC State Administration of Taxation (SAT) has issued various tax circulars to fight against treaty shopping in respect of passive income such as dividends, interest and royalties. In order to reduce PRC withholding tax on such income, foreign investors may wish to hold their PRC investment via an intermediary holding company, located in a country or area (such as Hong Kong or Singapore) that has lower treaty rates for such income. In 2009 the SAT issued the Tax Circular Guoshuihan [2009] No. 601 under which the beneficiary owner status of the foreign company receiving such income from China may be denied due to lack of its business substance, resulting in a non-applicability of the relevant low treaty rates. Subsequently, more tax circulars have been issued to provide detailed guidance in respect of the beneficiary owner status.

On 29 June 2012, the SAT issued an announcement to further clarify the definition of 'beneficiary owner'. The announcement stressed that the beneficiary owner status of a resident of the contracting country under the Double Taxation Treaty shall not be determined negatively or positively only due to the existence of certain unfavourable factors as mentioned in Guoshuihan [2009] No. 601 or the absence of the 'purposes of tax evasion or reduction, profit transfer or accumulation'. According to the announcement, a resident of the contracting country shall be directly identified as the beneficiary owner of the China-sourced dividend income if the resident of the contracting country is a listed company in that contracting country, or the resident is 100 per cent directly or indirectly owned by another listed resident company of the contracting country and such dividend income is derived from the shares held by the listed company. In addition, when an applicant designates an agent to receive China-sourced income, no matter whether the agent is a resident of the contracting country, this arrangement shall not affect the applicant to be identified as the beneficiary owner. However, the agent shall declare to the tax authorities that it is not the beneficiary owner of the relevant income.

Other means of profit extraction include interest, royalties, service fees, etc. The relevant expenses are normally tax-deductible in China subject to transfer pricing requirements and thin capitalisation rules. Apart from income taxes payable for these outbound payments, indirect taxes also apply. Interest is subject to 5 per cent BT, plus surcharges that cannot be recovered. Royalties are subject to 6 per cent VAT plus surcharges (creditable by the Chinese company). Services are subject to either VAT (creditable) or BT (non-recoverable) depending on the types of services involved.

Disposals (from the seller's perspective)

15 Disposals

How are disposals most commonly carried out – a disposal of the business assets, the stock in the local company or stock in the foreign holding company?

There is no simple answer to this question. The following factors are essential to determine the deal structure:

- Whether it is intended to dispose the whole business or only a branch of the business. If only a branch of the business is to be disposed, a disposal of the relevant business assets rather than disposal of stock is more often used. Of course, in such case, it is also possible to conduct a spin-off followed by disposal of the stock in the spun-off local company.
- Whether certain favourable tax attributes (eg, tax holiday, previous losses) of the local company is valuable to the buyer. Such tax attributes remain intact if the stock in the local company or stock in the foreign holding company is disposed.
- Whether the local company has large tax exposures that the buyer wants to avoid by all means.
- What is the composition of the assets and liabilities of the target company? For disposal of certain business assets (eg, real estate), heavy transactional taxes may be triggered. In such case, it is often more tax-efficient to undertake a stock disposal.
- Income tax burden of asset disposal is often higher than that of stock disposal. If business assets are disposed, the local company needs to recognise the relevant capital gains which are subject to 25 per cent corporate income tax (if there are no sufficient previous losses to absorb the gains). Subsequently, when the local company is liquidated, the retained earnings of the local company and the capital gains derived by its shareholders are further subject to income tax. If the stock of the local company is directly disposed, the 25 per cent corporate income tax at the local company level can be avoided.
- Disposal of the stock in the foreign holding company will normally have no PRC tax implications and may be a more tax-efficient exit strategy. However, under certain circumstances, due to lack of business substance of the legal structure, Chinese tax authorities may look through the intermediary holding structure and impose withholding tax on the gains.

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16 Disposals of stock

Where the disposal is of stock in the local company by a non-resident company, will gains on disposal be exempt from tax? Are there special rules dealing with the disposal of stock in real property, energy and natural resource companies?

Under PRC domestic tax law, such gains are subject to 10 per cent withholding tax. There is no tax exemption provided by domestic tax law. Such taxation right may be limited or even fully denied by some double taxation treaties concluded by China. However, if the main assets of the local company are real estate located within China, China has the taxation right under all its double taxation treaties.

17 Avoiding and deferring tax

If a gain is taxable on the disposal either of the shares in the local company or of the business assets by the local company, are there any methods for deferring or avoiding the tax?

As discussed in question 1, it is possible to achieve a tax free rollover effect to defer the tax on the relevant capital gains. For such purpose, the relevant conditions must be met so that the restructuring will qualify as a 'special enterprise restructuring'.

Among other conditions, if the shares in a local company are to be transferred by its foreign shareholder, the tax-free rollover treatment is only possible if the transferee is 100 per cent directly held by the transferor.

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