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The Impact of China's New Enterprise Income Tax Law on M&A Transactions and Advance Pricing Agreements

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Terminology

- EIT: Enterprise Income Tax
- FIE: Foreign Invested Enterprise
- WFOE: Wholly foreign owned enterprise
- SAT: State Administration of Taxation
- CHC: China Holding Company

Legal Sources

- New EIT law, which took effect on January 1, 2008
- Draft M&A tax rules, which will be issued over the next few months

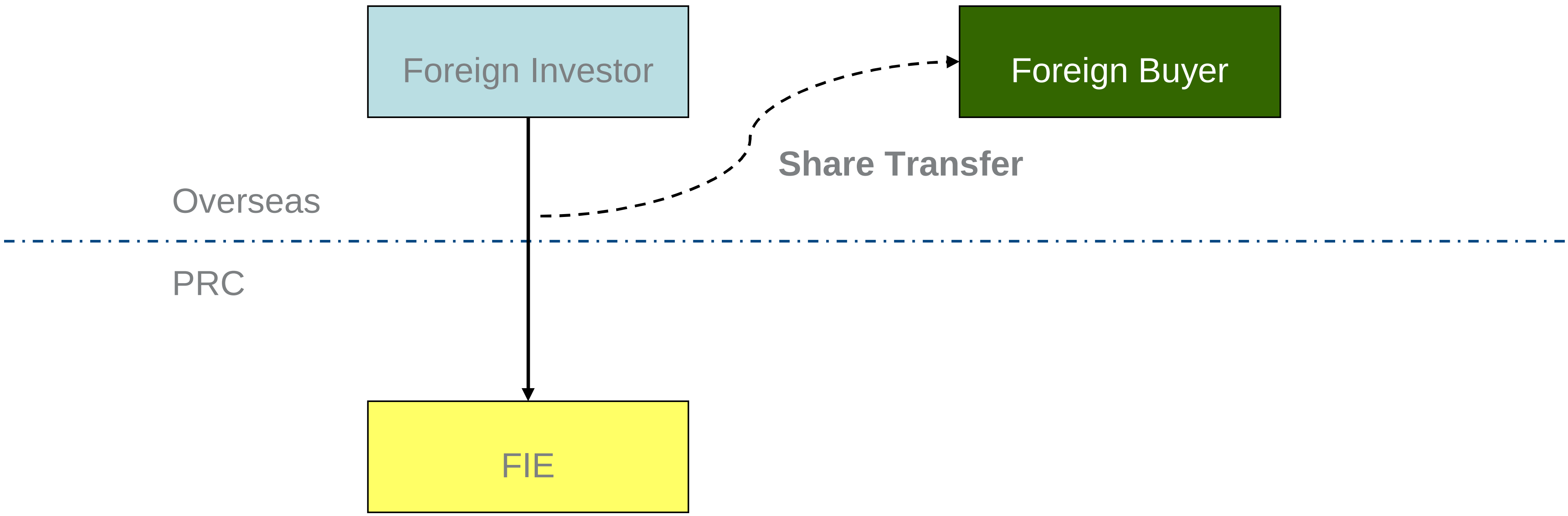
Topics for Discussion

- Tax Consequences of Typical M&A Transaction
  – Equity Deal
  – Asset Deal
  – Merger
  – Demerger / Division
- Impacts of New Tax Law on M&A Transactions
  – Dividend Withholding Tax - Holding Structure
  – General Anti-avoidance Rule - Tax Strategy
  – Thin Capitalization Rules - Financing Strategy
  – Residency Concept - Exit and Withholding
  – New Intra-Group Reorganization Rules
- Cost Sharing Agreements (CSA)
- Advance Pricing Agreements (APA)
- Transfer Pricing

Tax Consequences of Typical M&A Transactions

Equity Deal

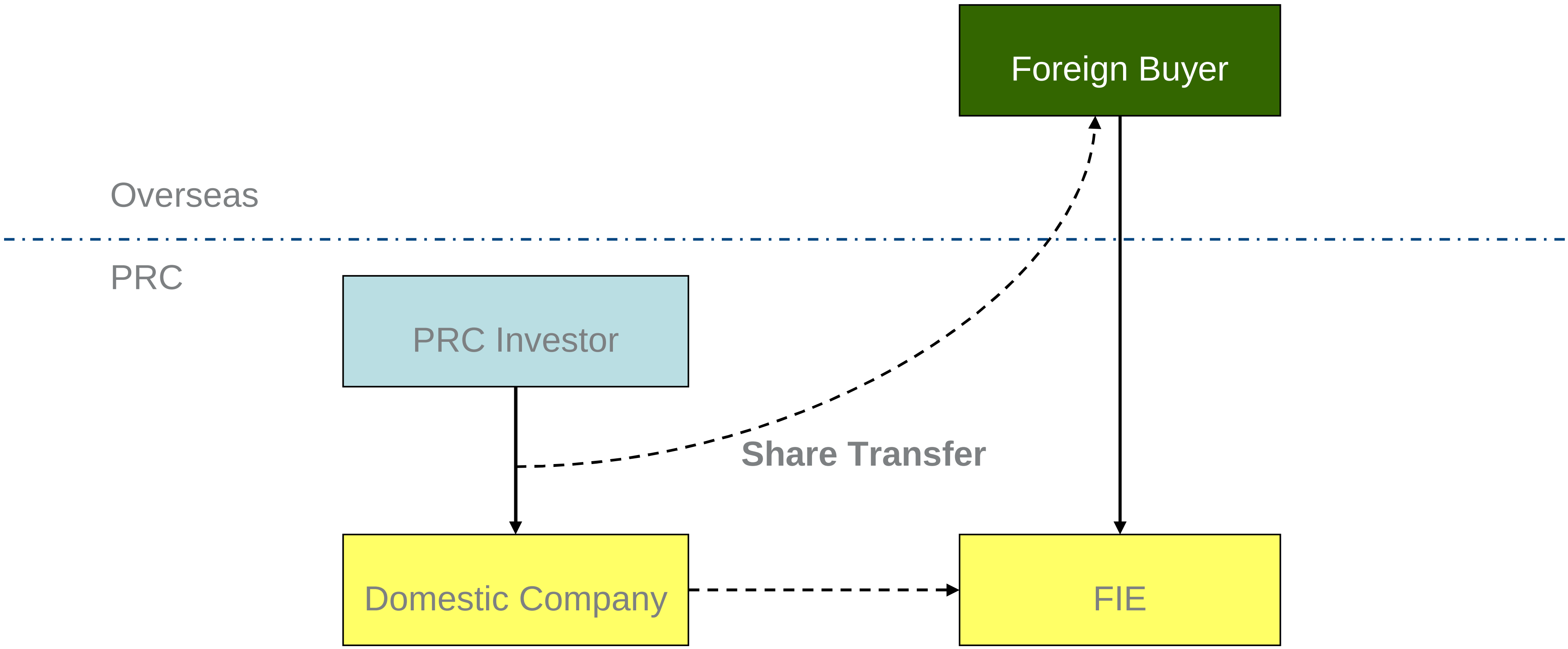
Acquisition of Shareholdings in FIE



Acquisition of Shareholdings in FIE

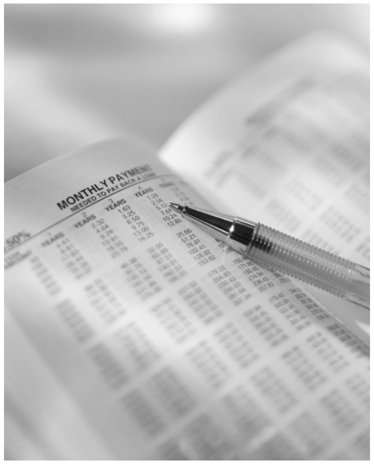
- Foreign seller's capital gain is subject to 10% PRC withholding income tax
  - capital gain is transaction price minus basis
  - Basis is generally the registered capital or the original acquisition price paid in by seller
  - Tax treaty may provide complete or partial exemption
- Stamp duty = 0.05% of price, payable by each of the seller and buyer
- Potential Issues
  - Foreign buyer has withholding obligation?
  - Can pre-2008 retained earnings of target be recognized as constructive dividends and thus deducted from capital gain?

Acquisition of Shareholding in Domestic Company

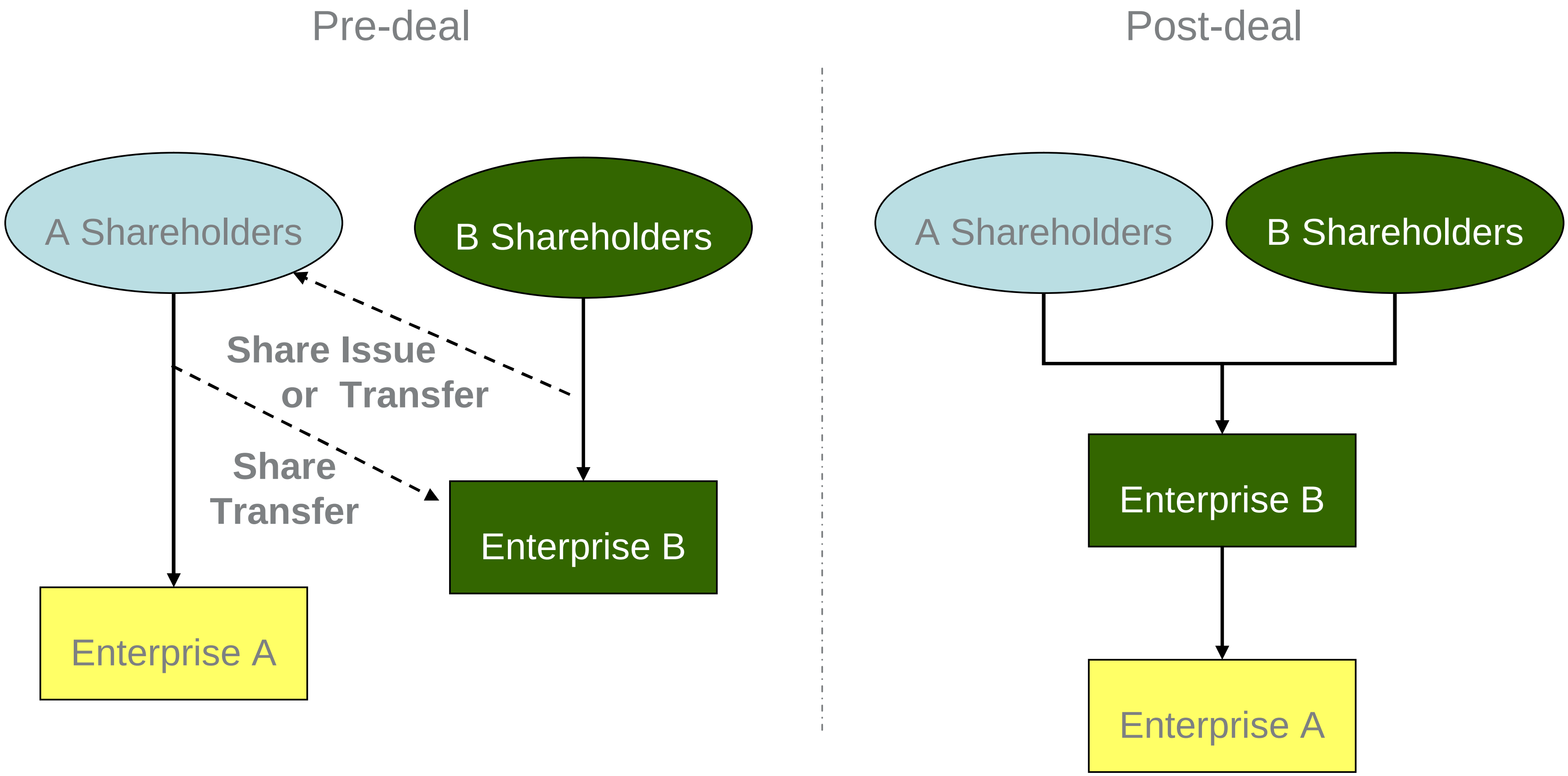


Acquisition of Shareholding in Domestic Company

- Foreign buyer's basis for equity investment is the price paid for the share
- Domestic seller is subject to enterprise income tax or individual income tax on gain
- Stamp duty = 0.05% of price, payable by each of seller and buyer
- Uncertainty: foreign buyer has withholding obligation if the seller is an individual?

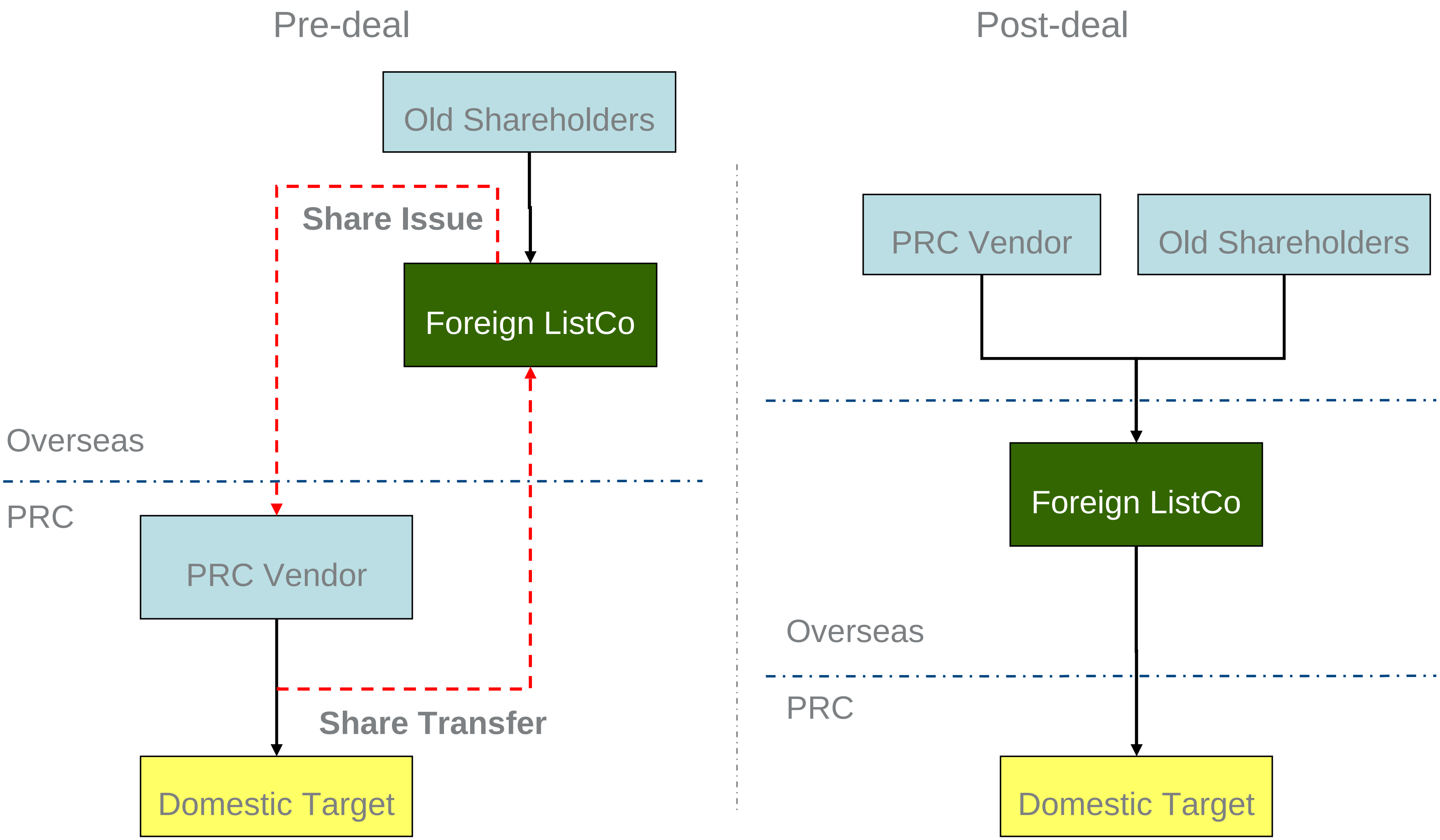


Share Swap (draft M&A tax rules)



- Share-for-share
- Possible receipt of boot (likely 20%)

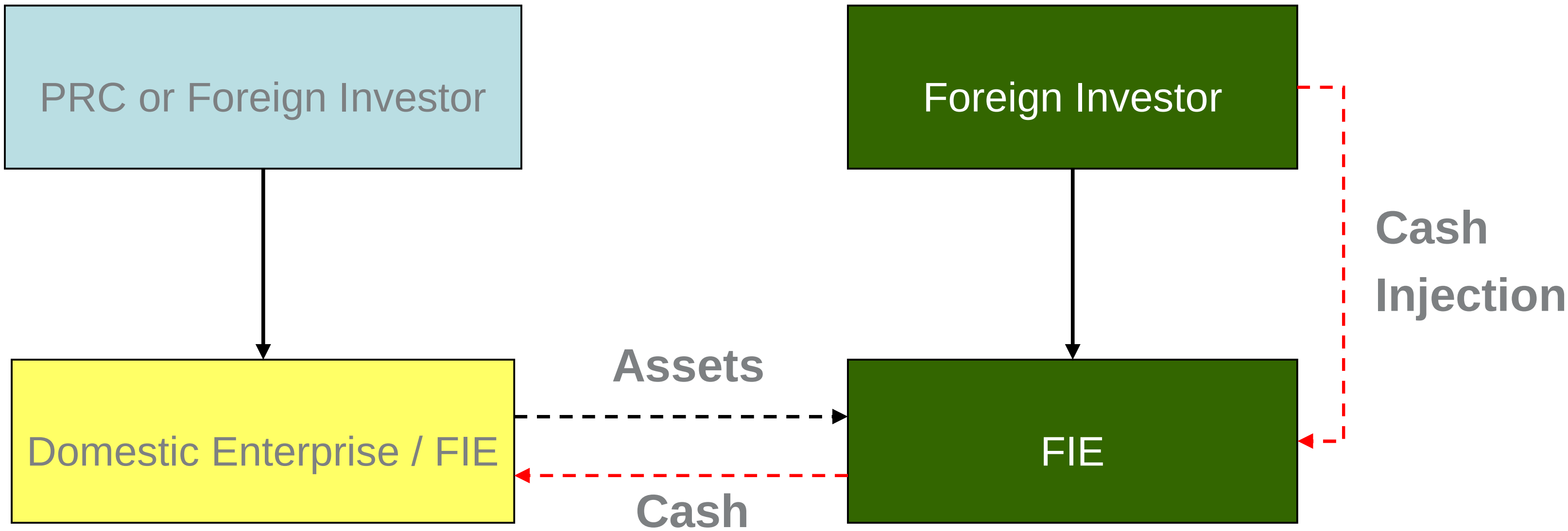
Share Swap – A Special Case



Tax Consequences of Typical M&A Transactions

Asset Deal

Asset Deal - Cash for Assets



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Asset Deal - Cash for Assets

Tax	Rate	Scope of Charge	Paid by	Notes
Business Tax	5%	Transfer of intangible assets or immovable properties	Seller	Transfer of technology is exempted from business tax
Deed Tax	3-5%	Transfer of land use rights or real estate	Buyer	If all the employees are taken over, deed tax can be exempted
Land Appreciation Tax	30-60%	Gain on disposal of land use rights and real estate	Seller	
Value-added Tax	17%	Transfer of inventory	Seller	Not a real tax cost since the buyer can claim input VAT credit
Value-added Tax	2%	Transfer of used equipment over purchase price	Seller	
Claw-back of import exemptions	It depends	Disposal of duty-free imported equipment within Customs supervision period	Seller	
Stamp Duty	0.03-0.05%	Execution of contractual documents	Seller and Buyer	
Enterprise Income Tax	25%	Gain on assets transfer	Seller	

Note: An asset sale may trigger another layer of tax when gains from the sales are distributed to the seller's shareholders in the form of dividends; inter-corporate dividends between two PRC enterprises are exempted.

Asset Deal - Cash for Assets

- Additional Considerations
  - Goodwill – not deductible (through amortization) under new tax law
  - Potential exemption of business tax and VAT under the regime of “complete transfers” (产权整体转让)
    - Depending on local practice
    - What about legality?

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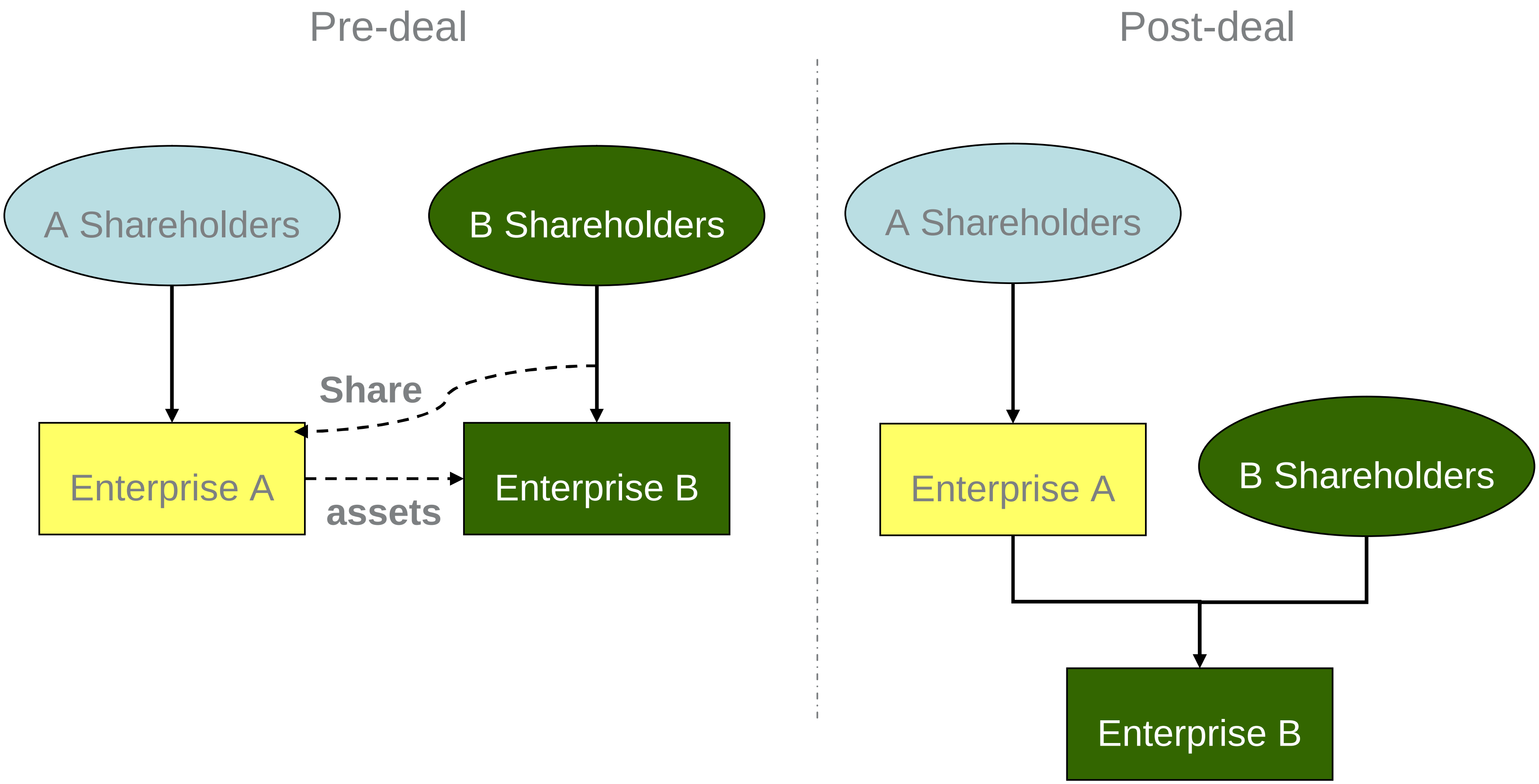
Asset Deal - Transfer of Total Assets (draft rules)



- Asset-for-share transfer (at least 75% of total assets)
- Possible receipt of boot (likely 20%)

Asset Deal - Exchange of Total Assets (draft rules)

- Asset-for-share transfer (at least 75% of total assets)
- Possible receipt of boot (likely 20%)

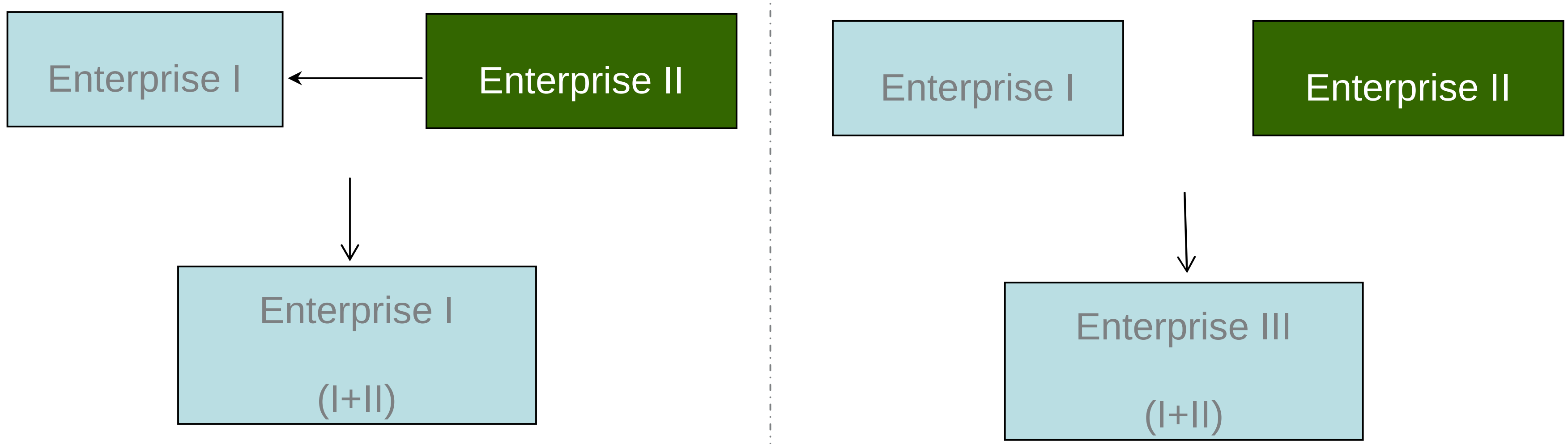
Tax Consequences of Typical M&A Transactions

Merger
Demerger / Division

Merger (draft M&A tax rules)

Merger by Absorption

Merger by New Establishment

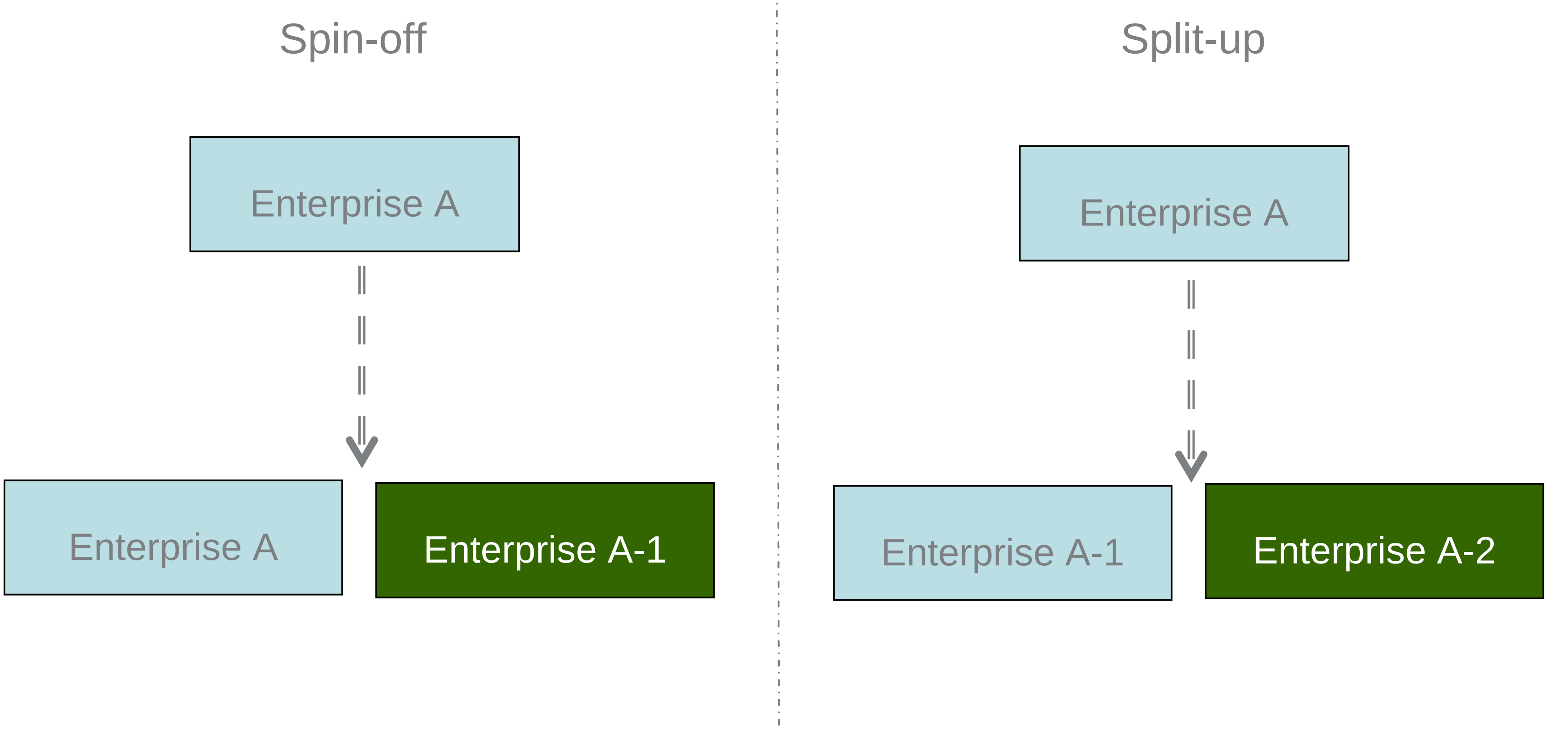


- Possible receipt of boot (likely 20%)

Merger (draft M&A rules)

- Qualified Merger
  - No income tax to Enterprise A or B and shareholders of Enterprise A or B
  - Deed tax and land appreciation tax are exempted
  - Stamp duty at 0.05%
  - Exemption of business tax and VAT
- Unqualified Merger
  - Income tax levied on hypothetic transaction based on fair market value
  - What about other taxes?
- Practical Obstacles

Demerger / Division (draft M&A rules)



- Possible receipt of boot (likely 20%)

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Demerger / Division (draft M&A tax rules)

- Qualified Demerger
  - Same consequences as in a merger
- Unqualified Demerger
  - Same consequences as in a merger

Impacts of New EIT Law on M&A Transactions

Dividend Withholding Tax - Holding Structure

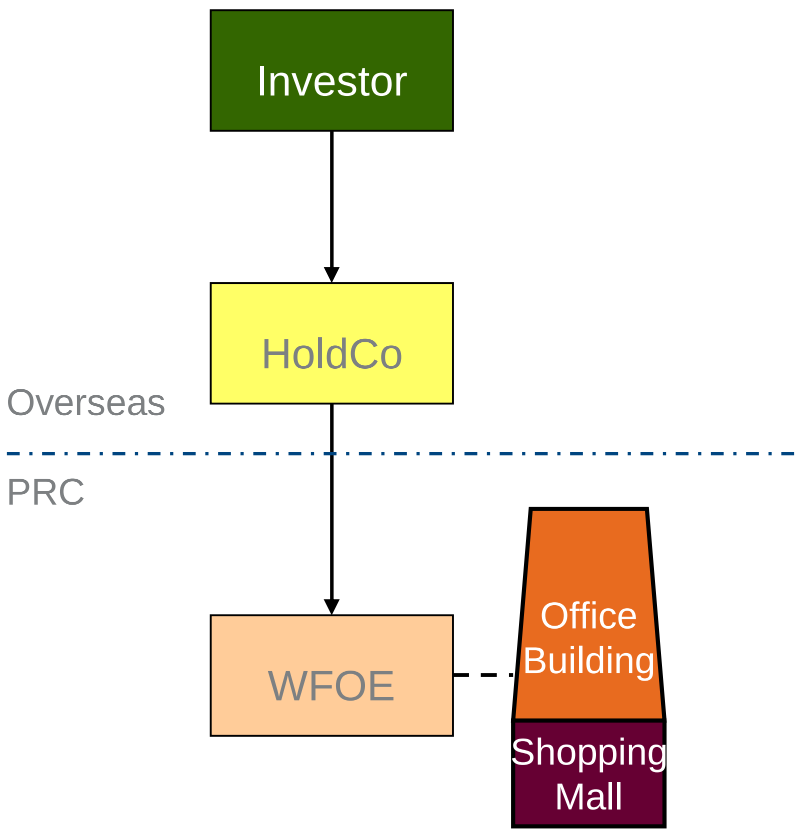
	Dividend	Interest	Royalties	Can PRC tax cap. gain on sale of shares in PRC real estate company?	Can PRC tax cap. gain on sale of >25% shares in PRC non-real estate company?
Barbados	5%	10%	10%	No	No
Lithuania	5% / 10%	10%	10%	Yes	No
Switzerland	10%	10%	10%	Yes	No
Ireland	5% / 10%	10%	10%	Yes	No
Mauritius	5%	10%	10%	Yes	Yes
Hong Kong	5% / 10%	7%	7%	Yes	Yes
Singapore	5% / 10%	10%	6%	Yes	Yes
Cyprus	10%	10%	10%	Yes	Yes
US	10%	10%	10%	Yes	Yes
Seychelles	5%	10%	10%	Yes	Yes
Luxembourg	10%	10%	10%	Yes	Yes

General Anti-avoidance Rule - Tax Strategy

- General Anti-avoidance Rule
  - Allows the tax authorities to adjust business arrangements if primary purpose is to reduce, avoid or defer tax payments
- Draft M&A Tax Rules
  - Strong business purpose test
  - Look collectively at a chain of transactions that occur within one year
  - 12-month holding period
- Tax Strategy
  - Balance between tax planning and risk management
  - Planning your transaction before signing LOI

Tax Strategy – Case Study

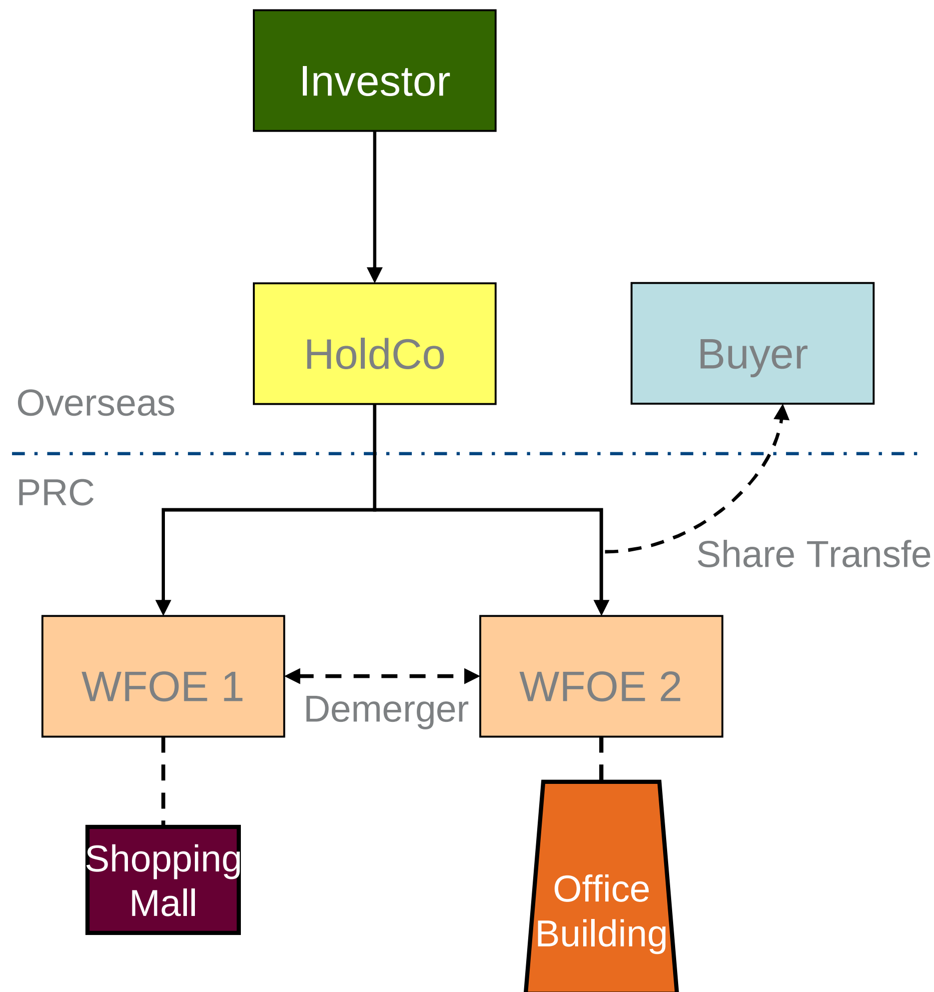
Current Structure



Business

- office building for sale (potentially block sale to large clients)
- shopping mall for leasing

Planning Strategy



Can this strategy work?

Thin Capitalization Rules - Financing Strategy

- Thin capitalization rules
  - Under the new tax law, excessive interest expenses incurred by an enterprise from related party debt financing will not be tax deductible if a prescribed debt-to-equity ratio is exceeded
    - 2:1 for non-financial enterprises
    - 5:1 for financial institutions
  - Two exceptions for interest paid to related party in China
    - arm's length
    - effective tax burden of payor not higher than that of payee

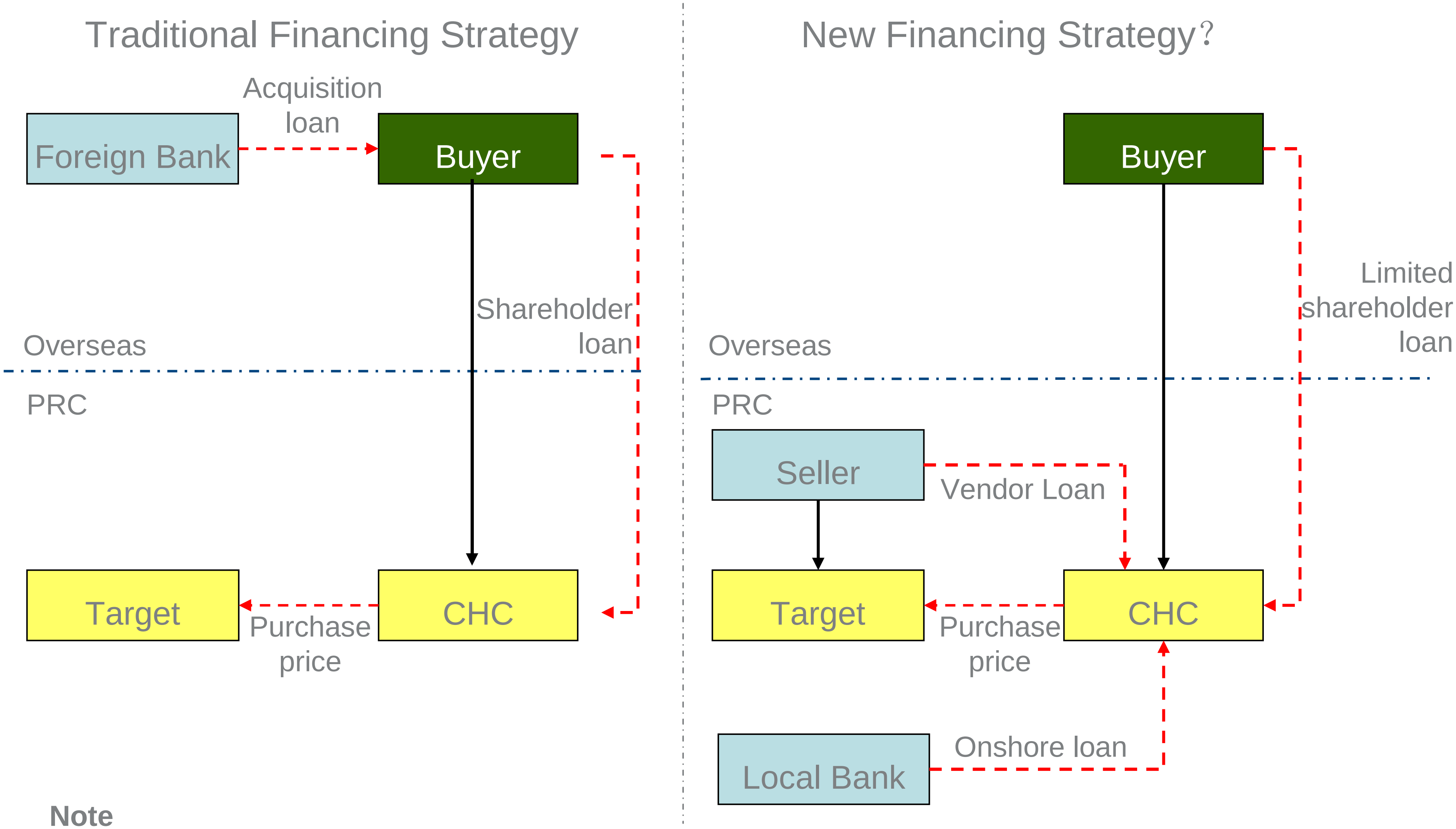
Thin Capitalization Rules - Financing Strategy

- Correlation with regulatory restrictions
  - Debt-equity ratio on foreign borrowing (including unrelated party financing)
  - Ban on debt funding for foreign-invested real estate enterprises

Total Investment	Ratio of Registered Capital to Total Investment	Debt Equity Ratio
US$3 million or below	70%	3:7
Greater than US$3 million but less than or up to US$10 million (inclusive)	50%	1:1
Greater than US$10 million but less than or up to US$30 million (inclusive)	40%	3:2
Above US$30 million	1/3	2:1

- Impacts
  - Reduce the tax efficiency of debt push-down
  - Consider local funding – legal restrictions – deal structuring

Thin Capitalization Rules - Financing Strategy



Note

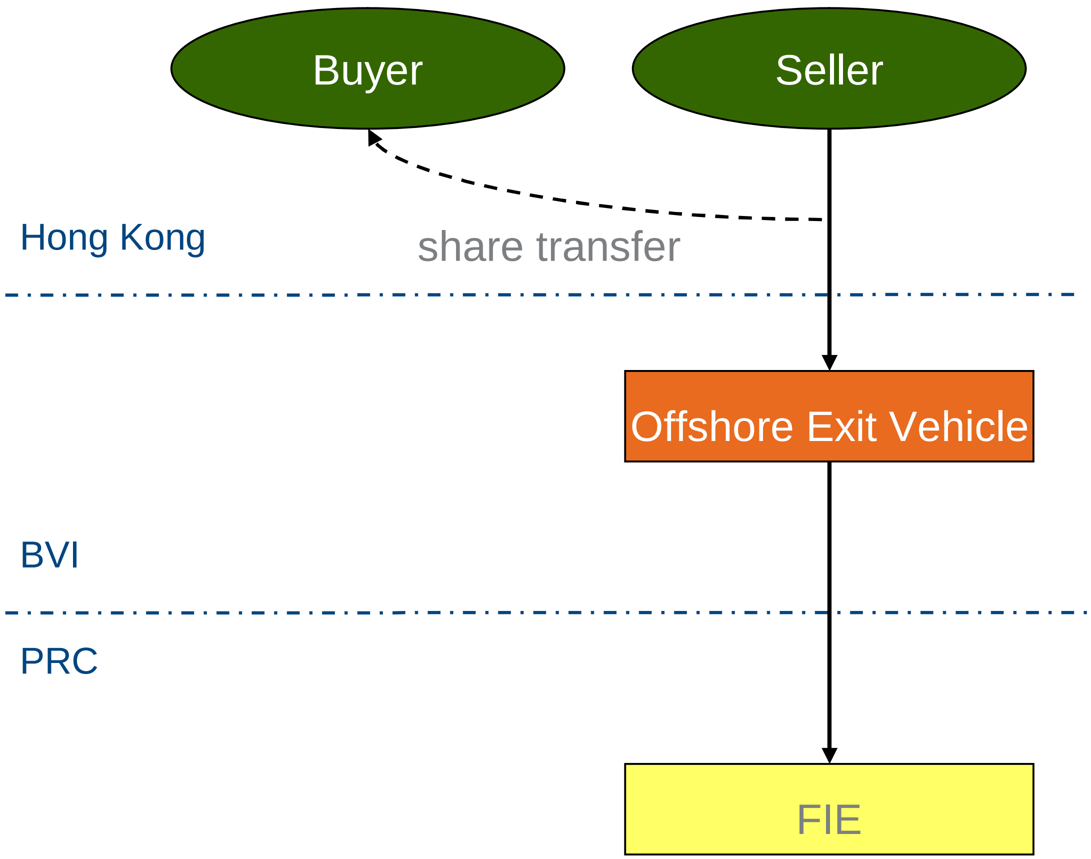
- Structure simplified for illustrative purpose
- Commercial loan cannot be used for equity purchase

Continuing Legal Education Code

Residency Concept – Exit and Withholding

- Residency
  - Tax residence based on incorporation or effective management and control in China
- Impacts
  - Offshore Exit
    - Do you think your exit is free of China tax? Think again
    - If the offshore exit vehicle (target company) is a PRC resident, withholding tax will apply to capital gain
    - If seller is a PRC resident, 25% enterprise income tax
  - Withholding Obligation
    - Does the buyer have the withholding obligation if the offshore exit vehicle (target company) is a PRC resident

Residency Concept – Exit and Withholding



Issues

- What will be the consequence if the offshore exit vehicle is a PRC tax resident?
- What will be the consequence if the Seller is a PRC tax resident?

Implementation Rules of EIT Law

"Place of effective management" refers an establishment that exercises, in substance, comprehensive management and control over production and business operations, personnel, finance and accounting, and properties.

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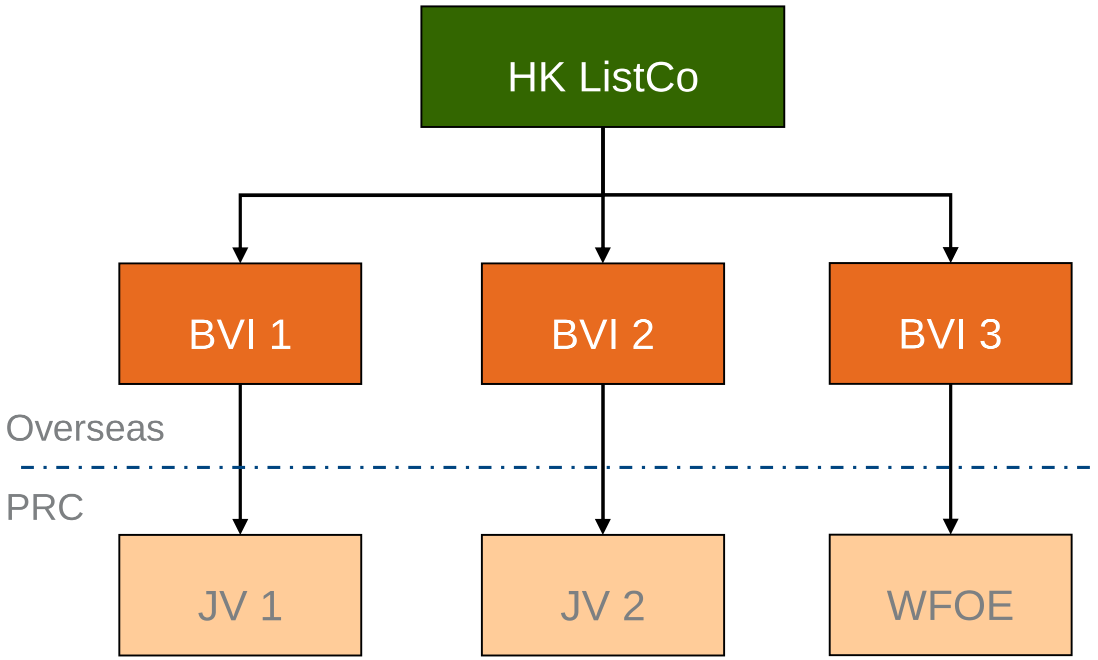
New M&A Tax Rule – Intra-group Reorganizations

- Intra-group Reorganizations
  - Circular 207 of FEIT Law
    - Share transfer can be made at "cost price" so that the seller does not have to recognize gain or loss if a foreign seller transfers its interest in an FIE to a 100% direct or indirect affiliate
  - New M&A Tax Rule
    - Circular 207 tax-free restructure has high likely been removed
    - Any transaction will be taxable if China loses the tax jurisdiction over the appreciation of value of the underlying assets or equity
  - Uncertainty: will the new M&A rules apply retroactively to 1 January 2008

Intra-group Reorganizations – Case Study



Issues

- 10% withholding tax applies to dividends paid by JVs and WFOE
- Any restructure to reduce dividend withholding tax?
- Should the BVI holding companies transfer the shares of JVs and WFOE to new Hong Kong holding companies?
- Can the share be transferred at cost?
- Any alternative

Points to Consider

- Withholding tax
- New M&A Tax Rule
- Residency
- Mainland-HK Double Taxation Arrangement

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Impact on Transfer Pricing, Advance Pricing, and Cost Sharing agreements

Cost Sharing Agreements (CSA)

- CSA is a contractual arrangement among Enterprises to share the costs and risks of developing assets, services or rights. Cost Sharing Agreements afforded legal status for first time under new law
  - Contract agreement with related party to jointly share incurred costs
  - Must document that expected costs will match expected benefits
  - Must be based on arm's length principals
  - CSA must be recorded with tax authority within 15 days of conclusion
  - Contemporaneous documentation required
  - CSA arrangement not available to Enterprises with less than 20 years of operational history

Cost Sharing Agreements (CSA)

- Recent SAT draft
  - Attempts to discourage CSAs that involve labor
  - Only acceptable service CSAs involve joint purchasing and marketing
- Benefit of CSA
  - Reduction of potential controversy with tax authorities
  - Elimination of both 10% W/H tax on royalties and 5% business tax

Advance Pricing Agreements (APA)

- New law allows Enterprises to use APAs to reduce transfer pricing risks with related parties
- SAT issued draft guidance to make APAs an important tool for both taxpayers and tax authorities
  - Detailed rules for six phases of the application process:
    - Pre-filing meeting
    - Formal application
    - Tax authority review and evaluation
    - Negotiation process
    - Signing of Agreement
    - Monitoring and execution

Advance Pricing Agreements (APA)

- APA Requirements
  - Related-party transactions amount above RMB 100 Million
  - Business operations lasting over 10 years
  - No substantial tax evasion in previous years
  - Compliance with required contemporaneous documentation
- APA effective for 2 to 5 consecutive years
- APAs can be concluded unilaterally, bilaterally or multilaterally

Continuing Legal Education Code

Transfer Pricing

- Transfer Pricing
  - ARM's length requirement/methods
  - Contemporaneous documentation requirement
  - Deemed income rule
  - Transfer pricing audit targets
- ARM's Length Requirement/Methods
  - Tax authorities may apply the following methods for tax adjustments on Inter-Company transactions:
    - Comparable Uncontrolled Price (CUP)
    - Resale Price Method (RPM)
    - Cost Plus Method (CPM)
    - Transactional Net Margin Method (TNMM)
    - Profit Split Method (PSM)
    - Any other method in compliance with ARM's Length Principle

Transfer Pricing

- Most reliable or reasonable method will be used
- If transactions between related parties do not conform to ARM's length standard, tax authorities have 10 years to make adjustments
- Interest will be imposed on unpaid tax resulting from transfer pricing adjustments
  - Interest not deductible
  - Interest calculated on RMB loan base rate published by People's Bank of China for relevant period plus 5%

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Transfer Pricing

- Enterprise subject to transfer pricing audit adjustment will be subject to a 5 years supervision period
  - Areas subject to tax authority supervision:
    - Compliance with contemporaneous documentation requirement
    - Changes to operations
    - Operating results
    - Related party transactions

Transfer Pricing

- Transfer Pricing Documentation Requirement
  - Enterprises must submit annual related-party transactions with annual tax returns
  - Upon transfer pricing audit, all related or relevant information must be provided
  - Time limit for submission
  - Information to be submitted will be agreed upon by the tax authorities and taxpayer

Transfer Pricing

- Contemporaneous Documentation Required:
  - Organizational structure
  - Overview of business operations
  - Related party transactions
  - Comparable analysis
  - Selection and application of transfer pricing methods.
  - Enterprises with a related party transaction range between RMB 20 million to RMB 100 million may use simplified documentation method
  - Exempted Enterprises
    - Related party transactions below 20 million
    - Covered by APA
    - Related party transactions solely within China

Transfer Pricing

– Documentation for 2008 calendar year must be completed before June 1, 2009
– Documentation
  • Must be in Chinese
  • Signed by legal representative
  • Retained for 10 years
  • Must be prepared separately for each legal entity in China
  • Submitted upon request
  • 15 day window
  • Taxpayers should consider performing functional analysis
  • Taxpayers may be required to disclose information from foreign related parties

Transfer Pricing

- Deemed Income Rule
  - Taxpayers not providing adequate information regarding related-party transactions will be subject to having their tax assessed on a "Deemed" basis
  - Methods being used by tax authorities when assessing taxable income on deemed basis
    - By reference to profit level of identical or similar enterprises
    - Based on the Enterprise's cost plus reasonable expenses and profit
    - Based on the reasonable proportion of the related party's group profit
  - Any other reasonable method
  - Taxpayers not agreeing with the deemed adjustment will need to provide relevant documentation to refute tax authorities position and seek confirmation and agreement from the tax authorities

Transfer Pricing

- Transfer Pricing Audit Targets
  - Significant number of related party transactions or many types of related party transactions
  - Long-term losses or marginal or fluctuating profits
  - Profit level lower than industry norm
  - Profit level lower than other group members
  - Profit level inconsistent with functions and risks
  - Transactions with related parties located in tax havens
  - Failure to properly report related party transactions
  - Failure to prepare required contemporaneous documentation
  - Failure to arm's length principles

Q & A

Thank you

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