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 Transactions
  – 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

Diagram:
- Foreign Investor
- Share Transfer
- Foreign Buyer
- Overseas
- PRC
- 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

Pre-deal:
- PRC Vendor
- Foreign ListCo
- Old Shareholders

Share Issue

Share Transfer

Post-deal:
- PRC Vendor
- Old Shareholders
- Domestic Target
- Foreign ListCo

Overseas

PRC
Tax Consequences of Typical M&A Transactions

Asset Deal
Asset Deal - Cash for Assets

PRC or Foreign Investor

Domestic Enterprise / FIE

Foreign Investor

FIE

Cash Injection

Cash

Assets
Asset Deal - Cash for Assets

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

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” (整体转让)
    • Depending on local practice
    • What about legality?
• 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

Enterprise I

Enterprise II

Enterprise I

(I+II)

Merger by New Establishment

Enterprise I

Enterprise II

Enterprise III

(I+II)

• 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)

Spin-off

Enterprise A

Enterprise A

Enterprise A

Enterprise A-1

Split-up

Enterprise A

Enterprise A

Enterprise A-1

Enterprise A-2

• Possible receipt of boot (likely 20%)
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

<table>
<thead>
<tr>
<th>Country</th>
<th>Dividend</th>
<th>Interest</th>
<th>Royalties</th>
<th>Can PRC tax cap. gain on sale of shares in PRC real estate company?</th>
<th>Can PRC tax cap. gain on sale of &gt;25% shares in PRC non-real estate company?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Barbados</td>
<td>5%</td>
<td>10%</td>
<td>10%</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Lithuania</td>
<td>5% / 10%</td>
<td>10%</td>
<td>10%</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Switzerland</td>
<td>10%</td>
<td>10%</td>
<td>10%</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Ireland</td>
<td>5% / 10%</td>
<td>10%</td>
<td>10%</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Mauritius</td>
<td>5%</td>
<td>10%</td>
<td>10%</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>5% / 10%</td>
<td>7%</td>
<td>7%</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Singapore</td>
<td>5% / 10%</td>
<td>10%</td>
<td>6%</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Cyprus</td>
<td>10%</td>
<td>10%</td>
<td>10%</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>US</td>
<td>10%</td>
<td>10%</td>
<td>10%</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Seychelles</td>
<td>5%</td>
<td>10%</td>
<td>10%</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>10%</td>
<td>10%</td>
<td>10%</td>
<td>Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>
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

Investor

HoldCo

WFOE

Office Building

Shopping Mall

PRC

Overseas

Planning Strategy

Investor

HoldCo

WFOE 2

Buyer

WFOE 1

Shopping Mall

Office Building

Demerger

Share Transfer

Can this strategy work?

Business

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

27
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

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

- Impacts
  - Reduce the tax efficiency of debt push-down
  - Consider local funding – legal restrictions – deal structuring
Thin Capitalization Rules - Financing Strategy

Traditional Financing Strategy

Foreign Bank \rightarrow \text{Buyer} \quad \text{Acquisition loan}

\text{Overseas} \quad \text{PRC}

\text{Target} \rightarrow \text{CHC} \quad \text{Purchase price}

New Financing Strategy?

Buyer \rightarrow \text{Overseas} \quad \text{Limited shareholder loan}

\text{Seller} \rightarrow \text{Vendor Loan}

\text{Overseas} \quad \text{PRC}

\text{Target} \rightarrow \text{CHC} \quad \text{Purchase price}

\text{Local Bank} \rightarrow \text{Onshore loan}

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.
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
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%
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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