

Tax Analysis

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SAT clarifies VAT treatment of asset restructuring transactions

The State Administration of Taxation ("SAT") issued a bulletin (Bulletin of the SAT [2011] No. 13, "Bulletin 13") on 18 February 2011 to clarify the Value Added Tax ("VAT") treatment of asset restructuring transactions. Effective as from 1 March 2011, Bulletin 13 provides that the transfer of all or part of the tangible assets of an enterprise, along with associated receivables, debts and workforce, through a merger, division, sale or swap in an asset restructuring transaction does not fall within the scope of VAT. This is a significant development on the VAT treatment of certain corporate restructuring transactions, an area that historically has been fraught with uncertainty.

Background

A corporate restructuring transaction involving the supply of tangible or intangible goods is subject to turnover taxes unless it falls within the scope of a specific exception. An exception is granted under Circulars 420¹ and 165,² which state that the transfer of an entire business (also called the transfer of the property rights of the enterprise) is outside the scope of VAT and Business Tax ("BT"). The transfer of an entire business for these purposes is defined as the full transfer of the assets, receivables, debts and workforce of an enterprise. Although the two circulars do not specify the rationale for the exemption, it is usually interpreted to mean that such a transfer is equivalent to the transfer of the equity interest in an enterprise, which is not within the scope of VAT and BT.

To supplement Circular 420, Circular 585³ was issued in response to a question on what constitutes the transfer of an entire business. Circular 585 states that a transfer of assets, liabilities and relevant rights and obligations by a transferor that remains a listed company after the transfer is not considered the transfer of a whole business and, thus, the transfer is subject to VAT. This may be interpreted to mean that where the transferor is a listed "shell company," the entire business is not regarded as having been transferred as the listed shell company is itself a valuable asset.

¹ Official reply of the SAT on the VAT Exemption on an Assignment of All Property Rights of an Enterprise (Guo Shui Han [2002] No. 420)

² Official reply of the SAT on the Business Tax Exemption on a Transfer of the Property of an Enterprise (Guo Shui Han [2002] No. 165)

³ Official reply to issues on the VAT Policy on the Restructuring of Assets (Guo Shui Han [2009] No. 585)

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Highlights of Bulletin 13

Bulletin 13 provides a significant change to the VAT treatment of a restructuring of assets as directed under Circulars 420 and 585. According to Bulletin 13, the transfer all or *part* of the *tangible assets* of an enterprise, along with associated receivables, debts and workforce to other units and/or individuals in an asset restructuring transaction via a merger, division, sale or swap, is outside the scope of VAT.

However, some caution is needed when reading Bulletin 13:

- The bulletin emphasizes that the right not to charge VAT is possible only if the transfer is *a combination* of tangible assets and associated receivables, debts and workforce of the enterprise.
- Unlike Circular 420, Bulletin 13 states that both a partial and a full transfer of tangible assets in an asset restructuring would not be subject to VAT.
- Although Bulletin 13 is effective as from 1 March 2011, it is applicable for asset restructurings that commenced before 1 March but where the tax has not yet been settled.

Comments

For non-VAT payers and VAT small-scale taxpayers that are unable to recover the VAT incurred on costs, Bulletin 13 brings an immediate VAT savings. Further, Bulletin 13 expands the non-VAT treatment of asset restructurings. The bulletin clearly provides enterprises with more scope for tax planning, especially those involved in numerous asset restructuring activities. Enterprises may be able to effectively reduce their tax burden and improve cash flows provided a careful and comprehensive analysis of Bulletin 13 is undertaken and the assets, receivables, debts and workforce are transferred together.

Although Bulletin 13 is welcome, it does create some uncertainties and leaves open some practical issues, such as:

1) *The definitions of certain terms are unclear:*

- "Asset restructuring" – Bulletin 13 only applies to asset restructuring transactions. However, the concept of "asset restructuring" is not well defined under current tax rules and it is unclear whether the tax authorities will issue any qualitative and/or quantitative requirements to further define the concept.
- "Merger/division, sale and swap" – it is unclear whether "swap" refers to an exchange of two VATable goods; and
- "Associated receivables, debts and workforce of the enterprise" – it is unclear whether receivables/debts should be calculated based on the percentage of transferred assets or on the actual amount incurred. The use of the word "associated" also requires clarification.

2) *BT treatment:* In the course of an asset restructuring, it is possible that the assets transferred may be subject to BT (e.g. intangible property or immoveable property). Circular 165 provides that the transfer of intangible goods (or immovable property) in the course of the transfer of an "entire business" will not fall within the scope of BT. However, Bulletin 13 is silent on the BT treatment of asset restructurings.

- 3) *Input VAT of the transferor*: Bulletin 13 is silent on the treatment of input VAT attributable to transactions falling within the scope of the bulletin. Since the relevant transfer is outside the scope of VAT and Bulletin 13 does not include an option to tax the transfer, it is likely that the tax authorities would disallow any input VAT credit. If the tax authorities do take that position, affected enterprises will need to determine how to transfer assets in order to minimise the loss of the deduction of the input VAT. Conversely, it may be necessary to examine whether the deal can be structured to fall outside the scope of Bulletin 13, so that a VATable transaction is created to allow the recovery of input VAT, when this is significant.
- 4) *Other issues*: Taxpayers that would like to structure transactions so that they fall within the scope of Bulletin 13 also need to consider business issues such as whether the transfer of debt is allowed by the creditors.

In summary, Bulletin 13 brings some welcome clarifications, but a closer reading demonstrates that there are several areas in which further SAT guidance may be needed. Deloitte is working to address the open points and we will provide updates once information is available.

For more information or advice on the above, please contact the Deloitte Indirect Tax and M&A Team.

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