Deloitte.
德勤

Tax
Issue P173/2012 – 2 November 2012

Tax Analysis

PRC Tax

Authors:

Shanghai
Hong Ye
Partner
Tel: +86 21 6141 1171
Email: hoye@deloitte.com.cn

Lucy Liao
Manager
Tel: +86 21 6141 1240
Email: luliao@deloitte.com.cn

For more information on the subject, please contact:

International Tax Services
National and Eastern Regional Leader
(Shanghai)
Vicky Wang
Partner
Tel: +86 21 6141 1035
Email: vicwang@deloitte.com.cn

Mergers & Acquisitions (M&A) Services
National and Southern Regional Leader
(Beijing)
Danny Po
Partner
Tel: +86 10 8520 7122
Email: dannpo@deloitte.com.cn

International Tax and M&A Services
Northern Regional Leader
(Beijing)
Kevin Ng
Partner
Tel: +86 10 8520 7501
Email: kevng@deloitte.com.cn

International Tax Services
Southern Regional Leader
(Hong Kong)
Sharon Lam
Partner
Tel: +852 2852 6536
Email: shalam@deloitte.com.hk

MOFCOM issues new rules on equity contributions

China's Ministry of Commerce (MOFCOM) released new rules on 24 October 2012 aimed at facilitating and promoting foreign investment in the country by allowing domestic and overseas investors to use the equity in Chinese companies as capital for foreign-invested enterprises (FIEs) (Provisional Rules Concerning an Equity Interest Contribution to Foreign-Invested Enterprises (MOFCOM Order [2012] No. 8 ("Order No. 8"))). Order No. 8, which applies as from 22 October 2012, contains detailed rules on the types of transactions covered, requirements for contributing equity, the valuation and pricing of equity and limits. The order is based on draft rules issued on 4 May 2011.

This analysis looks at the salient points of Order No. 8, as well as the implication of China's M&A tax rules on transactions permitted under Order No. 8.

Transactions covered by Order No. 8

Order No. 8 applies to two types of transactions:

1) A contribution by a Chinese or foreign investor of its equity interest in a Chinese domestic company to:

   - Establish a new FIE;
   - Increase the capital of a non-FIE in order to convert that entity to an FIE; or
   - Increase the capital of an FIE to change the shareholding of the company.

2) The acquisition by a foreign investor, in exchange for its equity interest in a Chinese company, of an equity interest of another investor in a Chinese company, i.e. a share swap. Order No. 8 provides that a share swap transaction will be governed by the rules concerning the conditions on an equity interest contribution and valuation, etc. provided in Order No. 8.

These two types of transaction are illustrated below.

In Diagram 1, Investor B contributes its equity interest in Chinese Co B1 to Chinese FIE A1.

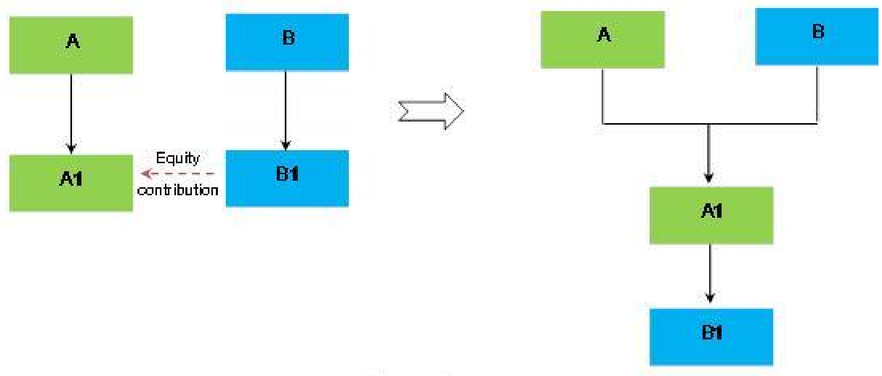

Diagram 1

In Diagram 2, Foreign Investor A acquires an equity interest in Chinese Co B1 from Investor B in exchange for Foreign Investor A's equity interest in Chinese Co A1.

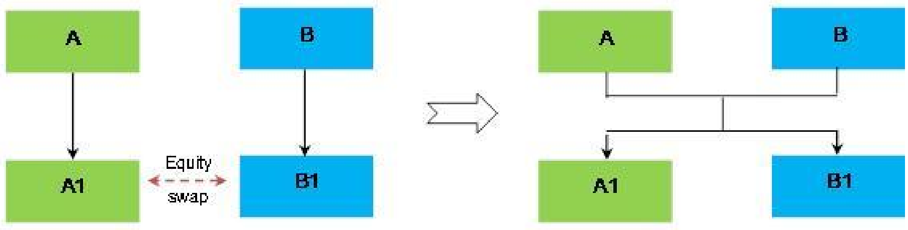

Diagram 2

Equity interests not allowed for contribution

Order No. 8 provides that an equity interest cannot be used for a capital contribution in the following circumstances:

- The registered capital of an enterprise has not been paid in full;
- The equity has been pledged;
- The equity is frozen under a court order;
- The equity cannot be transferred according to the Articles of Association of the enterprise;
- The enterprise fails to pass the annual joint inspection required for FIEs;
- The equity interest is in a real estate enterprise, foreign-invested investment enterprise or foreign-invested venture capital (or equity investment) enterprise; and
- Any other circumstances in which equity may not be transferred according to law.

Definitions of equity interest price and equity contribution and limits

According to Order No. 8, the equity interest price refers to the value of an equity interest contribution jointly agreed by the investor that contributes the equity interest and the shareholders or other investors of the enterprise that receives the equity interest contribution ("Invested Enterprise"). An equity contribution is the amount accounted for in the registered capital of the Invested Enterprise.

Order No. 8 also provides that both the equity interest price and the contribution can be negotiated based on the valuation of the equity interest contribution.

The equity interest contribution, together with any other non-monetary contributions of other investors, may not exceed 70% of the total registered capital of the company.

An enterprise whose equity interest has been contributed, the Invested Enterprise and their shareholding in other enterprises must comply with the Chinese regulations on foreign investment. If there would be any non-compliance after the equity interest contribution, restructuring on relevant assets, business or shareholding must be undertaken before applying for the equity interest contribution.

Comments

1. Eligibility for special reorganization

While the Implementation Rules to the Enterprise Income Tax Law do not specifically provide that a contribution is a taxable transaction, it is commonly understood that when making a non-monetary property contribution, a taxpayer must recognize gain or loss in an amount equal to the fair market value of the contributed property, less its tax basis. Therefore, when an investor makes an equity interest contribution under Order No. 8, the contribution would be taxable under the EIT Law. Further, guidance issued by the Ministry of Finance and the State Administration of Taxation (SAT) in 2009 (Caishui [2009] No. 59 ("Circular No. 59")), which currently governs reorganizations in China and provides for tax-free treatment of certain reorganizations, does not specifically list contributions.[1] Therefore, some Chinese tax officials believe that contributions generally are not covered by Circular No. 59 and thus may not be eligible for special reorganization treatment. If this is the case, as a type of contribution, equity interest contribution would not be eligible for special reorganization treatment under Circular No. 59.

An equity interest contribution potentially would be covered by Circular No. 59 if the transaction is considered an equity acquisition. For example, in Diagram 1, Investor B contributes its equity interest in Chinese Co B1 to Chinese Co A1. The transaction can be viewed as Chinese Co A1 acquiring the equity interest in Chinese Co B1 from Investor B in exchange for its own equity interest, which meets the definition of an equity transaction in Circular No. 59. Therefore, if Chinese Co A1 purchases 75% or more of the equity interest of Chinese Co B1, the transaction could potentially qualify for special reorganization treatment (provided the other relevant conditions also are satisfied).

The question, therefore, for purposes of Circular No. 59 is: (1) whether the Chinese tax authorities will view an equity interest contribution as a share acquisition and allow Circular No. 59 to apply; or (2) whether an equity interest contribution must be described as a share acquisition for Circular No. 59 to apply. If the answer to question 2 is in the affirmative, it would be logical to believe that the tax authorities would expect the legal documents effecting the equity interest contribution to describe the transaction as an equity acquisition rather than a contribution. In this case, would the regulatory authority still apply Order No. 8 to the transaction?

In a share swap transaction, as described above, Investor A purchases the equity interest of Chinese Co B1 from Investor B in exchange for Investor A's equity interest in Chinese Co A1. According to 2010 guidance issued by the SAT ("Bulletin No. 4"),[2] an acquirer can use the shares of the companies controlled by it as consideration for share acquisition. Therefore, such a transaction is covered by Circular No. 59. However, whether the transaction would qualify for special reorganization treatment must be analyzed according to Circular No. 59.

2. Implication for foreign debt borrowing capacity and duty-free import quota

Order No. 8 provides that if the Invested Enterprise is an FIE, for purpose of determining its foreign debt-borrowing capacity and duty-free import quota, the total investment should be determined with reference to the amount of registered capital reduced by the amount equal to the equity contribution. In another words, an equity interest contribution does little to increase the company's foreign debt-borrowing capacity and duty-free import quota.

In China, an FIE may borrow foreign debts up to an amount that is equal to the difference between the total investment and the registered capital. It may also enjoy a duty-free quota up to the total investment for importation of equipment. The amount of registered capital determines the maximum amount of the total investment as certain prescribed ratio between the two must be maintained.

Summary

In the past, it has been difficult for foreign investors to obtain approval for an equity interest contribution or a share swap transaction. Order No. 8 provides more restructuring opportunities to foreign investors. While Circular No. 59 covers a share swap transaction, it is yet to be seen how equity contributions will be treated for tax purposes.

Note: Contents discussed in this Tax Analysis pertains to Deloitte International Tax and M&A Services.

---

[1] Reorganizations covered in Circular 59 include changes of legal form, debt restructuring, equity and asset acquisitions, mergers and de-mergers. The only type of "contribution" addressed in Circular 59 is where a resident enterprise makes contributions to its 100%-owned nonresident subsidiary.

[2] Bulletin concerning Promulgation of the "Administrative Measures on the Enterprise Income Tax Treatment of Enterprise Reorganization."

Tax Analysis is published for the clients and professionals of the Hong Kong and Chinese Mainland offices of Deloitte Touche Tohmatsu. The contents are of a general nature only. Readers are advised to consult their tax advisors before acting on any information contained in this newsletter. For more information or advice on the above subject or analysis of other tax issues, please contact:

Beijing
Kevin Ng
Partner
Tel: +86 10 8520 7501
Fax: +86 10 8518 7501
Email: kevng@deloitte.com.cn

Hong Kong SAR
Sarah Chin
Partner
Tel: +852 2852 6440
Fax: +852 2520 6205
Email: sachin@deloitte.com.hk

Shenzhen
Constant Tse
Partner
Tel: +86 755 3353 8777
Fax: +86 755 8246 3222
Email: contse@deloitte.com.cn

Chongqing
Claude Gong
Partner
Tel: +86 23 6310 6206
Fax: +86 23 6310 6170
Email: clgong@deloitte.com.cn

Jinan
Eunice Kuo
Partner
Tel: +86 531 8518 1058
Fax: +86 531 8518 1068
Email: eunicekuo@deloitte.com.cn

Suzhou
Frank Xu / Maria Liang
Partner
Tel: +86 512 6289 1318 / 1328
Fax: +86 512 6762 3338
Email: frakxu@deloitte.com.cn
mliang@deloitte.com.cn

Dalian
Frank Tang
Partner
Tel: +86 411 8371 2888
Fax: +86 411 8360 3297
Email: ftang@deloitte.com.cn

Macau SAR
Quin Va
Partner
Tel: +853 8898 8833
Fax: +853 2871 3033
Email: quiva@deloitte.com.hk

Tianjin
Jason Su
Partner
Tel: +86 22 2320 6680
Fax: +86 22 2320 6699
Email: jassu@deloitte.com.cn

Guangzhou
Constant Tse
Partner
Tel: +86 20 8396 9228
Fax: +86 20 3888 0121
Email: contse@deloitte.com.cn

Nanjing
Frank Xu
Partner
Tel: +86 25 5791 5208
Fax: +86 25 8691 8776
Email: frakxu@deloitte.com.cn

Wuhan
Justin Zhu
Partner
Tel: +86 27 8526 6618
Fax: +86 27 8526 7032
Email: juszhu@deloitte.com.cn

Hangzhou
Qiang Lu
Partner
Tel: +86 571 2811 1901
Fax: +86 571 2811 1904
Email: qilu@deloitte.com.cn

Shanghai
Eunice Kuo
Partner
Tel: +86 21 6141 1308
Fax: +86 21 6335 0003
Email: eunicekuo@deloitte.com.cn

Xiamen
Lynch Jiang
Partner
Tel: +86 592 2107 298
Fax: +86 592 2107 259
Email: lijiang@deloitte.com.cn

About the Deloitte China National Tax Technical Centre

The Deloitte China National Tax Technical Centre ("NTC") was established in 2006 to continuously improve the quality of Deloitte China's tax services, to better serve the clients, and to help Deloitte China's tax team excel. The Deloitte China NTC prepares and publishes "Tax Analysis", "Tax News", etc. These publications include introduction and commentaries on newly issued tax legislations, regulations and circulars from technical perspectives. The Deloitte China NTC also conducts research studies and analysis and provides professional opinions on ambiguous and complex issues. For more information, please contact:

National Tax Technical Centre
E-mail: ntc@deloitte.com.cn

Eastern Region
Leonard Khaw
National Leader & Partner
Tel: +86 21 6141 1498
Fax: +86 21 6335 0003
Email: lkhaw@deloitte.com.cn

Northern Region
Angela Zhang
Partner
Tel: +86 10 8520 7526
Fax: +86 10 8518 1326
Email: angelazhang@deloitte.com.cn

Southern Region
Davy Yun
Partner
Tel: +852 2852 6538
Fax: +852 2520 6205
Email: dyun@deloitte.com.hk

If you prefer to receive future issues by soft copy or update us with your new correspondence details, please notify Wandy Luk by either email at wanluk@deloitte.com.hk or by fax to +852 2541 1911.

About Deloitte

Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee, and its network of member firms, each of which is a legally separate and independent entity. Please see www.deloitte.com/cn/en/about for a detailed description of the legal structure of Deloitte Touche Tohmatsu Limited and its member firms.

Deloitte provides audit, tax, consulting, and financial advisory services to public and private clients spanning multiple industries. With a globally connected network of member firms in more than 150 countries, Deloitte brings world-class capabilities and high-quality service to clients, delivering the insights they need to address their most complex business challenges. More than 195,000 Deloitte professionals are committed to becoming the standard of excellence.

About Deloitte in Greater China

We are one of the leading professional services providers with 21 offices in Beijing, Hong Kong, Shanghai, Taipei, Chongqing, Dalian, Guangzhou, Hangzhou, Harbin, Hsinchu, Jinan, Kaohsiung, Macau, Nanjing, Shenzhen, Suzhou, Taichung, Tainan, Tianjin, Wuhan and Xiamen in Greater China. We have nearly 13,500 people working on a collaborative basis to serve clients, subject to local applicable laws.

About Deloitte China

In the Chinese Mainland, Hong Kong and Macau, services are provided by Deloitte Touche Tohmatsu, its affiliates, including Deloitte Touche Tohmatsu CPA Limited, and their respective subsidiaries and affiliates. Deloitte Touche Tohmatsu is a member firm of Deloitte Touche Tohmatsu Limited (DTTL).

As early as 1917, we opened an office in Shanghai. Backed by our global network, we deliver a full range of audit, tax, consulting and financial advisory services to national, multinational and growth enterprise clients in China.

We have considerable experience in China and have been a significant contributor to the development of China's accounting standards, taxation system and local professional accountants. We provide services to around one-third of all companies listed on the Stock Exchange of Hong Kong.

This publication contains general information only, and none of Deloitte Touche Tohmatsu Limited, its member firms, or their related entities (collectively the “Deloitte Network”) is by means of this publication, rendering professional advice or services. Before making any decision or taking any action that may affect your finances or your business, you should consult a qualified professional adviser. No entity in the Deloitte Network shall be responsible for any loss whatsoever sustained by any person who relies on this publication.

©2012 Deloitte Touche Tohmatsu CPA Limited