

Tax Analysis

PRC Tax

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SAT Issues New Guidance on Special Tax Treatment on Intragroup Assignment of Shares or Assets

China's State Administration of Taxation (SAT) issued guidance (Bulletin 40) on 27 May 2015 on the special tax treatment (i.e. tax-deferred treatment through a tax basis carryover) for intragroup assignments of shares or assets. Previous guidance issued in December 2014 (Circular 109) allowed an intragroup assignment of shares or assets to qualify for the special tax treatment. Bulletin 40 provides additional guidance that applies to Enterprise Income Tax (EIT) returns for 2014 and thereafter, and to any qualifying intragroup assignments of shares or assets in previous years whose tax treatment has not been finalized.

Background

Corporate reorganizations normally result in a taxable transfer of shares or assets, although an enterprise may elect for special treatment to effectively achieve a deferral of EIT in certain cases. Circular 109 allows the application of special tax treatment to an intragroup assignment of shares or assets, if all of the following conditions are satisfied:

- The assignment of shares or assets is between resident enterprises that have a 100% direct control relationship, or that both are under the 100% direct control of the same resident enterprise or same group of resident enterprises;
- The assignment of shares or assets is based on the net book value (NBV);
- The transaction has a bona fide business purpose, and the primary purpose of the transaction is not to reduce, avoid or defer the payment of tax;
- There is no change in the original business operating activities in relation to the shares or assets concerned for 12 months after the assignment; and
- Neither the transferor nor the transferee enterprise has recognized any profit or loss for financial accounting purposes.

If qualifying parties elect for the special tax treatment:

- Neither the transferor nor the transferee enterprise will be required to recognize taxable income;
- The tax basis of the shares or assets received by the transferee will be determined based on the NBV in the hands of the transferor; and
- For tax-depreciable assets assigned to the transferee, the tax depreciation will be calculated based on the NBV in the hands of the transferor.

Bulletin 40

Bulletin 40 clarifies certain requirements under Circular 109 and imposes certain additional requirements to qualify for the special tax treatment.

1. Qualifying intragroup assignments

In addition to satisfying the conditions in Circular 109, an intragroup assignment of shares or assets must fall within the scope of one of the following situations to qualify for the special tax treatment:

	<i>Description</i>	<i>Accounting treatment for the transferor</i>	<i>Accounting treatment for the transferee</i>	<i>Impact to the tax basis of investment in the subsidiary (if special tax treatment is applied)</i>
Case (i)	Parent assigns shares or assets to its 100% subsidiary for an equity interest in the subsidiary	Debit (Dr): Investment in the subsidiary Credit (Cr): Shares or assets (being assigned)	Dr: Shares or assets (being assigned) Cr: Paid-in capital/capital surplus	Increase the tax basis by the amount of the shares or assets' tax basis in the hands of the parent
Case (ii)	Parent assigns shares or assets to its 100% subsidiary for no consideration	Dr: Paid-in capital/capital surplus Cr: Shares or assets (being assigned)	Dr: Shares or assets (being assigned) Cr: Paid-in capital/Capital surplus	N/A
Case (iii)	100% subsidiary assigns shares or assets to its parent for no consideration	Dr: Paid-in capital/capital surplus Cr: Shares or assets (being assigned)	Dr: Shares or assets (being assigned) Cr: Investment in the subsidiary or paid-in capital/capital surplus	Decrease the tax basis by the amount of the shares or assets' tax basis in the hands of the subsidiary
Case (iv)	100% subsidiary assigns shares or assets to another 100% subsidiary of the same parent (or group of parents) for no consideration	Dr: Shareholders' equity Cr: Shares or assets (being assigned)	Dr: Shares or assets (being assigned) Cr: Paid-in capital/capital surplus	N/A

2. Introduction of "assignment completion date"

For an intragroup assignment of shares or assets to qualify for the special tax treatment under Circular 109, there may not be any change in the original business operating activities in relation to the shares or assets concerned for 12 months after the assignment. Bulletin 40 clarifies that the 12-month period starts from the "assignment completion," i.e. the date the assignment agreement or relevant approval is effective and the parties to the assignment have recorded the transaction in their financial books.

3. Interpretation of NBV

Circular 109 provides that if special tax treatment is applied, the tax basis of the shares or assets received by the transferee must be determined based on the NBV in the hands of the transferor. There has been some criticism of the language used in Circular 109; certain parties have argued that the tax authorities should have used the term of "tax basis" instead of "NBV," which was considered to be more consistent with financial accounting terminology than with tax terminology. Bulletin 40 confirms that the NBV in the context of the tax basis determination should have the same meaning as tax basis.

4. Compliance and documentation

Bulletin 40 provides that the special tax treatment will apply to an intragroup assignment of shares or assets only if the transferor and transferee both agree to apply the special tax treatment. In other words, the treatment cannot be granted if only one party to the assignment (i.e. the transferor or transferee) elects to apply the special tax treatment while the other party chooses to step up the tax basis of the shares or assets being assigned to fair market value (FMV).

The transferor and the transferee must submit the following documents to the responsible tax authorities respectively:

- The Special Tax Treatment for Shares/Assets Assignment among Resident Enterprises form, which details the basic information regarding the assignment (i.e. names and tax identification number, relationship between the transferor and transferee, date the assignment was completed, tax basis of shares/assets being assigned) and the corresponding accounting treatment;
- General description of the assignment, with an explanation of the business purpose;
- Assignment agreement and relevant approvals (if applicable);
- Explanatory notes on the accounting book value and tax basis of the shares/assets being assigned;
- Explanatory notes on the assignment of shares/assets based on their NBV (supported by accounting-related documentation);
- Explanatory notes on the nonrecognition of gains or losses for financial accounting purposes (supported by accounting-related documentation); and
- Commitment letter agreeing not to change the original business operating activities in relation to the shares or assets concerned for 12 months following the assignment.

5. Post-assignment administration

"Post-assignment changes": After the special tax treatment has been applied, Bulletin 40 requires the transferor and transferee to submit a written document to the responsible tax authorities when they carry out the annual EIT return filing for the year following the year in which the assignment is completed, to demonstrate that no post-assignment changes have taken place that would disqualify the assignment from benefiting from the special tax treatment.

Circular 109 refers to changes "in the original business operating activities in relation to the shares or assets concerned for 12 months after the assignment." Bulletin 40, however, provides that:

"If one party to the assignment makes changes to its business operations, the nature of the company, assets or shareholding structure, etc. within 12 months from the assignment completion date so that the assignment no longer qualifies for the special tax treatment, that party must report to its in-charge tax authorities within 30 days of the changes, and notify the other party to the assignment in writing; the other party must report to its in-charge tax authorities within 30 days upon the receipt of the notification."

Bulletin 40 implies that post-assignment changes that may result in an assignment being disqualified from special tax treatment should be interpreted more broadly than the text of Circular 109, i.e. that such changes include changes relating to the shares or assets that are assigned, as well as changes relating to the transferor or the transferee.

Switch to "ordinary tax treatment": If a post-assignment change results in a disqualification from special tax treatment, both the transferor and transferee must switch to ordinary tax treatment (see below) within 60 days of the change and amend their tax returns for the previous year(s) accordingly.

Description	Ordinary tax treatment
Case (i) Parent assigns shares or assets to its 100% subsidiary for an equity interest in the subsidiary	<i>Transferor:</i> - Treat the assignment of shares or assets as a sale at FMV; and - Increase the tax basis of the investment in the transferee by the amount of the FMV of the shares or assets <i>Transferee:</i> - Determine the tax basis of the shares or assets received by the transferee by reference to the FMV of the shares or assets

<i>Description</i>		<i>Ordinary tax treatment</i>
Case (ii)	Parent assigns shares or assets to its 100% subsidiary for no consideration	<p><i>Transferor:</i></p> <ul style="list-style-type: none"> - Treat the assignment of shares or assets as a sale at FMV <p><i>Transferee:</i></p> <ul style="list-style-type: none"> - Determine the tax basis of the shares or assets received by the transferee by reference to the FMV of the shares or assets
Case (iii)	100% subsidiary assigns shares or assets to its parent for no consideration	<p><i>Transferor:</i></p> <ul style="list-style-type: none"> - Treat the assignment of shares or assets as a sale at FMV <p><i>Transferee:</i></p> <ul style="list-style-type: none"> - Treat the assignment of shares or assets as a divestment from the transferor
Case (iv)	100% subsidiary assigns shares or assets to another 100% subsidiary of the same parent (or group of parents) for no consideration	<p><i>Transferor:</i></p> <ul style="list-style-type: none"> - Treat the assignment of shares or assets as a sale at FMV <p><i>Transferee:</i></p> <ul style="list-style-type: none"> - Treat the assignment of shares or assets as receipt of capital from parent(s) - Determine the tax basis of the shares or assets received by the transferee by reference to the FMV of the shares or assets <p><i>Parent(s):</i></p> <ul style="list-style-type: none"> - Treat the assignment of shares or assets as a dividend distribution or divestment from the transferor, followed by an investment into the transferee at the FMV of the shares or assets

It has been controversial whether the transferee should treat the shares or assets assigned from the transferor as donation income for tax purposes in cases (ii), (iii) and (iv) where the shares or assets are assigned without consideration. Bulletin 40 seems to imply a tax-follows-accounting view, so that income would not have to be recognized for tax purposes by the transferee, similar to the nonrecognition of income provided in SAT Bulletin [2014] No. 29 where a shareholder assigned/donated assets to its invested company.

Comments

Although Bulletin 40 provides considerable guidance to facilitate the application of the special tax treatment to intragroup assignments of shares or assets, it also tightens the requirements for the special tax treatment by restricting the scope to four specific cases and broadening the interpretation of the post-assignment changes that may result in disqualification from the special tax treatment.

It is noteworthy that Bulletin 40 relies heavily on the applicable financial accounting treatment to determine whether an intragroup assignment qualifies for the special tax treatment. Therefore, companies that wish to apply the special tax treatment to intragroup assignments will have to consider the relevant accounting implications and whether their accounting records can support the tax treatment.

Bulletin 40 leaves some issues unanswered (e.g. the tax treatment for divestment in certain cases). Affected taxpayers should continue to monitor regulatory and practice development in this area and consult tax authorities or specialists where necessary.

Note: Contents discussed in this Tax Analysis pertain to Deloitte Mergers & Acquisitions Services.

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