

Tax Analysis

PRC Tax

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SAT Issues Guidance on Tax Administration of Enterprise Reorganizations

New guidance issued by China's State Administration of Taxation (SAT) on 24 June 2015 ("Issues Relating to the Collection and Administration of Enterprise Income Tax (EIT) on Enterprise Reorganizations" (Bulletin [2015] No. 48, "Bulletin 48")) is designed to promote mergers and acquisitions and reorganizations between enterprises, and to clarify certain issues arising from current practices. Bulletin 48 makes major changes to guidance issued in 2010 ("Administrative Measures on the EIT Treatment of Enterprise Reorganizations" (Bulletin [2010] No. 4, "Bulletin 4")); although Bulletin 4 remains in effect, a number of its procedural guidelines are repealed or amended. Bulletin 48 applies to enterprise reorganizations completed in 2015 and subsequent years. Bulletin 48 also applies to reorganizations for which the agreements have been signed, but the transactions have not yet been completed.

Background

The Ministry of Finance and SAT issued two sets of guidance in 2009 and 2010 (Circular 59 and Bulletin 4) to introduce special tax treatment (i.e. tax deferral) that may allow (1) a carryover of the tax basis of an acquired business, to achieve tax deferral for the transferor; or (2) recognition of the relevant income on an installment basis for EIT purposes. A reorganization generally must satisfy the following conditions¹ to qualify for the special tax treatment (i.e. to qualify as a special reorganization):

- The reorganization has a bona fide commercial purpose, and the primary purpose of the reorganization is not to reduce, avoid or defer the payment of tax;
- For share or asset acquisitions, at least 50% of the total equity of the target company, or the total assets of the transferor, is transferred in the reorganization;
- There is no change in the original business operating activities of the target business for 12 months after the reorganization;
- At least 85% of the total consideration received by the transferor is in the form of equity; and
- The major transferor does not transfer the acquired equity for 12 months after the reorganization.

To elect for the special tax treatment, taxpayers were required to obtain advance approval/filing from the tax authorities, submit certain documents to the competent tax authorities to demonstrate that the relevant conditions were satisfied.

¹ A cross-border reorganization needs to satisfy a few additional conditions to qualify for the special tax treatment.

Highlights of Bulletin 48

Bulletin 48 replaces the procedural rules under Bulletin 4 with a combination of an annual filing requirement and post-transaction monitoring. Although the bulletin abolishes the advance approval requirement, it retains the commercial justification requirements and introduces new - and more comprehensive - documentation requirements.

1. Elimination of advance approval requirement, and other administrative measures

In May 2015, the State Council announced that the approval requirement was no longer conducive to promoting corporate restructurings, so it abolished the "approval" requirement to obtain the special tax treatment. One of the purposes of Bulletin 48 is to implement the Council's new policy and revise the administration of enterprise reorganizations that qualify for the special tax treatment. Under Bulletin 48, an enterprise no longer has to obtain advance approval (through either filing with, or obtaining advance confirmation from, the tax authorities) to enjoy the special tax treatment. Instead, the parties involved in the reorganization must submit a specific form ("Form for Special EIT Treatment on Enterprise Reorganizations") to the competent tax authorities at the time the annual EIT return is filed.

Additionally, Bulletin 48 requires the competent tax authorities to strengthen the post-filing monitoring and management of special reorganizations, mainly through the following measures:

- 1) For special reorganizations where the relevant income is recognized on an instalment basis for EIT purposes (e.g. a qualifying debt restructuring, or the use of assets for an outbound capital contribution), the tax authorities must set up a system to track the relevant records and compare and analyze them annually, including information on the relevant tax basis of the equity acquired and the income reported by the taxpayer in the tax returns.
- 2) Tax authorities must focus on subsequent transfers and disposals of the assets or equity obtained through special reorganizations; specifically, they must compare and analyze the tax basis of the assets (equity) at the time when they were acquired through a special reorganization and at the time they are subsequently transferred or disposed of, as well as the tax basis reported in the relevant tax returns.

Some local tax authorities held views that assets (equity) should be transferred at cost in a special reorganization. Based on the filing requirements in Bulletin 48 relating to income reporting and tax basis tracking, it appears that the SAT does not hold such a viewpoint.

2. Clarification and amendment of certain key concepts

Bulletin 48 clarifies and amends certain concepts, including the following:

- Parties involved: Bulletin 4 stated that the "parties involved in the enterprise reorganization refer to the following enterprises..."; however, for an enterprise reorganization that involves a shareholder who is an individual, Bulletin 48 explicitly provides that parties involved in an enterprise reorganization also include individuals. Based on this amendment, when determining whether the conditions for special tax treatment are fulfilled (such as the requirement to acquire at least 50% shares of the company in a share acquisition), it appears that the shares sold by shareholders who are individuals also may be counted. However, even if the conditions for special tax treatment are met, only corporate transferors may enjoy the special tax treatment—transferors who are individuals still must file and pay the relevant individual income tax (IIT), since the special tax treatment provided by the EIT law is not available under the IIT law.
- Bona fide commercial purpose: Bulletin 48 specifically requires an explanation of the bona fide commercial purpose of a special reorganization, including information on the following: (1) type of the reorganization; (2) substantive consequences of the reorganization; (3) changes regarding the tax attributes and tax treatment of the parties involved in the reorganization; (4) changes regarding the financial positions of the parties involved in the reorganization; and (5) information about the participation of nonresident enterprises in the reorganization.
- Date of reorganization: The date of a reorganization is an important concept regarding the EIT treatment of an enterprise reorganization, since it affects the determination of the date on which the liability to pay tax arises and the year in which the tax return filing to report the reorganization must be made. Bulletin 48 has, to some extent, modified the rules for determining the date of reorganization for various forms of reorganizations. It increases the emphasis on the effective date of the reorganization agreement and the date on which the parties involved record the relevant accounting treatment and clarifies that "the year in which the reorganization is completed" is the tax year in which the date of reorganization falls.

- “Step” transactions: Bulletin 48 requires the parties involved in a special reorganization to report whether there have been other equity or asset transactions related to a reorganization within the 12-month period before the reorganization, and to explain whether such transactions should be considered as a single reorganization for tax purposes. The Bulletin indicates that an enterprise may treat a series of transactions taking place within a consecutive 12-month period as a single reorganization transaction for tax purposes. For example, assume that Company A, a Chinese tax resident, issues new shares in December 2015 in exchange for 40% of the shares in Company B, and it issues new shares again in June 2016 in exchange for an additional 15% of the shares in Company B. Based on these transactions, the percentage of the equity acquired would not yet reach the threshold (i.e. 50%) for application of the special tax treatment by the time the 2015 annual EIT return is due. However, because the estimated final percentage of the equity to be acquired (i.e. 40% + 15%) will exceed the threshold, the parties involved are allowed to apply the special tax treatment when they report the first step of the transaction with the 2015 annual filing, provided the other required conditions are fulfilled.

3. Increase in required documents/information to be filed

Bulletin 48 provides a new set of forms that must be filed with the tax authorities when the taxpayer elects to take the special tax treatment. Compared to the forms provided for under Bulletin 4, the information/documents to be provided in/with the forms required under new bulletin is more comprehensive and detailed. Given the similarities between the information/documents required for different types of special reorganizations, the form for an equity transfer is used as an example to illustrate the new requirements in Bulletin 48.

- 1) Bulletin 48 eliminates the reference to "other documents as required by the tax authorities" from the list of documents to be filed, to be more transparent and increase consistency as to the documents the local tax authorities should request.
- 2) In addition to explaining the commercial purpose of the transaction, the taxpayer also is required to explain the acquisition plan and provide basic information on the equity acquisition in a statement.
- 3) Valuation reports issued by competent valuation agents no longer are the only documents permitted to substantiate the fair market value of the equity (or other nonmonetary assets) transferred (or paid). Under Bulletin 48, taxpayers may provide other documents to support the fair market value of the relevant assets.
- 4) Bulletin 48 requires a statement certifying that the parties involved have reached consensus on electing the special reorganization treatment, and the statement must be stamped with the company chop/seal of all the parties.
- 5) Bulletin 48 requires the disclosure of any other equity or asset transactions within the 12 consecutive months before the reorganization, and the taxpayer must explain whether such transactions constitute step transactions of a single reorganization and, therefore, whether it has treated them as one transaction for tax purposes.
- 6) The taxpayer is required to provide a list of temporary differences between the tax basis and the book value of certain assets (equity). The tax authorities have been focusing on the correlation between accounting records and tax records; even prior to the issuance of the new bulletin, some tax authorities have required taxpayers to submit similar documentation.

Comments and recommendations

The main feature of Bulletin 48 is that an enterprise now may claim special reorganization treatment for a transaction without having to obtain the advance approval from the competent tax authorities that previously was required. However, the repeal of the advance-approval mechanism also creates uncertainty as to whether an election of the special reorganization treatment made by an enterprise may be challenged by the tax authorities.

Bulletin 48 also instructs the tax authorities to set up a tax basis tracking system for special reorganizations and to perform periodic follow-ups regarding the relevant information, which may indicate that special reorganizations could become an area of focus in future tax inspections and audits. Considering the change in policy, parties involved in a reorganization should pay special attention to the potential tax risks and should consider taking the following actions:

- Carefully evaluate whether the relevant conditions for electing the special tax treatment are fulfilled. If there is any ambiguity, the taxpayer may explore the possibility of seeking guidance from, or an advance discussion with, the competent tax authorities.
- Prepare and maintain proper documentation (relevant legal and transaction documents, financial records and tax data) for filing and future inspection. If allowed, an enterprise also may consider setting up special ledgers to account for the special reorganization and, to the extent possible, comparing the data with that held by the tax authorities, so that any discrepancies can be timely identified and remedied. Such preparation should enable the enterprise to be better prepared when dealing with tax inspections.
- Seek cooperation from the other parties involved in the reorganization, and ensure all parties take consistent actions.

From a procedural perspective, Bulletin 48 should benefit taxpayers. However, questions and inconsistencies in applying the special reorganization rules in practice remain unaddressed by Bulletin 48, such as how to determine whether a commercial purpose is bona fide. Additional guidance is anticipated from the SAT to clarify the application of the special reorganization rules.

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

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