client alert

TAX | CHINA | FEBRUARY 2015

KEY DEVELOPMENT ON THE PRC DEFERRED TAXATION REGIME

The Ministry of Finance ("**MOF**") and State Administration of Taxation ("**SAT**") recently released two new circulars, Caishui [2014] No. 109 ("**Circular 109**") and Caishui [2014] No. 116 ("**Circular 116**"), to update the enterprise income tax ("**EIT**") treatment of Chinese companies undergoing restructuring. To encourage more mergers and acquisitions in China, these two circulars substantially improve current EIT restructuring rules by relaxing conditions for deferred taxation for certain transactions.

BACKGROUND

Under PRC restructuring rules[1], companies undergoing restructuring (including mergers, splits, and asset and equity transfers) must conduct the related transactions at fair market value and accordingly recognise the resulting profits or losses. However, if a transaction meets certain criteria, the company may apply for a tax deferral. If granted, the company may transfer the assets or equity at book value (instead of fair market value) so that no capital gain is generated. With no gains, no EIT will be due — until the next time the assets or equity is transferred (i.e. deferred taxation). However, the criteria for deferred taxation were very restrictive so that very few companies could actually benefit from this regime.

RELAXED CONDITIONS FOR DEFERRED TAXATION

Circular 106 significantly improves the criteria for deferred taxation under Circular 59 in the following two aspects:

- The minimum percentage of assets or equity to be transferred is reduced from 75% to 50%; and
- A new type of tax deferral is introduced for domestic intra-group restructuring.

The following table highlights the changes to the deferred taxation criteria under Circular 106:

[1] The *Circular on the EIT Treatment of Enterprise Restructuring* (Caishui [2009] No. 59, promulgated by MOF and SAT on 30 April 2009 and effective retroactively from 1 January 2008, "**Circular 59**") and *Administrative Measures for EIT on Enterprise Restructuring* (Decree No. 6, promulgated by SAT on 26 July 2010) govern the EIT treatment of corporate restructurings.

Transaction	Circular 59	Circular 106
Equity/Assets Transfer	**General criteria:** • Reasonable commercial purpose • 85% threshold: at least 85% of total consideration must be paid in shares • 12-month operational continuity: no change of business for at least 12 months following completion of transaction • 12-month equity continuity: seller cannot transfer shares in buyer for at least 12 months following completion of transaction • 75% threshold: at least 75% of target's equity or assets must be transferred **Additional criteria for cross-border transfers:** • Foreign-to-foreign: 100% direct ownership; no reduction of WT on capital gains in subsequent_transfer; and no transfer of equity in buyer for at least 3 years • Foreign-to-domestic: 100% direct ownership	Same as Circular 59, except for: • 50% threshold: at least 50% of target's equity or assets must be transferred
Domestic Intra-group Restructuring (Intra-group Equity/Assets Assignment between Chinese Companies)	No special regime - companies should fulfil the general criteria for equity/assets transfers to qualify for Deferred Taxation.	General criteria: • Reasonable commercial purpose • Investment relationship: (i) 100% direct investment holding or (ii) 100% owned by same Chinese shareholder(s) • no consideration paid for equity/assets transfer: no 85% threshold requirement • 12-month equity continuity • No 50% threshold requirement EIT treatment: • Equity and assets are transferred at net book value • No capital gains

DEFERRED TAXATION FOR NON-MONETARY INVESTMENTS

Circular 116 introduces a new tax deferral system for equity investments using non-monetary assets (e.g. fixed assets, intangible properties, immovable properties, equity). Now, if a Chinese investor earns any capital gains from the appreciation of the non-monetary assets, such investor is entitled to amortise the gains and resulting EIT over a period of up to five years, even if the underlying transaction was not eligible for deferred taxation under Circular 59 or Circular 106.

Applicable Scope

The new tax deferral system is available to Chinese investors on their investments in Chinese companies (i.e. capital contribution to a new company or capital increase of an existing company) using non-monetary assets. Unlike the general deferred taxation regime under Circular 106, there are no specific qualifying criteria (e.g. minimum equity/asset investment, commercial purpose) for tax deferral under Circular 116.

EIT Treatment

Such investments will be treated as asset transfers. Therefore:

- Investors must realise capital gains (calculated as the fair market value of the asset minus the tax base) from such transfers when the Chinese target company is issued an updated business licence reflecting the non-monetary investment.
- However, investors may amortise the capital gains derived from their investment over a period of up to five years for EIT calculation.
- Investors must recognise the original tax base of the non-monetary asset as the tax base of the equity in the target and increase the tax base each year to include the amortised capital gains.
- Target companies must recognise the fair market value of the non-monetary assets as their tax base for asset depreciation for EIT deductions or future transfers.

Of course, Chinese investors can opt to apply for deferred taxation under Circular 59 and Circular 106 if they fulfil the criteria in the table above.

COMMENTS

Circular 109 and Circular 116 are both effective retroactively from 1 January 2014. They also apply to transactions carried out before 2014 whose EIT treatment has not yet been determined.

The relaxation of criteria for deferred taxation under Circular 109 and Circular 116 will significantly relieve the tax burden for companies undergoing mergers, acquisitions and intra-group restructuring in China. More transactions will be eligible for deferred taxation as a result of the reduced minimum threshold for asset and equity transfers and new criteria for domestic intra-group restructurings. Even if a restructuring does not meet the deferred taxation criteria under Circular 109, investors may still amortise their capital gains derived from their non-monetary investment and the corresponding EIT liability for up to five years.

We will keep monitoring the implementation of these circulars and keep you posted on the possible benefits they may bring.

CONTACTS

Beijing

THOMAS URLACHER
urlacher@gide.com

GUO MIN
guo@gide.com

Hong Kong

GILLES CARDONNEL
cardonnel@gide.com

REBECCA FINN
rebecca.finn@gide.com

Shanghai

ANTOINE DE LA GATINAIS
gatinais@gide.com

PAUL-EMMANUEL BENACHI
benachi@gide.com

FAN JIANNIAN
fan@gide.com

Paris

CHARLES-HENRI LEGER
leger@gide.com

GUILLAUME ROUGIER-BRIERRE
rougier@gide.com

STÉPHANE VERNAY
vernay@gide.com

DAVID BOITOUT
boitout@gide.com

You can also find this legal update on our website in the News & Insights section: **gide.com**

This newsletter is a free, periodical electronic publication edited by the law firm Gide Loyrette Nouel (the "Law Firm"), and published for Gide's clients and business associates. The newsletter is strictly limited to personal use by its addressees and is intended to provide non-exhaustive, general legal information. The newsletter is not intended to be and should not be construed as providing legal advice. The addressee is solely liable for any use of the information contained herein and the Law Firm shall not be held responsible for any damages, direct, indirect or otherwise, arising from the use of the information by the addressee. In accordance with the French Data Protection Act, you may request access to, rectification of, or deletion of your personal data processed by our Communications department (privacy@gide.com).