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China Tax Insights

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New Enterprise Income Tax rules for Enterprise Restructuring

On 30 April 2009 the Ministry of Finance and the State Administration for Taxation issued a *Notice Concerning Enterprise Income Tax Treatment for Enterprise Restructuring* (*Caishui* [2009] No. 59) (the "Notice"), explaining enterprise tax treatment for the 'restructuring' of enterprises. The Notice has particular relevance to transactions such as mergers and acquisitions.

'Enterprise restructuring' is defined in the Notice as a "transaction which changes the legal structure or economic structure of an enterprise other than that of the daily trading activities." The Notice divides such transactions into five different categories:

1. Change of legal formality;
2. An acquisition of shares;
3. An acquisition of assets;
4. Merger; and
5. Spin-off (or demerger)

The Notice provides two general rules which operate in relation to all forms of restructurings unless otherwise provided. First, when an enterprise changes from a legal entity to a non-legal entity (such as a sole trader or partnership), when an enterprise changes its registered address to one outside the People's Republic of China, it shall deemed to be wound up and its assets then taxed on a 'fair value' basis.

The second general rule is that minor changes in legal formality — defined as a 'simple change of the enterprise', such as altering its name, address, or articles of association — should be registered with tax authorities. However, such minor changes will not alter the enterprise's tax basis, except for loss of eligibility for tax incentives if its registered address changes from a location entitling them to tax incentives to one that does not.

The Notice distinguishes between ordinary restructuring and special restructuring. To be regarded as 'special', a restructure must satisfy all of the following five critical requirements:

1. It was carried out for a reasonable commercial purpose, and not to reduce or defer tax liability;
2. The ratio of the acquired, merged or spun-off assets or shares must meet the prescribed standard, effectively 75% of the total equity of the company for an equity purchase or 75% of the company's total assets for an asset purchase;
3. The company's business activities must be continuous for the following 12 months;
4. At least 85% of payment for the transaction must be in the form of equity in the acquirer; and
5. Any equity consideration received by the seller must not be transferred for 12 months.

Where these five criteria are met, tax losses or gains in relation to the equity payment may be deferred. Otherwise, the restructure will be treated as 'ordinary', and all taxable gains or losses will be recognised immediately.

Tax Benefits for Culture and Media Enterprises

In late March 2009 the State Administration for Taxation issued its *Notice of Some Issues related to Taxation Policies on Supporting the Development of Cultural Enterprises* (the "Notice").

The Notice, which applies from 1 January, 2009 to 31 December, 2013, includes generous tax concessions to "cultural and media enterprises", as follows:

1. A business tax and VAT exemption for companies which supply certain media and cultural services; and

2. A reduced enterprise income tax rate of 15% for "cultural supporting enterprises" recognized as new and high-technology and which develop culture-related technology.

To ascertain whether your business can take advantage of these new concessions, please contact our tax specialists.

New Rules for Review of Tax Decisions

The State Administration for Taxation ("SAT") has issued draft amendments to the Tax Administration Review Rules which governs the rights of taxpayers to apply for administrative review of a tax determination. The SAT will accept public consultation on the draft rules up until 20 June 2009.

The Draft Rules have two notable features: a decision made by the review board cannot be less favourable than the original determination; and taxpayers not satisfied with the review board's decision may appeal to the People's Court.

These amendments are the first changes to the Rules since their introduction in 2004, and represent another step in the growing sophistication of China's tax regime.

We are currently in the process of translating the draft Rules into English. If you would like to receive a copy, please contact us at *mail@lehmanlaw.com*.

June Tax Briefing:

Preventing Excessive Debt in China

The *China Tax Insights* June 2009 Tax Briefing examines the operation of China's thin capitalisation regime, a recent addition to China's tax laws. Before looking at the rules themselves, it is important that to understand the reasoning behind rules against thin capitalisation. By limiting the deductibility of debt expenses, the aim of restrictions on thin capitalisation is to reduce leakage of tax revenue to low-tax jurisdictions.

On a general level, a company is said to be thinly capitalised where it has a disproportionately high level of debt in contrast to its equity. The concern is that companies can shift debt expenses from low-taxing jurisdictions to high taxing jurisdictions in order to reduce the level of taxable income in the latter, despite the fact that the relevant debt expenses are for the purpose of generating income in the low tax jurisdiction. This results in a higher level of taxable income in the low-tax jurisdiction and a lower level of taxable income in the high-tax jurisdiction, which lead to a reduction in the company's overall tax burden.

China's thin capitalisation rules are contained in several Chinese tax laws and regulations. Article 46 of the Enterprise Income Tax Law prohibits deduction of interest payments to a related party where the debt-to-equity ratio of the enterprise exceeds 'prescribed standards'. These are listed in Article 119 of the *Regulations on the Implementation of the Enterprise Income Tax Law of the People's Republic of China*, issued by the Ministry of Finance and the State Administration of Taxation in the *Notice on the Tax Deductibility of Interest Expense Paid to Related Parties* (*Caishui* [2008] No. 121), at 5:1 for financial entities and 2:1 for other enterprises.

Article 85 of the *Implementation Measures of Special Tax Adjustments (Provisional)* (the 'Measures') defines 'related party debt-to-equity ratio' as the "portion of the debt investment received [by the entity] from all its related parties ('related party debt investment') to the equity investment ('equity investment')".

Importantly, the Measures also provide that related party debt investment includes 'debt investment guaranteed by related parties in any form.' Figures for related party debt investment and equity investment are calculated based on monthly averages over twelve months, pursuant to Article 86 of the Measures.

Finally even if the debt-to-equity ratio is exceeded, Article 89 of the Measures appears to raise the possibility of deductions nevertheless being allowable where the taxpayer can demonstrate that the transaction is otherwise consistent with arm's-length principles.

Page 2 of each edition of *China Tax Insights* is dedicated to a briefing on a particular aspect of Chinese tax law, with a focus on issues affecting international transactions.

High-Tech Status Provides Opportunities for Tax Savings

Obtaining status as a high technology enterprise is one of the most significant ways that a company can secure tax savings in China. Enterprises that obtain high technology status are entitled to a preferential corporate income tax rate of 15%, which is substantially lower than China's ordinary 25% corporate tax rate. This can obviously lead to significant tax savings for such enterprises.

So-called 'high technology enterprises' are essentially companies which own independent, core IP rights, and which derive a specified portion of their income from new high technology products. Other requirements include employing of specified numbers of qualified engineers.

Tax incentives have helped high technology status to be very popular with businesses in China, and to date approximately sixteen thousand enterprises have been granted certification.

Lehman, Lee & Xu's corporate and international taxation team, in association with Lehman Tax & Accounting, offers clients unrivalled and comprehensive services relating to both Chinese and international taxation matters, and provides a high standard of technical expertise with a practical and commercial approach.

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