



MERGERS AND ACQUISITIONS

China

Taxation of Cross-Border
Mergers and Acquisitions

2010 Edition

TAX

China

Introduction

This chapter outlines the general income tax rules applicable to mergers and acquisitions (M&A) under the Corporate Income Tax (CIT) Law system, and discusses specific corporate reorganization rules recently introduced in the People's Republic of China (the PRC).¹

Over recent years, the PRC tax law system has undergone significant changes, particularly the introduction of the CIT Law in 2008 (applicable from 1 January, 2008), which merged the previous Foreign Enterprise Income Tax Law and Enterprise Income Tax Law. Under the CIT Law, foreign companies and foreign investment enterprises undertaking M&A transactions are subject to the same CIT rules as applied to domestic enterprises.

Where certain conditions are met, the Circular on Corporate Income Tax Treatment of Corporate Restructuring Transactions (Cai Shui [2009] no. 59) (Circular 59) allows for a deferral of recognition of taxable gain on qualifying corporate reorganizations.

The standard CIT rate is a flat 25 percent, which may be reduced under limited circumstances in a domestic context. The standard withholding tax (WHT) rate is 20 percent, which is reduced to 10 percent on PRC-sourced income earned by a non-resident enterprise without an establishment or place of business in the PRC (subject to tax treaty relief), or whose PRC-sourced income is not effectively connected with its establishment or place of business in the PRC.

This chapter discusses the three fundamental decisions faced by a prospective purchaser in implementing M&A transactions in the PRC.

- What should be acquired: the target's shares, or its assets?
- What will be the acquisition vehicle?
- How should the acquisition vehicle be financed?

¹ For the purposes of this chapter, the terms "China" and the "People's Republic of China", or ("PRC") are used interchangeably and do not include the Hong Kong and Macau Special Administrative Areas, which have their own taxation systems.

Recent Developments

Since the last publication of this book in the 2008, there have been substantial changes in PRC tax laws, regulations, and tax law administration procedures, which have potential implications for cross-border M&A.

The key developments in PRC tax laws and regulations include the following.

General Anti-Avoidance Rules (GAAR) Provision

The CIT Law introduced article 47, the GAAR provision, which stipulates that when an enterprise enters into a transaction that lacks any reasonable business purpose, and the transaction results in a reduction in the enterprise's taxable profits or revenue, the tax authorities have the power to make reasonable adjustments to the enterprise's taxable profits or revenue. Without reasonable business purposes under article 47 refers to situations where a transaction's primary purpose is to have the effect of reduction, avoidance or deferral of tax payments.

Further to the GAAR provision, the State Administration of Taxation issued the Implementation Measures of Special Tax Adjustments (Provisional) (STA), Guoshuifa [2009] no.2, on 8 January 2009 which specifically stated that the GAAR applies to situations where taxpayers may be considered to have engaged in abusive use of tax treaties, or forms of enterprise organization. Hence, investors need to be careful in implementing investment holding corporate structures to effect their investment in the PRC (particularly if the acquisition vehicle is established in a tax treaty jurisdiction) to ensure there is sufficient commercial substance in the overall holding structure to avoid an application of the GAAR provision.

For enterprises established without economic substance, particularly those incorporated in tax havens and that cause their related parties or non-related parties to avoid CIT, the tax authorities are also empowered under the STA to disregard the existence of the enterprises and annul the tax benefit obtained by the enterprise from implementing such tax avoidance arrangements.

Other Relevant Anti-Avoidance Administration Provisions under STA

In addition to the GAAR rules the CIT Law and the STA also introduce other anti-avoidance rules that affect M&A transactions, including:

- transfer pricing rules;
- thin-capitalization rules; and
- controlled foreign companies rules.

Transfer Pricing Rules

If transactions between an enterprise and its related party do not comply with the arm's-length principle, thereby reducing the taxable income or revenue of the enterprise or the related party, the tax authorities are empowered to make adjustments using reasonable methods. Enterprises may enter into advance pricing agreements (APAs) with the tax authorities.

Thin-Capitalization Rules

Under the thin-capitalization rule, deductions for interest expenses on excess debts are denied if the ratio of debt investments to equity investments received from related parties exceeds the prescribed threshold.

Controlled Foreign Company (CFC) rules

Under the CFC rule, when a PRC-resident enterprise by itself, or together with other PRC residents, controls an enterprise that is established in a foreign country or region where the effective tax burden is lower than 50 percent of the standard CIT rate of 25 percent (that is, 12.5 percent), and the enterprise established in the foreign country or region does not distribute its profits or reduces the distribution of its profits for reasons other than any reasonable operational needs, the portion of the profits attributable to the PRC-resident enterprise has to be included in its taxable income for the current period. This rule could potentially affect China outbound investments.

Impact of STA

The impact of STA on M&A transactions is likely to be three-fold:

- the imposition of the transfer pricing rules would require intra-group M&A transactions be undertaken between related parties to conform with the arm's-length principle;
- the imposition of thin-capitalization and CFC rules may affect the acquisition and financing structures of M&A transactions; and

- the CFC rules would affect Chinese companies investing abroad and which seek to defer income earned by offshore subsidiaries.

This is a fast-changing area and investors are advised to seek advice concerning potential tax-efficient acquisition and financing structures.

Corporate Reorganization Rules

Circular 59 Issued by the Ministry of Finance (MOF) and the State Administration of Taxation (SAT)

Circular 59 was issued on 30 April 2009, and took effect retroactively on 1 January 2008. It provides investors with a tax-neutral framework to structure qualifying acquisitions, divestments or internal reorganizations under the CIT Law. Regulations governing the income tax treatment of corporate reorganizations under the previous Foreign Enterprise Income Tax and Enterprise Income Tax Laws were repealed along with their enabling legislation as of 1 January, 2008, subject to certain grandfathering provisions.

Circular 59 covers the tax treatments of major forms of M&A transaction, including: change in legal form, debt restructuring, share acquisition, asset acquisition, merger, and de-merger. Generally speaking, the tax treatments of these transactions are classified into either ordinary corporate reorganization or special corporate reorganization.

Ordinary Corporate Reorganizations

For ordinary corporate reorganizations under the CIT Law, gains or losses are included in the taxable profits of the transaction parties at the time of the transaction based on fair market value where non-cash consideration is paid.

Special Corporate Reorganizations

Provided a corporate reorganization has satisfied certain criteria, the transaction may qualify as a special corporate reorganization. Under a qualifying special corporate reorganization, the transaction parties may elect temporarily to defer recognizing the taxable gain or loss arising on the transactions (subject to meeting requirements imposed under the CIT Law). Please refer to Equity section for a more detailed discussion on these qualifying criteria in order to be entitled to the special tax treatment.

Tax Compliance

Notice on Issues Relevant to the Implementation of Dividend Provisions in Tax Treaties (Notice 81)

In issuing Notice 81, the SAT has sought to limit the tax benefit of a non-PRC incorporated entity using a special purpose vehicle established in a jurisdiction that has concluded a favorable tax treaty with the PRC to acquire and hold its PRC investments.

Notice 81 sets out the criteria a foreign investor must meet to claim the relevant treaty benefit for dividends received from PRC tax-resident enterprises, including the requirement that the foreign investor must be the beneficial owner of the dividend and must satisfy the minimum ownership requirement for at least 12 consecutive months prior to the receipt of the dividends.

Circular on How to Recognize the Beneficial Owner in the Double Tax Agreements (DTAs), Guoshuihan [2009] No.601 (Circular 601)

Pursuant to the applicable DTAs and the principle of substance over form, Circular 601 further strengthens the position that the foreign investor should qualify as a beneficial owner of dividends, interest and royalties to be granted the tax relief.

Provisional Measures for the Administration of Withholding of CIT for Non-Resident Enterprises, Guoshuifa [2009] No. 3 (Circular 3)

The procedures prescribed under Circular 3 primarily apply to a non-resident enterprise's derivation of China-sourced dividend, interest, rental, and royalty income, and gains from the alienation of properties. A copy of each contract generating the above income, along with a registration form and other relevant documents, must be submitted to the relevant tax bureau within 30 days of signing the contract. In addition, the withholding (generally conducted by the onshore withholding agent) should be accompanied by the filing of a WHT return and other relevant documents, and tax payments should be made within seven days of the tax being withheld.

Administrative Measures Governing Non-Residents' Claiming for DTA treatments. Guoshuifa [2009] No.124 (Circular 124)

Under Circular 124, a taxpayer or its withholding agent is required to apply for approval from the PRC tax authorities to enjoy treaty benefits applicable to certain passive income (such as dividends, interest, and royalties). Such approval, if granted, will be valid for

three calendar years provided there is no change in the facts stated in the application.

Impact of Notice 81, Circular 601, Circular 3, and Circular 124

The impact of the above notices/circulars on M&A transactions includes:

- commercial substance requirements affect the choice and implementation of a holding company in an acquisition and the holding structure, particularly where tax treaty benefit is sought;
- the applicability of tax treaty benefits to a holding company will affect the tax leakage on dividend repatriation and on exit from the PRC target post-acquisition; and
- investors need to comply with the requirements set out under Circular 3 and 124 when undertaking M&A transactions, particularly the imposition of withholding obligations to overseas sellers on gains realized on the sale of a PRC company, and where PRC-sourced passive investment income is earned during the period of investment holding.

PRC Tax-Residency

Circular on the Recognition of Overseas Incorporated Domestically Controlled Enterprises as PRC Resident Enterprises Based on the Place of Effective Management Criteria, Guoshuifa [2009] No.82 (Circular 82)

Under the CIT Law, a foreign incorporated enterprise could be considered a PRC tax-resident enterprise if its place of effective management can be considered to be located in the PRC. The SAT has issued Circular 82 to set out certain proposed interpretative guidance on what constitutes a place of effective management.

Under Circular 82, the SAT have indicated that an overseas incorporated, domestically-controlled enterprise that satisfies all the following requirements shall be considered to have a place of effective management in the PRC:

- the enterprise's senior management personnel responsible for the enterprise's day-to-day production and business operations and the place where senior management divisions discharge their duties are mainly located in the PRC;
- strategic control over the enterprise's finances (such as borrowing, lending, capital raising, financial risk management, etc.) and personnel (such as

employee appointment, hiring, dismissal, and remuneration, etc.) are made by an establishment(s) or an individual(s) located in the PRC or require the approval from an establishment(s) or an individual(s) located in the PRC;

- the enterprise's major assets, accounting records, corporate seals and minutes of board of directors and shareholder meetings are located or maintained in the PRC; and
- 50 percent or more of the Board members with voting rights or senior management personnel habitually reside in the PRC.

As an over-riding consideration, the SAT also states in Circular 82 that the basis for determination of the place of effective management shall comply with the substance-over-form principle.

Impact of PRC Tax-Residency Rules

The acquisition structure for an M&A transaction and the holding and operational structures post-acquisition should be carefully monitored and managed to avoid the PRC tax-residency risks of the overseas companies. This issue is particularly relevant to situations where the target company is considered an overseas incorporated, domestically-controlled enterprise.

Asset Purchase or Share Purchase

Aside from tax considerations, the execution of an acquisition in the form of either an asset purchase or a share purchase in the PRC is also subject to regulatory requirements and other commercial considerations.

Some of the tax considerations relevant to asset purchase and share purchase are discussed below.

Purchase of Assets

A purchase of assets will usually result in an increase in the cost base of those assets for capital gains tax purposes, although this increase is likely to be taxable in the hands of the seller. In addition, historical tax liabilities generally remain with the company and are not transferred with the assets.

Purchase Price

For tax purposes, it will be necessary to apportion the total consideration among the assets acquired. It is generally advisable for the purchase agreement to specify the allocation, which will normally be acceptable for tax purposes, provided it is commercially justifiable.

Goodwill

Under the CIT Law, expenditures incurred in acquiring goodwill cannot be deducted until the complete disposal or liquidation of the enterprise.

Amortization is allowed under the CIT Law for other intangible assets held by the taxpayer for the production of goods, provision of services, leasing, or operations and management, including patents, trademarks, copyrights, land-use rights, proprietary technologies, etc. Intangible assets can be amortized over no less than 10 years using the straight-line method. Those acquired through investments or acquisitions can be amortized over their useful lives as prescribed under relevant laws or contracts.

Depreciation

Fixed assets refer to non-monetary assets held for more than 12 months for the production of goods, provision of services, leasing, or operations and management, including buildings, structures, machinery, mechanical apparatus, means of transportation and other equipment, appliances, and tools related to production and business operations.

Depreciation on fixed assets is generally computed on a straight-line basis. The residual value of particular fixed assets is to be reasonably determined based on the nature and use of the assets. Once determined, the residual value cannot be changed. The minimum depreciation periods for relevant asset types are as follows:

Assets	Years
Buildings and structures	20
Aircrafts, trains, vessels, machinery, and other production equipment	10
Instruments, tools, furniture, etc. related to production and business operations	5
Transportation vehicles other than aircraft, locomotives and ships	4
Electronic equipment	3

Any excessive accounting depreciation over the tax depreciation calculated based on the above minimum depreciation period should be added back to the taxable income for CIT purposes.

Certain fixed assets are not tax-depreciable, including:

- fixed assets, other than buildings and structures, that are not in use;
- fixed assets leased from other parties under operating leases;

- fixed assets leased to other parties under finance leases;
- fixed assets that are fully depreciated, but are still in use;
- fixed assets that are not related to business operations;
- separately appraised pieces of land that are booked as fixed assets; and
- other non-depreciable fixed assets.

Tax Attributes

Generally, tax attributes (including tax losses and tax holidays) are not transferred on an asset acquisition. They remain with the enterprise or are extinguished.

Value-Added Tax (VAT)

VAT is levied at the rate of 17 percent (except for small-scale taxpayers) on the sale of tangible goods and the provision of processing, repair and replacement services within the PRC territory. From the year 2009, the purchaser of fixed assets is entitled to claim full input VAT credit on fixed assets against the output VAT.

The transfer of a business as a going concern, however, is outside the scope of VAT, provided certain conditions are met. A sale of assets, in itself, may not be regarded as a transfer of a business as a going concern and hence should not enjoy the VAT exemption.

Transfer Taxes

Stamp duty is levied on instruments transferring ownership of the assets in the PRC. Depending on the type of assets being transferred, the transferor and the transferee are each responsible for the payment of stamp duty of 0.03 to 0.05 percent of transfer consideration for the assets in relation to their own copies of the transfer agreement (that is, a total of 0.06 percent to 0.10 percent stamp duty payable).

Purchase of Shares

The purchase of a target company's shares does not result in an increase in the base cost of that company's underlying assets; there is no deduction for the difference between underlying net asset values and consideration.

Tax Indemnities and Warranties

In a share acquisition, the purchaser assumes ownership of the target company together with all of its related liabilities, including contingent liabilities. The

purchaser will, therefore, normally require more extensive indemnities and warranties than in the case of an asset acquisition. An alternative approach is for the seller's business to be hived down into a newly-formed subsidiary with a view to allowing the purchaser to acquire a clean company. However, for tax purposes, unless tax relief applies, this may crystallize any gains inherent in the underlying assets and may also crystallize a tax charge in the subsidiary to which the assets had been transferred when it is acquired by the purchaser.

To identify such tax issues, it is customary for the purchaser to initiate a due diligence exercise, which would normally incorporate a review of the target's tax affairs.

Tax Losses

Under the CIT Law, generally speaking, a share transfer resulting in a change of the legal ownership of a PRC target company would not affect the PRC tax status of the PRC target company, including tax losses. However, since the introduction of the GAAR, the transaction parties should ensure that there is a reasonable commercial rationale for the underlying transaction and that the use of the tax losses of the target is not considered to be the primary purposes of the transaction (thus triggering the application of GAAR). Provided that the GAAR do not apply, any tax losses of a PRC target company can continue to be carried forward to offset against its future profits, for a maximum period of five years from the year in which the loss was incurred after the transaction. There are currently no group consolidation regulations in the PRC for grouping of tax losses.

There is limitation on the use of tax losses through mergers.

Crystallization of Tax Charges

The PRC does not yet have tax rules to deem a disposal of underlying assets under the normal share transfer, but the purchaser should pay attention to the inherent tax liabilities of the target company on acquisition, and the application of GAAR.

Pre-Sale Dividend

In certain circumstances, the seller may prefer to realize part of the value of the target company as income by means of a pre-sale dividend. The rationale here is that the dividend may be subject to a lower effective rate of dividend WHT than capital gains. Hence if dividends are paid prior to a share sale, this would reduce the

proceeds of sale and thus the gain arising on the sale, which leads to a lower WHT leakage overall. The position is not straightforward, however, and each case must be examined on its facts.

Transfer Taxes

The transferor and the transferee are each responsible for the payment of stamp duty of 0.05 of the transfer consideration for the shares in PRC company in relation to their own copies of the transfer agreement (that is, a total of 0.10 percent stamp duty payable).

Tax Filing Requirements for Special Corporate Reorganizations

The special corporate reorganization is elective. To enjoy the tax deferral under a special corporate reorganization, companies must submit, along with their annual CIT filings, relevant documentation to substantiate the reorganizations' qualifications for the special corporate reorganization. Failure to do so will result in the denial of the tax-deferred treatment.

Choice of Acquisition Vehicle

The main forms of business enterprise available to foreign investors in China are:

Foreign Parent Company

The foreign purchaser may choose to make the acquisition itself, perhaps to shelter its own taxable profits with the financing costs. However, the PRC charges WHT on dividends, interest, royalties and capital gains. So, if relevant, an intermediate company resident in a more favorable treaty territory may be preferred, or other structures or loan instruments that do not attract a WHT liability or attract a lower WHT rate may be considered.

Non-Resident Intermediate Holding Company

If the foreign country taxes capital gains and dividends received from overseas, an intermediate holding company resident in another territory could be used to defer this tax and perhaps take advantage of a more favorable tax treaty with the PRC. However, the purchaser should be aware that the STA's GAAR contain 'anti-treaty shopping' provisions and other anti-tax avoidance measures, such as Notice 601, Notice 81, etc., which may restrict the purchaser's ability to structure a deal in a way designed solely to obtain such tax benefits.

Joint Ventures

Joint ventures can be formed either as an equity joint venture or co-operative joint venture.

Equity Joint Venture

An equity joint venture has the following features:

- A limited liability company may be set up by one or more PRC enterprises together with one or more foreign enterprises or individuals.
- Foreign partners must own at least 25 percent of the equity interest in the equity joint venture.
- Profits and losses must be distributed according to the ratio of each partner's capital contribution.
- Earnings are taxed at the enterprise level.
- From 1 January 2008, there is a WHT of 10 percent on dividends paid to non-resident enterprises without establishment or place of business in the PRC. A tax treaty may reduce the domestic income WHT rate.

Co-Operative Joint Venture

A cooperative joint venture has the following features:

- May be formed by one or more Chinese enterprises and one or more foreign enterprises or individuals.
- May be established as either a separate legal person with limited liability or a non-legal person/form.
- Profits and losses may be distributed according to the ratio agreed by the joint venture agreement and can be varied over the contract term.
- If the joint venture is a separate legal person, the earnings are taxed at the enterprise level; otherwise, the earnings are taxed at the investor level.
- From 1 January 2008, there is a WHT of 10 percent on dividends paid to non-resident enterprises without establishment or place of business in the PRC. A tax treaty may reduce the domestic income WHT rate.

Wholly Foreign-Owned Enterprise

A wholly foreign-owned enterprise has the following features:

- A limited liability company may be set up by one or more foreign enterprises or individuals.
- Profits and losses are distributed according to the ratio of each shareholder's capital contribution.

- Earnings are taxed at the enterprise level.
- From 1 January 2008, there is a WHT of 10 percent on dividends paid to non-resident enterprises without establishment or place of business in the PRC. A tax treaty may reduce the domestic income WHT rate.

Joint-Stock Company

A joint-stock company has the following features:

- Also known as a company limited by shares.
- Established primarily for the purpose of listing the company on stock markets.
- Only one class of capital stock.
- Earnings are taxed at the company level.
- From 1 January 2008, there is a WHT of 10 percent on dividends paid to non-resident enterprises without establishment or place of business in the PRC. A tax treaty may reduce the domestic income WHT rate.

Choice of Acquisition Funding

Generally, an acquiring company may fund an acquisition with equity or a combination of debt and equity. Interest paid or accrued on debt used to acquire business assets may be allowed as a deduction to the payer. From 1 January 2008, dividends and interest paid by PRC enterprises to non-resident enterprises without establishment in the PRC or place of business are subject to 10 percent general WHT on distribution/payment to these non-resident enterprises.

Debt

Funding an acquisition with foreign debt is subject to the limitation of the investee company's registered capital to total investment ratio. The registered capital of a foreign investment enterprise (FIE) is the sum of the amount of equity that must be contributed by the investors in the enterprise. The total investment of an FIE is the sum of its registered capital and the maximum amount of a foreign loan that an enterprise is permitted to borrow.

The minimum ratios of the registered capital to the total investment are generally as follows:

Registered Capital	Minimum Registered Capital as a Percentage of Total Investment (%)
Under USD 2.1 million	70

Over USD 2.1 million but less than USD 5.0 million	50
Over USD 5.0 million but less than USD 12.0 million	40
Over USD 12.0 million	33

Source: KPMG in China, 2008

Loans from a foreign lender to a Chinese borrower must be registered with the local branch of the State Administration of Foreign Exchange. If an acquisition is funded by foreign debts, the FIE must register the foreign debt within 15 days of signing of the loan agreement. Without the proper registration, the FIE is not legally permitted to remit principal and interest payments outside China. From 2007, more stringent foreign debt registration rules were introduced for companies engaged in real estate transactions.

Any related-party loans also need to comply with the arm's length principle under the PRC transfer pricing rules.

Deductibility of Interest

Under the CIT Law, non-capitalized interest expenses incurred by an enterprise in the course of its business operations are generally deductible for CIT purposes, provided the applicable interest rate does not exceed applicable commercial lending rates.

The CIT Law also contains thin-capitalization rules generally triggered, for non-financial institutions, when a resident enterprise borrows money from a related party that results in a debt-equity ratio exceeding the two-to-one ratio stipulated by the CIT Law. Interest incurred on the excess portion is not deductible for CIT purposes. The arm's-length principle must be observed in all circumstances.

Withholding Tax on Debt and Methods to Reduce or Eliminate

Payments of interest by a PRC company to a non-resident without establishment or place of business in the PRC are subject to WHT at 10 percent. The rate may be reduced under a double tax treaty. Business tax at 5 percent would also arise on interest income earned by the non-resident from the PRC company.

Under Notice 124, a taxpayer or its withholding agent is required to apply for approval from the PRC tax authorities to enjoy treaty benefits (such as a reduced interest WHT rate).

Checklist for Debt Funding

- The use of third-party bank debt may mitigate the application of thin-capitalization and transfer pricing issues.

- Consider what level of funding would enable tax relief for interest payments to be effective.
- It is possible that a tax deduction may be available at higher rates than in the recipient's jurisdiction.
- WHT of 10 percent would apply on interest payments to non-PRC entities unless a lower rate applies under the relevant double tax treaty.

Equity

A purchaser may use equity to fund its acquisition, possibly by issuing shares to the seller, and may wish to capitalize the target post-acquisition.

The use of equity, although offering less flexibility when the parent subsequently wishes to recover the funds it has injected, may be more appropriate than debt in certain circumstances, such as:

- There may be foreign debt restrictions on a PRC company.
- If the company is thinly capitalized, it may be disadvantageous to increase borrowings. A tax-efficient structure normally requires an appropriate mix of debt and equity so that the debt-to-equity ratio is adequate for PRC tax purposes.

Tax-Neutral Treatment on Special Corporate Reorganizations

Circular 59 issued on 30 April 2009 that took effect retroactively on 1 January 2008, provides investors a tax-neutral framework to structure qualifying acquisitions, divestments, or internal reorganizations under the CIT Law.

Provided a corporate reorganization has satisfied certain criteria, the transaction may qualify as a special corporate reorganization. Under a qualifying special corporate reorganization, the transaction parties may elect temporarily to defer recognizing the taxable gain or loss arising on the transactions (subject to meeting requirements imposed under the CIT Law).

One of the major criteria for qualifying as a special corporate reorganization is that at least 85 percent of the transaction consideration should be equity consideration (that is, stock-for-stock or stock-for-assets). Other relevant criteria include:

- the transaction is motivated by reasonable commercial needs and its major purpose is not achieving tax avoidance, reduction, exemption or deferral;

- the ratio of assets/equity that are disposed, merged, or split off meets the prescribed threshold ratio for share transfers, that is, at least 75 percent of the target's shareholding needs to be transferred;
- the operation of the re-organized assets will not be changed materially within a consecutive 12-month period after the reorganization; and
- original shareholders receiving consideration in the form of shares should not transfer such shareholding within a 12-month period after the reorganization.

For qualifying special corporate reorganizations, the tax deferral is achieved through the carry-over to the transferee of tax bases in the acquired shares or assets, but only to the extent of that part of the purchase consideration comprising shares. Gains or losses attributable to non-share considerations, such as cash, deposits, and inventories, would have to be recognized at the time of the transaction.

Certain cross-border reorganizations would need to meet conditions in addition to those described above before the special corporate reorganization becomes available, including such as 100-percent shareholding relationship between the transferor and transferee in the case of inserting an offshore intermediate holding company.

Hybrids

Consideration may be given to hybrid finance – that is, instruments treated as equity for accounts purposes in the hands of one party and as debt (giving rise to tax-deductible interest) in the other. There are currently no specific rules or regulations that distinguish between equity and debt interests for tax purposes under PRC tax regulations. In practice, however, hybrids are difficult to implement in the PRC, particularly in a cross-border context, because of a restricted legal framework.

Other Considerations

Company Law

The PRC Company Law prescribes how the PRC companies may be formed, operated, re-organized and dissolved.

One important feature of the PRC company law concerns the ability to pay dividends. A PRC company is only allowed to distribute dividends to its shareholders after it has satisfied the following requirements:

- the registered capital has been fully paid up in accordance with the articles of association;
- the company has made profits under PRC GAAP (that is, after using the accumulated tax losses from prior years, if any);
- CIT has been paid by the company or the company is in a tax exemption period; and
- the statutory after-tax reserve funds (such as general reserve fund, enterprise development fund and staff benefit, and welfare fund) have been provided for.

For corporate groups, this means the reserves retained by each company, rather than group reserves at the consolidated level. Regardless of whether acquisition or merger accounting is adopted in the group accounts, the ability to distribute the pre-acquisition profits of the acquired company may be restricted, depending on the profit position of each company.

Group Relief/Consolidation

There are currently no group relief or tax consolidation regulations in the PRC.

Transfer Pricing

If, following an acquisition, an inter-company transaction occurs between the purchaser and the target, failure to conform with the arm's-length principle may give rise to transfer pricing issues in the PRC. Under the PRC transfer pricing rules, the PRC tax authorities are empowered to make tax adjustments within 10 years of the year during which the transactions took place and claw back any underpaid PRC taxes.

Dual Residency

There are currently no dual residency regulations in the PRC.

Foreign Investments of a Local Target Company

The PRC CFC legislation is designed to prevent the PRC companies from accumulating profits offshore in low-tax countries. Under the CFC rule, when a PRC resident enterprise by itself, or together with individual PRC residents, controls an enterprise that is established in a foreign country or region where the effective tax burden is lower than 50 percent of the standard CIT rate of 25 percent (that is, 12.5 percent), and the enterprise established in the foreign country or region does not distribute its profits or reduces the distribution of its profits for reasons other than reasonable operational needs, the portion of the profits attributable to the PRC

resident enterprise has to be included in its taxable income for the current period. There are exemption conditions under the rules, which stipulate that, if satisfied, the CFC rules would not apply.

Comparison of Asset and Share Purchases

Advantages of Asset Purchases

- The purchase price may be depreciated or amortized for tax purposes.
- Previous liabilities of the company are usually not inherited by the acquirer.
- There is no acquisition of a historical tax liability on retained earnings.
- It is possible for the purchaser to acquire part of a business only.
- Profitable operations can be absorbed by a loss-making company if the loss-making company is used as the acquirer.

Disadvantages of Asset Purchases

- The purchaser needs to renegotiate the supply, employment, and technology agreements.
- Government licenses pertaining to the vendor are not transferable.
- It may be unattractive to the vendor (high transfer tax costs to the vendor if the value of the assets has appreciated substantially), thereby increasing the price.
- It may be time-consuming and costly to transfer assets.
- Accounting profits of the acquired business may be affected by the creation of acquisition goodwill.
- The benefit of any losses incurred by the target company remains with the vendor.

Advantages of Share Purchases

- The purchaser may benefit from existing government licenses, supply contracts, and technology contracts held by the target company.
- The transaction may take less time to complete and be easier to effect.

Disadvantages of Share Purchases

- The purchaser is liable for any claims or previous liabilities of the target company.

Withholding Tax Rate Chart

The rate information and footnotes contained in this table are from the 2009 IBFD/KPMG Global Corporate Tax Handbook.

Country	Dividends		Interest ¹ (%)	Royalties (%)
	Individuals, Companies (%)	Qualifying Companies (%)		
Albania	10	10	10	10
Algeria	10	5 ²	7	10
Armenia	10	5 ²	10	10
Australia	15	15	10	10
Austria	10	7 ²	7 ⁸ /10	10 ⁷
Azerbaijan	10	10	10	10
Bahrain	5	5	5	10
Bangladesh	10	10	10	10
Barbados	5	5	10	10
Belarus	10	10	10	10
Belgium	10	10	10	10 ⁷
Brazil	15	15	15	15/25 ³
Brunei	5	5	10	10
Bulgaria	10	10	10	7 ⁴ /10
Canada	15	10 ⁵	10	10
Croatia	5	5	10	10
Cuba	10	5 ²	7.5	5
Cyprus	10	10	10	10
Czech Republic	10	10	10	10
Denmark	10	10	10	10 ⁶
Egypt	8	8	10	8
Estonia	10	5 ²	10	10
Finland	10	10	10	10 ⁶
France	10	10	10	10 ⁷
Georgia	10	0 ¹⁴ /5 ¹⁵	10	5
Germany	10	10	10	10 ⁶
Greece	10	5 ²	10	10
Hong Kong	10	5 ²	7	7
Hungary	10	10	10	10
Iceland	10	5 ²	10	10 ⁶
India	10	10	10	10
Indonesia	10	10	10	10
Iran	10	10	10	10
Ireland	10	5 ²	10	10
Israel	10	10	7 ⁸ /10	10 ⁶
Italy	10	10	10	10 ⁶
Jamaica	5	5	7.5	10
Japan	10	10	10	10
Kazakhstan	10	10	10	10
Korea (Rep.)	10	5 ²	10	10
Kuwait	5	5	5	10
Kyrgyzstan	10	10	10	10
Laos	5	5	10	10
Latvia	10	5 ²	10	10
Lithuania	10	5 ²	10	10
Luxembourg	10	5 ²	10	10 ⁷
Macau	10	10	7 ⁸ /10	10
Macedonia	5	5	10	10
Malaysia	10	10	10	10/15 ⁹
Malta	10	10	10	10
Mauritius	5	5	10	10
Mexico	5	5	10	10
Moldova	10	5 ²	10	10

Country	Dividends		Interest ¹ (%)	Royalties (%)
	Individuals, Companies (%)	Qualifying Companies (%)		
Mongolia	5	5	10	10
Morocco	10	10	10	10
Netherlands	10	10	10	10 ⁷
New Zealand	15	15	10	10
Norway	15	15	10	10
Oman	5	5	10	10
Pakistan	10	10	10	12.5
Papua New Guinea	15	15	10	10
Philippines	15	10 ⁵	10	10/15 ¹⁰
Poland	10	10	10	10 ⁶
Portugal	10	10	10	10
Romania	10	10	10	7
Russia	10	10	10	10
Saudi Arabia	5	5	10	10
Serbia and Montenegro ¹¹	5	5	10	10
Seychelles	5	5	10	10
Singapore	10	5 ²	7 ⁸ /10	10
Slovak Republic	10	10	10	10
Slovenia	5	5	10	10
South Africa	5	5	10	10 ⁶
Spain	10	10	10	10 ⁷
Sri Lanka	10	10	10	10
Sudan	5	5	10	10
Sweden	10	5 ²	10	10 ⁶
Switzerland	10	10	10	10 ⁷
Thailand	20	15 ²	10 ¹²	15
Trinidad and Tobago	10	5 ²	10	10
Tunisia	8	8	10	5 ¹³ /10
Turkey	10	10	10	10
Ukraine	10	5 ²	10	10
United Arab Emirates	7	7	7	10
United Kingdom	10	10	10	10 ⁶
United States	10	10	10	10 ⁶
Uzbekistan	10	10	10	10
Venezuela	10	5 ⁵	5 ⁸ /10	10
Vietnam	10	10	10	10

Notes

- Many of the treaties provide for an exemption for certain types of interest, such as interest paid to public bodies and institutions, banks or financial institutions, or in relation to sales on credit or approved loans. Such exemptions are not considered in this column.
- The rate generally applies with respect to participations of at least 25 percent of capital or voting power, as the case may be.
- The higher rate applies to royalties arising from the use or the right to use trademarks.
- The lower rate applies to royalties in the case of the use, or the right to use, industrial, commercial, or scientific equipment.
- The rate generally applies to participations of at least 10 percent of capital or voting power, as the case may be.
- In the case of royalties from payments of any kind received as a consideration for the use of, or the right to use, industrial, commercial, or scientific equipment, WHT is imposed on 70 percent of the gross amount.
- In the case of royalties from payments of any kind received as a consideration for the use of, or the right to use, industrial, commercial, or scientific equipment, withholding tax is imposed on 60 percent of the gross amount.
- The lower rate applies to payments to a bank in the case of Venezuela, or a bank or financial institution in all other cases.
- Ten percent for payments for the use of, or the right to use, any patent, know-how, trademark, design or model, plan, secret formula or process, copyright of any scientific work, or for the use of, or the right to use, industrial, commercial, or scientific equipment, or for information concerning industrial, commercial or scientific experience; 15 percent for payments for the use of, or the right to use any copyright of literary or artistic work including cinematographic films, or tapes for radio or television broadcasting.
- Ten percent for royalties arising from the use of, or the right to use, any patent, trademark, design or model, plan, secret formula or process, or from the use of, or the right to use, industrial, commercial, or scientific equipment, or for information concerning industrial, commercial or scientific experience; 15 percent for royalties arising from the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematographic films or tapes for television or broadcasting.
- This treaty was concluded by the former Yugoslavia and remains applicable in relations between Serbia and China. Montenegro has declared that it will honor all tax treaties that applied with respect to Serbia and Montenegro. However, application of the treaty with Montenegro has to be confirmed by China.
- The rate applies to interest paid to a financial institution (including an insurance company); otherwise the domestic rate applies.
- Five percent for royalties paid for technical or economic studies or for technical assistance; 10 percent for royalties paid for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematographic films, or films or tapes for radio or television broadcasting, any patent, trademark, design or model, plan, secret formula or process, or for the use of, or the right to use, industrial, commercial or scientific experience.
- The 0-percent rate generally applies to participations of at least 50 percent of capital or voting power and when more than EUR 2 million has been invested in the capital of the company paying the dividends.
- The 5-percent rate generally applies to participations of at least 10 percent of capital or voting power and when more than EUR 100,000 has been invested in the capital of the company paying the dividends.

KPMG in China

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