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China alert

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VAT relief for corporate restructuring now possible, but many uncertainties still exist

Regulations discussed in this issue:

- Announcement on VAT Issues in relation to Asset Restructuring of Taxpayers, SAT Announcement [2011] No. 13, issued by State Administration of Taxation on 18 February 2011, effective from 1 March 2011

Background

The State Administration of Taxation issued Announcement [2011] No. 13 ("Announcement 13") on 18 February 2011. Announcement 13 sets out circumstances under which the transfer of tangible goods may not be subject to Value Added Tax (VAT) in a corporate restructuring.

The key points of Announcement 13 are set out below:

1. Under what circumstances will there be exemption from VAT in a corporate restructuring?

According to Announcement 13, certain corporate restructuring involving the transfer of tangible goods will be regarded as falling outside the scope of VAT. The criteria for a qualified corporate restructuring are as follows:

- The taxpayer transfers tangible goods in a corporate restructuring that takes the form of a merger, de-merger, sale, swap
- The taxpayer transfers all or part of the tangible assets together with related debt claims, liabilities and work force to other units or individuals.

2. What is the technical basis of Announcement 13?

It appears that Announcement 13 distinguishes between the transfer of the whole or part of a business as a going concern and the separate sales of the underlying tangible goods. While the latter falls within the scope of VAT, the former does not. Such a distinction is, however, not obvious from the provisions in the Provisional Regulations on VAT (VAT Regulations) or the implementation rules (VAT Rules).

Corporate restructuring potentially involves a wide range of taxes including CIT, VAT, Business Tax, local taxes, Deed Tax, Land Appreciation Tax and Stamp Duty. It can result in the claw-back of taxes and customs duty as well. However, if planned carefully, corporate restructuring in China can still be done in a tax effective manner. Thorough planning in advance is of paramount importance.

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According to the VAT Regulations, there should be a taxable transaction as long as the ownership of goods is transferred. Therefore, it maybe implied in Announcement 13 that SAT takes that view that there is no actual transfer of ownership of the underlying assets in a qualified corporate restructuring.

It is also important to note that Announcement 13 does not treat qualified corporate restructuring as being exempt from VAT; instead, it treats such restructuring as being outside the scope of VAT. If such corporate restructuring were treated as being exempt from VAT, then there would be a technical risk that the transferor of the tangible goods would not be able to use its unused input tax credit, if any, after the corporate restructuring. Now that such corporate restructuring is treated as being outside the scope of VAT, there could be grounds for the unused input tax credit, if any, of the transferor to be utilised after the transfer. Please refer to Point 6 below for further comment on this point.

3. Were there not similar rules in the past? How different is Announcement 13 from those rules?

SAT issued a ruling, Guo Shui Han [2002] No 420 ("Circular 420"), to the state tax bureau of Jiangxi Province back in 2002 in respect of a specific taxpayer. Circular 420 contained similar provisions to Announcement 13. However, according to Circular 420, only the transfer of the complete right over the property of an enterprise should fall outside the scope of VAT. In other words, the assets, debt claims, liabilities and work force of the enterprise should be transferred in their entirety. In contrast, Announcement 13 allows the transfer of part of the business.

However, in 2009, SAT issued another ruling, Guo Shui Han [2009] No. 585, ("Circular 585") to the state tax bureau of Dalian City in 2009 in relation to another taxpayer. In Circular 585, it was stated that where, in a corporate restructuring, a listed entity transferred its assets and liabilities and related rights and obligations to its holding company and continued to retain its status as a listed entity, Circular 420 should not apply, and the transfer of the taxable goods involved should be subject to VAT. This ruling further restricted the application of Circular 420. There was also another ruling, Guo Shui Han [2010] No. 350, that dealt with the transfer of the complete right over the property of an enterprise in respect of China Direct Broadcast Satellite Co Ltd.

Following the release of Announcement 13, all the abovementioned circulars have now been abolished. It appears that Announcement 13 has further widened and relaxed the corporate restructuring rules for VAT purposes. It is, however, important to note that based on our discussion with the relevant SAT officials in the past, Circular 420 was intended to deal with the transfer of the ownership of certain entities whose capital structure was not constituted by equity interests such that the only practical way to transfer the ownership would be to transfer the underlying assets or businesses. As the transfer of equity interests or equivalent is outside the scope of VAT, Circular 420 excluded the transfer of the complete right over the property of an enterprise from VAT. However, it is not clear if Announcement 13 is based on the same principle. If so, the scope of application of Announcement 13 would be much narrower than its wording suggests.

4. What if only a small part of the business is transferred?

Unlike the corporate restructuring relief for CIT purposes, Announcement 13 does not impose any minimum ratio on the value of the assets (or the business of which the assets form a part) that will be transferred in a corporate restructuring. Based on the wording of Announcement 13, the transfer of part of the tangible assets should suffice as long as the related debt claims, liabilities and work force are transferred together with those

assets. The rules seem to be too loose. It should not be surprising the rules will be tightened in due course.

In addition, terms such as "merger", "de-merger", "sale" and "swap" are not defined. It is not clear if such terms should take on the meaning of the same or similar terms contained in other tax laws or regulations e.g. Cai Shui [2009] No. 59 ("Circular 59") on the Corporate Income Tax (CIT) treatments of corporate restructuring. In addition, there are no clear criteria for identifying the debt claims, liabilities and work force that are related to the assets being transferred, and there is also no guidance on the timing of the transfers of underlying assets and liabilities for them to be regarded as being transferred together. Should the transfers be made within a period of twelve months or less? It is conceivable further circulars will be released in due course to clarify these aspects of Announcement 13.

5. What if there are assets that were acquired before 2009?

Logically, the rules in Announcement 13 should apply to both assets acquired before 2009 and those acquired in or after 2009. This means that pre-2009 assets would escape VAT in a qualified corporate restructuring according to Announcement 13. It should be noted that barring some exceptions, the transfer of pre-2009 assets would normally give rise to VAT at a levy rate of 2 percent.

6. What if one party to a corporate restructuring has unused input tax credit before a corporate restructuring?

Announcement 13 does not specifically address this point. One possibility is that since the transfer of tangible goods in a corporate restructuring is outside the scope of VAT, any unused input tax credit of the transferor cannot be used against the output tax of the transferee after the transfer. This would seem too drastic a result.

Another possibility is that the unused input tax credit of one party before the corporate restructuring can be used against the output tax of the other party as if the goods had always been in the same entity. But might there be a limit to such credit, as with the case of the restriction of pre-merger loss for CIT purposes under Circular 59? Might there also be post-restructuring ring-fencing so that future input tax from one business may only be set off against the output tax of that business after the corporate restructuring? Announcement 13 does not address these questions.

If the unused input tax credit of one party in a corporate restructuring, e.g. merger, can be set off against the output tax of the other party with no limit, Announcement 13 could benefit companies that have a disproportionately large amount of unused input tax credit that would not be capable of being fully utilised in normal sales e.g. companies in a chronic loss position.

More complex issues may arise if one party to a corporate restructuring is an ordinary VAT payer while the other party is a small scale taxpayer or a Business Tax payer.

Announcement 13 also does not address issues of VAT invoices should unused input tax credit of one party be allowed against the output tax of the other party after the corporate restructuring. Would the fact that the VAT invoices were issued to a different party make the utilisation of the related input tax credit by the other party impossible?

The extension of Urban Maintenance and Construction Tax and Education Levy from domestic enterprises to foreign investment enterprises has increased the tax burden of foreign investors. These local taxes are inextricably tied with VAT and Business Tax. As such, there are even more reasons now for foreign investors to plan their corporate restructuring in China carefully in order to minimise tax leakages.

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7. What if the goods transferred are customs bonded materials or equipment?

The transferor of customs-bonded imported materials or equipment should still require prior consent from the customs authority for the transfer. If the transferee is eligible for the bonded importation of materials or equipment, the transfer of the goods can still be carried out on a bonded basis and therefore shall not be subject to import VAT. If the transferee is not so eligible, the transfer of the goods involved shall be subject to import VAT.

For equipment that was imported on or after 1 January 2009 on a bonded basis for customs duty purposes but not VAT purposes, since import VAT has been paid on them, there should not be any claw back of import VAT upon their subsequent transfer.

8. Does it follow that the transferor in a corporate restructuring should not issue VAT invoices to the other party?

It is logical to take that position because VAT invoices should only be issued for transactions that are subject to VAT.

9. How about local taxes?

The transferor of tangible goods in a qualified corporate restructuring should also escape Urban Maintenance and Construction Tax and Education Levy at both national and local level. These local taxes are based on VAT paid. As there is no VAT on the transfer of the tangible goods in a qualified corporate restructuring, there should be no liability for such local taxes. However, if the corporate restructuring gives rise to Business Tax, such local taxes can still be incurred. It is important to bear in mind that while VAT is potentially creditable, Business Tax, Urban Maintenance and Construction Tax and Education Levy do not carry any credit. These taxes would be real leakages in corporate restructuring transactions.

10. What about Business Tax?

Announcement 13 only covers VAT. However, it is interesting to note that SAT issued a circular, Guo Shui Han [2002] No. 165 ("Circular 165"), to the Hainan state tax bureau in respect of a specific taxpayer back in 2002 – the same years as Circular 420 mentioned in Point 3 above, to deal with similar issues. According to Circular 165, again, the transfer of assets, debt claims, liabilities and workforce of an enterprise in their entirety should fall outside the scope of Business Tax. Circular 165 seems to imply that because, in such transaction, the price of the transfer does not merely depend on the value of the underlying assets, the transaction is completely different from the act of transfer of immovable properties and intangible assets separately. It seems that while Circular 165 contains more stringent rules than Announcement 13, Circular 165 is still in force. It is therefore interesting to see how Announcement 13 will interact with Circular 165 in practice.

11. Does it mean that there is no need to comply with the conditions set out in Circular 59 in order to apply the rules in Announcement 13?

Announcement 13 stands in sharp contrast with Circular 59. In Circular 59, very stringent conditions are laid down for rollover relief for CIT purposes. These conditions include reasonable commercial purposes, minimum ratio for assets transfer, minimum ratio for equity consideration and continuation of substantive business after the corporate restructuring.

As part of its key economic and industrial policy, the Chinese government encourages domestic companies in critical industries to consolidate so as to enhance their global competitiveness. This calls for tax policies that are conducive to corporate restructuring. Circular 59 is an example of such policy initiatives. However, it is generally felt that the conditions set out in Circular 59 for rollover relief are so stringent that few taxpayers can benefit from it. On the other hand, the rules in Announcement 13 can do with further development.

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As it currently stands, Announcement 13 do not impose similar requirements.

It is not clear if the taxpayers must or are simply allowed to follow the rules in Announcement 13 in a qualified corporate restructuring. Announcement 13 does not make clear if the taxpayers can elect to treat the asset transfer as being subject to VAT.

12. Should the taxpayer notify the tax authority in charge of the fact that it applies the rules in Announcement 13?

Unlike Circular 59, Announcement 13 does not require the taxpayer to notify the tax authority in charge when the taxpayer applies the rules in the announcement. However, it would not be surprising if SAT or the state tax bureaux at the local level subsequently impose a similar notification requirement.

13. When does Announcement 13 become effective?

Announcement 13 is effective from 1 March 2011. However, it is stated in Announcement 13 that where the matter has not been dealt with before, the rules in Announcement 13 shall apply. This implies that where no VAT has ever been paid on transfer of tangible goods in a qualified corporate restructuring, there is no need to go back to prior years and make up the VAT payments. However, where VAT has been paid, there shall be no refund of the tax either.

Again, it is not clear if transactions that took place before 1 January 2009 should also follow the rules in Announcement 13 if no VAT has been paid on those transactions before. This question is pertinent because Announcement 13 is released after the VAT Regulations and Rules were revised, and the revised VAT regulations and rules only take effect from 1 January 2009.

KPMG observations

It appears that Announcement 13 is intended to provide relief to certain corporate restructuring. However, it is not apparent if this announcement is only meant for the transfer of businesses in lieu of equity interests as mentioned in Point 3 above. In addition, the rules seem to be too loose e.g. there is not any minimum requirement on the amount of assets that will be transferred or any limit on the cash consideration for the transaction concerned. There is also still uncertainty in a number of key areas e.g. the utilisation of unused input tax credit before the corporate restructuring. It is likely that SAT will issue more circulars to clarify various aspects of Announcement 13.

As such, it is important for companies to do thorough research and make the relevant inquiries with the tax authorities in charge in order to ascertain the potential VAT implications of a corporate restructuring before embarking on that transaction. In addition, there is also a possibility that SAT will issue an announcement to apply similar rules to assets that are subject to Business Tax e.g. intellectual properties (including goodwill), land use right and buildings. Therefore, companies contemplating corporate restructuring should look out for developments in this aspect of Business Tax regulations as well.

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