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China Alert

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Chinese authorities looking to make equity contribution feasible

For various tax and business reasons, many multinational companies are considering different forms of corporate reorganisation involving equity/share payments or equity contributions. However, under the existing regulatory guidelines, many practical issues need to be resolved to make such reorganisations feasible and practical to implement, especially for transactions involving foreign and foreign-invested enterprises. The Ministry of Commerce is currently collaborating with other authorities to draft additional guidelines on equity contribution/payment aiming to resolve these practical issues. KPMG has been invited by the central Ministry of Commerce to share our experience and practical concerns, and to provide feedback on the draft guidelines.

Regulations discussed in this issue:

- Draft Administrative Measures for Equity Contribution of Foreign Investment Enterprises, issued by the Ministry of Commerce on 4 May 2011
- Administrative Rules on the Registration of Equity Contribution, State Administration for Industry and Commerce (SAIC) Decree No.39 , issued by the SAIC on 14 January 2009, effective from 1 March 2009

Background

In January 2009, the State Administration for Industry and Commerce issued Decree 39, Administrative Rules on the Registration of Equity Contributions. In April 2009, the Ministry of Finance and State Administration of Taxation issued Circular [2009] No. 59 (Circular 59) on Corporate Income Tax Treatment of Corporate Reorganisations. Under Circular 59, if the percentage of equity consideration paid is not less than 85 percent of the total consideration, and if other conditions are also met, a corporate reorganisation (including asset and equity acquisition, merger, and de-merger) can potentially qualify as a special reorganisation i.e. gain derived by the relevant party can potentially be deferred from recognition for corporate income tax purposes. Hence, it is very common to use equity exchanges for corporate reorganisations, especially those involving the transfer of 100 percent of a company's equity. Some multinational companies, on the other hand, consider capital contribution in the form of equity, due to cash flow considerations.

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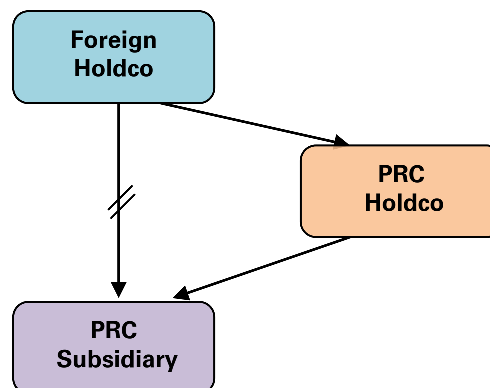
Companies that have tried to reorganise through equity considerations have faced regulatory uncertainties and practical hurdles that made it difficult to implement the reorganisation plans.

The Ministry of Commerce (MOFCOM) is currently collaborating with other authorities to draft additional guidelines on equity contribution/payment to resolve these practical issues. KPMG has been invited by the central MOFCOM to share our experience and practical concerns, and to provide feedback on the draft guidelines. To provide our readers with an overview of the major issues experienced by multinational companies in this area, we are sharing some common issues that have been identified in practice.

For illustrative purposes, we will use the example of a foreign holding company transferring its Chinese subsidiary's equity to a Chinese holding company in exchange for the Chinese holding company's equity.



1. Appraised value versus agreed upon transaction value

In a reorganisation, if the recipient of the equity consideration (i.e. the PRC Holdco in the above illustration) is a limited liability company, it effectively has a capital increase for the value of the equity consideration received (i.e. value of the equity of the PRC subsidiary in the above illustration). The practical problem then is how should the value of the equity received be determined?

Should it simply be based on the agreed upon transaction value? One argument for this is that mergers and acquisitions, in particular those between non-related parties, are usually concluded at the price determined as a result of general market drive, specific commercial considerations, as well as negotiations between the parties. Hence, regardless of whether a corporate reorganisation qualifies as a special reorganisation for tax purposes, the equity considerations paid, if any, should be reflective of the market value.

Another argument is that the value should be determined based on an appraisal performed by a qualified valuation firm. The issue then becomes the difference between the agreed upon transaction value and the appraised value. Should the appraised value serve as the ceiling to prevent the recipient company from having inflated registered capital? If so, should there be a floor pricing as well? The Company Law specifically states that the value of non-cash assets contributed as capital should be assessed and verified, and its value should not be overstated or understated.

One further complication is when the value of the recipient company has appreciated or depreciated as compared to the original registered capital. We will illustrate the issue in the following example:

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	Original registered capital of the entity	Fair market value of the entity prior to reorganisation
PRC Holdco	USD 30 million cash	USD 120 million
PRC Subsidiary	USD 20 million cash	USD 60 million

In this case, the Foreign Holdco contributing the PRC Subsidiary's equity to the PRC Holdco should be different from the original investor of the PRC Holdco. To ensure the post-contribution investor ownership percentages reflect the fair market value of the PRC Holdco and the PRC Subsidiary, the original investor of the PRC Holdco is very unlikely to agree to the Foreign Holdco owning USD 60 million of the registered capital of the post-contribution PRC Holdco. This would change the legal ownership of the post-contribution PRC Holdco to a 33 percent / 67 percent (USD 30 million registered capital owned by original investor versus USD 60 million registered capital owned by Foreign Holdco) ownership split rather than a 67 percent / 33 percent (USD 120 million attributed to the original investor versus USD 60 million attributed to the Foreign Holdco) split based on the fair market value of the companies. Therefore, the PRC Holdco's original investor is more likely to agree to an equity contribution by Foreign Holdco to account for USD 15 million of registered capital, to maintain the 67 percent /33 percent ownership split (USD 30 million registered capital owned by original investor versus USD 15 million registered capital owned by Foreign Holdco). Should that be the case, how would those factors affect the approval granted by the relevant authorities?

MOFCOM has taken feedback on these practical concerns into consideration in drafting the guidelines. Based on the current draft, the approved transaction value of the equity transfer should not exceed the appraised value. Further, the amount of the total transaction value that is recognised as registered capital should not be more than the transaction value. Therefore, in the illustration above, despite the fact that the fair market value of the PRC Subsidiary is USD 60 million, it is possible for the equity contribution made by the Foreign Holdco to only account for USD 15 million of the registered capital of the PRC Holdco.

2. How should the capital verification be performed?

The next issue is the capital verification. Should the CPA firm also perform an independent verification of the value of the equity contributed for the purpose of capital verification? What if the result of this valuation differs from the agreed upon transaction value?

Alternatively, to eliminate potential disagreements, would the approvals issued by government bodies (e.g. equity contribution verification letter issued by the State Administration of Foreign Exchange, or SAFE) suffice? Based on Circular Huizongfu [2010] No.3, issued by SAFE on the capital verification of capital contributions made by foreign investors of a foreign investment enterprise in the form of equity contributions, the equity contribution verification letter issued by SAFE would be sufficient. Nevertheless, the circular also explicitly states that the verification letter will only state the book value of the equity contribution, which is not reflective of the market value of such equity. In this case, rather than providing measures to tie up the various loose ends and offer an affirmative solution at the time of capital verification, SAFE has essentially diverted the process away from the question over the recognised value of the equity contribution. Additional guidance on this issue is limited so far from the draft guidelines provided by MOFCOM. We are waiting to see if additional clarification will be made available.

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3. How much of the equity contribution should be recorded as registered capital? The remaining in capital surplus?

Without certainty on the value of the equity contribution to be recognised for regulatory purposes, how the equity contribution should be recognised for accounting purposes becomes another issue. If the appraised value or the agreed upon transaction value of the equity of the PRC Subsidiary exceeds the registered capital contribution amount approved by the relevant authorities, should the difference be recorded as Capital Surplus? As noted earlier, under the draft guidelines, the appraised value is the ceiling for the transaction value, and the transaction value in turn is the ceiling for registered capital. To avoid ambiguity, the draft guidelines explicitly state that the excess of the transaction value over the registered capital will be recognised as capital surplus.

4. Practical issue with the 70 percent limitation on non-cash capital injection

Under the Company Law, the capital contribution amount made by shareholders in cash should be no less than 30 percent of the total registered capital. This means if the equity contribution is the only non-cash contribution the company has ever received, the value of such equity contribution should not exceed 70 percent of the total registered capital of the company post-equity contribution. This may not be an issue when equity is contributed into a brand new company. However, in the case of a reorganisation involving payment in the form of equity of two existing companies, depending on the level of appreciation in the value of the respective companies involved, it may become an issue.

If the company whose equity is being contributed (e.g. PRC Subsidiary in the illustration) has a very robust outlook, its appraised value may have appreciated significantly in comparison with its registered capital. The original registered capital of the recipient company (e.g. PRC Holdco in the illustration), on the other hand, will not change although the fair market value of its equity (e.g. equity of the PRC Holdco) may have appreciated substantially as well. As a result, it is possible for a proposed equity contribution transaction to be denied, although according to fair market value, the equity contributed does not exceed 70 percent of the total value of the recipient company post-equity contribution.

This issue can be illustrated as below, again in the case of a Foreign Holdco transferring 100 percent equity of a directly held PRC Subsidiary to a PRC Holdco in exchange for the equity of the PRC Holdco:

	Original registered capital of the entity	Fair market value of the entity prior to reorganisation
PRC Holdco	USD 30 million cash	USD 120 million
PRC Subsidiary	USD 20 million cash	USD 80 million

Assuming the equity of the PRC Subsidiary contributed is valued at the fair market value, which is USD 80 million, the total registered capital of the PRC Holdco will be USD 110 million (being the original USD 30 million plus the USD 80 million fair market value of the PRC Subsidiary). In that case, as USD 80 million accounts for over 70 percent of total registered capital, this transaction may not receive approval from the authorities. On the other hand, whether looking at the original registered capital or the post-contribution fair market value, the PRC Subsidiary only accounts for 40 percent of the value of the post-contribution PRC Holdco.

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To move this transaction forward, would it solve the problem if only part of the value of the PRC Subsidiary's equity were recognised as capital contribution? In other words, what if the PRC Holdco and the Foreign Holdco agree that out of the USD 80 million, only USD 70 million will be recognised as registered capital and the remaining USD 10 million will be recorded as capital surplus by the PRC Holdco? In this case, the equity contribution only accounts for 70 percent of the total registered capital of the post-contribution PRC Holdco (i.e. USD 70 million out of a total USD 100 million, which includes the original USD 30 million registered capital contributed in cash and the current USD 70 million contributed in equity).

The draft guidelines so far are only imposing the 70 percent limitation on the aggregate registered capital of the company. Hence, in this example, recognising USD 70 million out of the USD 80 million transaction value as registered capital may be feasible.

5. Practical issue with approval procedure – the chicken and egg problem

Under the current regulations, when the equity of an existing Chinese company is contributed to another Chinese company in exchange for the equity of the latter, both Chinese companies involved need to obtain approval from their respective in-charge authorities.

To use the same illustration again – the PRC Subsidiary's investor will change as a result of the proposed equity contribution. Hence, it must obtain approval from its in-charge authorities for the transfer of its equity to a different investor.

The PRC Holdco, on the other hand, will have a capital increase as a result of the proposed equity contribution. Hence, it must obtain approval from its in-charge authorities for the capital increase.

In practice, there are cases in which the PRC Subsidiary's in-charge authorities will not issue approval for the change in investor until it is confirmed that the PRC Holdco will be able to become the PRC Subsidiary's new investor. This, however, is contingent upon the PRC Holdco's in-charge authorities' approval for the capital increase.

The PRC Holdco's in-charge authorities, on the other hand, will not issue approval for the capital increase until it is confirmed that the PRC Holdco will be able to legally own the equity of the PRC Subsidiary. That, however, is contingent upon the PRC Subsidiary's in-charge authorities' approval for change of investor.

As a result, with the respective authorities' approval being contingent upon the other party's approval, this has become a chicken and egg situation that runs in loops without reaching a result. Hence, it is critical for a standardised approval sequence to be established.

After considering feedback on practical issues that companies have experienced in the past, the draft guidelines state that MOFCOM or the provincial level commission in charge of the jurisdiction in which the investee company (i.e. the PRC Holdco in the above example) is located will be responsible for granting the approval for such equity contributions. If the same clause is in the final guidelines, it will help to resolve the circular approval problem mentioned above.

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Contact us

Khoonming Ho
Partner in Charge, Tax
China and Hong Kong SAR
Tel. +86 (10) 8508 7082
khoonming.ho@kpmg.com

Beijing/Shenyang
David Ling
Partner in Charge, Tax
Northern China
Tel. +86 (10) 8508 7083
david.ling@kpmg.com

Qingdao
Vincent Pang
Tel. +86 (532) 8907 1728
vincent.pang@kpmg.com

Shanghai/Nanjing
Lewis Lu
Partner in Charge, Tax
Central China
Tel. +86 (21) 2212 3421
lewis.lu@kpmg.com

Hangzhou
Martin Ng
Tel. +86 (571) 2803 8081
martin.ng@kpmg.com

Chengdu
Anthony Chau
Tel. +86 (28) 8673 3916
anthony.chau@kpmg.com

Guangzhou
Lilly Li
Tel. +86 (20) 3813 8999
lilly.li@kpmg.com

Fuzhou/Xiamen
Jean Jin Li
Tel. +86 (592) 2150 888
jean.j.li@kpmg.com

Shenzhen
Eileen Sun
Partner in Charge, Tax
Southern China
Tel. +86 (755) 2547 1188
eileen.gh.sun@kpmg.com

Hong Kong
Karmen Yeung
Tel. +852 2143 8753
karmen.yeung@kpmg.com

Northern China
David Ling
Partner in Charge, Tax
Northern China
Tel. +86 (10) 8508 7083
david.ling@kpmg.com

Vaughn Barber
Tel. +86 (10) 8508 7071
vaughn.barber@kpmg.com

Roger Di
Tel. +86 (10) 8508 7512
roger.di@kpmg.com

John Gu
Tel. +86 (10) 8508 7095
john.gu@kpmg.com

Jonathan Jia
Tel. +86 (10) 8508 7517
jonathan.jia@kpmg.com

Vincent Pang
Tel. +86 (10) 8508 7516
+86 (532) 8907 1728
vincent.pang@kpmg.com

Michael Wong
Tel. +86 (10) 8508 7085
michael.wong@kpmg.com

Irene Yan
Tel. +86 (10) 8508 7508
irene.yan@kpmg.com

Tracy Zhang
Tel. +86 (10) 8508 7509
tracy.h.zhang@kpmg.com

Catherine Zhao
Tel. +86 (10) 8508 7515
catherine.zhao@kpmg.com

Hiroyuki Takahashi
Tel. +86 (10) 8508 7078
hiroyuki.takahashi@kpmg.com

Leonard Zhang
Tel. +86 (10) 8508 7511
leonard.zhang@kpmg.com

Abe Zhao
Tel. +86 (10) 8508 7096
abe.zhao@kpmg.com

Central China
Lewis Lu
Partner in Charge, Tax
Central China
Tel. +86 (21) 2212 3421
lewis.lu@kpmg.com

Anthony Chau
Tel. +86 (21) 2212 3206
+86 (28) 8673 3916
anthony.chau@kpmg.com

Cheng Chi
Tel. +86 (21) 2212 3433
cheng.chi@kpmg.com

Bolivia Cheung
Tel. +86 (21) 2212 3268
bolivia.cheung@kpmg.com

Dawn Foo
Tel. +86 (21) 2212 3412
dawn.foo@kpmg.com

Chris Ho
Tel. +86 (21) 2212 3406
chris.ho@kpmg.com

Sunny Leung
Tel. +86 (21) 2212 3488
sunny.leung@kpmg.com

Martin Ng
Tel. +86 (21) 2212 2881
+86 (571) 2803 8081
martin.ng@kpmg.com

Yasuhiko Otani
Tel. +86 (21) 2212 3360
yasuhiko.otani@kpmg.com

Grace Xie
Tel. +86 (21) 2212 3422
grace.xie@kpmg.com

Zichong Xu
Tel. +86 (21) 2212 3404
zichong.xu@kpmg.com

Jennifer Weng
Tel. +86 (21) 2212 3431
jennifer.weng@kpmg.com

William Zhang
Tel. +86 (21) 2212 3415
william.zhang@kpmg.com

David Huang
Tel. +86 (21) 2212 3605
david.huang@kpmg.com

Amy Rao
Tel. +86 (21) 2212 3208
amy.rao@kpmg.com

Southern China
Eileen Sun
Partner in Charge, Tax
Southern China
Tel. +86 (755) 2547 1188
eileen.gh.sun@kpmg.com

Jean Jin Li
Tel. +86 (755) 2547 1128
+86 (592) 2150 888
jean.j.li@kpmg.com

Jean Ngan Li
Tel. +86 (755) 2547 1198
jean.li@kpmg.com

Lilly Li
Tel. +86 (20) 3813 8999
lilly.li@kpmg.com

Kelly Liao
Tel. +86 (20) 3813 8668
kelly.liao@kpmg.com

Angie Ho
Tel. +86 (755) 2547 1276
angie.ho@kpmg.com

Hong Kong
Ayesha M. Lau
Partner in Charge, Tax
Hong Kong SAR
Tel. +852 2826 7165
ayesha.lau@kpmg.com

Chris Abbiss
Tel. +852 2826 7226
chris.abbiss@kpmg.com

Darren Bowdern
Tel. +852 2826 7166
darren.bowdern@kpmg.com

Alex Capri
Tel. +852 2826 7223
alex.capri@kpmg.com

Barbara Forrest
Tel. +852 2978 8941
barbara.forrest@kpmg.com

Ken Harvey
Tel. +852 2685 7806
ken.harvey@kpmg.com

Nigel Hobler
Tel. +852 2143 8784
nigel.hobler@kpmg.com

Charles Kinsley
Tel. +852 2826 8070
charles.kinsley@kpmg.com

John Kondos
Tel. +852 2685 7457
john.kondos@kpmg.com

Curtis Ng
Tel. +852 2143 8709
curtis.ng@kpmg.com

Kari Pahlman
Tel. +852 2143 8777
kari.pahlman@kpmg.com

John Timpany
Tel. +852 2143 8790
john.timpany@kpmg.com

Jennifer Wong
Tel. +852 2978 8288
jennifer.wong@kpmg.com

Christopher Xing
Tel. +852 2978 8965
christopher.xing@kpmg.com

Karmen Yeung
Tel. +852 2143 8753
karmen.yeung@kpmg.com

kpmg.com/cn

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