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MOF and SAT issued new regulations to encourage corporate restructuring and investment with non-monetary assets

Circular on Corporate Income Tax Treatments to Encourage Corporate Restructuring, issued by the Ministry of Finance (MOF) and the State Administration of Taxation (SAT) on 25 December 2014, Caishui [2014] No.109 ("Circular 109"), effective 1 January 2014 and for unresolved corporate restructuring cases before the issuance of the regulation

Circular on Corporate Income Tax Treatments on Investment with Non-Monetary Assets, issued by the MOF and SAT on 31 December 2014, Caishui [2014] No.116 ("Circular 116"), effective 1 January 2014 and for unresolved investment cases using non-monetary assets before the issuance of the regulation

Background

The State Council issued a circular Guofa [2014] No.14 "Guidelines on Further Optimizing Market Environment for M&A Restructuring", which requires finance and tax authorities to "amend the regulations governing special tax treatment for M&A restructuring activities, relax the ratio limit on the acquired shares (assets) out of the total shares (assets) of the acquiree entity, broaden the scope for special tax treatment and release relevant regulations on Corporate Income Tax (CIT) treatment for investment with non-monetary assets".

As a response, the MOF and SAT jointly issued Circular 109 and Circular 116 respectively in December 2014 to clarify further regarding the above mentioned "ratio limit", "scope broadening" and "investment with non-monetary assets".

PRC entities which are conducting or plan to conduct internal restructuring and investment activities should evaluate the impact of the two circulars and optimize their current restructuring and investment scheme in order to take advantage of the favorable tax treatments stipulated in these two circulars.

Main contents of Circular 109

Articles 1 & 2 of Circular 109 relax the "ratio limits" in relation to share or asset acquisition to enjoy special restructuring under Circular 59:

Circular 59	Circular 109
For a share acquisition, the shares acquired should be at least 75% of the total shares of the acquiree entity	For a share acquisition, the shares acquired should be at least 50% of the total shares of the acquiree entity
For an asset acquisition, the assets acquired should be at least 75% of the total assets of the acquiree entity	For an asset acquisition, the assets acquired should be at least 50% of the total assets of the acquiree entity

Article 3 of Circular 109 adds the following two additional situations which can qualify for special restructuring:

Circular on Several Issues on Corporate Income Tax Treatments for Corporate Restructuring Transactions, issued by the MOF and SAT on 30 April 2009, Caishui [2009] No.59 ("Circular 59"), effective 1 January 2008

Circular on Corporate Income Tax Treatments for Asset Restructuring (such as Non-Monetary Asset Investment) of Entity in China (Shanghai) Pilot Free Trade Zone, issued by the MOF and SAT on 15 November 2013, Caishui [2013] No.91 ("Circular 91"), effective 15 November 2013

Restructuring situation	Conditions	Special tax treatment
➢ The PRC transferor and the PRC transferee have a 100% direct-investment holding relationship ➢ The PRC transferor and the PRC transferee are 100% directly owned by the same PRC shareholder or the same group of PRC shareholders	➢ The shares or assets will be assigned ("划转") with net book value (NBV) ➢ The assignment (划转) is conducted for reasonable commercial purposes and not for tax purposes such as reduction of taxes, exemption of taxes or deferral of taxes ➢ The original operating activities of those shares or assets assigned ("划转") should not be changed within 12 months of the assignment ➢ Neither the transferor or the transferee will recognize profit/loss for accounting purpose	➢ Neither the transferor or the transferee needs to recognize income derived from the assignment ➢ The tax basis of the shares/assets received by the transferee shall be based on the original NBV of the transferor ➢ The depreciation of the assets received by the transferee shall be calculated with the basis of the original NBV

Circular 109 took effect 1 January 2014 and is valid for corporate restructuring cases unresolved before the issuance date of the circular.

Main contents of Circular 116

The CIT treatment for investment with non-monetary assets under Circular 91, which was adopted for entities in Shanghai Pilot Free Trade Zone, has been expanded to the rest of China due to the release of the Circular 116.

Entity	Tax treatment
Investor	➢ <u>Tax treatment for the gains derived from investment with non-monetary assets</u> Investment gains = fair market value (FMV) of the invested assets – tax basis of the assets (Investment gains can be realized equally for no more than five years for CIT purposes. The investment gains will be realized when the investment agreement becomes effective and relevant registrations have proceeded.) ➢ <u>Tax treatment for the shares of the investee obtained</u> Tax basis of the shares obtained = the original tax basis of the invested assets + investment gain realized each year (The tax basis should be adjusted each year in line with the investment gain realized.)

Investee	Tax basis of the non-monetary assets obtained = FMV

If the investor later transfers the shares obtained or retracts those investments or is liquidated, the above tax deferal treatment is terminated and all the gains are immediately subject to CIT.

Circular 106 also adds that investment with non-monetary assets includes situations when a new PRC resident enterprise is established with non-monetary assets or an existing PRC resident enterprise is injected with such assets. When the entity conducts investment with non-monetary assets and it also qualifies for special restructuring under Circular 59, the entity can elect such special tax treatment stipulated in Circular 59.

Similar to Circular 109, Circular 116 also took effect 1 January 2014 and is valid for investment cases unresolved before the issuance date of the circular.

KPMG Observation

The release of Circular 109 and Circular 116 is a significant improvement to corporate restructuring and investment activities.

Specifically, Circular 109 relaxes the current conditions for special restructuring under Circular 59 by reducing the minimum ratio limit from 75% to 50% for share/asset acquisition. It provides more flexibility to corporate restructuring. Furthermore, Circular 109 specifies that as long as certain conditions are met, the share/asset assignment (“划转”) between PRC enterprises having a direct holding relationship or under the same control will no longer be limited to the ratio requirements under Circular 59 and can adopt tax deferral treatment accordingly. Compared to the conditions in Circular 59, the conditions set in Circular 109 remove the requirement that the original main shareholder should not transfer the shares obtained within the following 12 months. It could be good news for PRC entities to conduct internal restructuring that involves multiple steps of transfer.

Circular 106 allows PRC entities to pay PRC CIT derived from investment with non-monetary assets by instalment. It will relieve the cash flow issue that arises when all the CIT must be paid all at once.

Given that the two circulars give favourable tax treatments to corporate restructuring and investment, proper tax planning of the restructuring and investment scheme becomes extremely necessary. Therefore, PRC entities conducting or planning to conduct internal restructuring and investment activities should evaluate the impact of the two circulars and optimise the current restructuring and investment scheme to take advantage of these favorable tax treatments.

Uncertainties in the circulars

The new restructuring situation proposed in Circular 109 only applies to PRC resident enterprises. Similar situations for cross-boarder corporate restructuring have not been relaxed and will continue to be governed under Circular 59. We can see that the MOF and SAT are still reluctant to ease the requirements of special restructuring involving PRC non-resident enterprise or cross border transactions.

In addition, there are some uncertainties in Circular 109:

1) For the share/asset assignment (“划转”)between the PRC transferor and the PRC transferee which are 100% directly owned by the same group of PRC shareholders, the regulation does not clearly state that whether the PRC shareholders need to hold same shareholding in both transferor and transferee.

2) Circular 109 uses the word "assignment"(“划转”) but does not provide further interpretation. Such wording is more oftenly used in circulars related to the restructuring of state-owned enterprises (SOEs) and public institutions. We have noticed that similar wording is also used in several recent tax regulations such as SAT Announcement [2014] No.29 "Clarification of Certain Taxable Income Issues for CIT purposes" and Caishui [2012] No.4 "Deed Tax Incentives for the Restructuring of Corporates and Public Institutions". Does it

mean that the use of the word has been extended to normal corporates as well, or has the regulation been released mainly for the current SOE reform initiative?

In addition, there are still a few uncertainties whether the assignment (“划转”) is free of charge or is compensated with considerations, whether it is an activity of giving for free or capital reduction in one entity and capital increase in another, and how the accounting treatment will be determined when the transferor and transferee will not realize a profit/loss.

There may be further interpretations of these uncertainties from SAT in the future. We have also noted that SAT is currently in discussions to revise Circular 59 based on the practical issues encountered over the years. Please stay tuned for updates.

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