2011

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Citation Details
Wei Cui & Richard Krever, "The Tax Consequences of Corporate Reorganisations in China" (2011) 3 Brit Tax Rev 340.

The Tax Consequences of Corporate Reorganisations in China

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Abstract

The story of China's income taxation of corporate reorganisations falls into four distinct periods. The first years of the development of a market economy were a period of benign neglect as tax authorities came to grips with a new tax system and some domestic taxpayers exploited unintended exemptions for reorganisation transactions. A dialectic emerged during the second period of reform with a shift towards a more conventional company tax system based on widely-accepted normative tax principles, while at the same time concessional rules were enacted for transactions favoured by the economic planners. The third stage saw a winding back of concessional rollovers while the current stage has seen a further rollback of some concessions and at the same time the introduction—and apparent importation from Western countries—of new ones.

Introduction

The taxation of company reorganisations has been a persistent topic in Chinese tax policy since the early 1980s, when the country began its shift from a planned economy to a market-based economy. During this time of transition, incorporations, listings, privatisations, asset sales, and bankruptcies of state-owned enterprises—all of which fall into the broadest understanding of reorganisations—were all most familiar events. Indeed, it is hard to think of an area of Chinese tax law that more closely tracks the path of China's economic reform.

The income tax treatment of reorganisations has been the subject of more than 60 central government regulations and rulings issued between 1992 and 2010.[1] In many ways, the changing rules are a mirror that reflects the political decisions, economic programmes, and tax policy goals which have moulded the country's transition to a market economy more generally. This article tracks the development of the corporate income tax in China through the prism of the corporate reorganisation measures.

China's path to modern company tax legislation started in 1980 when a company income tax law was adopted for enterprises with foreign investors,[2] followed, in 1983, by the promulgation of experimental measures to substitute taxes for profit appropriations from state-owned enterprises.[3] The first domestic company law was still a decade away. Developments were rapid

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[1] More regulations and rulings may have been issued that are neither publicly available nor included in current legal databases.

[2] Enterprise Income Tax for Sino-Foreign Joint Ventures (promulgated by the National People's Congress, September 10, 1980, effective September 10, 1980).

[3] Experimental Provisions on Substituting Tax for Profits in State-Owned Enterprises (promulgated by the State Council, April 24, 1983, effective January 1, 1983).

in the years that followed and, like post-socialist Chinese development generally, decades of evolution in more developed countries were compressed into a few years in China. Like all post-socialist Chinese laws, the tax rules reflect steep learning curves as legislators and administrators acquired a better understanding of market transactions and the principles of the rule of law. The tax rules also reflect the challenges faced by Chinese officials in coping with the delicate post-socialist dialectic of measures aimed at protecting market neutrality and interventionist rules designed to promote desired economic outcomes.

The story of corporate reorganisation tax rules in China falls into four distinct periods. The first is marked by something akin to benign neglect in respect of many transactions, as tax authorities came to grips with a new tax system and some domestic taxpayers exploited unintended exemptions for reorganisation transactions. During the second period, tax authorities moved towards a more conventional company tax system consistent with widely-accepted normative tax principles, replacing exemptions or full taxation with rollovers for transactions involving legal changes of ownership but no shift in underlying economic interests. A pattern emerged, however, as parallel concessional rules were enacted for some transactions that were, perhaps, favoured by the economic planners.

The third stage saw a winding back of concessional rollovers while the fourth stage, highlighted by the release, in 2009, of a seminal ruling on takeover transactions,[4] saw a further rollback of some concessions and at the same time the introduction of new ones apparently transplanted from the federal income tax law of the United States. The support for transplanted law and mimicked concessions came not as result of industry lobbying but rather emanated from within the Government, displaying an apparent belief on the part of many Chinese government officials that laws can be selectively transplanted without regard for the broader structures and legal environment in which they were developed.

Opening the door to a market economy and foreign investment: 1979–1991

Prior to Deng Xiaoping's reforms in the late 1970s, company income tax was not an element of the Chinese public revenue system. All enterprises were owned by government entities at different levels and all levels of government relied on profit appropriations from the state-owned enterprises for much of their revenue.

The initial step to a market economy was to allow the start up of new private businesses to operate alongside state-owned enterprises. There was very little in the way of privatisation of existing firms and no effort to incorporate firms so as to separate the Government's administrative and ownership roles. Reform of state-owned enterprises mainly took the form of contracting out their management without change of ownership.

During this period, initial steps were taken to shift from direct profit appropriation to a more formal tax regime. But the initial income tax laws for domestic enterprises developed in a fragmented fashion, with different income tax laws applying to entities with different legal forms or different types of owners. "Collectively-owned" entities were subject to different tax laws

[4] Ministry of Finance (MOF) and State Administration of Taxation (SAT), Caishui [2009] 59 (April 30, 2009) [Notice Regarding Several Issues in the Enterprise Income Tax Treatment of Enterprise Restructuring], commonly referred to as "Circular 59".

from those to which state-owned entities, for example, were subject. By the early 1990s, the failure of these early measures was self-evident. Many state-owned enterprises had bargained to substitute fixed payments in lieu of tax on profits, an arrangement that in a time of inflation led to the Government being short-changed.[5] The time was ripe for reform of income taxation for domestically-owned firms.

Separately, after 1979, the Government invited foreign investors to set up shop in China. Foreign investors seeking to establish operations in China were initially required to establish investment vehicles known as "joint ventures" in collaboration with Chinese partners, with wholly foreign-owned enterprises becoming possible in the mid-1980s.[6]

The pieces of the puzzle are put into place: 1991–1994

The early 1990s was a most potent juncture of history, from which China's current market economy and modern tax system emerged. Company law, accounting law and tax law were reformed almost simultaneously and by the mid-1990s a significantly new landscape was in place.

Modern company law and company forms in China date from 1992 with the release of interim company measures,[7] followed by the enactment of the Company Law at the end of 1993.[8] The Company Law created two types of companies known as joint stock companies and limited liability companies. The English titles are, perhaps, a little misleading as both types of companies enjoy limited liability. The key differences between the two forms relate to the minimum capital contribution required for formation of the company (it is much higher for the joint stock company) and the fact that joint stock companies can issue shares to the general public while limited liability companies cannot.

In the meantime, the Government decided to incorporate many previously state-owned and collectively-owned enterprises. Two factors in particular prompted the change. One was recognition that the interim path to reform—outsourcing management—had not led to the levels of modernisation sought. It was hoped that incorporation would better delineate the ownership and control rights between government agencies and the enterprises they supervised.[9] Secondly,

[5] See Liu Kegu and Jia Kang, *Thirty Years of Chinese Fiscal and Tax Reform: Personal Accounts and Retrospections* (Economic Science Press, 2009), Ch.2; Roger Gordon and Wei Li, "Taxation and Economic Growth in China," in Yum Kwan and Eden Yu (eds), *Critical Issues in China's Growth and Development* (Ashgate Publishing, 2005), 22–40.

[6] Governing laws were the Law on Chinese-Foreign Equity Joint Ventures (promulgated by the Standing Committee of the National People's Congress, July 1, 1979, effective as amended March 15, 2001); the Law on Chinese-Foreign Cooperative Joint Ventures (promulgated by the National People's Congress, April 13, 1988, effective as amended October 31, 2000); and the Law on Wholly Foreign-Owned Enterprises (National People's Congress, April 12, 1986, effective as amended October 31, 2000).

[7] State Commission for Restructuring the Economic System (SCRES), Tigaisheng [1992] 31 (May 15, 1992) [Opinions on Standards for Joint-Stock Companies and Opinions on Standards for Limited Liability Companies].

[8] The Company Law (National People's Congress, promulgated December 29, 1993, amended December 25, 1999, August 28, 2004 and October 27, 2005).

[9] The Central Committee of the Communist Party of China passed the Decision Regarding the Establishment of a Socialist Economic Market System in November, 1993. The decision advocated "the establishment of a modern enterprise system" and pointed out that, "modern Enterprises can assume a variety of organizational forms according to the constitution of assets. The incorporation of state-owned enterprises is a beneficial exploration of the establishment

some state-owned enterprises were also incorporated explicitly for the goal of partial or complete privatisation through the sale of new shares to the public, a process that lasted well into the next decade.

Direct appropriations of profits were not possible following incorporation and the pressure for a better domestic company income tax law became acute, even though there was still a large overlap between the role of the Government as the owner of state-owned enterprises and its role as tax collector.[10] Before turning to the domestic company tax law, in 1991, the National People's Congress (the parliamentary body) revised the foreign investment and foreign enterprises income tax law.[11] Two years later, in 1993, the multiple income tax regimes for domestically-owned enterprises were consolidated into a single domestic enterprise income tax regulation enacted by the State Council (the executive branch of government) rather than by the parliament, that applied from 1994.[12]

The parallel adoption of a uniform set of tax accounting rules for all state- and privately-owned enterprises facilitated the application of a single domestically-owned company tax law.[13] At the same time, to disentangle itself from the heavy reliance on revenues collected from state-owned enterprise profits, the Government pursued a second track of tax reform by consolidating a range of transaction taxes into two new comprehensive indirect taxes, a value added tax on the sale of goods and a "business tax" on the provision of services.[14] The VAT and business tax would emerge as the principal sources of tax revenue over the following decade.

Unwitting exemption for some and strict recognition for others: 1994–1997

The development of modern companies following the enactment of the Company Law in 1993 gave rise, first, to a period of incorporations as owners of existing enterprises and joint ventures sought to shift their investments into corporate form, and, later, to various types of reorganisations as investors shuffled assets and subsidiaries within corporate groups in response to the changing business environment. The period also saw a growth in merger activities as owners of compatible enterprises joined forces by shifting their existing businesses into new jointly owned companies.

The starting point for determining the tax consequences of these transactions should have been legislation. But, like all Chinese tax laws passed by the National People's Congress or tax

of a modern enterprise system". See Stephen Green and Guy S. Liu, *Exit the Dragon: Privatisation and State Control in China* (Chatham House, 2005), Ch.1.

[10] MOF and SCRES, *Interim Provisions on Financial Management of Joint-Stock Pilot Enterprises* (June 6, 1992, repealed January 30, 2003) (accounting rules for newly incorporated state-owned enterprises contained tax rules).

[11] Income Tax Law of the People's Republic of China for Enterprises with Foreign Investment and Foreign Enterprises (promulgated by the National People's Congress, April 4, 1991, effective July 1, 1991).

[12] Provisional Regulations for the Enterprise Income Tax (State Council Decree No.137, December 13, 1993, effective January 1, 1994). The rudiments of the new income tax system for domestically-owned enterprises were first put in place for joint stock companies in 1992. See SAT and SCRES, Guoshuifa [1992] 137 (June 12, 1992) [Temporary Provisions Regarding the Taxation of Joint-Stock Pilot Enterprises]; MOF, Caiyusuanzi [1992] 102 (October 10, 1992, repealed January 30, 2003) [Notice Regarding Budgetary Management with Respect to Income Tax Paid by Joint-Stock Pilot Enterprises].

[13] Accounting Standards for Enterprises (MOF Decree No.5, issued November 30, 1992 and effective July 1, 1993).

[14] The Chinese Business Tax is a turnover tax imposed on the service sector as well as on the transfer of real and intangible properties. See Wei Cui, "Business Tax: China's Quasi-VAT" (2009) 21(4) *International VAT Monitor* 291–295.

regulations enacted by the State Council, the foreign-invested and domestically-owned enterprise income tax law and regulations were, at best, skeletal. Both set out the broad elements of the tax base, but provided little or no detail on the many arrangements and transactions involving modern corporations.

Some meat was added to the legislative skeleton through "implementation regulations"[15] but most of the substance came through informal documents (commonly labelled "circulars") issued by the tax authority, the State Administration of Taxation (SAT) or jointly by the SAT and Ministry of Finance (MOF). Circulars are indications of how the SAT will apply the law, particularly to situations not explicitly addressed in the law, and are somewhat akin to public rulings in Western tax systems. Unlike such rulings, circulars are binding on taxpayers unless they can be shown to be beyond the scope of the law itself and taxpayer challenges to the validity of circulars are infrequent. In effect, therefore, these administrative rulings create the law.

But in a period of sometimes frantic restructuring and reorganisation raising important tax questions, the SAT and MOF remained completely silent in respect of the tax consequences of the reorganisations taking place in domestically-owned enterprises. The lack of guidance is explicable in part, perhaps, by the desire for caution. The owners of domestic enterprises subject to the new tax and the officials responsible for administering the law were equally ignorant of tax norms and practice elsewhere, not to mention the technical details of company law and the precise legal steps needed to give effect to reorganisations. Reluctance on the part of officials to spell out exact rules could be expected.

The explanation most likely goes beyond benign neglect, however. The adoption of company income tax laws and a Company Law was part of a larger agenda by the political leadership in this period to propel the Chinese economy towards a more conventional market economy. Turning a blind eye to the tax implications of business reorganisations may have been tantamount to forgoing tax revenue, but the fiscal cost might have been seen as a small price to pay for encouragement and facilitation of extensive economic restructuring. The overarching political objective was the growth and rationalisation of private enterprises and development of a domestic share market.

As it turned out, an implicit subsidy for business growth and rationalisation by way of lost tax revenue is exactly what transpired. In theory, in the absence of special rules, the default tax rules applicable to disposals should have applied so that every company rearrangement triggered a tax event as shares or assets changed ownership and gains and losses crystallised. It appears that many tax administrators and taxpayers simply ignored the potential liability of persons disposing of shares or assets in the course of incorporations or conversions of private limited liability companies to domestically-owned joint stock companies. At the same time, in some cases at least, the transferee companies were allowed to record the acquisition of assets received as consideration for the issuance of shares at the full appraised value of the assets.[16] The effect

[15] Detailed Rules for the Implementation of the Income Tax Law for Enterprises with Foreign Investment and Foreign Enterprises (State Council, June 30, 1991, effective July 1, 1991, superseded by the Enterprise Income Tax Law on January 1, 2008).

[16] SAT, Guoshuihan [1999] 574 (August 24, 1999, repealed April 30, 2006) [Reply Regarding the Enterprise Income Tax Depreciation on Fixed Asset with Built-In Gain upon Valuation].

was a wholesale exemption from tax for transferors and transferees, a generous implicit subsidy for private enterprise reorganisations.

The SAT and MOF were not silent with respect to reorganisations involving wholly or partly foreign-owned enterprises, however. In contrast to their domestically-owned counterparts, foreign-owned firms discovered, through several SAT circulars issued in 1993 and 1994, that they would enjoy no deferral or exemption opportunities. Instead, the circulars confirmed that the tax consequences of transfers of assets in the course of corporate reorganisations would be the same as for any transfer of an asset for cash or non-cash consideration,[17] with full recognition of gain or loss resulting from the transfers. The transferee company would treat the market value of the transferred assets as their cost base for depreciation purposes. The only concession took the form of a decision that allowed the transferor to pay any tax due as a consequence of asset transfers to a newly created subsidiary in interest-free instalments for up to five years.[18]

Although the governing circulars offered no exemptions or exceptions, the SAT and MOF indirectly conceded that they were allowing some wholly or partly foreign-owned enterprises to shift assets into joint stock companies at cost with no recognition of gain or loss, presumably on the basis of negotiated departures from the circular.[19]

Gradual convergence for domestically-owned and foreign-owned firms: 1997–2000

By 1997, many state-owned enterprises had proven to be non-viable even after conversion into corporate form, and the central Government made the fateful decision to reduce the number of state-owned enterprises and force non-viable firms into asset sales.[20] Thus, in addition to incorporations as enterprises converted to company form, large-scale asset and share sales as well as business combinations also became common. On an entirely separate front, foreign investors were also offered new opportunities to restructure their Chinese operations. Formerly, they had been required to establish separate wholly or partly foreign-owned enterprises for each project in China. However, in 1995 the ministry responsible for foreign trade decided to allow foreign investors to establish holding companies to manage multiple investments. The decision

[17] See SAT, Guoshuifa [1993] 087 (September 22, 1993) [Notice Regarding the Application of Taxation Laws to Joint-Stock Pilot Enterprises]; SAT, Guoshuifa [1993] 139 (December 3, 1993) [Notice Regarding Some Policies of Taxation Involving Foreign Parties for Joint-Stock Pilot Enterprises]; MOF and SAT, Caishuizi [1994] 083 (January 13, 1995) [Notice Regarding the Tax Treatment of the Investment Activities of Foreign-Invested Enterprises]. Compare with Guoshuifa [1997] 71 (April 28, 1997) [Notice Regarding the Income Tax Treatment of Mergers, Divisions, Equity Restructurings, Asset Transfers and other Reorganisations of Foreign-Invested Enterprises], [2].

[18] In one subsequent transaction, the tax authorities extended this period of payment to 10 years. See MOF and SAT, Caishuizi [1997] 92 (December 30, 1997) [Reply Regarding the Taxation of the Investment and Restructuring of International Trade Center]. The five-year payment period was retained until November 26, 2010, finally abolished by Gong Gao [2010] 19, October 27, 2010.

[19] The conclusion derives from Caishuizi [1997] 92, above fn.18, which indicated that a joint stock company would be required to use the prior book value (in the hands of the transferor) of assets as its cost base for tax depreciation purposes if the transferring wholly or partly foreign-owned enterprise recognised the disposal of transferred property at book value. See also MOF, Caikuaizi [1994] 28 (July 4, 1994, repealed November 19, 1999) [Notice Regarding the Accounting Treatment of Asset Revaluation in the Restructuring of Foreign-Invested Enterprises into Joint-Stock Enterprises]; SAT, Guoshuifa [1993] 139, above fn.17; a later circular made clear that the same rule applied to joint-stock companies that are wholly or partly foreign-owned enterprises as well. SAT, Guoshuihan [1996] 124 (March 19, 1996) [Reply Regarding the Tax Treatment of Asset Revaluation of Foreign-Invested Enterprises].

[20] Green and Liu, above fn.9, 18.

triggered an independent round of reorganisations as the separately owned companies were made into subsidiaries of new holding companies and foreign owners exchanged their shares in the separate companies for interests in the holding companies.[21]

New tax rules for transfers in the course of corporate reorganisations came in two tranches. First to appear, via two circulars issued in April 1997, were rules for wholly or partly foreign-owned enterprises, replacing the full recognition of gain and loss for all reorganisation transactions with rollovers for many restructuring arrangements. A year later, rules for domestically-owned enterprises were released. These substituted explicit rollover rules for many of the transactions that previously enjoyed implicit exemptions by way of legislative silence and also, perhaps, the failure of tax officials to appreciate how the general law should apply to restructuring transactions in the absence of specific measures. The new rules helped to close the gap between the rules for foreign investor enterprises and those for domestically-owned enterprises, though some important differences remained. These may simply be attributable to the fact that wholly or partly foreign-owned enterprises and domestically-owned enterprises were subject to two different tax laws and a different division of the SAT was responsible for the rule-making for each.

The 1997 circulars, as with those which followed in later periods, made no distinction between intra-group and extra-group transactions—the same rules applied to transactions between two entities under common ownership and between two companies belonging to completely different owners. From a policy perspective, it might be thought that the application of the same rules to both intra-group and extra-group transactions revealed that Chinese tax policy was tracking two different paths at this point. One, in the direction of what would today be recognised as normative tax rules for conventional reorganisation transactions, with full rollover treatment for intra-company group transfers or incorporations by individuals involving changes in legal ownership but with no alteration in underlying economic interests. The second was in the adoption of explicit concessions for some types of reorganisations involving changes in underlying economic interests. This latter approach echoed earlier attempts to subsidise activities that might result in market rationalisation.

A measure which fell into the first camp of non-recognised transactions (where legal ownership has changed but not the underlying economic interests which remain the same) is the provision of rollovers for intra-group share transfers. A measure that straddled the two categories is the provision of rollovers for a transaction known as a "division" in local parlance, a term borrowed from US company and tax law.[22] These transactions involve an initial transfer of assets to a new subsidiary in the course of an incorporation spin-off, followed by distributions in kind of the shares in the newly-created subsidiary to existing shareholders and redemption of some shares or simply redemption of some shares.[23] While the first step occurs completely within the corporate

[21] See Ministry of Foreign Trade and Economic Cooperation, *Tentative Provisions on the Establishment of Companies with an Investment Nature by Foreign Investors* (issued and effective on April 4, 1995).
[22] SAT, Guoshuifa [1997] 71 (April 28, 1997) [Notice Regarding the Income Tax Treatment of Mergers, Divisions, Equity Restructurings, Asset Transfers and other Reorganizations of Foreign-Invested Enterprises]. A variation of "division" transactions could be used to spin-off subsidiaries in a way that led to a fundamentally different shareholding.
[23] SAT, Guoshuihan [1997] 207 (April 17, 1997) [Notice Regarding the Income Tax Treatment of the Transfer of Company Share by Foreign-Invested Enterprises and Foreign Enterprises]. SAT, Guoshuifa [1997] 71, above fn.17; MOF and SAT, Caishuizi [1997] 77 (June 23, 1997) [Notice Regarding the Income Tax Treatment of Asset Valuation

group, the second may result in changes in the underlying economic interests of shareholders. Gaps remained in the architecture, revealing perhaps the lack of a full appreciation by Chinese authorities of the policy rationale for intra-group rollovers. The most serious gap was the absence of a general rollover for intra-group asset transfers to match the rollover for intra-group share transfers. The rollovers for intra-group asset transfers were only provided for transfers to newly created subsidiaries.

The growing appreciation of normative rules is reflected both in the use of new terminology and in the policy-oriented explanation for the new rules. This was, for example, the first time that the term "reorganisation" began to be used, a term that carried a connotation of rearrangement of business operations purely for commercial purposes, in contrast to the prior terminology of "change in organisation" or "remaking", which, especially as applied to domestically-owned enterprises, had implications of institutional and systematic reform pursuant to economic policy. Similarly, a 1999 circular stated that the purpose of the rollovers was to:

> "encourage organisational changes required by the normal operation of enterprises by not creating tax burdens for such changes, while at the same time preventing enterprises from using organisational change as a subterfuge for the transfer of assets and avoiding paying tax on the gain on such assets."[24]

The dialectic tension between a move towards normative tax principles and the use of tax concessions to further economic rationalisation goals remained in place.

The second group of transactions, involving changes in underlying economic interests but receiving concessional rollover treatments, included divisions that resulted in changes in investment holdings by some or all shareholders, as well as what were often referred to as "merger" arrangements, in which the owners of two or more unrelated companies would fold their investments into a new company.[25]

An interesting aspect of the rollover rules for "merger" transactions was the absence of any restrictions on the type of consideration received by the transferor. The rules were silent on how a rollover would work where the consideration was partly or wholly cash and it is unknown whether the absence of guidance regarding cash consideration led to de facto exemptions to the extent that payment was received in cash in a rollover transaction. However, regulatory obstacles to mergers and divisions in the 1990s meant that the opportunity to carry out reorganisations qualifying for the merger rollover was frequently unavailable in practice.[26]

Appreciation of Enterprises], [4]. See also MOF and SAT, Caishuizi [1998] 50 (April 20, 1998) [Supplementary Notice Regarding the Income Tax Treatment of Asset Valuation Appreciation of Enterprises]; MOF, Caishuihanzi [2000] 26 (April 5, 2000) [Reply of the Tax Policy Division of the MOF to the Inquiry of the Law Department of the State Audit Administration Regarding the Income Tax on Built-In Gain upon Valuation]; see MOF and SAT, Caishuizi [1997] 77, above, (deferral treatment for in-kind contributions); SAT, Guoshuifa [1998] 97 (June 24, 1998) [Notice Regarding Temporary Provisions for the Income Tax Treatment of the Organizational Change and Restructuring of Enterprises] (deferral treatment of mergers, acquisitive mergers, and divisions).

[24] SAT, Guoshuihan [1999] 574, above fn.16.

[25] A concession described by Ajay Mehrotra in the US context as "corporate welfare". See Ajay Mehrotra, "The Story of the Corporate Reorganization Provisions," in Steven A. Bank and Kirk J. Stark, *Business Tax Stories* (Foundation Press, 2005).

[26] By anecdotal accounts, both the wholly or partly foreign-owned enterprises and the domestically-owned enterprises deferral rules for mergers and divisions encountered serious difficulties in implementation, as protectionist local governments were loath to see companies reorganised out of existence. Consequently, neither set of rules was widely

One of the most significant rollovers for wholly or partly foreign-owned firms was for intra-group share transfers. This transaction was relatively easy to engineer and, as it turned out, offered foreign owners of Chinese enterprises an easy path not only to deferral but also to outright avoidance through a cross-border transaction. This was possible because the rollover rules applied to all share transfers within the company group, including, remarkably, transfers to non-resident subsidiaries of the same group. Tax on the sale of a Chinese subsidiary could be easily avoided by first transferring the interest in the subsidiary to an offshore member of the group through a tax-free rollover, and then selling the offshore company.[27] Although the circular contained a "valid business purpose" requirement for its application, this was apparently sufficiently easy to meet (or sufficiently difficult to enforce) and the simple and favourable result subsequently became the yardstick for foreign investors in judging proposed tax rules for reorganisations.[28]

While the 1997 and subsequent supplementary circulars set out the key elements of the rollover regime, the law remained silent on all transactions not described in the circulars. Silence did not mean tax authorities automatically reverted to general principles, however. More commonly, transactions for which there were no specific rules were simply ignored. Apart from the reorganisation rollover measures, there were rarely fall-back rules to govern the tax consequences of related transactions such as in-kind contributions to companies in exchanges for shares, distributions of in-kind benefits to shareholders, reductions of capital and cancellation of shares, and so on.

Refining the concessions and renewing a divergence: 2000–2007

More missing pieces of the company tax puzzle were filled in, for domestically-owned companies, at least, through a pair of circulars issued in 2000.[29] For the first time, it was made clear that the transfer of assets as consideration for the issuance of shares in a company was a taxable disposal unless the transfer qualified for a rollover. Similarly, it was made clear that distributions in-kind to shareholders constituted taxable disposals and that the cost base of assets received in the course of a taxable disposal was the market value recognised to the party disposing of the asset.

The new circulars also restricted rollovers for asset-for-share exchanges to transfers of the entire assets of the transferor or of a complete branch that kept its own books and records, a limitation that prevented companies from accessing the rollovers for selective asset sales for portfolio or strategic investment stakes. On the other hand, rollover treatment was extended to a new category of transactions, namely the exchange between two companies of their entire assets or independent branches. Once again, the rollovers applied to both intra-group transfers (under common ultimate ownership) and transfers outside the group.

used. Conversations with SAT officials (June 2008), and with a Deloitte M&A partner who practised in China in the 1990s (December 2009).

[27] If foreign company, ForeignCo, wished to sell the shares of its Chinese subsidiary, ChinaCo, to foreign buyer, BuyerCo, ForeignCo could simply form an offshore subsidiary, SubCo, and transfer its shares in ChinaCo to SubCo at cost—without recognising any gain. ForeignCo would then sell SubCo shares at full value to BuyerCo without a Chinese tax liability, since SubCo was not a Chinese company.

[28] See text accompanying fn.44, below.

[29] Circular 118 and Circular 119, SAT, Guoshuifa [2000] 118 (June 21, 2000) [Notice Regarding the Income Tax Treatment of Equity Investments of Enterprises]; Guoshuifa [2000] 119 (June 21, 2000) [Notice Regarding the Income Tax Treatment of Mergers and Divisions of Enterprises].

These types of asset swaps were carried out by domestically-owned firms as a response to the difficulties faced by some newly listed state-owned enterprises. In the 1990s, a limited number of stock market listings were granted to state-owned enterprises that had powerful local government sponsors. Many such enterprises performed poorly and soon faced the threat of delisting. Some of them were able to boost their performance by engaging in swaps of entire operations with non-listed companies through complex bargaining and sometimes coercion by local governments.[30] The rollovers for complete asset swaps were of particular benefit to these companies.

The restrictions on rollovers for asset transfers were accompanied by a tightening of the rules where transferors were paid partly in cash for transferred assets. Under the new rules, transfers could qualify for assets-for-assets rollovers if up to 25 per cent of the consideration received from the transferee was cash and for assets-for-share rollovers if up to 16.6 per cent of the consideration received from the transferee was cash.[31] In contrast to the 1997 rules, the 2000 rules did provide for some recognition of gain when the consideration was partly in cash.

Ironically, the non-recognition of both intra-group and extra-group transfers did not suit all taxpayers. Following the 2000 reforms, tax authorities faced unexpected pressure from one group of taxpayers for the right to opt out of the rollover regime for qualifying transfers. A number of large state-owned enterprises had survived privatisation in the 1990s and became quite influential economically and politically. In the period after 2000, some entered into complex reorganisations, often with the aim of packing "good assets" into a joint stock holding company to be listed on a domestic or foreign stock exchange. Because the transactions were largely done intra-group, most could have been carried out in forms that qualified them for deferral. The circulars introducing the new rollover rules did not anticipate taxpayers opting out of the automatic rollovers, but a number of state-owned enterprise groups petitioned the MOF and the SAT to treat the reorganisations as taxable, so that after the transfer, the cost base of the relevant shares or assets for the company to be listed was "stepped up" to their fair market value.[32] At the same time, the state-owned enterprises asked the Government to *exempt* (permanently) from tax the gains that were recognised on the transfer. This was reminiscent of the de facto exemption for state-owned enterprise reorganisations before 1997 as discussed earlier, except that the ascendance of income tax norms in the intervening 10-year period meant that such treatment came to be reserved only for the most powerful enterprises.

The modern regime

A number of pressure points emerged in the years following the adoption of the revised domestic rollover regimes in 2000. As noted, authorities faced pressure from large state-owned enterprises for continuation of the previous exemption regime for intra-group reorganisations. At the same

[30] See, e.g. Yao Hao, "An Examination of Pursuits of Asset Swaps by Listed Companies" 1998 (7) *Operation and Management* 43–45; Cui Yong, "Rearranging State-Owned Assets of Listed Companies Through Asset Swaps" 1997 (8) *China Reform* 56–57.

[31] Specifically, the transferor need not recognise gain if the consideration it received other than the transferee's equity did not exceed one-sixth of the total consideration received.

[32] Because many state-owned enterprises had large real estate holdings, the fair market value of their assets tended to be higher than their historical book value.

time, the gap between the asset transfer rollover rules for domestically-owned and foreign investment firms was problematic. Wholly or partly foreign-owned firms could enjoy rollovers for "mergers" and "divisions" regardless of the type of consideration (cash or non-cash) provided by transferees. Such firms could also access rollovers for share-for-share swaps within a company group, including transferring Chinese subsidiaries to non-resident group members as a means of avoiding Chinese tax through the indirect sale of the subsidiaries.

The inconsistencies between the rollover rules in the two laws evaporated on January 1, 2007, when the separate tax laws for domestically-owned and wholly or partly foreign-owned companies were replaced by a single unified Enterprise Income Tax Law (EITL). In 2007, when the MOF and the SAT commenced work on implementation regulations for the new EITL to be adopted by the State Council,[33] they hoped to incorporate in the law substantial portions of the reorganisation provisions set out in the circulars which had been issued in 2000 for domestically-owned companies. The proposal signalled both the agencies' sense of the importance of the topic of reorganisations and the view of some officials that the existing rules were already "mature". However, the issues remained contentious, and in the end it was decided to leave resolution of the questions out of the implementation rules and to issue ministerial guidance instead. A new circular providing such guidance was not released until 2009,[34] when it quickly became one of the most widely-discussed tax rulings issued by the authorities, generating almost unprecedented commentary by the tax profession.

Perhaps the most important aspect of the new rollover rules was that they stood as exceptions to the general rule clearly articulated in the State Council implementation regulation for the EITL: unless a rollover exception is provided by the MOF and SAT, all intra-group and extra-group transfers of assets or shares give rise to taxable disposals at market value[35] and all acquisitions in the course of these transactions are also treated as having been made at market value.

The 2009 circular altered both the intra-group reorganisation measures and the concessions for extra-group arrangements. The most significant change to rules for intra-group transactions was the removal of any rollover for intra-group share transfers. As noted earlier, this rollover had been exploited by foreign-owned groups to avoid Chinese tax on the sale of Chinese subsidiaries by shifting ownership to offshore members of the group that could then be sold free of Chinese tax. Rather than simply limit the rollover to share transfers within members of the group located in China, the rollover was removed completely.

Some other concessions were also wound back significantly, the most important change in this respect being the removal of asset swaps from the list of transaction forms eligible for rollovers, leaving only asset-for-share exchanges. At the same time, the rollover regime was extended by creating concessions facilitating takeovers and related changes in ownership through

[33] These were eventually issued as The Enterprise Income Tax Law Implementation Regulations (State Council, Decree No.512, November 28, 2007) (herein referred to as the "EITLIR" or "EIT Law Implementation Regulations"). An "administrative regulation" (*xingzheng fagui*) adopted by the State Council, such as the EITLIR, is a level of regulation subordinate to statutes but superior to all ministerial rules (*bumen guizhang*). The EITLIR is thus binding on both the MOF and SAT as well as on the rule-making activities of provincial and local tax agencies.
[34] MOF and SAT, Caishui [2009] 59 (April 30, 2009) [Notice Regarding Several Issues in the Enterprise Income Tax Treatment of Enterprise Restructuring], commonly referred to as "Circular 59".
[35] EITLIR, above fn.33, art. 25.

share-for-share exchanges. Where the acquiring company issued shares in itself as consideration for the acquisition of at least 75 per cent of shares in the target corporation, a rollover applied to the shareholders in the target company who could carry over their original cost base to the shares received in the acquiring company. The acquiring company was deemed to have a cost base in the shares acquired equal to the cost base of the shares of the person or entity from which it was acquired, the same treatment as was given to asset-for-share transactions.

Most interestingly, there is no evidence that the new concession was the result of lobbying by the corporate sector or tax advisors. The initiative, it seems, was that of the drafters of the new rules in the MOF and SAT. The new regime appears to have been based largely on a US model.[36] The primary objective appears to have been to emulate the generous concessional provisions in US federal income tax law to facilitate takeovers and sales of whole (or substantially whole) enterprises.

Eligibility for the rollover concession is subject to four anti-avoidance rules. First, the takeover must have a reasonable commercial purpose and the primary purpose of the transaction must not be to reduce, avoid, or defer tax payments.[37] Second, a "continuity of business" test is applied so that the target company must carry on the same business activities for 12 months after the takeover.[38] A third condition is a continuity of ownership test which requires major shareholders of the acquired company to hold the shares they have received in a reorganisation for at least 12 months after the takeover to retain their rollover treatment. The fourth condition is yet another importation of a US tax concept, the so-called step transaction doctrine that allows tax authorities to disregard the tax consequences of separate transactions when they may be regarded as steps towards the completion of a larger transaction. The concept is not unlike the fiscal nullity doctrine. In the Chinese version, other share or asset disposals occurring within a consecutive 12-month period during which the takeover takes place will be treated as part of the takeover transaction in accordance with the principle of substance over form. These ancillary transactions may remove entitlement to rollover treatment.[39]

An interesting extension of the basic takeover rollover is the provision of rollovers for a "triangular" takeover, another US concession authorities thought should be transplanted to Chinese law. One example of a "triangular" takeover is a transaction in which an acquiring company issues shares in itself to shareholders of a target company but arranges for the assets (or shares) of the target company to be transferred to a subsidiary of the acquiring company

[36] Basing tax concessions on another nation's model is an exercise fraught with difficulty at the best of times. Quite often, the foreign model represents the ascension of parochial interests and effective sectoral lobbying in a political system rather than any universal policy objectives. To the extent concessions are intended to address particular policy goals—to foster activities that generate positive externalities or subsidise transactions inhibited by known market failures—the rationales for intervention by way of tax concessions are unlikely to be replicated to the same extent in another jurisdiction, particularly one with a substantially different legal, social and economic system. The problems of transplanted law are compounded when the transplanted rules contain concepts or terminology peculiar to the legal system from which the measures were borrowed.

[37] Circular 59, above fn.34, art.5(1). A subsequent implementation circular, "Administrative Measures on the Enterprise Income Tax Treatment of Enterprise Reorganisation" SAT Gonggao [2010] 4 (Circular 4) sets out information requirements to demonstrate a "bona fide business purpose".

[38] Circular 59, above fn.34, art.5(3). No definition of "same business" is supplied. The starting point for measuring the 12-month test period is clarified in art.7 and art.19, Circular 4, above fn.37.

[39] Circular 59, above fn.34, art.10.

rather than to the acquiror itself.[40] This type of transaction is not uncommon in the US and can be executed in such a way as to allow rollover treatment for the target shareholders. Its advantage lies in its ability to keep the parent acquiring company insulated from any liabilities associated with the assets acquired. While the arrangement would not be possible in many jurisdictions (a company cannot issue shares without receiving direct payment for the shares), it is technically possible in China.

An interesting rollover is that available to creditors in debt–equity swaps, where a lender agrees to cancel debt owned by a company in financial stress in return for shares in the debtor company. Under previous law,[41] at least when conversion to equity occurred as a result of the modification of the terms of the debt,[42] the conversion was treated as a taxable event to both the creditor and debtor. The new system provides a rollover to the creditor that cancels debt in exchange for shares in a company in financial distress. As the creditor in these cases almost inevitably suffers losses on the transaction, the provision of a rollover that requires the creditor to defer recognition of its losses is, at first look, difficult to understand. The explanation is to be found in the special treatment afforded to the borrower in these circumstances. If the creditor agrees to the rollover and deferral of loss recognition, the borrower is allowed to spread out the recognition of its gain on the cancellation of debt over the following five years. Creditors who become new shareholders following an equity-for-debt restructure may be willing to defer recognition of losses to provide their newly (and perhaps reluctantly) acquired company with the tax benefit of gain deferral. The rollover is not compulsory and presumably will be invoked only where the benefit of gain deferral to the company is worth more than the deferral of loss recognition to the creditors.

The 2009 circular provoked interesting reactions from the tax profession. Relative to any normative income tax benchmark, the concessional rollovers offered by the circular are remarkably generous, subsidising market transactions that probably would not need a sweetener in the form of tax savings to proceed. A benchmark tax was not the starting point for the tax profession, however. Rather, the profession's starting point was the preceding golden era of complete exemptions for takeover transactions or that of generous rollovers for intra-group and extra-group transactions. Representatives of the corporate sector did not regard the very generous 75 per cent threshold to qualify for share-for-share rollovers as fair, arguing that a far lower threshold would be consistent with the goal of the concession, even including cases where the acquiring company only acquired a minority interest in the target.[43] This "unfairness" argument was voiced not only by representatives of multinational corporations but also by many service providers and even by SAT officials themselves.[44]

[40] Circular 59, above fn.34, art.1(3) and 6(2). This type of transaction is referred to in the US as a "Triangular B reorganisation".
[41] SAT, Decree No.6 (January 23, 2003) [Measures for the Income Tax Treatment of the Debt Restructuring of Enterprises].
[42] There was no guidance on the tax treatment of convertible debt, where conversion to equity occurs by the terms of the debt.
[43] For a report of a discussion of these issues during a meeting organised by the IBFD between multinational corporations and the SAT in June 2009, see Houlu Yang, "Conducting Corporate Reorganization: A New Tax Landscape — Part 1" [2009] *Derivatives & Financial Instruments*, Section 6.2.2, 195–208.
[44] Interviews by one author with accounting firm partners and SAT officials in 2009.

A second complaint was that the rollover rules were "too complicated".[45] The claim is surprising given the fact that the final version of the new circular was far simpler than the first drafts of the new rules and is not greatly different in terms of detail or complexity from the earlier circulars it replaced. If anything, the view that the new rules are too complicated suggests that some had systematically disregarded earlier law. The complications of the new regime could of course have been avoided if no deferral treatment was granted to any type of takeover arrangement, but those who complained about complexity almost certainly did not have this in mind. Instead, it is more likely that they were expressing a preference for the unconditional deferral approach that was prevalent between 1997 and 2000 and lasted in the wholly or partly foreign-owned enterprise sector until 2008.

Conclusion

In many ways the story of the tax consequences of corporate reorganisations in China reflects a broader story of post-socialist China. The initial euphoria of change with precious little regulation or rules and no apparent policy framework was gradually replaced with law based on principles consistent with a benchmark income tax as officials came to grips with tax policy fundamentals. A tension remained, however, between a view that the tax system should seek to raise revenue in a neutral, non-distorting fashion and another view that tax law, and particular concessions for consolidation and company rationalisation, should be used as a tool of economic progress.

The most recent development reflects a slightly different story, one that is somewhat at odds with the experience in the US, whose rules proved to be the inspiration for the most recent changes in China. The US story on corporate reorganisation provisions starts with a statutory regime that applied the same fundamental principles to company reorganisations as applied to all other disposals and realisations of gain or loss. The integrity of the benchmark rules was gradually chipped away as the legislature responded to entreaties by corporate lobbyists and progressively replaced the benchmark treatment with concessional rollovers for various takeover arrangements.[46] In China, the move to codify concessions was not the consequence of interest group lobbying, but rather reflected the inclination of policymakers to take the US federal income tax rules as a well-tried model from a successful economy. The transplantation of tax concessions to Chinese law may have been made without concern for a rationale for the enactment of new subsidies or how it might impact upon the development of principled company tax law in China in the future.

[45] According to the authors' interviews with SAT officials, some senior members of the SAT itself hold this view. It was also expressed by members of the Tax Section of the Shanghai Bar Association in November 2009.
[46] See Ajay Mehrotra, above fn.25; Steven A. Bank, "Mergers, Taxes and Historical Realism," (2000) 75 *Tulane Law Review* 1; Yariv Brauner, "A Good Old Habit, or Just an Old One? Preferential Treatment for Reorganizations" [2004] *Brigham Young University Law Review* 1.

China; Foreign investment; Groups of companies; Reorganisation