# China Law Update

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## China M&A Tax Issues - Installment 2: Ordinary versus Special Reorganizations in Share Deals and Asset Deals

**Acquisitions: Share Deals**

One of the two typical methods in which foreign investors can acquire a domestic Chinese company is through a share deal, which involves buying the shares or equity in the target company. As a result, liabilities will be inherited with the target company since the legal entity remains unchanged. In China, certain restrictions on foreign ownership of domestic companies prevent share deals from being transacted.

In terms of the tax issues involved in a share deal, the EITL dictates that accretions in the value of equity or assets are taxable at the time of realization. VAT or business tax will not be levied on a share transfer. China's rules on stamp duty, however, require a 0.1% stamp duty on the sale price of the share transfer.1[1] Lastly, the target company's losses are permitted to be carried forward for up to 5 years.

The M&A rules require the fair market value be the tax basis of the equity or assets. If the shareholder is a foreign enterprise, then the tax rate on a share transfer is 10%. For special reorganizations, however, the tax basis of the acquired equity or assets is the seller's original tax basis in these equity or assets. For example, if the seller originally purchased the target company for $2 million, and the buyer presently acquires the target company from the seller for $3 million, then the buyer's tax basis is $3 million in an ordinary reorganization but only $2 million in a special reorganization. This difference in tax treatment for special reorganizations prevents any taxable gain from arising and allows the seller's original purchase price to remain as the tax basis for further sales of the equity or assets.

After a transaction is completed, a buyer's acquisition expenses cannot be deducted by the target company. These include interest expenses incurred for loans used for the acquisition, which will be capitalized into the costs of the asset according to the EITL Implementation rules. Furthermore, the tax basis of assets of the target company remains unchanged after the deal.

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**Acquisitions: Asset Deals**

The other way in which many foreign investors acquire domestic Chinese companies is through an asset deal, which involves forming a new legal entity in China and acquiring the assets of the target company. The main goal for an asset deal is to minimize risk because unlike in share deals, liabilities are not inherited with assets in asset deals unless the liabilities are attached to assets. As a result of this, asset deals are also not subject to as much legal due diligence as share deals. They also do not need regulatory approval. On the other hand, asset deals are subject to more categories of taxes.

The tax cost of the assets is the purchase price of the assets. VAT on fixed assets is at 17%, while business tax on intangible assets is at 5%. Land-value appreciation tax is levied on assets that are land. Stamp duty is 0.03%-0.05% of the sale price of the transfer of assets. Deed tax of 3%-5% is levied on the sale of land or real estate. Unlike in share deals, the losses of the target company in an asset deal cannot be carried forward.

As with share deals, gains from the transaction are taxable at the time of realization of the asset and foreign enterprises are subject to a 10% tax. The asset receivers in deals that are considered special reorganizations also enjoy the advantage of being subject to the asset transferor's original tax basis in those assets. Interest expenses connected to the asset acquisition and incurred by the newly established entity will be capitalized and depreciated over the life of the assets.

**Conclusions**

Choosing a deal structure to achieve tax efficiency thus depends on the particular set of circumstances. For example, the tax burden in an asset deal may not be excessive if the target company does not hold a lot of land and thus is not subject to land-value appreciation tax. Finally, in maximizing tax saving opportunities, deductions on interest expense or other tax benefits associated with different financing structures should also be taken into consideration.

Authored By:

Jennifer Ding
jding@sheppardmullin.com

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2[1] Provisional Rules of the People's Republic of China on Stamp Duty (Order of the State Council of the People's Republic of China (No. 11)), article 2 (the stamp duty rules).