China Law Update

Posted at 9:26 AM on March 9, 2010 by Sheppard Mullin

China M&A Tax Issues - Installment 3: Mergers and Special Purpose Vehicles

Mergers

A merger involves two or more enterprises forming a single legal entity through combining their assets and liabilities. In China, the absorption of an existing company or the creation of a new entity are the two methods through which a merger can be transacted. Though the former resembles an acquisition, different tax rules apply if the transaction is recognized as a merger.

For a merger that is considered an ordinary reorganization, tax on assets and liabilities being transferred will be based on the fair market value. Tax losses of the enterprise whose assets and liabilities were transferred (merged enterprise) cannot be carried over to the enterprise to which assets and liabilities were transferred (merging enterprise). The assets of the merged enterprise are taxed based on the transaction price.

If a merger is considered a special reorganization, assets transferred will have the same tax basis as the original tax basis of the merged enterprise's assets and liabilities. As in an acquisition that is considered a special reorganization, taxable gain will not arise and the original purchase price will be the tax basis for future sales of the transferred assets in the current merger. The merged enterprise's losses can also be carried forward, though the amount that can be used must be equal to the net operating loss (which is equal to the fair market value of the transferred assets multiplied by the bond yield of the government bond with the longest maturity term at the end of the year that the merger occurred). If the merger occurs through the absorption of an existing enterprise, then the tax incentives of the merging enterprise can be carried over if the merger is considered a special reorganization.

If a transaction can satisfy the requirements of a special reorganization, it might be more tax-efficient to structure it as a merger rather than an asset acquisition, since the losses of the merged enterprise can be carried forward in a merger that is considered a special reorganization while they cannot be carried forward in an asset acquisition that is a special reorganization.

Special Purpose Vehicles

A Special Purpose Vehicle (SPV) is a subsidiary entity of an enterprise established to achieve specific objectives such as isolating the parent company from risk or accumulating tax benefits as a result of treaties between China, in this case, and the SPV's jurisdiction of incorporation.

In China, no tax liabilities result from the sale of an SPV by its foreign parent; however, the General Anti-avoidance rule in the EITL enables the SAT to remove these tax benefits if it considers a transaction as having no reasonable business purpose. Thus, recent changes in the Chinese tax regulations may cause SPVs to lose their attractiveness as a tax-efficient instrument for equity transfers.

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