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New Guidance Clarifies IIT Treatment of Post-Acquisition Capitalization of Undistributed Profits or Reserves

On 7 May 2013, China's State Administration of Taxation (SAT) issued supplementary guidance (Bulletin No. 23) addressing how the capitalization of "undistributed profits," "capital reserves" or "statutory reserves" accumulated by a PRC company while owned by former shareholders (collectively referred to as "old reserves") should be taxed under China's Individual Income Tax (IIT) rules subsequent to the acquisition of 100% of the equity in the company by new individual investors. Bulletin No. 23 is effective as from 6 June 2013.

According to the official announcement explaining the background and legislative intent of Bulletin No. 23, the circular was developed in response to an equity acquisition case in which a number of individual investors acquired a 100% shareholding in a PRC company and then converted the old reserves, which had not been capitalized by the former shareholders before the equity transfer, to registered capital.

The capitalization of the reserves of a company generally would result in the shareholders being deemed to have received "dividends" in the amount of the reserves capitalized. However, many taxpayers argued that such treatment of capitalized reserves was unfair because the old reserves would effectively be taxed twice:

- the former shareholders would have been subject to tax in respect of the gain on their disposal of the company, the valuation thereof which would have taken account of the old reserves, and
- the new shareholders would be subject to tax in respect of the amount of the reserves that are capitalized.

Bulletin No. 23 clarifies the appropriate IIT treatment in such cases.

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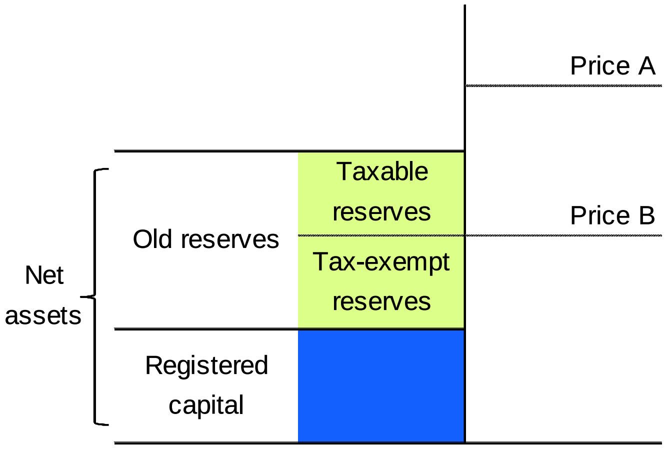
Highlights of Bulletin No. 23

IIT implications of capitalization of old reserves

When individual investors acquire the entire equity interest in a PRC company and the calculation of the purchase consideration takes into account the "un-capitalized" old reserves of the company and the former shareholders have paid income tax on the equity transfer, the PRC IIT implications for the individual investors on capitalizing the old reserves of the acquired company post-acquisition would be depicted as follows:



(I) If the price paid for the acquisition is equal to or exceeds the net asset value[1] of the acquired company (i.e. Price A), no PRC IIT should be levied on the new investors on the capitalization of the old reserves.

(II) If the price paid for the acquisition is lower than the net asset value of the acquired company (i.e. Price B), among the old reserves:

- PRC IIT will be levied on the portion that exceeds the price; such reserves (i.e. taxable reserves) will be subject to IIT as dividends, currently at a rate of 20%; and

- no PRC IIT should be levied on the portion below the price; that portion (i.e. tax-exempt reserves) would have been subject to PRC income tax in the hands of the former shareholders at the time the equity in the company was transferred.

Taxable reserves must be prioritized over tax-exempt reserves when being capitalized for IIT purposes.

Bulletin No. 23 is silent on whether a distribution of old reserves under Price A (or tax-exempt reserves under Price B) other than a capitalization will be exempt from IIT.

Cost basis for subsequent transfer

When the new investors subsequently transfer their equity interests, their cost basis would be the consideration paid for the acquired company being sold and any applicable taxes.

[1] Although not specified, both the tax bulletin and interpretation notes released by the SAT seem to suggest the "net asset value" refers to the book value of net assets.

Administrative matters

All changes in shareholding, the pre-transaction accounting records of the old reserves, the number of shares being capitalized and the tax to be withheld must be reported to the in-charge tax authorities within 15 days after the end of the month in which the transaction takes place.

Comments

As noted above, the shareholders generally would be deemed to receive dividends in the amount of the reserves that are capitalized. Although many taxpayers argue that the treatment of reserves in the circumstances described in the bulletin is unfair on the grounds that those old reserves would effectively be taxed twice, this result may be attributed to the choice of vehicle through which the individuals wish to carry on business. The "double taxation" of the reserves results from the application of the tax law and regulations by reference to the following:

- the company is a legal person separate from its shareholders; and
- the legal form of the two transactions – the sale by the former shareholders to the new shareholders of the shares of the company (*gains derived by the former shareholders*) and the capitalization of the old services (*deemed dividend received by the new shareholders*).

It is unclear whether the SAT is offering a concession to taxpayers (the new shareholders) whose particular fact patterns are identical to the fact pattern described in the bulletin, or whether the SAT intends to establish a general principle, effectively disregarding the company as a legal person separate from its shareholders, as well as the legal form of the two transactions, and applying the tax law and regulations to the transactions by reference to their "substance": the new shareholders "acquired" assets represented by the old reserves and the capitalization of those old reserves should not be subject to tax if, in substance, no additional assets or benefits are derived by the shareholders as a result of the transaction.

The bulletin implies that such additional assets or benefits are, in substance, obtained only if the consideration paid by the new shareholders is lower than the amount of the net asset of the company at the time of acquisition. If so, the new shareholders are deemed to receive a dividend determined by reference to the amount of that difference. Notably, in such a situation, the cost base of the new shareholders in the company remains the amount of the consideration paid by the new shareholders for shares in the company.

We believe that Bulletin No. 23 likely addresses taxpayers whose fact pattern is identical to the fact pattern described in the bulletin. Other taxpayers seeking similar concessional tax treatment would find Bulletin No. 23 valuable in supporting their arguments with the tax authorities, but they should not assume that such arguments generally would be accepted.

Note: Contents discussed in this Tax Analysis pertains to Deloitte Merger & Acquisitions Tax Services and Global Employer Services

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