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Chinese court rules offshore merger by absorption does not qualify for special reorganization relief

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A Chinese court located in Zhifu District, Yantai City in Shandong Province issued a decision in December 2015,[1] in which it concluded that the merger of two Italian companies by an upstream absorption (that resulted in a change of the shareholders of a Chinese company) does not qualify for special reorganization treatment in China and, hence, the tax authorities' decision to tax the deemed capital gains derived from the share transfer is justified.

Under China′s merger and acquisition tax rules (as set out in Circular 59), a reorganization can be considered either an ordinary reorganization or a special reorganization. An ordinary reorganization is taxed under the normal enterprise income tax rules governing the transfer of assets, with any taxable gain or loss recognized at the time of the transaction. By contrast, a special reorganization is a tax-free transaction under which recognition for tax purposes of the gain or loss on the transfer of shares or assets is deferred, provided certain conditions are satisfied. Special rules apply to cross-border reorganizations.

Facts of the case

The case before the Zhifu court involved a wholly owned Italian subsidiary, Illva Saronno Investment S.r.l. ("Italian Sub"), that was merged into its immediate parent company, Illva Saronno Holding S.p.A. ("Italian Parent" or "Taxpayer"), following a shareholders' meeting resolution to carry out an intragroup merger in July 2012. After the merger, the absorbed Italian Sub was deregistered and all of its assets and liabilities (including its 33% share in Yantai Changyu Group Co. Limited, a Chinese resident enterprise ("ChinaCo")) were taken over by the surviving Italian Parent.

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[1] The decision was published in April 2016 through http://wenshu.court.gov.cn .

The State Tax Bureau took the position that the merger included a direct transfer of the 33% share of ChinaCo for Chinese enterprise income tax purposes and that the transfer price was not on arm's length terms. As a result, the tax authorities adjusted the consideration to 33% of ChinaCo's net assets as at end of June 2012, and a 10% withholding tax was imposed on the resulting China-source gains. The Taxpayer had argued that the special reorganization relief as provided under Circular 59 should apply, as well as the nondiscrimination provision in the China-Italy tax treaty. The tax bureau disagreed and the Taxpayer appealed the case to the court.

The Zhifu District Court ruled as follows:

- The merger by absorption, in essence, resulted in a transfer of Italian Sub's 33% share in ChinaCo;
- As a result of specific provisions in Circular 59 that apply to cross-border reorganizations, the Taxpayer is not entitled to the tax deferral relief; and
- The rule applicable to nonresident enterprises is not discriminatory, but the Taxpayer is free to invoke the mutual agreement procedure in the relevant treaty.

Comments

Articles 5 of Circular 59 set out five conditions for a reorganization to qualify for the special reorganization relief. According to these provisions, an upstream merger of a wholly owned subsidiary into its immediate parent and that has a valid commercial purpose generally will qualify for the deferral of gains or losses. However, if a reorganization involves "share or asset acquisitions between Chinese and foreign parties" ("cross-border share or asset acquisitions"), additional conditions, as set out in article 7 of Circular 59, must be fulfilled to qualify for special reorganization relief. Article 7 effectively limits qualifying cross-border share or asset acquisitions to the following three scenarios:

(1) A transfer of the shares of a Chinese company by a nonresident company to its wholly owned nonresident subsidiary (foreign-to-foreign reorganization), where the transferor holds the shares of the subsidiary for a minimum three-year period after the transfer (three-year holding test);
(2) A transfer of the shares of a Chinese company by a nonresident company to its wholly owned Chinese subsidiary (foreign-to-domestic reorganization); and
(3) A transfer of the assets of a Chinese company to its wholly owned nonresident subsidiary (outbound transfer of assets).

It has long been disputed whether a change of a Chinese company's shareholding resulting from an absorption of its direct foreign parent into another foreign company should be governed *only* by article 5 of Circular 59, or by both articles 5 and 7, when determining whether the special reorganization relief applies.

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Circular 59 defines the terms "asset acquisition," "share acquisition," "merger" and "division," etc. by reference to reorganizations undertaken by "enterprises" without differentiating between "nonresident enterprises" and "resident enterprises." Under a literal interpretation, a foreign merger should be covered by article 5. In addition, since share acquisitions and mergers are defined separately in Circular 59, one may argue, as the Taxpayer did in the case, that article 7 cannot be applied to a merger according to a literal interpretation of the term "share or asset acquisitions between Chinese and foreign parties" (i.e. cross-border circumstances).

However, guidance issued in 2013 (Bulletin 72) seems to imply a different view. Bulletin 72 provides that a "foreign-to-foreign reorganization" in article 7 should include the transfer of the shares of a Chinese company arising from a merger or division of the company's foreign parent. It generally has been believed that Bulletin 72 aims to grant special reorganization relief to a transfer of the shares of a Chinese company as a result of a downstream merger of the immediate foreign parent into its wholly owned foreign subsidiary. It, therefore, is interesting to note even such a downstream merger arguably can fail the three-year holding test of article 7 (where the foreign parent is dissolved and could be considered as having transferred the shares of its subsidiary to the shareholders of the foreign parent) so that special reorganization relief still would be denied. This issue has not been entirely clarified and the guidance in Bulletin 72 could create new uncertainty and confusion.

The issue was debated in the case and the Zhifu District Court agreed with the tax authorities that the term "share or asset acquisitions between Chinese and foreign parties" in article 7 should be interpreted broadly to include any change in the shareholders of a Chinese company as a result of the absorption of its direct foreign parent into another foreign company; as a result, article 7 would preclude the Taxpayer from benefiting from the special reorganization relief (because it would not be a qualifying share or asset acquisition, as set out above).

It also is not surprising that the tax authorities cited Bulletin 72 to support their position. According to the tax authorities' interpretation, Bulletin 72 provides that the transfer of the shares of a Chinese company as a result of a downstream merger of the immediate foreign parent into its wholly owned foreign subsidiary should be considered a foreign-to-foreign reorganization for purposes of article 7 of Circular 59. The Taxpayer had suggested that Bulletin 72, which was issued subsequent to the merger at issue, should not be relevant. The court disagreed with the Taxpayer, concluding that Bulletin 72 clarified article 7.

The special reorganization relief was introduced to facilitate M&A activities, and the State Council issued an opinion in 2014 (Opinion 14) stating that the council intends to expand the applicable scope of special tax treatment policies that apply specifically to M&A and reorganizations. However, from our observation, taxpayers still find it difficult to obtain the relief, particularly, for cross-border reorganizations. The three scenarios in which article 7 of Circular 59 allows deferral relief are limited and do not encompass many typical corporate reorganization transactions, such as the upstream merger in the *Illva Saronno* case. The ambiguity of the existing guidance somehow implies additional challenges. If the Chinese government wishes to better align the application of the special reorganization relief to cross-border transactions, it perhaps should consider re-examining the provisos under article 7 to fine tune the language and explore the possibility of expanding its scope; this would contribute to levelling the playing field for cross-border reorganizations compared to purely domestic reorganizations.

The local tax authorities have adopted inconsistent and practices and positions on the tax treatment of reorganizations. For example, there have been instances in which taxpayers have obtained advance rulings[2] qualifying similar offshore absorption mergers for special reorganization relief, thus allowing them to defer tax on the gains. Unlike in certain countries, the decision of a Chinese court does not carry any precedential weight. That being said, it remains to be seen how this unfavorable court decision will affect taxpayers in similar circumstances that were able to obtain favorable rulings or in cases where the fact pattern of a previously obtained ruling is identical to that in the *Illva Saronno* case, whether there will be any retroactive effect, and if so, would this constitute a violation of the principle of legal certainty. Since the Chinese government has been contemplating the introduction of a formal advance ruling system, it is a topic that the tax authorities should study carefully.

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[2] There currently is no advance ruling system nationwide, although it has been reported that a few provinces have been piloting an advance ruling system for certain taxpayers (notably certain large businesses).

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