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# PRC Tax Considerations on Capital Contributions in the Form of Shares and Debt-Equity Swaps: New Possibilities

**By David Yu and Clare Lu**

Following the issuance of the consultative draft of the "*Measures on the Administration of Capital Contributions to Foreign-Invested Enterprises in the Form of Shares*" (the Draft MOFCOM Measures) by the Ministry of Commerce (MOFCOM) in May 2011, the State Administration for Industry and Commerce in August 2011 published the consultative draft of the "*Measures on the Administration of the Registration of Debt-for-Equity Swap*" (the Draft SAIC Measures). Due to the fact that "capital contributions in the form of shares" and "debt-for-equity swap" are common issues in corporate restructurings, the provisions governing special tax treatment for corporate income tax purpose under the "*Notice concerning Corporate Income Tax Treatment in Corporate Restructurings*" (Caishui [2009] No. 59, hereinafter referred to as Notice No. 59) and "*Measures on the Administration of Corporate Income Tax on Corporate Restructurings*" (Announcement of the State Administration of Taxation No. 4/2010, hereinafter referred to as Announcement No. 4) apply. This article attempts to discuss corporate income tax implications in the above-mentioned drafts.

## Capital Contributions to foreign-invested enterprises (FIEs) in the form of Shares

The Draft MOFCOM Measures propose to allow both domestic and foreign investors to incorporate FIEs by contributing capital in the form of shares. The details are as follows:

- Scope of application: (i) incorporation of FIEs as new corporate legal entities; (ii) increase in capital to convert domestic enterprises into FIEs; and (iii) increase in capital that causes alteration of the ownerships of shares in FIEs.

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- The contributed shares must be appraised lawfully such that the monetary consideration of these shares must not be higher than the appraised value and the capitalized value of these shares must not exceed the monetary consideration of the same.

- The total amount of the capitalized value of the contributed shares and capitalized value of the non-monetary assets to be contributed must not exceed 70% of the registered capital of the target company (hereinafter referred to as the 70% rule).

The term, "capital contributions in the form of shares" is not mentioned in the aforesaid tax provisions. We believe that, before the tax authority announces any special rules governing capital contributions in the form of shares, the corporate income tax rules on acquisitions of shares may be consulted in considering the issues in connection with capital contributions in the form of shares. Notice No. 59 provides that special tax treatment may be available for an acquisition of shares if the following requirements are met: (1) there is a reasonable commercial purpose; (ii) the number of shares in the target company to be purchased by the corporate acquirer must not be less than 75% of the total shares in the target company; (iii) the original substantial business activities for the assets after the restructuring must not be changed within 12 consecutive months after the completion of the restructuring; (iv) the amount paid by the corporate acquirer by the time the acquisition is transacted must not be lower than 85% of the total value of the transaction; and (v) the original major shareholders who obtain considerations in form of share in the corporate restructuring must not transfer the shares they obtained within 12 consecutive months after completion of the restructuring. In addition, according to our experience, where the special tax treatment is available for the capital contributions in the form of shares, the following issues have to be considered:

- Scope of application

  There are two events involving capital contributions in the form of shares, incorporation and increase in capital. However, Notice No. 59 and Announcement No. 4 does not cover the former, and the term, "considerations in the form of shares" under the Notice No. 59 and Announcement No. 4 means use of the shares in the enterprise or the equity rights or shares in an enterprise directly held by the enterprise as a consideration when purchasing or exchanging for shares of the target company in enterprise restructuring. Therefore, it is worth to discuss how to reasonably arrange a transaction in the form of “incorporation” under the current provisions so as to ensure that the special tax treatment is available. As both Notice No. 59 and Announcement No. 4 do not mention "capital contributions in the form of shares", for the purpose of using the special tax treatment, investors are advised to consider and understand the different wordings of the relevant new rules and tax regulations in the course of contacting the competent governmental authorities and preparing their documentations.

- The requirement on percentage of cash payment

  The Draft MOFCOM Measures introduce the 70% rules. According to Notice No. 59, the special tax treatment is available only when the number of shares to be purchased by the corporate acquirer is not less than 75% of the total shares in the target company. In this sense, if the special tax treatment is considered in capital contributions in the form of shares, the consistent application of the Draft MOFCOM Measures and Notice No. 59 has to be ensured.

- Foreign exchange rules and procedures

  According to the Draft MOCCOM Measures, shares which are to be contributed as capital must be verified by a recognized asset appraisal firm. The asset appraisal firm, prior to the issuance of the capital verification certificate, is required to file a written confirmation with the local foreign exchange bureau that has jurisdiction over the location where the target company resides. According to the relevant procedures of the foreign exchange authority and industrial and commercial registrar, the foreign investor must obtain the certificate of tax payment or exemption, with which to obtain confirmation from the local foreign exchange bureau, complete the capital verification; and then finish the re-registration of the shares with capital verification certificate.

  However, according to Notice No. 59, an enterprise which intends to enjoy the special tax treatment must, in the course of filing the annual corporate income tax returns for the year in which the restructuring is completed, the interested parties are required to file the required documents with the competent tax authority to proof that the transaction has met all the special requirements for the special tax treatment. Due to the fact that different governmental authorities may apply their different tax-related rules to capital contributions in the form of shares by foreign investors, enterprises which choose the special tax treatment shall well cooperate and communicate with the competent authorities of taxation and foreign exchange in connection with the presentation of the certificates of tax exemption as well as the timelines.

## Debt-for-equity swap

The Draft SAIC Measures propose to allow a creditor to swap the debt meeting the following requirements for shares to increase the company's registered capital:

- Scope of application: (i) the debt in question have been agreed in the contracts between the creditor and company in the course of the company's business; (ii) the debt that is affirmed by the people's court; and (iii) the debt that is included in the restructuring proposal or settlement agreement as approved or affirmed by the people's court in the course of restructuring due to liquidation or reaching a settlement.

- The creditor who intends to swap the FIE's debt for shares, or overseas creditor who intends to swap the company's overseas debt already lawfully registered with the competent authority of foreign exchange for the company's shares, shall also comply with the relevant provisions and obtain the required approval.

- The debt which is to be swapped for shares must be appraised, and the monetary consideration and the capitalized value of the debt-for-equity swap must not exceed the appraised value of the debt in question.

In this sense, the scope of the Draft SAIC Measures includes contractual debts, debts affirmed by the people's courts and debts included in restructuring proposals for liquidation or settlement agreements. The Draft SAIC Measures also cover the requirement of approval for overseas creditors who apply for the swap of lawfully registered overseas debts for shares. In the current practice, foreign debts may be swapped for shares after and only after such debts meeting the relevant foreign exchange rules and being registered, verified and approved. Thus, based on our understanding, swap of overseas debts for shares in reliance on the Draft SAIC Measures is also required to be registered and approved. Notice No. 59 and Announcement No. 4 state that debt-for-equity swap is a two-stage process: repayment of debts and investment in shares, and the gain or loss after repayment of a debt shall be recognized. The special tax treatment may be available, provided that the relevant requirements are met. Therefore, we recommend that creditors who intend to choose the special tax treatment should maintain effective communications with the competent authorities and be aware of other relevant departmental rules and regulations in the course of preparing their transaction documents.

## Appraisal

Both the draft measures require that the shares to be contributed and debts to be swapped for shares must be appraised by appraisal firms lawfully incorporated in China and that the monetary consideration of the shares/debts must not exceed the appraised value, though there is no requirement of minimum value. According to our experience, in the event that the transacting parties choose the ordinary tax treatment and that the monetary consideration is unreasonably low, the tax authority concerned has the power to do adjustments accordingly.

Currently, the consultation on the two draft measures is close. The final versions are not yet released. The interpretation, application and implementation of the finalized measures as well as the required registrations and approval processes remain uncertain until these measures come into operation. Particularly, it will be a challenge on how to satisfy different requirements of different government departments when applying the two measures in respect of the legal framework, inter-departmental communications and legal instruments. We will closely monitor the development of the legislation in this area and timely share our experience.

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