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Peoples Republic of China companies may be classified according to the nature of ownership: state owned enterprise, collectively owned enterprise, privately owned enterprise, and foreign investment enterprise (FIE). PRC companies may also be classified whether they are a legal person or non-legal person: limited liability company, joint stock limited liability company, partnership, sole proprietorship, and branches of domestic company or foreign companies.

This article has focus on three areas:

(i) the legal and tax implication on share and asset acquisitions;

(ii) the difference in the PRC accounting rules and tax rules in the contexts of share transfer, asset transfer, merger and acquisitions;

(iii) the planning and structuring an acquisition including the choice between direct and indirect acquisition, legal consideration, tax consideration, and lastly the payment.

The article concludes with a summary of the analysis and highlights the areas needing attention from parties involved in business acquisitions in China. The transfer of equity or assets arising from company restructuring is not covered as it does not perfectly fall into the scope of business acquisition.

Comparison Between Share and Asset Transfer

In general, the advantages of a share transfer are just the disadvantages for asset transfer. It is useful to compare the main points in Table 1 below.

If there is a change in the investors in an EJV, the transferor and the transferee have to obtain the consent from all other parties. In addition, the new JV agreement between the incoming investor and the remaining parties must be submitted for approval by the administrative bodies.[1]

An FIE engaged in certain specific industries is required to obtain administrative approval on an operating licence, in addition to the approval for the application to set up the FIE itself. Operating licences issued by the administrative bodies in China are not transferable. The purchaser of the assets has to make its own arrangements unless it has been engaged in the same line of business as the seller. In respect of the transfer of assets like a hotel or shopping mall, it is necessary to transfer other business contracts in association with the change in ownership of the assets. The management contract needs to be transferred because the contract may not end on the same date of the asset transfer. Likewise, the shopping mall may have sitting tenants. So it is necessary to transfer the lease agreements as well. Other relevant issue may be the insurance agreement and probably the intellectual property rights such as trade names and logos. It is necessary to transfer all the relevant contracts in an asset transfer.

I. Choice Between Share and Asset Acquisition

A. Reasons for Asset Acquisition

First, the scope of the assets is wider than that for shares. The owners of certain assets are non-corporate bodies such as partnership and sole proprietorship. Some assets are held by state owned enterprises that are legal persons but may not be organised as a company with share capital. The buyers can only opt for assets, not the shares. Note that the PRC

Table 1

Share transfer	*Asset transfer*
Advantages No requirement to change the name of operating licenses and business contracts; If the acquired company has been granted tax concession, it can be continued without any interruption; Likewise, tax losses may be carried forward regardless of the change in shareholder structure.	**Advantages** The buyer doesn't take up the liability; Depreciation deductible in full; Due diligence may not be required. If required, it can be conducted with less scope coverage.
Disadvantages The acquiring company assumes the liability of the acquired company; Share transfer requires the consent from other shareholders; The acquiring company has to carry out due diligence to protect itself.	**Disadvantages** Asset buyer cannot obtain the benefit of tax concession and tax loss; There is a need to transfer all operating licences; There is a requirement for the novation of all relevant contracts

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Company is a legal person in China but a legal person is not necessarily a company.[2]

The second issue is related to the restriction imposed on the share acquisition under the PRC Company Law, which provides that the amount of external investment shall not exceed 50 percent of the investing company's total net asset.[3] If the 50 percent ceiling is reached, any additional acquisition of shares shall be unlawful. The obvious choice is for asset purchase, which will not be subject to such a legal restriction.

B. Reasons for Share Acquisition

First, under the PRC tax law, income tax credits are granted in connection with purchase of domestically manufactured equipment. If the disposal takes place within five years from the date of purchase, the tax authority will revoke the income tax credit.

Second, the PRC tax law will also grant tax concessions to production type FIEs in the form of two years of tax exemption and three years tax reduction for years that follow immediately. If the disposal of the major asset gives rise to a change of business scope such that the FIE will no longer satisfy the criteria of a production type FIE, then the tax concession will not be available to the FIE. This will justify a share transfer rather than an asset transfer.

Third, the PRC law imposes restrictions on the transfer of certain assets under certain conditions. One example is the import duty and VAT-exempted production equipment that is used in the manufacture of export goods using bonded import materials. Such tax-exempted assets are not freely transferable until they are released from China customs supervision in accordance with the law.[4] The PRC law also prohibits foreign companies and nationals from owning land use rights in China. Equally if the land use right held under the name of a WFOE is to be transferred, the WFOE needs to obtain approval from the original approval authority that grants it the approval certificate.[5] Under both of the above circumstances, share transfer will be a feasible alternative.

Fourth, the PRC government imposes geographical restrictions on foreign investors in certain market sectors. One example is the banking industry in which foreign investors are permitted to establish business presence in designated locations inside China in accordance with the agreed timetable. Geographical restriction prevents foreign banks from expanding their business operations beyond the designated cities in China. The obvious alternative is for the foreign investor to acquire the shares of the domestic Chinese banks. For example, the acquisition by the HSBC of a 19.9 percent equity interest in the Central Bank of Communications, which has over 2,700 branches throughout China, is just such a case in point.[6]

II. Legal Issues in Share and Equity Transfers

Share transfers in China are subject to legal restrictions in several areas: the 50 percent limitation on amount of external investment under the PRC Company Law, the 25 percent threshold for foreign ownership in JV projects, the restriction on the foreign ownership as per provisions in the PRC Foreign Investment Industry Catalogue, the legal requirement for the transfer of state owned assets, and the shares in listed companies that are not tradable in the stock exchanges.

First, the PRC Company Law provides that the parties to the share transfer in a PRC company must obtain the consent from other shareholders who make up more than 50 percent of the shareholders.[7] In addition, the shareholders who do not give consent to the transfer shall have a preferential option to buy the shares in question under like terms and conditions. In the case of an equity transfer in an EJV, the parties to the transfer must obtain the consent from all other parties to the JV.[8] Second, the Chinese tax rule provides that if the foreign ownership in an EJV is less than 25 percent, the FIE shall not be entitled to receive any preferential tax treatment. However, it does not follow that foreign investors can decide on the percentage of foreign ownership in a foreign project beyond the 25 percent threshold. Third, the Chinese government classifies foreign investment projects into four4 categories:

- encouraged,
- permitted,
- prohibited, and
- restricted ones.

Foreign investors are not allowed to invest in projects under the prohibited category. In respect of foreign investment projects falling into the restricted category, 100 percent foreign ownership will not be allowed. Depending on the industry sectors, foreign ownership in FIE may take the following percentages:

- 100 percent foreign ownership,[9]
- majority foreign ownership,[10]
- foreign ownership not exceeding 50 percent;[11] and
- in a JV with no party having majority ownership, the Chinese party should have the largest ownership percentage among several stakeholders in the JV.[12]

Fourth, if the state owned equity is a subject of the share acquisition or disposal in a JV, there is a legal requirement for the asset to be valued by designated state owned asset appraisal agents and the appraisal report has to be approved by the PRC State Owned Assets Supervision and Administration Commission (the SASAC) in accordance with the State Owned Asset Appraisal Regulations.[13] The requirement for approval on the transfer of state owned assets is separate and in addition to the approval the foreign investor has to obtain from the PRC Ministry of Commerce. Such requirement also applies to the transfer of state-owned non-tradable shares in listed companies.

Shares in listed companies are classified either as tradable shares and non-tradable shares. Tradable shares are Yuan-denominated A shares that are restricted for trading among local residents, and Hong Kong dollar denominated B share for trading by local residents and foreign investors. Both A-shares and B-shares are traded inside China. Shares in listed Chinese companies are also classified as S-shares, N-shares and H-shares if they are listed in Singapore, New York and Hong Kong. Non-tradable shares, which accounts for more than two thirds of the total issued shares in the listed companies, consist of state owned shares held by the Chinese Central government and local governments, and "legal-person" shares held by various state owned enterprises.[14] Non-tradable shares are not traded in China's regulated stock exchanges, instead, they are transferred either under private treaty or by public auctions.[15]

Foreign investors cannot have direct access to A shares. They can only acquire the shares through Qualified Foreign Institutional Investors (QFII). Transactions involving the transfer of tradable shares require reporting to the CSRC and issue of public notice if they meet the threshold of the notifiable transactions. If a single shareholder holding 30 percent of the issued shares would like to acquire additional shares, it has to make a general offer to all other shareholders in the listed company under the PRC Securities Law.[16]

III. Accounting and Tax Rules in Share and Asset Acquisition

Bearing in mind that both legal and tax considerations will affect our choices, let us look at the tax rules in terms of income tax, tax loss, tax base, and tax concessions. We also examine how the composition of the consideration will impact on tax, the difference between accounting and tax treatment, the issue of cash compensation arising in a non-currency transfer, and the turnover taxes in association with the transfers.

In both share and asset transfers, the transferor will in general be subject to income tax on the difference between the cash price and the tax cost of the shares or assets. Because share transfer only occurs at the shareholder level, it will not have a tax impact on the target company, its tax loss, or the tax base of assets. Share transfer will also have no impact on the tax concessions, subject to a percentage of foreign ownership requirement.[17] The transfer of assets will impact on the corporate income tax at the company level. The tax base (cost) will either increase or decrease after the transfer. Disposal of assets will not impact on the tax loss, and the tax concession granted to the target FIE, subject to a business-scope-change exception.[18]

If the consideration is in cash, the seller will be liable to income tax on the difference between the selling price and the tax cost of the asset. If the consideration is something other than cash, the PRC accounting and tax rules provide different treatments. The accounting rule for non-currency transactions shall be adopted if the FIE gives up one asset for another.[19] The acquiring company shall not recognise any profit or loss in connection with the transfer. It shall carry the acquired asset at the net book value of the asset given up. The accounting rules for non-currency transactions also apply in the exchange of non-cash assets for equity interest in the form of investment in other companies. The PRC tax rules do not work like this. Instead, the non-currency transaction is to be split into two separate transactions involving a disposal of assets at fair value on one side and an acquisition of assets at fair value on the other side. The seller will be liable to income tax on the difference between the fair value and the original tax cost of the assets, and the fair value is taken to be the tax cost of the acquired asset. Note that there is an exception: if the entire assets of a company or a division, the operating result of which is accounted for under separate accounting system, are swapped for the entire assets of another company or division, the income tax can be exempted subject to the approval of the tax authority.[20]

A transaction with cash payment may still be regarded as a non-currency transfer. The accounting rules for non-currency transactions shall apply in both situations: either the consideration wholly consists of non-cash assets, or the cash payment being less than 25 percent of the total amount of cash and non-cash consideration. Cash compensation arises because it is necessary to settle the difference between the fair value of the assets received and that given up. Whatever the reason for the cash compensation, the accounting rules recognise the profits that arise from the cash compensation in proportion to the book value of the assets given up over the total fair value of the assets given up.[21] The PRC tax rule does not recognise the profit arising from cash compensation. The transfer price for the disposal of assets on one side and the acquisition on the other side is determined by reference to the fair value. Otherwise double tax will arise because the tax base of the asset has been adjusted by the adoption of fair value.

If the consideration consists of cash, the transfer will not attract turnover tax like VAT or business tax. If the consideration consists of non-cash assets, there are turnover tax consequences. The acquiring company giving up assets in return for the economic benefits received in the form of equity shares in other company will be liable to turnover taxes under the deemed sales provisions.[22] VAT, and consumption tax if applicable, are payable if inventory or fixed assets are exchanged for equity interest in a JV or a domestic Chinese company. VAT at 17 percent will be imposed on the transferor by reference to the selling price or the average selling price of the same type of goods sold in the same month. There will be four percent VAT on the transfer of used fixed assets at above the original cost.[23] However, if the fixed asset is transferred at below the original cost, there will be no VAT liability.[24] A five percent business tax is payable if intangible assets are given up in exchange for the equity interest. The buyer giving up landed property in return for equity interest will be liable to land appreciation tax.[25] Both the buyer and the seller are subject to stamp tax with reference to the consideration as provided in the transfer agreement.[26] However, there is an exception. The transfer of non-cash assets to a company as capital contribution will be exempted from turnover taxes.[27] The Chinese tax law does not impose tax because the non-cash assets given up by the acquiring company is in the nature of undertaking risk in a business adventure, which is different from the supply of taxable goods and services as normal business transactions. Likewise, the transfer of landed property to the target company as capital contribution will also be exempted from land appreciation tax. The target company receiving the landed property will also be exempted from deed tax.[28]

IV. Accounting and Tax Rules in M&A

It is useful first to examine the provisions in the PRC Company Law for mergers and acquisitions:

1. the M&A must have the approval from two thirds of the voting shareholders for all PRC companies, and the approval from the provincial government for the transfer of equity interest in joint stock limited liability companies;[29]
2. the acquiring company takes up all the assets (rights) and liabilities (obligations) of the target company;
3. the protection of creditors' rights. The target company is required to notify the creditors and put up public notice for the acquisition. The creditors may either request the debts to be repaid or request the acquiring company to put up a guarantee for the amount of the unpaid debts.[30]

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Table 2				
	Accounting Rule Cash>25%	*Accounting Rules* Cash<=25%	*Taxable Transfer* Cash=>20%[a]	*Non-taxable Transfer Cash<=20%*[b]
Non-cash asset for equity investment	Fair value	NBV	Fair Value	Carry-over of book value in target company
Shares issued for net assets in a merger or absorption	Fair value	Fair value *	Fair Value	Carry-over of book value in target company
[a] The PRC Accounting Standard for non-currency transaction does not apply in merger and acquisition even if cash compensation falls below 25% of the total consideration. Instead of using net book value, fair value is adopted which is determined by the asset appraisal agents.				
[b] If cash compensation is less than 20% of the face value of the shares issued in exchange, the transaction is treated as a non-taxable transfer.				

The PRC accounting rule governing non-currency transactions shall not apply in cases of direct business acquisition involving absorptions and mergers. Instead, the acquiring company shall report the fair value of the acquired assets in the accounting books. Note that the PRC accounting treatment will differ from the tax treatment if the transaction is treated as a non-taxable transfer under which book value is adopted.

As discussed previously, a non-currency transaction may either be classified as a transfer with cash compensation or a transfer without cash compensation. Note that the consideration may consist of some cash but the transfer is still regarded as non-currency transaction so long as the cash portion does not exceed certain percentage in the total consideration.[31] The first reason for the consideration to contain cash payment is that the fair value of the assets received is not equal to the fair value of the assets given up. The second reason may be that some of the shareholders in the target company will not accept the new shares in the acquiring company. They request to receive cash and do not stay within the new shareholding structure. The acquiring company will pay cash to some shareholders and issue shares to other shareholders in the target company. If cash is paid in any merger and acquisition, the transaction is taxable for all purposes. If the acquiring company is to issue shares to settle the acquisition, then the tax implication on the transaction will vary according whether the share swap is classified as a taxable transfer or non-taxable transfer. The transfer will be treated as a non-taxable transaction subject to the following conditions being satisfied:[32]

- The acquiring company assumes all the assets and liabilities (net assets) of the target company in the non-currency transaction;
- Cash is paid to settle the difference between the fair value of the assets received and the fair value of the asset given up. Cash payment is less than 20 percent of the face value of the shares issued in exchange;[33]
- The taxpayer has to submit an application to the tax authority;
- The tax authority has approved the application.

If the conditions for a non-taxable transfer are not satisfied, the transaction is taxable in the same way as we mentioned in the case of the exchange of assets for equity investment in a JV or subsidiary. If the transaction satisfies the conditions for a non-taxable transfer, it has the following tax impact: first, the transferor need not recognise the gains from the disposal of assets. The tax cost of the old shares will be used as the tax base for the new shares, thus effectively putting off the income tax liability of the shareholders in the target company. The acquiring company shall adopt the book value of the acquired asset as the tax base of the assets taken up.[34] Second, if there are any tax losses, they can be carried over from the target to the acquiring company for use over the unexpired period in proportion to the fair value of acquired assets to the fair value of the combined assets after the acquisition. Third, if the acquired company has been granted any income tax concession, the acquiring company can use it in the same manner and to the same extent as that for tax loss.

We shall also take into account the turnover taxes. If the consideration is in cash there will be no turnover tax implications. If the consideration is in shares, the Chinese tax rules specifically exempt the parties from business tax liability in the acquisition involving non-currency transactions on same grounds as we mentioned previously in the exchange of non-cash assets for equity investment.[35] Note that the exemption from turnover tax is granted automatically under the law meaning that there is no requirement to apply for administrative approval, but the income tax exemption is not automatically granted. The taxpayer must submit the application and obtain the approval from the tax authorities. If the taxpayer does not submit the application, the transfer is taxable under all circumstances. The rules are summarised in Table 2 above.

V. Planning and Structuring an Acquisition

A. Types of Acquisition

Business acquisitions in China can be classified as direct acquisition and indirect acquisition. Direct business acquisition can further be divided into acquisition by absorption, in which the acquiring company absorbs one or more target companies, and acquisition by merger, in which two or more target companies are merged into a new one. Indirect business acquisition usually takes the form of QFII, investment in JV, or wholly owned subsidiaries.[36]

Direct acquisition can only take place inside China. Indirect acquisition can either take place within China, in which a PRC-domiciled holding company is to acquire the equity interest in a target company, or take place across border, in which a non-PRC domiciled company acquires the equity interest in the target inside China. Different legal rules shall apply to cross-border and domestic acquisitions respectively.[37] As is mentioned earlier in this article, the Chinese firm may be classified according to different type of ownership. Accordingly different legal rules shall apply for different acquisition targets, which may be FIEs or non-FIEs such as domestic Chinese companies,[38] or state owned enterprises.[39]

B. Choices Between Direct and Indirect Acquisition

It is useful to contrast the differences between a direct business acquisition and an indirect acquisition. In a direct business acquisition, the corporate identity of the target company ceases to exist and they are usually dissolved afterwards.[40] In an indirect acquisition, the corporate identity of the target company will continue to exist and a holding-subsidiary company structure shall emerge afterwards. Second, direct business acquisition can only take place inside China while indirect business acquisition can either take place inside China or across the border. Third, if the acquisition is by way of investment in JV or subsidiary, then the investment should not exceed 50 percent of the net assets in the acquiring company. But direct acquisition can get around such a restriction. Fourth, an FIE obtaining the status of high and new technology enterprise receives tax incentive in the form of lower income tax rate. If the FIE is dissolved after a direct acquisition, its independent taxpayer status no longer exists. Then it is not sensible to choose direct acquisition. Instead, acquiring the equity of the target company through indirect investment could retain the lower income tax rate afterwards. Fifth, check whether the name of the target company is to be in use after the acquisition. If yes, the acquisition could only take the form of indirect acquisition. Otherwise, the name of the target will cease to exist following a transfer of net assets to the acquiring company in a direct acquisition. If there is a name change following a direct business acquisition, then there is a requirement to make changes to all business contracts and employment agreements previously entered into by the target company. There is no such requirement in an indirect business acquisition, in which the name of the target company remains in use and unchanged.

C. Legal and Tax Considerations

Again one needs to consider the legal framework in planning an acquisition. First, one should check which category the proposed foreign investment project should fall into under the PRC Foreign Investment Industry Catalogue. If the target is engaged in activities falling into the restricted category, there are restrictions on the percentage of foreign ownership. If the target is engaged in encouraged activities, then a wholly foreign owned enterprise is no problem. Second, check the types of administrative approvals required. The division of authority in the Chinese government is as follows: the PRC State Development and Reform Commission (the SDRC) grants approval on the project and the feasibility report; the Ministry of Commerce grants approval on the JV contract and articles of association. If the size of the acquisition is large, one needs to obtain project approval from the SDRC or even the PRC State Council. Otherwise one can obtain the approval from the SDRC office at the provincial government level or below. If the target company operates in an industry sector regulated by other ministries than the Ministry of Commerce, then one needs to obtain additional administrative approval. Third, check whether state owned assets regulations should apply. If the target company is owned by the PRC government, then one needs to obtain the approval from the State Owned Assets Supervision and Administration Commission. In the absence of approval from the SASAC, the transfer agreement will not become valid. Fourth, check the relevant provisions in the PRC Company Law to ensure that the required percentage of consent is obtained from the investors. Fifth, check whether the acquisition takes place inside the PRC or across border. Different legal rules for domestic and cross-border acquisition shall apply. Sixth, check whether there is any financing arrangement for the acquisition. If yes, whether there are applicable foreign exchange regulations. Finally if the proposed scale of business acquisition is large, also check whether there is any anti-monopoly legislation in place in that particular industry sector.

The scope of tax consideration includes short and long tax position, the tax rules in the PRC and home jurisdiction, the ownership nature of the target company, the form and composition of the consideration, and the source of funds to finance the M&A.

Income tax, tax concession and tax loss will have impact in the short term while tax on dividend and income tax rate will impact on the operating results in the longer term. First, dividends distributed by the FIE are exempted from income tax. One should check whether the dividend is taxed in the home jurisdiction. If yes, whether it is taxed on receipt basis or on as-earned basis. Different company structure may be adopted depending very much on the home tax rules. Second, one should ask whether there is any unilateral credit at home for tax paid in China or bilateral credit in place between China and the home country. If there is a bilateral tax treaty, check whether both the acquiring company and the target company satisfy the requirement for tax residents. If yes, then check whether there is both direct credit and indirect credit in the bilateral credit. Direct credit applies to dividends flowing between the treaty countries. Indirect credit goes one level down. It applies to the income that is exempt at the company level and creditable against the income reported in the home country. Third, if there is bilateral credit, then whether there is any tax sparing provision in place. If there is, the foreign investor will benefit from the tax saving in the form of tax concession or lower income tax rates. If there is none, the tax saving will go to the state coffers in the home country of the foreign investor – what is exempted from tax in China will become taxable in the home country in which the foreign investor is tax resident. If there is tax-sparing credit, one needs to find out whether the tax-sparing credit shall apply indirectly to the business profits at the company level. If there is, the foreign investor will benefit from the tax saving. Note that in the Sino-U.S. double tax agreement, there is no tax sparing credit provision, so there is no point in raising the issue of tax concession and lower income tax rates to U.S. investors.

The ownership nature of the target company may have different income tax implications. Foreign investors may target the acquisition to equity interest in the FIE, or the equity interest in non-FIE (state owned enterprises, and the shares in privately owned companies). In general the PRC tax rules provide that acquisition of equity in existing companies or enterprises is not regarded as new foreign investment project and therefore no preferential tax treatment shall be granted.[41] However, there is an exception. The PRC tax rules provide that foreign investors that acquire equity interest in state owned enterprises or privately owned companies are treated as new projects and being eligible for preferential tax treatment.[42]

The foreign investor who plans to acquire the equity interest in PRC companies or enterprises can structure the form and composition of consideration to take advantage of the relevant tax provisions. The consideration may be divided into cash and non-cash considerations. Non-cash consideration can further be divided into tangible assets, like inventory and production equipment, and intangible assets like land use

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rights or IP rights.[43] Depending on the percentage of cash payment in relation to the total fair value, the transaction can be classified as being non-taxable subject to administrative approval.

D. Financing

First, an acquisition may be financed by debt or equity. If the debt financing is adopted, one has to check whether the company is over-borrowed. The PRC law imposes on the FIE a maximum amount of borrowing,[44] which is defined as the difference between registered capital and the amount of total investment. If it has not been exceeded, then it can go ahead with debt financing. Second, if the loans are solely used to finance the investment, then the interest payment will not be deductible again the income because the dividend received from invested company is exempt from tax.[45] Note that the dividend income is taxable for domestic companies, and therefore the interest expenses are deductible against the taxable income. The tax rules on the deduction of interest expenses as mentioned here are different between domestic and foreign investment enterprises. Third, indirect business acquisition may be financed by borrowing inside China or across border. If cross-border borrowing is chosen, the debt is denominated in foreign currency. There is a legal requirement to obtain approval from the approval authority in the case of an equity transfer in an EJV or CJV by way of foreign currency loans. However, there is no requirement to obtain the approval in the case of an equity transfer for the WFOE involving foreign currency loans. Fourth, the FIE should register the loan agreement at the local office of the State Administration of Foreign Exchange (SAFE) if the loan is denominated in foreign currency. Otherwise when the loan is later redeemed, the principal cannot be repatriated outside China for want of registration. Last, the source of financing the acquisition may come from retained earnings or injection of capital. If the source of finance is by way of a capitalisation of retained earnings, there will be income tax on the Chinese party in the JV. The Chinese law provides that the bonus issue will be treated as a dividend. The foreign party however will be exempted from income tax on dividend. Furthermore, if the capitalisation is used to finance the acquisition of equity interest in domestic Chinese company, the foreign investor shall be eligible for income tax refund for the re-invested profits.[46]

E. Payment

Payment is an important condition for closing the deal. Foreign investors who acquire equity interest in domestic company shall pay the consideration within the period as prescribed under the Chinese law. Different payment schedules shall apply depending upon whether it is an acquisition or a new project. If it is an acquisition of interest in domestic enterprises or state owned enterprises, the purchaser must pay up all the considerations within three months from the date of the newly granted business licences. For a new project or the acquisition by way of an increase in the amount of the registered capital in the target company, the payment of capital contribution is subject to different requirements. If it is made in a lump sum, it must be paid within six months from the date the business licence is granted. If the importation of capital is made by instalments, then the payment should be made according to the schedule as provided in the JV contracts and Articles of Association. 15 percent of the total capital contribution has to be fully paid up within three months.[47] The payment may be made in convertible foreign currency or in local currency. If in foreign currency, the foreign investor must directly import the cash capital into China. Very often a party who has the legal relationship with the foreign investor makes the payment on its behalf. For example, the payment may be made by the shareholder, or a fellow subsidiary under the common control of the shareholder in a group of companies. Such arrangement will not be legally acceptable as capital importation by the foreign investor. Payment in local currency may come from the retained earnings of the FIE or from other sources, subject to approval by the SAFE. The capital contribution in local yuan may take the following forms:[48]

1. The capitalisation of the development funds, the reserve funds (capital reserve or revenue reserve) of the existing FIE;
2. The transfer to the capital account from the unappropriated profits, dividends payable, and the interest payable on outstanding dividends;
3. The principal of the duly registered foreign currency loans, and the interest payable on the loans;
4. The amount from the return of capital prior to the termination of the FIE, the amount realised from liquidation, the transfer of equity interests, and the reduction of capital in the FIE within the Chinese territories.

VI. Summary

We have dealt with the PRC Company Law and EJV law, the accounting, tax and foreign exchange regulations in connection with business acquisitions. Business acquisition in the PRC requires a thorough consideration of many factors that include an examination of the current legal and tax rules issued from different sources, by the authorities at different levels, the applications of those rules in the FIE sector or in the non-FIE sector, the application of those rules in domestic and cross-border acquisition, and the interaction between those rules. We have also examined the limitations as imposed under the Chinese rules, and compared different options and probably found the ways to deal with those legal restrictions. In this article, we have analysed extensively what would happen to the target company if one is going to do this or that among available options. But one must not overlook what has already happened to the target companies, especially in areas of tax compliance. It is not uncommon that the tax preferential treatment has been granted ultra vires, or the target company has kept multiple sets of accounting records for some reason or other. Accordingly the target company usually under reports its tax liabilities intentionally or unintentionally. Because of the diversity and complexity in the Chinese rules, the importance of extensive legal and tax due diligence cannot be over-emphasised, and that can not be covered in this article for space reasons.

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1 The Ministry of Commerce of the PRC is the approval authority in the change of JV contract for the foreign investmententerprise. Article 3 of the PRC Law for Sino-foreign Equity Joint Venture Enterprises refers.

2 The PRC Company was enacted in December 29, 1993.

3 Article 12 of the PRC Company Law, 1994. It is reported that the 50 percent ceiling is to be lifted upward pending an amendment by the National People's Congress or its Standing Committee when the NPC is not in session.

4 Article 18 of the PRC Tax and Exemption Measures and Customs Supervision on Import-export Goods of the Foreign Investment Enterprises, the PRC General Administration of Customs, July 25, 1992.

5 Article 35 of the Detailed Implementation Regulations of the PRC Law for Wholly Foreign Owned Enterprises, approved on October 28, 1990 and amended on April 12, 2001 by the State Council

6 August 6, 2004, China Daily

7 PRC Company Law, Article 35 refers. Note that the requirement for shareholder consent in a share transfer is different from that in a merger and acquisition in which the consent of two thirds of the voting shareholders must be obtained as per Article 39 of the PRC Company Law.

8 Article 20, the Implementation Regulation of the PRC Law for Sino-foreign Equity Joint Venture Enterprises

9 As per the Administrative Measures of the Commercial Sectors for Foreign Investments, Circular (2004) 8, Ministry of Commerce, the wholesale and retail distribution sector is fully opened to foreign investment after December 2004

10 As per the Tentative Measures for Provision of Cinema Services by Foreign Investment Enterprises, Ministry of Commerce, State Administration of Radio, Film and Television, and Ministry of Culture, November 25, 2003, majority foreign ownership is allowed in the Cinema service after December 31, 2003.

11 As per the Administrative Measure of the Foreign Investment Telecommunication Enterprises, Decree No. 333, the State Council, December 31, 2001, foreign ownership shall be increased to no more than 50 percent in value-added telecommunication service after December 31, 2001.

12 As per the Provisions of Foreign Investment in Civil Aviation Industry, China Administration of Civil Aviation, State Reform Development Commission, and Ministry of Foreign Trade and Economic Co-operation, 1st August 2002, only the Chinese party is permitted to have the largest ownership percentage in companies operating in the Civil Aviation Industry sector.

13 Decree No. 91, State Council, November 16, 1991

14 June 14, 2005, China Daily

15 On April 29, 2005, the China Security Regulatory Commission announced pilot programs to end the split share structure and eliminate the trading right difference between tradable and non-tradable shares.

16 Article 81, the PRC Securities Law

17 Article 4 of the EJV law. If the foreign ownership falls below 25 percent, it is not entitled to receive any tax preferential treatments.

18 If an FIE disposes of a large portion of its productive assets to the extent that it is no longer treated as a production type FIE, then it will not be eligible for the tax concession previously granted.

19 See circular Cai Hui (2001) 7, the Ministry of Finance. Non-currency transaction occurs in following circumstances: exchange some assets for other assets; business acquisition; and company re-structuring.

20 Guo Shui Han (2002) 420, and Guo Shui Han (2002) 165, State Administration of Taxation

21 Profit recognised = Cash compensation * (1 – book value of assets given up / fair value of assets given up), See Circular Cai Hui (2001) 7, the Ministry of Finance

22 See Article 4 of the Detailed Implementation Rules of the PRC VAT Tentative Regulations.

23 See Cai Shui (2002) 029, jointly promulgated by the Ministry of Finance and the State Administration of Taxation. The VAT is reduced by half from four percent to two percent.

24 Circular Cai Shui (2002) 29, State Administration of Taxation

25 Deed tax will be payable by the target company in receipt of the landed property.

26 The Chinese law provides that the parties to the agreement for the transfer of shares or landed property shall pay scale charges for statutory notarisation.

27 Guo Shui Han (2002) 420, and Guo Shui Han (2002) 165, State Administration of Taxation

28 Cai Shui (2003) 183

29 Article 183, The PRC Company Law

30 Article 184, The PRC Company Law

31 25 percent to the total consideration if the consideration consists of assets other than shares, and 20 percent to total face value of shares if the consideration consists of shares.

32 Guo Shui Fa (1997) 71, State Administration of Taxation

33 The 20 percent requirement is different from the 25 percent on the fair value of the non-currency transaction under the PRC accounting rules.

34 Note that the adoption of book value is a departure from international practices which use original tax cost.

35 Circular Cai Shui (2002) 191, Ministry of Finance and State Administration of Taxation

36 Qualified Foreign Institutional Investors (QFII) are permitted to invest in the A-shares in domestically listed companies subject to 10 percent restriction imposed on the equity investment by a single QFII in a single listed company, and 20 percent restriction by all the QFII in a single A-share listed company.

37 (i) Tentative Measures for the Acquisition of Domestic Enterprise by Foreign Investors, promulgated on 7th March 2003, effective as from April 12, 2003.

(ii) Tentative Measures for Domestic Investments by Foreign Investment Enterprises, promulgated on July 25, 2000 by Ministry of Foreign Trade and Economic Co-operation and the State Administration of Industry and Commerce

38 (i) Measures Government the Mergers and Spin-off among Foreign Investment Enterprises, jointly promulgated by the Ministry of Foreign Trade and Economic Co-operation and the State Administration of Industry and Commerce, on November 22, 2001 effective on November 22, 2001.

(ii) The Tentative Measure Governing the Acquisition of Domestic Companies by Foreign Investors, jointly promulgated by the Ministry of Foreign Economic Trade and Co-operation and the State Administration of Industry and Commerce, on July 25, 2000 effective on September 1, 2000.

39 The Tentative Measure Governing the Re-organisation of the State Owned Enterprise by Using Foreign Investment, promulgated by the State Economic and Trade Commission, on September 14, 1998.

40 The target company can also be kept alive after the acquisition. But they just become cash holding companies.

41 Circular Guo Shui Fa (1997) 071, State Administration of Taxation

42 Circular Guo Shui Fa (2003) 60, State Administration of Taxation

43 The IP rights cannot exceed 20 percent of the registered capital. Article 24 of the PRC Company Law

44 Article 11, the Tentative Measures for the Merger and Acquisition of Domestic Enterprise by Foreign Investors, promulgated on March 7, 2003, effective as from April 12, 2003.

45 Article 19, the PRC Tax Law for Foreign Investment Enterprises and Foreign Enterprises

46 The Circular Guo Shui Fa (2003) 60, State Administration of Taxation

47 Article 9, the Tentative Measure Governing the Merger and Acquisition of Domestic Enterprises by Foreign Investors, promulgated on March 7, 2003, effective on April 12, 2003.

48 The Circular (2003) 30 issued by the State Administration of Foreign Exchange.

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