世民律師事務所 SHIMIN LAW OFFICES

# Introduction on a Tax Law Case Concerning Overseas Merger

## i. Facts

On September 29th 2005, Italy Ilva Saronno lnvestment Company Limited (hereinafter referred to as "Italian IC"), officially approved by the Cooperate Office of Foreign Trade and Economy of Shandong Province, acquired for an consideration of RMB 481,424,260 yuans 33% out of Yantai Zhangyu Group Company Limited (hereinafter referred to as "Yantai Zhangyu Co") equity shares.

On July 17th 2012, Italy Ilva Saronno Holding Company (hereinafter referred to as "Italian HC") and Italian IC, accordingly and respectively to a resolution of the General Shareholders' Meeting, decided to carry out a merger: Italian HC accepted Italian IC's whole capital and responsibility, among those including Yantai Zhangyu Co's 33% equity shares.

After the merger operation, on November 21st, 2012, Italian IC was legally deregistered, thus Italian HC being the direct holder of Yantai Zhangyu's aforementioned shares.

On July 17th, 2012, Italian HC informed Yantai Zhangyu Co by letter, explaining the circumstances and mechanisms of the operated merger. Italian HC considered, in accordance with t*he Notice of the Ministry of Finance and State Administration of Taxation on Certain Issues Concerning the Handling of Enterprise Income Tax in Enterprise Reorganization* (hereinafter referred to as *Cai Shui [2009] No. 59*)[1], that according to the general rules of enterprise reorganization regarding merger operation[2], they would enjoy the conditions of a preferential treatment by the tax administration;

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[1] Article 5 of *Document Cai Shui [2009] No. 59*：
Special taxation provisions shall be applicable when enterprise reorganization satisfies the following conditions simultaneously:
(1) Having reasonable business purpose without taking deduction, exemption or deferment of tax payment as the primary purpose.
(2) The proportion of the assets or equity purchased, merged or separated confirms to the proportion prescribed by this Notice.
(3) Maintaining the original substantive business activities for 12 consecutive months after the enterprise reorganization.
(4) The amount of payment of equity interests involved in the consideration in reorganization confirms to the proportion prescribed by this Notice.
(5) The original main shareholders who have obtained the payment of equity interests in enterprise reorganization may not, within 12 consecutive months after the reorganization, transfer the equity obtained.

[2] Article 1 of *Document Cai Shui [2009] No. 59*：
The term "enterprise reorganization" mentioned in this Notice means transactions other than an enterprise's daily operation activities, which greatly change its legal structure or economic structure, including change of legal form of enterprise, debt reorganization, equity acquisition, asset acquisition, merger, split-up, etc.
(3) "Equity acquisition" means a transaction that an enterprise (hereinafter referred to as the "acquiring

hence, this very one transaction shall not be subject to tax.

The State Administration of Taxation of Shandong Province, Yantai City, Zhifu District (hereinafter referred to as "Zhifu SAT") considers that aforementioned merger essentially establishes a direct transfer of the equity interest and this very transfer's price fails to conform to the independent trading principles; according to the People's Republic of China's Taxation Legal Regulations in force, this very one transaction would be subject to tax. On September 9th 2013, the State Tax Administration of Yantai released a notice (2013 No. 002) concerning tax issues on the basis of the stipulations of article 7 of the Guo Shui Han [2009] No. 698 , carrying out a tax adjustment based on Yantai Zhangyu Co's net assets (RMB 2, 863, 169, 524.88 Y) dated Jun 30, 2012, and Italian HC was required to pay the enterprise income tax RMB46,342,168.32 before September 25th, 2013. On September 22th, the required amount of RMB 46, 342, 168.32 Y was paid by the plaintiff.

Nevertheless, Italian HC remained unconvinced by the above-mentioned notice, and demanded its administrative reconsideration by the National Administration of Taxation of Shandong Province, Yantai City (hereinafter referred to as "Yantai SAT) on Nov.20, 2013, with the purpose to have it revoked. After the reconsideration, above-mentioned notice was maintained by Yantai SAT.

Italian HC still disapproved such a statement, bringing an administrative case on April 24th 2014 to the People's Court of Shandong Province, Yantai District, Zhifu District (hereinafter mentioned to as "Zhifu Court") in order to ask for the cancellation of the State Tax Administration of Yantai Notice and the refund of paid enterprise income tax.

### ii. The Key Points of the Judgment

According to Zhifu Court, this lawsuit raises three contentious key points: the first point is to decide whether the reorganization of this transaction should be considered as a merger or a transfer of equity shares. The second point is to verify if the aforementioned reorganization complies with the rules of preferential tax treatment stipulated in Document No. 59 of the Ministry of Finance. Finally, the third point is to know whether the plaintiff, based on the Sino-Italian Tax Agreement and the Sino-Finnish Investment Agreement's most favored nation trading status stipulations, shall enjoy preferential tax treatment during this very transaction. [3]

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enterprise") purchases equity interests of another enterprise (hereinafter referred to as the "target enterprise") for the purpose of controlling the target enterprise. The payment of consideration by an acquiring enterprise may be in the form of payment of equity interests, payment of non-equity or combination of both.

(5) "Merger" means that one or more enterprises (hereinafter referred to as the "merged enterprises") transfer all of its or their assets and debts to another existing or new enterprise (hereinafter referred to as the "merging enterprise"), and the merged enterprises obtain in return the payment of equity interests or non-equity interests from the merging enterprise, thereby realizing the legal merger of two or more enterprises.

[3] In accordance with the first item of Article 3 of *Agreement between the Government of the People's Republic of China and the Government of the Republic of Italy Concerning the Encouragement and Reciprocal Protection of Investments*：
The treatment accorded to the investments by nationals or companies of either Contracting Party (in the territory of the other Contracting Party) shall not be less favorable than that accorded to the investments by nationals or companies of any third State.
the second item of Article 3 of *Agreement between the Government of the Republic of Finland and the Government of the People's Republic of China on the Encouragement and Reciprocal Protection of Investments*：
Each Contracting Party shall accord to investments by investors of the other Contracting Party treatment no less favorable than the treatment it accords to investments by its own investors with respect to the operation,

Following the hearing, the court delivered its conclusion regarding the first issue: in accordance with the relevant documents provided by the plaintiff, the Italian IC to the Yantai SAT on March 4th, 2013, the subsidiary of the plaintiff, Italy IC only holds the equity interest in Yantai Changyu Company. The main assets of the Italian IC is the equity investment for Yantai Changyu Company. This merger directly causes the shareholders of the Yantai Changyu Company to become the plaintiff instead of the Italian IC; thus, the plaintiff realizes the direct control over the Yantai Changyu Company. Therefore, the defendant, Zhifu SAT correctly regarded this transaction as a legal equity transfer. Besides, *the announcement [2013] No. 72* of the State Administration of Taxation promulgated on December 12nd ,2013, demonstrated that the circumstances in which the equity of Chinese resident enterprise is transferred due to merger of overseas enterprises be categorized as the equity transfer, which further proves the legitimacy of defendant's opinion.

For the second issue, although the plaintiff's overseas equity transfer is in compliance with Article 5 of *Cai Shui [2009] No. 59* concerning the application for preferential tax treatment, Article 7 of *Cai Shui [2009] No. 59* has also stipulated the rule that if an enterprise is involved in an equity or assets acquisition transaction between inside and outside Mainland China and abroad (including Hong Kong, Macao and Taiwan), which and, in addition to the conditions prescribed in Article 5 of this Notice, the following requirements must be satisfied so that preferential tax treatment may be applied:(1) when a non-resident enterprise transfers equity interest of a resident enterprise it owns to another non-resident enterprise under its wholly direct control. That is the situation when "the parent company transfers equity interest in a resident enterprise to its subsidiary company". However, the plaintiff's situation is that "the subsidiary company transfers equity interest it holds to its parent company" [4]. Therefore, the plaintiff Italian HC shall not enjoy the preferential tax treatment regulated by Cai Shui [2009] No. 59. The tax notice issued by Zhifu SAT in accordance with *Tax letter [2009] 698* satisfies the legal requirements.

For the third issue, with respect of the "Law of the People's Republic of China on Enterprise Income Tax" and "Regulations on the Implementation of Enterprise Income Tax Law of the People's Republic of China" and Tax letter [2009] 698, the act of taxation for equity transfer, the application for domestic resident enterprises and overseas non-resident enterprises and the application

management, maintenance, use enjoyment, expansion, sale or other disposal of investments that have been made. In this case, Italian holding company holds the opinion that special taxation provisions shall be applicable as he believes he should enjoy the treatment for investing in China no less than the treatments Finland (the third country) enjoys, which is no less than the treatments Chinese investor enjoys.

[4] The conditions for applying the preferential tax treatment provisions shall be well noted. Whether the preferential tax treatment provided by Document Caishui（2009）59 regarding reorganization of enterprises is applicable shall not be generalized but shall be treated differently. It depends especially on whether the Article 7 of Document Caishui （2009）59 is applicable or not.

With respect to the equity and asset acquisitions between inside and outside China, the preferential tax treatment provisions shall be applied in circumstances that both the transferor and transferee are non-resident enterprises only if the requirements stipulated in article 5 and Item1, Article 7 of Document Caishui（2009）59 are satisfied. ; meanwhile, it is important to note that Item1, Article 7 which stipulates that the transferee shall be the transferor's subsidiary under its wholly control refers to the condition that the parent company transferring equity interest to the subsidiary, but not include the condition that the subsidiary company transferring equity interest to the parent company. This case is about the subsidiary Italian investment company transferring equity interest to the parent company Italian holding company which does not fall under the circumstance stipulated in Item1, Article 7 of Document 59, therefore, the preferential tax treatment provision shall not apply.

among overseas non-resident enterprises in any country are consistent identical, without any discrimination. In the law system of China Enterprise Income Tax Law, although China has formulated the provisions on the administration of collection based on special characteristics of non-resident enterprises, which is recognized as the world convention, it shall not be deemed as discrimination discriminatory against plaintiff non-resident enterprises.

In conclusion, the Zhifu Court deemed that, in connection with the notice (2013 No.002) concerning tax issues made by the defendant, Zhifu SAT, the facts are clearly ascertained and the laws correctly applied with procedures conducted in compliance with relevant laws and regulations. Therefore, the plaintiff's request for withdrawal shall be rejected, rather than being supported. Its request for returning the paid tax was lack of both legal basis and tangible facts and thus shall be denied.

So far, whether the Italian HC has appealed this lawsuit to the higher court is unknown. However, we will continue to follow up with any development of this case.

### iii. Explanations

First of all, the merger was carried out in Italy in accordance with related provisions of Italian Corporate Law[5], and the alteration of foreign investor of Chinese domestic enterprises will also be proceeded in accordance with Italian Tax Law. Secondly, from the perspective of China Corporate Law and other relevant laws and regulations, in accordance with 1997's "*Certain Provisions on Alteration of the Equity Interests of the Investors of a Foreign-Invested Enterprise*", a "Merger of any Investor of the Enterprise" is a special kind of "Alteration of the Equity Interests of the Investors of a Foreign-Invested Enterprise", which is clearly distinguished from the "Transfer of Equity Interests". In case of a merger, the successor shall inherit the equity interest of former investor and carry out the formalities of altering the investors. The contentious points of this case is how to deal with the tax issues concerning the Chinese company reorganization when the foreign enterprise successor inherited the equity interest of the Chinese subsidiary held by the original foreign investor as a result of the merger of the foreign enterprises. That is whether the successor shall, under those circumstances, enjoy preferential tax treatment. Should the reorganization be deemed as a merger or a transfer of equity interest? We will clarify this controversy point as follows.

Document Caishui （2009）59 provided special regulations regarding cross-border acquisition of equity interest. However, it is not clearly stipulated in this document regarding the rules for the foreign enterprise successor inheriting the equity interest of the Chinese subsidiary held by the original foreign investor as a result of the merger of the foreign enterprises. Although the draft of clear principles is desirable, it is also rather difficult to find crystal-clear regulations on practical

[5] In China, the merger carried out in accordance with related provisions of Italian corporate laws itself will not cause controversy. As it is recognized as the premise of equity transfer in China's tax system, it can be assumed that the Italian holding company who received the equity interest of domestic enterprise is taxed in China on the premise that the tax obligation of Italian Investment Company (transferor) was inherited by the Italian holding company due to the merger.

issues. Although foreign legal regime of cross-border mergers shares a lot of similarities with Chinese legal regime of mergers, they are not completely identical. For instance, in some countries, a merger may be conducted in a much more flexible way compared with that in China. Tax law attaches great importance both to the form and the substance, which makes things even more difficult. Under those unclear circumstances, local administrations of taxation in various parts of China may have different opinions regarding whether preferential tax treatment shall be applied, thus failing to provide rational explanation to clarify the doubts of foreign enterprises. The cross-border enterprise, after the merger being carried out abroad, will still be in the unstable condition that the tax relationship regarding the alteration of investors of Chinese subsidiary being unable to be determined.

In this case, the overseas enterprise, as the plaintiff, claims that this is the merger in *Cai Shui [2009] No. 59.* In order to enjoy the special treatment, namely preferential tax treatment, the plaintiff has no other choice but to claim this is the enterprise reorganization expressly approved, i.e. the merger. If the merger is not within the conditions expressly approved, the plaintiff cannot claim for the preferential tax treatment. The mergers in *Cai Shui [2009] No. 59* include not only the merger between Chinese enterprises, but also the merger between overseas enterprises. The court upheld the decision by the Zhifu SAT that this is a direct transfer of equity shares instead of a merger.

The main reasons supporting the opinion that it is a transfer of equity shares are as follows: the transaction is an equity transfer in nature because the overseas merged party only holds the shares of domestic enterprise and is not involved in other business activities. In other words, the essential characteristic of the merger is the succession of all assets and liabilities related to business. The object of the succession in this case is the equity shares of Chinese subsidiary. Therefore, it is regarded as the equity transfer though the legal form is a merger.

The other reason is the publication and implementation of a new regulation after the merger in this case*. The Announcement [2013] No. 72* of the State Administration of Taxation is to clarify how to apply the preferential tax treatment regulated in Article 7 (1) and Article 7 (2) (that is, cross-border equity transfer) of *Cai Shui [2009] No. 59.* Article 1 thereof explicitly stipulated that the circumstances under Article 7 (1) of *Cai Shui [2009] No. 59* (where a non-resident enterprise transfers equity of a resident enterprise it owns to another non-resident enterprise under its wholly direct control) include the circumstances where the equity of Chinese resident enterprises is transferred due to division or merger of overseas enterprises. [6]According to this new regulation, it has been expressly recognized that the alteration of investor of Chinese resident enterprises due to merger of overseas enterprises is categorized as the equity transfer, rather

[6] With respect to the effective period of Announcement [2013] No. 72 of the State Administration of Taxation, this Announcement shall come into effect on the date of promulgation in accordance with article 10 of Announcement [2013] No. 72 of the State Administration of Taxation. The matters relating to the application of special tax settlement to the equity transfer by non-resident enterprises that occurred before the effectiveness of this Announcement but have not yet settled shall be handled according to the provisions of this Announcement. Although the merger of Italian holding company was carried out in 2012, this case was still not settled in2013. Therefore, Announcement [2013] No. 72 may be applied.

than a merger in *Cai Shui [2009] No.59*. However, this new regulation has not clearly explained the following two circumstances. The first one is that whether the overseas merger causing the change of investors in resident enterprise can be considered as the equity acquisition but not the merger. (wether the merger in *Cai Shui [2009] No.59* only refers to the merger in domestic enterprises.) The second is that if the overseas merger can lead to such investor change for Chinese resident enterprise, which could be regarded as an equity merger or an equity acquisition, what is the difference between these two circumstances is. For example, it is not clear how to deal with the circumstance of the overseas combined party not only holds the equity of domestic enterprise but also engages in other business activities (That is, in addition to the equity of Chinese subsidiary, it also inherits the assets and liabilities related to business abroad). The judgment as mentioned above is based on the conclusion that it is an equity transfer but not a merger, by reason that this reorganization is essentially a equity transfer. So, it doesn't have the explanation of the new regulation which is not clear for the scope of application. After the new regulation takes effect, it is still in an unstable state whether a merger of foreign enterprises will be taxed or not.

However, considering the written endorsement for dealing with this case as an equity transfer instead of a merger in accordance with the *Cai Shui [2009] No. 59*, local tax authority may be more inclined to give broad interpretation for the unclear scope of application to the new regulation and thus reject the application for the preferential tax treatment. Originally preferential tax treatment shall not be granted on a routine basis, but rather shall be granted on the basis of some exceptional policy reason. From the local tax authority's perspective, if the delay for the taxation is accepted, the receipt of tax will also be postponed. Since the taxation for the overseas enterprises is more difficult than that for the Chinese domestic enterprise, they will consider collecting tax when they confirm capital gain from this equity transfer. This different treatment between domestic reorganization and overseas reorganization as this case mentioned above has also been recognized in foreign countries. In addition, even if the overseas combined party not only holds the equity of domestic enterprise but also engages in other business activities (which means, in addition to the equity of Chinese subsidiary, the combining party also inherits the assets and liabilities related to business abroad), from the Chinese local tax authority's perspective, the merger could easily be re-categorized as an equity transfer, because among the gains of the non-resident enterprise sourced from China only the gains derived from equity transfer may be subject to taxation in case of an overseas merger. We need to pay close attention to the development of rationale for solving this issue, especially awaiting the explanation given by the central tax authorities to unify the understanding of the local tax authorities in different regions of the country (even if there may still be some defects).