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Taxation of M&A Transactions in China

The State Administration of Taxation has resolved one outstanding issue affecting foreign-related M&A. The Interim Provisions on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors, issued March 7, 2003 and effective April 12, clarified the rules and opened the door wider to foreign investment through M&A, as opposed to greenfield investments, whether through the purchase of equity interests from existing investors or the contribution of fresh capital. However, the post-transaction tax status of the enterprise remained unclear.

The Notice Concerning Tax Assessment Issues Relating to Foreign Investors Merger and Acquisition of Equity Interests in Domestic Enterprises, Guoshuifa [2003] No. 60, issued on May 28, 2003 with effect retroactive to January 1, has affirmed that such enterprises will be treated in the same way as greenfield foreign-invested enterprises ("FIEs") for purposes of enterprise income taxation. Thus, if the proportion of equity held by foreign investors after the transaction exceeds 25% (arguably 25% or more to be consistent with the laws on joint ventures and other forms of foreign investment), the enterprise shall thenceforth be treated in accordance with the taxation laws generally applicable to FIEs with such level of foreign investment.

Such laws make qualifying FIEs eligible for various preferences, especially a two-year tax holiday followed by a three-year 50% tax mitigation period beginning with the FIE's first profitable year. The Notice provides that if the newly converted FIE had accumulated deficits as of the date that its new business license is issued, such losses may be carried over to the next tax year and set off against corresponding income in such year. The Notice further provides that for the purpose of establishing eligibility for tax preferences, the first profitable year shall be the first year in which profits are earned after deducting carried over losses. If that year is less than six months, the newly converted FIE may elect the following year as its first profitable year provided that taxes are paid on profits earned during the FIE's abbreviated first year.

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If you need additional assistance or information concerning any issue raised by this memo, or on any related issues, please contact the following Paul, Weiss attorneys:

Beijing Office:
Lester Ross (8610-6505-6822 or lross@paulweiss.com)
Kenneth Zhou (8610-6505-6822 or kzhou@paulweiss.com)

Hong Kong Office:

Jeanette K. Chan (852-2846-0388 or jchan@paulweiss.com)
John E. Lange (852-2846-0333 or jlange@paulweiss.com)
Marcia Ellis (852-2846-0377 or mellis@paulweiss.com)
Hans-Günther Herrmann (852-2846-0331 or hherrmann@paulweiss.com)

New York Office:

Yvonne Y.F. Chan (212-373-3255 or ychan@paulweiss.com)
Nicholas C. Howson (212-373-3109 or nhowson@paulweiss.com)