

Exploring Interpretation Approach by Taking Examples

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Exploring the Rule-based Interpretation Approach Under the Statutory Taxation Principle - Taking Cross-border Demerger and Merger Transactions as Examples

Multinational enterprise groups sometimes adjust their holding structures due to the needs of business. In this regard, the internationally accepted practice is to follow the principle of tax neutrality, which means the rules of special tax treatments could be applied to cross-border reorganizations so as to achieve the tax deferral effects if relevant conditions are satisfied.

Within the current Chinese framework of tax rules, the application of enterprise income tax (“**ET**”) special tax treatment for cross-border intra-group reorganizations is a matter accompanied with uncertainties. The status of relevant uncertain tax rules not only brings confusions to enterprises, but also increases the legal enforcement risks for tax authorities.

In our view, when encountering the ambiguities of tax rules, the rule-based interpretation approach based on the statutory taxation principle is helpful to settle doubts and resolve disputes between tax authorities and taxpayers. That is, following the general pattern and methodology of legal interpretation, and using the specific legal interpretation methods such as textual interpretation, systematic interpretation, legislative purpose interpretation, and etc., in a scientific and logic manner, may effectively settle and reconcile the logic contradictions among the tax rules, so as to find out the “true intent” of relevant tax rules, and thus can help the taxpayers and the tax authorities reach an acceptable agreement.

In this article, we will take the current special tax treatment rules for cross-border enterprise demergers and mergers as examples to explore how the rule-based interpretation approach under the statutory taxation principle may be conducted when relevant tax rules are not clear or when there are contradictions between tax rules.

I. The starting point for discussion: essential meaning and key conditions of special tax treatment for cross-border reorganizations.

The essential meaning of special tax treatment is “tax deferral” rather than “tax exemption”. In other words, for enterprise reorganizations that qualify for the conditions of special tax treatment, the transfer income or loss of relevant assets (including equities) is not recognized at the time of the reorganization, and at the meantime, the original tax basis of relevant assets (or equities) should not be increased or decreased.

As for the key conditions of special tax treatment for cross-border reorganizations and some issues reflected in practice, as early on August 31, 2016, Mr. Wang Haiyong of the State Administration of Taxation (“**SAT**”) published an article “*Improving Income Tax Policies to Remove Obstacles for Enterprise Reorganizations*” on the *China Taxation News*. In this article, he pointed out that, “Special tax treatment for enterprise reorganizations needs meeting 4 key conditions, say: continuity of operation, continuity of equity rights, lack of necessary funds to pay tax, and reasonable commercial purposes. This is the base of the incentive tax policy for the enterprise reorganizations and as well the starting point and basic principle for further improvement of the reorganization tax regime. Since the implementation of the reorganization income tax policy, especially since the implementation of Circular 59, relevant local tax authorities have commented that some provisions are still difficult to catch the actual meaning under relevant cases, and thus further clarity is needed. Considering the presence of foreign parties in the cross-border reorganizations, in addition to the general conditions for ‘special reorganization’, it is also necessary to ensure that the tax jurisdiction on the implied added value of the assets of the restructured enterprises remains within China, so that the special tax treatment could be applied for the relevant foreign parties. This is the bottom line when designing special tax treatment policy for the cross-

border reorganizations.”

The above-mentioned viewpoints were published later than the issuing time of the 2 key tax circulars which are closely related to the special tax treatment rules for cross-border reorganizations (i.e., *the Notice of the Ministry of Finance (“MOF”) and the SAT on Several Issues Concerning the Treatment of EIT for the Enterprise Reorganizations* (Caishui [2009] No. 59, “[Circular 59](#)”) and *the Announcement of the SAT on Issues Related to Application of Special Tax Treatment for the Equity Transfer by Non-Resident Enterprises* (No. 72 Announcement of the SAT in 2013 (“[Bulletin 72](#)”))), and thus can be regarded as a preliminary summary and further thoughts on the implementation issues and the existing problems of relevant tax policy.

The above-mentioned viewpoints are in nature a presentation of principles rather than going into details. In the practice of tax collection and administration, when facing specific uncertain points, it is still necessary for relevant parties to settle disputes via using the agreed interpretation methodology. During the course of interpretation, the key requirements such as reasonable commercial purposes, continuity of operation, continuity of equity rights, and lack of necessary funds to pay tax (for cross-border reorganizations, there is one more requirement, that is, the tax jurisdiction on the implied added value of the assets of the restructured enterprises remains within China) shall play a decisive guiding role in the “substance over form” judgment process.

Article 5 of Circular 59 sets out 5 conditions for the application of special tax treatment. Among them, the 1st condition (“The relevant reorganization shall have reasonable commercial purposes, without setting the main purpose to reduce, exempt or defer taxes”) acts as the outlining and leading rule. The 2nd condition through the 5th condition are technical requirement conditions. Especially, with respect to the 2nd condition (“The proportion of assets or equity interests of the acquired, merged or demerged part shall be in accordance with the proportion requirement as specified in this Notice”) and the 4th condition (“The amount of the equity consideration payment involved in the reorganization transaction consideration shall be in accordance with the specific proportion requirement as specified in this Notice”), their corresponding detailed technical condition requirements need to be referred to the rules as provided under Article 6 of Circular 59; while with respect to the 3rd condition (“Within a consecutive 12 months after the reorganization, the reorganization related assets shall not change their original substantial business”) and the 5th condition (“The original main shareholder(s) receiving equity shares as payment consideration during the reorganization shall not transfer such received equity shares within 12 months after the reorganization”), they are relatively detailed and straightforward.

Furthermore, Article 7 of Circular 59 sets out additional circumstances and conditions for the application of special tax treatment for the cross-border equity acquisition transactions and cross-border asset acquisition transactions. On the other hand, Bulletin 72 (Article 1) provides that, “the situations stipulated in Article 7(1) of Circular 59 [include](#) the cases where the equity interest of a PRC resident enterprise is transferred due to the demerger or merger of foreign enterprises”.

Since “cross-border demerger and merger” and “cross-border equity and asset acquisitions” are different types of enterprise reorganization arrangements, the mixing-up by Bulletin 72 of the special tax treatment conditions for “cross-border demerger and merger” with those originally designed for “cross-border equity and asset acquisitions” is likely to result in the “uncareful grafting caused rejection reaction effects”.

The result of “rejection reaction effects” is mainly because that, “cross-border equity and asset acquisitions” do not involve the deregistration of enterprises, whereas “cross-border mergers” inevitably involve the deregistration of enterprises; and in the “cross-border equity and asset acquisitions”, the relationship of the parties can be a parent-subsidiary relationship, while by contrast, in the “cross-border demerger”, upon completion of the demerger, the split enterprise and the beneficiary enterprise should be siblings or in other non-parent-subsidiary relationship.

Of course, such “rejection reaction” is certainly not the intended result of Bulletin 72, but is caused by the complexity of the cross-border reorganization arrangements.

II. Conflicting tax rules shall be interpreted in favor of taxpayers, by applying the rule-based interpretation

approach (methodology) under the statutory taxation principle.

The cross-border demergers and mergers were not fully considered when the conditions for cross-border reorganizations were designed under Circular 59 in 2009. As mentioned above, Bulletin 72 later includes into scope of Article 7(1) of Circular 59 the situations where equity interest of a PRC resident enterprise is transferred as result of a demerger or merger of foreign enterprises, aiming to supplement and clarify the relevant rules. However, the actual effect is that, the rules still did not fully consider the characteristics of the cross-border enterprise demergers and mergers, and accordingly, Bulletin 72 incurs contradictions and uncertainties in the application of and reconciliation among relevant rules of Circular 59.

With respect to the interpretation of taxation rules under the situation of contradictions and uncertainties of relevant rules, the Supreme People's Court clearly pointed out in the *Retrial Administrative Judgment of the Guangzhou Defa Real Estate Construction Co., Ltd. vs. the First Inspection Bureau of Guangzhou Local Tax Bureau of Guangdong Province* (judgement date: April 7, 2017) that, "According to the basic requirements of lawful administration, administrative authorities shall not make decisions that affect the legitimate rights and interests of the administrative counterparties or increase their obligations without the supporting rules from laws and regulations. When there are multiple interpretations of relevant legal provisions, priority shall be given to the interpretation that is favorable to the administrative counterparties."

That is to say, based on the basic requirements of lawful administration, when there are multiple interpretations of relevant tax rules, priority shall be given to the interpretation that is favorable to taxpayers so as to protect their legitimate rights and interests. In essence, such position is to interpretate the tax rules under the "statutory taxation principle".

Specifically, Article 7(1) of Circular 59 stipulates 3 conditions : (1) The non-resident enterprise transfers equity interest in the resident enterprise to another non-resident enterprise in which it has 100% direct control; (2) There shall be no change in future for the PRC withholding income tax burden on the taxable income of the equity transfer which may occur in future; and (3) The transferor non-resident enterprise undertakes in writing to the competent tax authority that it will not transfer the equity interest in the transferee non-resident enterprise for a period of 3 years.

On the matters of applying special tax treatment to cross-border demerger and merger, at present, there are mainly the following viewpoints (explanations):

One of these views [Viewpoint A] is that the transfer of equity interests in resident enterprises resulting from the demerger of cross-border enterprises does not meet all the conditions for applying special tax treatments. This is because that, upon completion of the demerger, the equity interests in the demerged enterprise and the beneficiary enterprise will be held by their respective shareholders, and the demerged enterprise and the beneficiary enterprise will not hold each other's equity interests, let alone "holding for 3 years without transferring" as required by the condition (3) of Article 7(1) of Circular 59. This is one of the manifestations of the "rejection reaction" as mentioned earlier.

Another view [Viewpoint B] considers that, among the various cases of cross-border demergers and mergers, there is only one case i.e. "foreign subsidiary absorbing foreign parent company" resulting in equity transfer of resident enterprise, that can meet all the conditions for applying the special tax treatment.

While a third view [Viewpoint C] considers that, even the case " foreign subsidiary absorbing foreign parent company" is unable to meet all the conditions stipulated in Article 7 (1) of Circular 59, especially, unable to meet the 3rd condition stipulated in Article 7 (1) (it stipulates that, the transferor non-resident enterprise (Note: in such case, it refers to the foreign merged enterprise (i.e., the parent company being merged) that originally held the equity interest of the resident enterprise) shall promise not to transfer the transferee non-resident enterprise owned by the transferor within 3 years (Note: in such case, the transferee non-resident enterprise refers to the foreign merger enterprise (i.e., the foreign subsidiary which absorbs the foreign parent company) that receives the equity interest of the resident enterprise being transferred). This is because that, after the merger is completed, the transferor (the original foreign parent company) will no longer exist, and so it is impossible for it to continue holding the equity shares of the transferee (the foreign subsidiary), let alone holding it for 3 years. This embarrassing situation is another manifestation of the "rejection reaction" as described earlier.

Some people also believe that [Viewpoint D], the condition (3) stipulated in Article 7(1) can be implemented in a flexible way, that is, since the parent company (the transferor) in the case of “foreign subsidiary absorbing foreign parent” will be deregistered, it could be the original foreign parent company’s shareholders to undertake not to transfer the equity of the transferee non-resident enterprise (the foreign subsidiary) within 3 years.

Another view [Viewpoint E] considers that, “equity acquisition / asset acquisition” and “demerger / merger” have significant differences in their legal natures and business operation approaches, and thus their common factors in the special reorganization tax treatment regime are quite limited (quite fewer). That is to say, in the 3 conditions stipulated in Article 7(1) of Circular 59, only the 2nd condition (“There shall be no change in future (comparing current tax burden) for the PRC withholding income tax burden on the taxable income of the equity transfer which may occur in future”) is their common factor (commonly shared technical point of the tax rules). For further analysis of the “common factor”, please see below.

After carefully studying the relevant rules in Circular 59 and Bulletin 72, we found that Viewpoint A is tenable concerning cross-border demergers, because the conditions for “cross-border demerger” and the conditions originally set for “cross-border equity acquisition and asset acquisition” are unreasonably twisted together in Bulletin 72.

In terms of the viewpoints concerning cross-border mergers, we think that Viewpoint C is more reasonable than Viewpoint B, and Viewpoint C is a proper explanation approach of the rule-based and logical-based interpretation methodology. And we consider that Viewpoint D is “muddying the water”, which tries to ignore the conflicts in the rules. As for View E, we think it is essentially a further interpretation and the underlying logic of View C, and we think that the combination of the 2 views (View C + View E) is an appropriate approach to resolving disputes under the rule-based interpretation approach.

In other words, if it would be to mechanically consider that “cross-border demergers and mergers must satisfy all the 3 conditions under Article 7(1) of Circular 59” so as to apply the special tax treatment, then it will result in the embarrassing situation that “all the equity transfers of resident enterprises resulting from cross-border demergers and mergers will be inapplicable for the special tax treatment”. Regarding this result, please refer to our detailed analysis below in the Section III.

Further, if the relevant rules would be enforced mechanically, it will exclude the opportunities of applying special tax treatment for all the cross-border demergers and mergers, and thus will not only violate the principle of tax neutrality, but also will directly contradict with the statement that the demerger and merger of foreign enterprises shall be “included” as stipulated in Article 1 of Bulletin 72. Just imagine, the wording “including” used in Bulletin 72 must be intended to give the relevant circumstances the opportunity to apply special reorganization tax treatment when they are eligible, and thus, if relevant conditions actually could not be met, this situation will undermine the intention of “including” as provided in Bulletin 72, say, it will be inconsistent with the purpose for which Bulletin 72 was formulated.

Some people may think that [which may be the underlying cognitive logic of Viewpoint D], in the context of cross-border mergers, among the 3 conditions stipulated in Article 7(1) of Circular 59, the 1st condition (“the non-resident enterprise transfers equity interest in the resident enterprise to another non-resident enterprise in which it has 100% direct control”, which corresponds to the situation where an foreign subsidiary absorbs its foreign parent company in the context of foreign mergers) and the 2nd condition (“there shall be no change in future for the PRC withholding income tax burden on the taxable income of the equity transfer which may occur in future”) are the most important conditions and they must be met, while the 3rd condition (“**and** the transferor non-resident enterprise (in the case of a cross-border mergers, it refers to the original foreign parent company) undertakes in writing to the competent tax authority that it will not transfer the equity interest in the transferee non-resident enterprise (in the case of cross-border mergers, it refers to the foreign subsidiary) for a period of 3 years”) can be implemented “flexibly”.

We do not agree with such view. This is because that, as you may notice, there is a word “**and**” at the beginning of the sentence in the 3rd

condition, which indicates that, from a textual point of view, the 3rd condition is indispensable and it must be met together with the first 2 conditions. From the perspective of the rules system, Circular 59 and Bulletin 72 do not stipulate which of the 3 conditions is in a high-grade status and which is in a low-grade status.

Let's take a closer look at this issue from the perspective of systematic interpretation approach. In the circumstances stipulated in Article 7 (2) and (3) of Circular 59, there provides no additional condition of "no transfer for 3 years". Thus, we can see that the condition of "no transfer for 3 years" is tailored to the rule in Article 7 (1) of Circular 59, and this requirement is not an optional condition but a mandatory condition. In other words, this condition shall not be implemented in a "flexible" approach and cannot be ignored.

Taking a step back, even if one of the 3 conditions is indeed "more indispensable", it should be the 2nd condition ("there shall be no change in future for the PRC withholding income tax burden on the taxable income of the equity transfer which may occur in future") that plays this role.

This is because that "to ensure that the tax jurisdiction for the implied added value of the assets of restructured enterprise remains within China" is not only one of the conditions expressly provided in Article 7(1), but also an implied requirement in the circumstances provided in Article 7(2) and (3). According to the provisions of Bulletin 72, the circumstances specified in these 2 provisions (Article 7(2) and (3)) are not directly related to the demerger or merger of foreign enterprises, and therefore, using them as a reference for the core purpose of the relevant rules is objectively convincing. Also based on this reason, we could conduct a "simulated restatement" of the relevant rules in Circular 59 and Bulletin 72 via the rule-based interpretation approach in the following contents.

Specifically, in the circumstances provided in Article 7(2) ("transfer of equity interest in a resident company by a non-resident enterprise to another resident enterprise in which it has a 100% direct holding relationship), the transferee is a PRC resident enterprise. Compared to the situation before the transfer, the PRC tax jurisdiction is strengthened rather than weakened. And in the circumstances specified in Article 7(3) ("a resident enterprise invests with its own assets or equity into a non-resident enterprise that it has 100% directly holding relationship"), since the ultimate parent company is a PRC resident enterprise, compared to the situation before the transfer, China's tax jurisdiction remains in control.

Therefore, the condition (2) stipulated in Article 7(1) of Circular 59 ("There shall be no change in future for the PRC withholding income tax burden on the taxable income of the equity transfer which may occur in future") is qualified to play the role of "common factor".

In other words, if there would be a "flexible" approach, then, not only the condition (3) in Article 7(1) of Circular 59 needs to be applied in a flexible approach, but the condition (1) also needs to be applied flexibly. Say, only the condition (2) cannot be applied "flexibly", because it is the only "common factor".

On the other hand, if it is considered that the condition (1) in Article 7(1) of Circular 59 cannot be applied in a flexible approach and only the condition (3) can be applied in a flexible approach, then, all the cases of equity transfer of resident enterprises resulting from the demerger of cross-border enterprises will be excluded from the scope of the special tax treatment. This result will contradict the wording of Article 1 of Bulletin 72, which states that the circumstances of the demerger of a foreign company are to be "included", and therefore this result would be inconsistent with the purpose of issuing Bulletin 72. Just imagine, Bulletin 72 uses the word "include", but if it would actually mean "not including" the situation of demerger, why does Bulletin 72 not just tell this position directly?

In summary, if all the 3 conditions stipulated in Article 7(1) of Circular 59 must be met (the literal meaning of the rules requires so), this will lead to the embarrassing situation where no "equity transfer of resident enterprises resulting from the demerger and merger of foreign enterprises" can be eligible for the special tax treatment. And this embarrassing situation, in turn, is inconsistent with the purpose of formulating Bulletin 72.

In the following Section, we will analyze in details the conflicting tax rules on the application of special tax treatment to the transfer of equity interests in PRC resident enterprises resulting from the demerger and merger of foreign enterprises, and accordingly, we will conduct a

“simulated restatement” of the relevant rules in Circular 59 and Bulletin 72 based on the rule-based interpretation approach under the statutory taxation principle.

III. Conflicting tax rules on the application of special tax treatment to the cross-border demergers and mergers, and our simulated restatement suggestion.

1. Specific conditions for application of special tax treatment to demergers, mergers and relevant cross-border reorganizations.

According to the provisions of Article 5 and Article 6 (5) of Circular 59, if a **demerger** meets the relevant conditions, it may choose to apply special tax treatment. These conditions include:

Conditions of Applying Special Tax Treatment for Demerger	The Corresponding Provisions of Circular 59
(1) The relevant reorganization has reasonable commercial purpose, without the main purpose to reduce, exempt or defer PRC taxes;	Article 5 (1)
(2) Each of the shareholders of the Split Enterprise (which is divided into 2 or more enterprises) holds the same share percentage of the Beneficiary Enterprise (which accepts part of the assets from the Split Enterprise as result of the demerger) as the share percentage it holds in the Split Enterprise, and both the Beneficiary Enterprise and the Split Enterprise shall not change its original substantial business activities;	Article 5 (2); Article 6 (5)
(3) Within a consecutive 12 months after the reorganization, the reorganization related assets shall not change their substantial business;	Article 5 (3)
(4) The equity shares as payment consideration received by the shareholders of the Split Enterprise for such reorganization shall account for at least 85% of the total consideration; and	Article 5 (4); Article 6 (5)
(5) The original main shareholder receiving equity shares as payment consideration shall not transfer such received equity shares within 12 months after the reorganization.	Article 5 (5)

According to the provisions of Article 5 and Article 6 (4) of Circular 59, if a **merger** meets the relevant conditions, it may choose to apply special tax treatment. These conditions include:

Conditions of Applying Special Tax Treatment for Merger	The Corresponding Provisions of Circular 59
(1) The relevant reorganization has a reasonable commercial purpose, without the main purpose to reduce, exempt or defer PRC taxes;	Article 5 (1)
(2) The Merged Enterprise and the Merger Enterprise are under the same shareholder's control and no payment consideration is required, or the payment consideration in the form of equity shares received by the shareholder for such merger shall account for at least 85% of the total consideration;	Articles 5 (2) and (4); Article 6 (4)
(3) Within a consecutive 12 months after the reorganization, the reorganization related assets shall not change their substantial business; and	Article 5 (3)
(4) The original main shareholder receiving equity shares as payment consideration shall not transfer such received equity shares within 12 months after the reorganization.	Article 5 (5)

In addition to the above-mentioned tax rules, Article 7 of Circular 59 provides that, “Where enterprises are engaged in **equity acquisition and asset acquisition transactions** between China and a foreign country/region (including Hong Kong, Macau and Taiwan), **in addition to the conditions prescribed in Article 5 of this Circular, the following conditions shall also be satisfied for the application of special tax treatment:** ...”. Please note that although the explicitly mentioned conditions needing to be met only include those stipulated in Article 5 and the additional conditions in Article 7 of Circular 59, while the provisions in Article 6 of Circular 59 is not explicitly mentioned, however, in accordance with the systemic interpretation methodology, since the conditions stipulated in Article 6 are detailed ones for those generally stipulated in Article 5 for specific types of reorganizations, it shall not be concluded that the conditions stipulated in Article 6 do not need to be met for the cross-border reorganizations.

Among them, it should be specially noted that, with respect to Articles 5 (2) (“The proportion of assets or equity in the acquired, merged or demerged part shall be in accordance with the proportion as specified in this Notice”) and 5 (4) (“The amount of the equity consideration payment involved in the reorganization transaction consideration shall be in accordance with the proportion as specified in this Notice”) of Circular 59, the stipulated “proportion” (percentage) in such rules shall only be linked to the stipulated “proportion” (percentage) as provided in Article 6 of Circular 59. Otherwise, the provisions of Article 5 of Circular 59 could not be implemented.

Besides, Article 6(5) of Circular 59 not only stipulates the specific conditions for the special tax treatment of demerger, but also stipulates the corresponding specific tax treatments. And Article 6(4) not only stipulates the specific conditions for the special tax treatment of merger, but also stipulates the corresponding specific tax treatments.

Therefore, Article 7 of Circular 59 not only needs to refer to the provisions of Article 5, but also needs to refer to the provisions of Article 6. That is to say, Article 7 is in any case inseparable from Article 6.

Some people may think that the demerger of a foreign company according to foreign law or the merger between two (or more) foreign companies according to foreign law is not a referenced “demerger” or “merger” under PRC law, and therefore the resulted transfer of equity interests in PRC resident enterprises should be deemed as a pure “equity transfer” under PRC law so as to determine whether special tax treatments are applicable. By following this reasoning method, it might imply that, even if Article 7 of Circular 59 needs to refer to the conditions stipulated in Article 6, the “actual” reference should be made to the provisions of paragraph (2) (equity acquisition) or paragraph (3) (asset acquisition), rather than to the provisions of paragraph (5) (enterprise demerger) or paragraph (4) (enterprise merger).

We do not agree with such view. This is because that, in the rule system of Circular 59, “demerger”, “merger”, “equity acquisition” and “asset

acquisition” are different types of enterprise reorganization arrangements, and each type of the reorganizations has its clear corresponding definition. This is clearly and unambiguously stipulated in Article 1 of Circular 59, and thus they should not be confused with each other.

Moreover, the company laws of different countries generally stipulate the relevant rights, obligations, liabilities and remedies for demergers and mergers, while their tax laws stipulate the subject matter, consideration and other elements of a “transaction”, and thus each type of law performs its own specific functions. Accordingly, although it could not be ruled out that the company law of some overseas jurisdictions provides a more diverse range of merger and demerger types, or its perspectives of classifications are different from those in China, as you can see, from a tax perspective, no matter how “diverse” or “different” the types and perspectives may be, when the relevant entities carry out the relevant merger and demerger procedures, the common elements involved in tax treatment, such as the transfer of assets and liabilities and the matters involving consideration, are still in position. In other words, the provisions of the company law of a foreign jurisdiction regarding the rights, obligations, responsibilities, remedies, decision-making procedures, classification of the merger or demerger of foreign enterprises does not affect our judgment from a “transaction perspective” under the PRC tax treatment principles.

Furthermore, regardless of the classification of merger or demerger, the result of a “merger” is that the Merged Enterprise is deregistered, and its relevant assets and liabilities are transferred to the Merger Enterprise; while the result of a “demerger” is that the Split Enterprise is divided, and the Beneficiary Enterprise receives the relevant assets of the Split Enterprise. Therefore, it is feasible to focus on the two elements ((1) the transfer of equity of a PRC resident enterprise, and (2) payment of consideration), and accordingly, to deal with them using the method of “common factor consolidation”.

Accordingly, when extracting the core elements of “transfer of assets” and “payment of consideration” of the relevant arrangement for tax treatment according to the method of “common factor consolidation”, if the relevant transaction could meet the conditions of special tax treatment required by the PRC tax system, it can be processed according to special tax treatment; if not, it can be processed according to general tax treatment.

Therefore, we think that, for the demerger of a foreign company or the merger of two or more foreign companies, it is not necessary to dwell on whether it constitutes a demerger or merger “in the sense of PRC law”. From the perspective of tax-related judgment, it is fair enough to assess whether it constitutes a “demerger” or “merger” in the sense of Circular 59, which means to assess in accordance with the definition of demerger and merger of Circular 59. We think this is the most concise, clear and operable approach.

Let’s look into this specifically:

A “merger”, according to the provisions of Article 1 of Circular 59, is a transaction where one or more enterprises (hereinafter referred to as the “Merged Enterprise”) transfer all their assets and liabilities to an existing or newly established enterprise (hereinafter referred to as the “Merger Enterprise”), and the shareholders of the Merged Enterprise accordingly receive equity shares payment or non-equity-shares payments from the Merger Enterprise, achieving the lawful merger of the 2 or more enterprises. One of the core elements of the merger is that the shareholders of the Merged Enterprise get equity or non-equity payments of the Merger Enterprise, of which, under the conditions of special treatment, according to Article 6(4) of Circular 59, the payment consideration in the form of equity shares received by the shareholder for such merger shall account for at least 85% of the total consideration, or if the Merged Company and the Merger Company are under the same shareholder’s control, there may be no need to pay/acquire the consideration.

Besides, a “demerger”, according to the provisions of Article 1 of Circular 59, is a transaction where a company (hereinafter referred to as the “Split Enterprise”) separates and transfers a part or all of its assets to an existing or newly established company (referred to as the “Beneficiary Enterprise”), and the shareholders of the Split Enterprise receive the equity shares or non-equity-shares payments from the Beneficiary Enterprise, achieving the lawful separation of the enterprise. One of the core elements of the demerger is that the shareholders of the Split Enterprise get the equity or non-equity payment of the Beneficiary Enterprise, of which, under the conditions of special treatment, according to Article 6(5) of Circular 59, each shareholders of the Split Enterprise holds the same share percentage of the Beneficiary Enterprise as the share

percentage it holds in the Split Enterprise, and the equity shares as payment consideration received by the shareholder of the Split Enterprise shall account for at least 85% of the total consideration, and etc.

According to the provisions of Article 2 of Circular 59, the “equity (shares) payment” means the payment made by the party purchasing assets in a reorganization, with the payment consideration in the form of equity shares of itself or of the enterprise controlled by it. According to Article 6 of the *Announcement of the SAT on Publishing the “Administrative Measures on EIT in Enterprise Reorganizations”* (SAT Announcement No. 4 in 2010), the “the enterprise controlled by it” referred to in Article 2 of Circular 59 means an enterprise whose shares are directly held by the relevant party purchasing assets.

In conclusion, a demerger or merger of foreign enterprise(s) involving the transfer of equity interests in a Chinese resident enterprise shall be deemed to satisfy the conditions for special tax treatment if it meets the definition set forth in Article 1, the basic conditions set forth in Article 5, the technical conditions set forth in Article 6(5)/(4), and the condition of the “common factor” set forth in Article 7(1) (i.e. the condition (2), “no change in future (comparing current tax burden) for the PRC withholding income tax burden on the taxable income of the equity transfer which may occur in future”).

In such case, one may ask that, if Article 7 of Circular 59 indeed requires reference to the Paragraph (5) (enterprise demerger) and Paragraph (4) (enterprise merger) of Article 6, then, since the specific methods of special tax treatment stipulated in Paragraphs (5) and (4) appear to be designed originally for enterprise demergers and mergers among PRC enterprises, how should these rules be appropriately applied when dealing with demergers and mergers of foreign enterprises? Will it be difficult to completely apply these rules in such situations?

We think that when applying Article 6(5) and 6(4) of Circular 59 to cross-border demergers and mergers, these provisions need only be applied to the portion of assets involving equity interests in PRC resident enterprises, which means that, the relevant tax basis shall remain unchanged, with no step-up or step-down. As for the tax treatment of foreign assets involved in cross-border demergers and mergers, when applying the relevant rules of Circular 59, since these assets have no direct relationship with the equity interests in the PRC resident enterprises, the relevant provisions can be treated as “redundant provisions”, say, no PRC tax treatment shall be applied to the foreign assets.

In fact, when applying to cross-border transactions, not only Article 6(4) and Article 6(5) of Circular 59 have “redundant provisions”, this situation (redundant provisions) may also exist if one would attempt to apply provisions of Article 6(2) (equity acquisition) and (3) (asset acquisition) of Circular 59 to overseas enterprise demergers and mergers, and moreover, there are also cases of “vacant (missing) provisions” when applying to overseas enterprise demergers and mergers.

For example, Article 6(2) (equity acquisition), which provides that “the EIT treatment of the acquiring enterprise, the acquired enterprise ... other relevant income tax matters shall remain unchanged”, may be considered a redundant provision in the case of a demerger or merger of foreign enterprises. And Article 6(3) (asset acquisition) does not stipulate the tax treatment for shareholders of the transferring enterprise and the transferred enterprise, so this is a “vacant (missing) provision” situation in the case of a demerger or merger of foreign enterprises.

Therefore, Article 7 of Circular 59 needs to refer to the conditions stipulated in Article 6. Specifically, the reference shall be made to relevant provisions applicable to the transfer of equity interest of PRC resident enterprises as provided in Paragraphs (5) (enterprise demerger) and (4) (enterprise merger), including those related to their shareholders.

In the coming contents, we will further analyze the conflict of rules (“rejection reaction effects”) between Bulletin 72 and Circular 59.

In 2013, the SAT issued Bulletin 72 which supplemented the provisions of Circular 59. According to Bulletin 72, the situations stipulated in Article 7(1) of Circular 59 **include** the cases where the equity interest of a PRC resident enterprise is transferred due to the demerger or merger of foreign enterprises. According to its literal meaning, Bulletin 72 **expands the scope** specified in Article 7(1) of Circular 59 (a non-resident enterprise transferring equity interests of a resident enterprise through **an equity acquisition or asset acquisition transaction**) to also **include** the circumstances where the equity interest of a resident enterprise is transferred due to a **demerger or merger of foreign enterprises**.

Although Bulletin 72 includes the situation where the equity interest of a resident enterprise is transferred as result of a demerger or merger of foreign enterprises into the scope of Article 7(1) of Circular 59, this does not imply that a demerger or merger, as another type of reorganization, shall be treated the same as an “equity acquisition” or an “asset acquisition”. As previously mentioned, “demerger” and “merger” remain separate types of reorganization as explicitly defined in Circular 59, and they are completely different from the “equity acquisition” or “asset acquisition” as defined in Circular 59. Therefore, the reason why the special tax treatment conditions for cross-border “demerger” and “merger” need to be clarified is only because such “demerger” and “merger” will result in the change of the resident enterprise’s ownership.

Therefore, it is foreseeable from the technical perspective that Bulletin 72’s inclusion of cross-border “demerger” and “merger” into the scope of rules originally intended for cross-border equity acquisition and cross-border asset acquisition as outlined in Circular 59 may “naturally” create potential inconsistencies and conflicts of tax rules due to the differences among different types of reorganizations. The occurrence of such potential conflicts is caused by the significant differences in legal nature and operational practices of the “equity acquisition” and “asset acquisition” from those of the “demerger” and “merger”. So, if the differences would be ignored, and thus the existence of the rules conflicts would be ignored, then this will lead to a “mechanical interpretation and implementation” of Circular 59 and Bulletin 72.

Specifically, Article 7(1) of Circular 59 stipulated 3 conditions: (1) The non-resident enterprise transfers equity interest in the resident enterprise to another non-resident enterprise in which it has 100% direct control; (2) There shall be no change in future (comparing current tax burden) for the PRC withholding income tax burden on the taxable income of the equity transfer which may occur in future; and (3) The transferor non-resident enterprise (here means the non-resident enterprise that transfers the equity interests of the resident enterprise) undertakes in writing to the competent tax authority that it will not transfer the equity interest in the transferee non-resident enterprise (here means the non-resident enterprise that receives the equity interests of the resident enterprise) for a period of 3 years.

We think that, with respect to the cross-border enterprise demerger and merger transactions, there is an inherent logical contradiction between the foregoing conditions of Article 7(1) (in particular, the conditions (1) and (3) of Article 7(1)) and the detailed conditions for application of special tax treatment for mergers and demergers as set out in Article 6(4) and Article 6(5) and as well even the definitions of mergers and demergers, making it impossible to satisfy them simultaneously. Accordingly, if the cross-border enterprise demergers and mergers would be required to satisfy the 3 conditions in Article 7(1) “mechanically”, then, all the cross-border demerger or merger would not be able to enjoy the special tax treatment. We believe this is not the intention of the SAT.

In summary, in the case of cross-border enterprise demerger, the Split Enterprise needs to first transfer the PRC resident enterprise to the Beneficiary Enterprise, and in order to achieve the final goal of demerger, the shareholder(s) of the Split Enterprise needs to obtain the equity shares of the Beneficiary Enterprise. However, the condition (3) of Article 7(1) requires that the transferor non-resident enterprise (Split Enterprise) undertakes to the tax authority that it will not transfer the equity interest in the transferee non-resident enterprise (Beneficiary Enterprise) within 3 years. This will lead to the situation that the shareholder(s) of the Split Enterprise could not immediately obtain the equity shares in the Beneficiary Enterprise, and the shareholder(s) shall wait for 3 years. Accordingly, the intended demerger will in fact not complete. Conversely, if a demerger is to be completed, the transferor could not continue to hold equity shares in the resident enterprise, let alone for 3 years.

While in the case of cross-border enterprise merger, the Merged Enterprise transfers the PRC resident enterprise to the Merger Enterprise, and then the Merged Enterprise will be deregistered so as to complete the enterprise merge process. However, the condition (3) of Article 7(1) requires that the transferor non-resident enterprise (Merged Enterprise) undertakes to the tax authority that it will not transfer the equity interest in the transferee non-resident enterprise (Merger Enterprise) within 3 years. This will lead to the situation that (1) if the enterprise merge process is completed, then, because the Merged Enterprise has been deregistered, it could not hold the equity shares of the Merger Enterprise, let alone holding for 3 years; (2) on the other hand, if insisting on requiring the transferor non-resident enterprise (Merged Enterprise) not transfer the equity interest in the transferee non-resident enterprise (Merger Enterprise) within 3 years, then, the transferor non-resident enterprise (Merged Enterprise) shall not be deregistered, and accordingly, the intended merger will in fact not complete.

In addition, there are other contradictions between the rules, and we will address them separately in details in the following Sub-Section 2.

These conflicting rules essentially stem from the fact that the provisions of Article 7 of Circular 59 were originally intended to apply to the situations where “enterprises are engaged in cross-border equity or asset acquisition transactions”. However, equity and asset acquisition transactions are “instantaneous” transactions in nature. That is to say, when the relevant acquisition is completed under an equity or asset acquisition transaction, there is no need for a further demerger, and therefore, it will not give rise to the contradictory situation of “the transferor under a demerger could not continue holding the equity interest in the non-resident enterprise transferee (let alone for 3 years) if it wants to complete the demerger” and “the transferor under a demerger could not complete the demerger if it wants to continue holding the equity interest in the non-resident enterprise transferee (for at least 3 years)”. Besides, after the relevant acquisition under an equity or asset acquisition transaction is completed, there is no need for a further merger, and therefore, it will not give rise to the contradictory situation where “one party to the transaction needs to be deregistered and therefore it could not hold (let alone for 3 years) the equity interests of the transferee (which receives the resident enterprise’s equity).”

As shown by the above analysis, there are ambiguities (contradictions) of the relevant tax rules when they are designed and formulated. Therefore, reasonable interpretation and simulated restatement are necessary in order for the relevant tax rules to be correctly implemented.

In the following contents, we will further use the approach of “case analysis + transaction chart illustration” to present and analyze so as to demonstrate and explain more intuitively the conflict of tax rules as mentioned above.

2. Detailed analysis of rule conflicts for cross-border demerger and merger transactions.

(1) Under the Scenarios of Cross-border Demergers

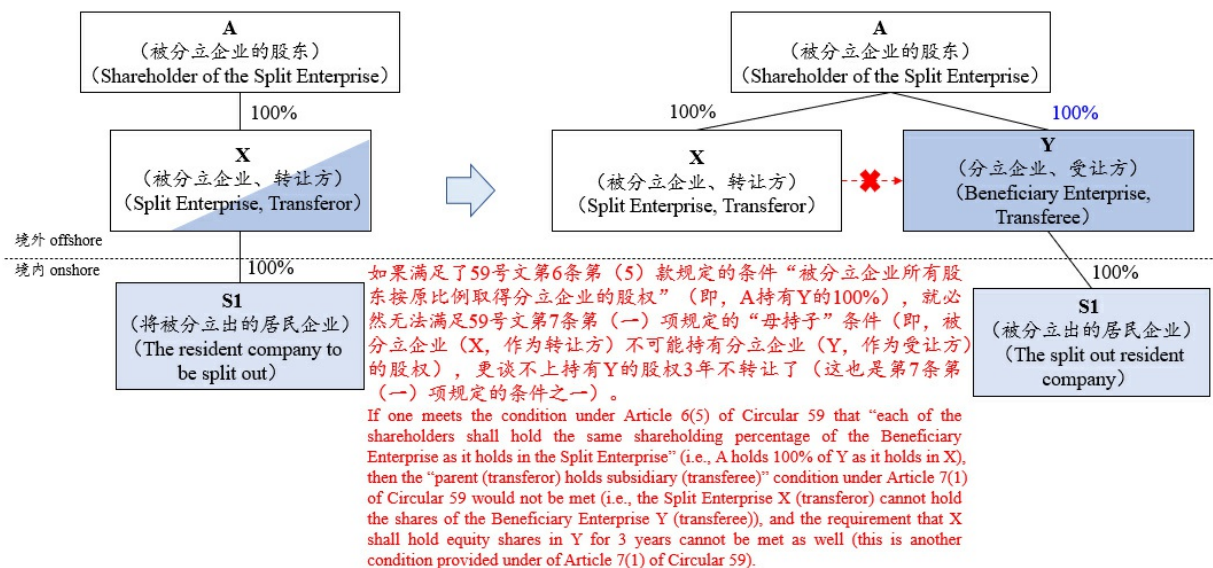
As provided by Circular 59, a demerger is a transaction where the Split Enterprise transfers assets to the Beneficiary Enterprise, and the **shareholders** of the Split Enterprise receive the equity or non-equity payment from the Beneficiary Enterprise in exchange. Accordingly, there are inherent logical contradictions between the condition set out in Article 6 (5) of Circular 59 (conditions for special tax treatment) that “each of the **shareholders** of the Split Enterprise shall hold the same share percentage of the Beneficiary Enterprise as the share percentage it holds in the Split Enterprise” and the condition (1) under Article 7 (1) (“parent transfers to subsidiary”) as well the condition (3) under Article 7 (1) (the transferor (i.e., the Split Enterprise, rather than the shareholders of the Split Enterprise) shall hold equity interests in the transferee (i.e., the Beneficiary Enterprise) for at least 3 years) of Circular 59, making it impossible to satisfy them simultaneously under the cross-border demerger scenario. Moreover, even if the **shareholders** of the Split Enterprise do not hold shares of the Beneficiary Enterprise in the original proportions as they hold in the Split Enterprise, the fact of their holding shares in Split Enterprise and Beneficiary Enterprise respectively itself will make it impossible for the Split Enterprise to hold the shares of the Beneficiary Enterprise (let alone for 3 years). In other words, the situation that the shareholders’ holding shares in the Split Enterprise and the Beneficiary Enterprise respectively does not allow the Split Enterprise holding shares in the Beneficiary Enterprise.

Specifically, the condition (1) of Article 7(1) of Circular 59 requires a non-resident enterprise (the parent company) to transfer equity interest in the resident enterprise to another non-resident enterprise (the subsidiary) in which it directly holds 100% equity interests, i.e., the requirement is “transfer of the equity interest in a PRC resident enterprise from the parent company to its subsidiary”. However, the condition set forth in Article 6 (5) of Circular 59 (one of the conditions for special tax treatment for the demerger) stipulates that “each of the shareholders of the Split Enterprise” shall “acquire the equity interests in the Beneficiary Enterprise in same proportion as the original shareholding percentage it holds in the Split Enterprise”, i.e., it is required that the same parent company holds the same equity interest percentage in sibling companies respectively after the demerger, say, the Split Enterprise (the non-resident enterprise that holds the equity interests in the resident enterprise) and the Beneficiary Enterprise (the non-resident enterprise that receives the equity interests in the resident enterprise) shall be siblings. **This means that, if the condition of Article 7(1) of Circular 59 (parent holds subsidiary, and accordingly parent company transfers the PRC**

resident company to the subsidiary company) must be satisfied, then the requirement of Article 6 (5) of Circular 59 could not be satisfied at the same time (which requires that, under the demerger situation, the Split Enterprise and the Beneficiary Enterprise shall be siblings, rather than parent-subsidiary relationship as required by Article 7(1)).

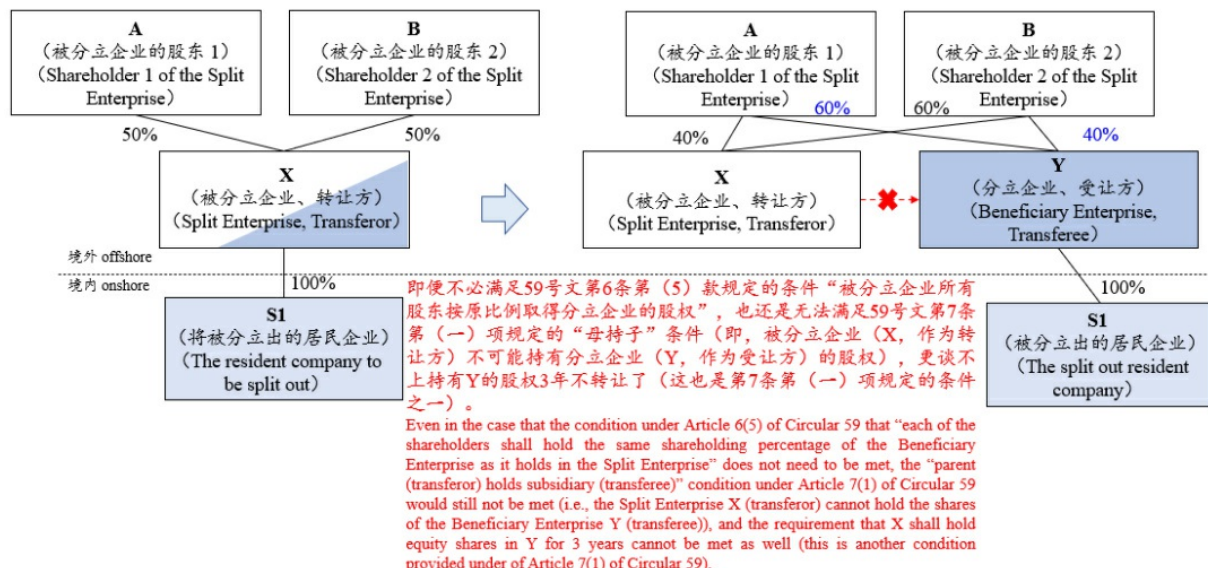
The above-mentioned analysis may be a little bit abstract, so, let's illustrate the rule conflicts in the relevant cases by drawing example transaction charts to show them more directly.

As presented in **Picture 1-1** below, X as the Split Enterprise, splits out the Beneficiary Enterprise Y (as X's sibling company), and after the demerger, X and Y are both 100% held by A (their common shareholder, so, satisfying the condition set forth in Article 6 (5) of Circular 59 regarding “the same shareholding percentage held by the shareholder in the Split Enterprise and the Beneficiary Enterprise”). However, under such a situation, X is impossible to hold equity shares in Y (they are not in a parent-subsidiary relationship, and therefore do not meet condition (1) of Article 7(1) of Circular 59), let alone the requirement that X shall (promise to) hold equity shares in Y for 3 years (therefore could not meet condition (3) of Article 7(1) of Circular 59). Thus, under such a situation, Article 6 (5) of Circular 59 and Article 7(1) of Circular 59 conflict with each other.



△ Picture 1-1

In addition, even if it is not required to satisfy the condition of “each of the shareholders of the Split Enterprise holds the same share percentage of the Beneficiary Enterprise as the share percentage it holds in the Split Enterprise” as stipulated in Article 6(5) of Circular 59, but as long as “the shareholders of the Split Enterprise need to hold the equity shares of the Beneficiary Enterprise (whether as the proportion as their original shareholdings or not)” (which is required by the definition of demerger), then, it also conflicts with the requirement that “the transferor non-resident enterprise undertakes that it will not transfer the equity interest in the transferee non-resident enterprise for a period of 3 years”. In other words, you cannot have your cake and eat it. This specific situation is shown in the example in **Picture 1-2** below:



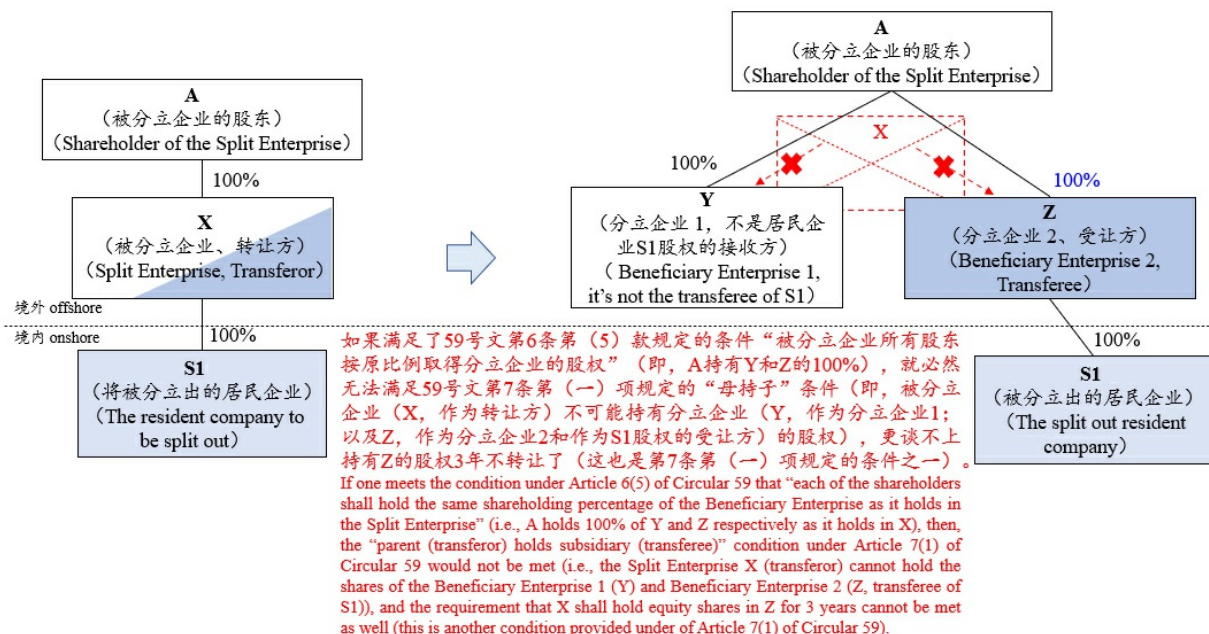
△ Picture 1-2

The reason why we analyzed the situation that does not satisfy “the condition that each of the shareholders of the Split Enterprise holds the same share percentage of the Beneficiary Enterprise as the share percentage it holds in the Split Enterprise”, is to illustrate that, even if someone would argue that “Article 7 of Circular 59 only mentions that it is necessary to meet the conditions in Article 5, but it does not require to also meet the conditions in Article 6(5)”, we can see that the actual situation under such an interpretation would still create an inherent conflict between the conditions stipulated in Article 7(1) (especially the condition(3)) and the intrinsic requirements of the definition of the demerger.

The above two pictures reflect the survival case of the Split Enterprise, say, the **demerger with the survival of the Split Enterprise**.

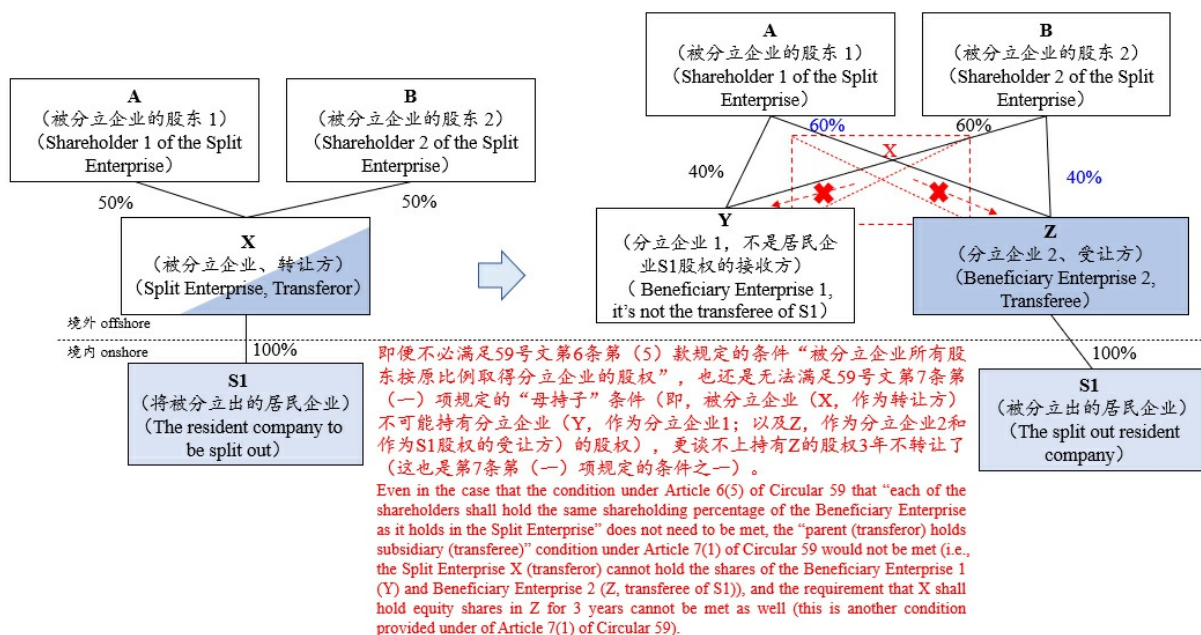
In the case that the demerged enterprise (Split Enterprise) ceases to exist upon the demerger is completed (say, the **demerger with the deregistration of the Split Enterprise**), it is even more impossible for the Split Enterprise to (undertake to) hold the equity shares of the Beneficiary Enterprise for 3 years. Specifically:

As presented in **Picture 1-3** below, **X as the Split Enterprise, and it splits out the Beneficiary Enterprise 1 (Y) and Beneficiary Enterprise 2 (Z)**. After the demerger, Y and Z exist while X ceases to exist. After the demerger, Y and Z are both 100% held by A (their common shareholder, so, satisfying the condition set forth in Article 6 (5) of Circular 59 regarding “the same shareholding percentage held by the shareholder in the Split Enterprise and the Beneficiary Enterprise”). However, under such a situation, since X has been deregistered, it is impossible to hold equity shares in Y and Z (they are not in a parent-subsidary relationship, and therefore do not meet condition (1) of Article 7(1) of Circular 59), let alone the requirement that X shall (undertake to) hold equity shares in (Y and) Z for 3 years (therefore does not meet condition (3) of Article 7(1) of Circular 59). Thus, under such a situation, Article 6 (5) of Circular 59 and Article 7(1) of Circular 59 conflict with each other as well.



△ Picture 1-3

In addition, similar to the case in Picture 1-2, where the Split Enterprise does not survive after the completion of the demerger, even if it is not required to satisfy the condition that “each of the shareholders of the Split Enterprise holds the same share percentage of the Beneficiary Enterprise as the share percentage it holds in the Split Enterprise” as stipulated in Article 6(5), as long as “the shareholders of the Split Enterprise need to hold the equity shares of the Beneficiary Enterprise (whether as the proportion as their original shareholdings or not)” (which is required by the definition of demerger), then, it also conflicts with the requirement that “the transferor non-resident enterprise undertakes that it will not transfer the equity interest in the transferee non-resident enterprise for a period of 3 years”. Moreover, in this case, it is also similar to Picture 1-3, since the Split Enterprise will no longer exist, it is unlikely that it will hold the equity interest in the Beneficiary Enterprise, let alone hold it for 3 years. This specific situation is illustrated by the example in [Picture 1-4](#) below:



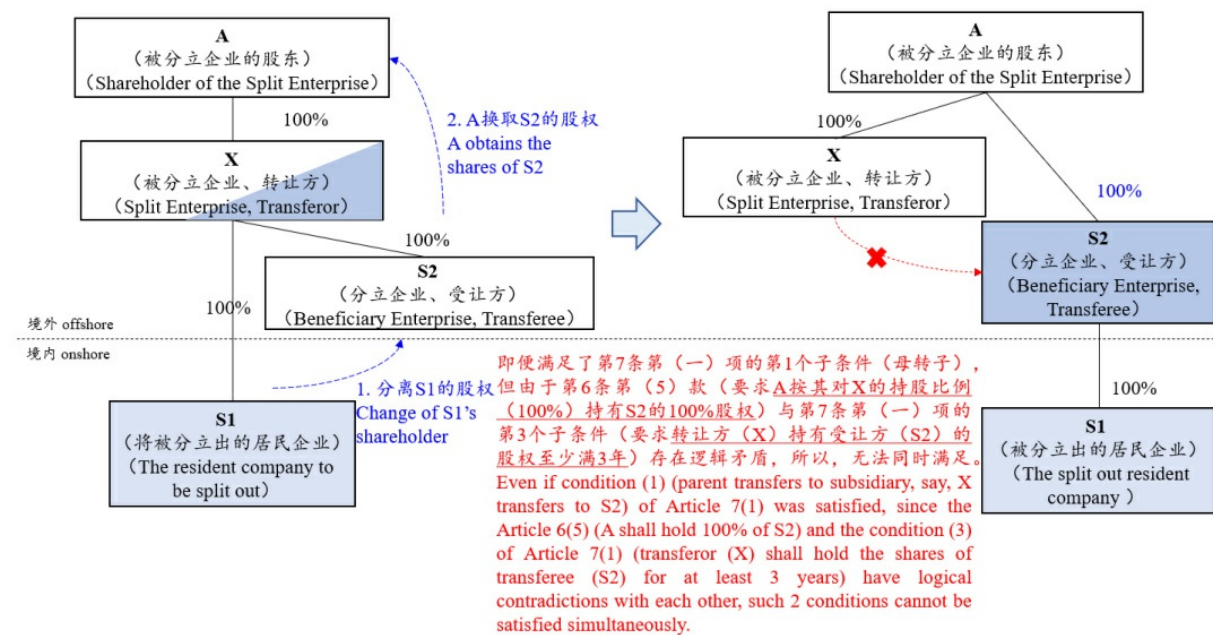
△ Picture 1-4

Similar to the above, the reason why we analyzed the situation that does not satisfy “the condition that each of the shareholders of the Split Enterprise holds the same share percentage of the Beneficiary Enterprise as the share percentage it holds in the Split Enterprise”, is to illustrate that, even if someone argues that “Article 7 of Circular 59 only mentions that it is necessary to meet the conditions in Article 5, but it does not require to also meet the conditions in Article 6(5)”, we can see that the actual situation under such an interpretation would still create an

inherent conflict between the conditions stipulated in Article 7(1) (especially the condition(3)) and the intrinsic requirements of the definition of the demerger.

On the other hand, even if there would be a certain type of “cross-border demerger” that meets the conditions of Article 7(1) of Circular 59 (say, parent holds subsidiary, and accordingly parent company transfers the PRC resident company to the subsidiary company), it could not simultaneously meet the conditions of Article 6(5) of Circular 59, thus making it impossible to achieve the goal of “special demerger” business plan as well.

Specifically, assuming a “parent-transfer-to-subsiary” type of cross-border demerger could occur, that is, assuming that the governing law of the non-resident enterprise’s country (region) allows such a demerger, thus could meeting the condition (1) of Article 7(1) of Circular 59, then, as presented in **Picture 2-1** below, A is the shareholder of the Split Enterprise, X is the Split Enterprise (as the transferor of the equity interest in the resident enterprise S1), and S2 is the Beneficiary Enterprise (as the transferee (receiver) for the equity interests in S1 and it is the non-resident enterprise whose equity interests is 100% held by X). We can see that, if the cross-border demerger is ultimately completed (**after a relatively short interval**) through transitional steps, and then **satisfies** the condition “the shareholder of the Split Enterprise holds the same share percentage of the Beneficiary Enterprise as the percentage it holds in the Split Enterprise” (which satisfies the Article 6(5) of Circular 59, because by that time A finally holds 100% equity interests of S2), then, we can see that it will be **impossible to also** simultaneously **satisfy** the condition “the transferor non-resident enterprise undertakes in writing to the competent tax authority that it will not transfer the equity interest in the transferee non-resident enterprise for a period of 3 years” (this is the condition (3) of Article 7(1) of Circular 59). This is because that at the time point that A holds 100% equity interests of S2 after waiting for a short while to take over the shares in S2, X will accordingly no longer hold any equity interests of S2, let alone the requirement of holding for 3 years. **Thus, under such a situation, Article 6 (5) of Circular 59 and Article 7(1) of Circular 59 conflict with each other.**



△ Picture 2-1

It should be noted that, the step 1 in **Picture 2-1** above (the arrangement that “X separates S1’s equity interest to S2”) is an act of “re-investment” by X. This arrangement itself is not a “demerger” of X under the definition of Article 1 of Circular 59. This is because that S2 is X’s investee company, which is still a part of X’s assets, and X merely converts its “equity investment” in S1 into the “equity investment” in S2, i.e., there is no demerger of X’s property, but only a “reclassification” of relevant property. According to Article 1 of Circular 59, a demerger is only realized when “**the shareholders of Split Enterprise** get equity or non-equity payments of the Beneficiary Enterprise”. As we can see, in step 1 as mentioned above, the “reinvestment” takes place entirely within X, with no connection to A, and A does not obtain any equity or non-equity payment from S2, nor A has any legal basis to obtain the relevant payment.

Let's make a summary here: under Circular 59, in the case of demerger, it is the "shareholders of the Split Enterprise" who acquire the equity interest of the Beneficiary Enterprise (as equity payment) or the non-equity payment, say, the recipients of relevant "payment" are the "shareholders of the Split Enterprise" rather than the "Split Enterprise". By contrast, in the case of a "reinvestment", it is the parent company (X), not the shareholder (A) of the parent company, that receives the "payment". This is the core difference.

Thus, only when X's shareholder A holds an equity interest in S2 (after step 2 in [Picture 2-1](#) above has been completed), then Steps 1 and 2 could possibly (reluctantly) be considered together as X's "demerger".

But it should be noted that although the definition of "demerger" in Article 1 of Circular 59 does not explicitly mention that the arrangement for the separation and transfer of assets from the "Split Enterprise" to the "Beneficiary Enterprise" and the arrangement for the "exchange of equity or non-equity payments by the shareholders of the Split Enterprise" shall occur simultaneously, however, under the common sense, these 2 arrangements should at least occur in quick succession with a specified sequence. This view is supported by Article 10 of Circular No. 59, which stipulates that: "If an enterprise conducts transactions of its assets or equity in several stages within 12 consecutive months before and after reorganization, such transactions shall be treated as a single enterprise reorganization transaction based on the "substance over form" principle." The "12 months" here serves as a technical threshold for applying the "substance over form" judgment standard. Therefore, beyond the 12-month threshold — for example, if the so-called "Step 2" is carried out after 3 years — it would be difficult to convincingly argue that it could be combined with "Step 1" and that the 2 steps could be viewed as the "same one" reorganization (demerger) transaction.

Therefore, even if the relevant transactions could theoretically be viewed as being carried out in several steps (such as Step 1 in [Picture 2-1](#) where X makes a "reinvestment" and Step 2 where X transfers the asset formed under the "reinvestment" (i.e., S2) to its shareholder A), however, if the overall arrangement needs 3 years to be finally completed, then, from the perspective of PRC tax rules, they could not be regarded as "a single" enterprise demerger transaction. In other words, this would at most be a conceptual "demerger" rather than a demerger in the sense of PRC tax rules.

It should be mentioned here that the "reinvestment" in step 1 above is called "separation of objects" in some jurisdictions, that is, a company injects its assets into another company as a form of investment. While in the sense of Circular 59, this arrangement could be either viewed as an "equity acquisition" (i.e., X acquires the equity of S2 and the consideration paid is the asset held by X (i.e., the equity of S1), or as an "asset acquisition" (i.e., S2 acquires the asset held by X (i.e., the equity of S1) and the consideration paid is S2's own additionally issued shares). But in anyway this is not a "demerger" in the sense of Circular 59 rules system. This is because that the "demerger" provided in Article 1 of Circular 59 requires X's shareholder A to participate in the transaction (to get equity or non-equity payment), while the above-mentioned "reinvestment" / "separation of objects" does not involve A's participation.

So, based on the above mentioned situation, as well based on some other similar situations, we consider that "the provisions of the company law of a foreign jurisdiction regarding the rights, obligations, responsibilities, remedies, decision-making procedures, classification of the merger or demerger of foreign enterprises does not affect our judgment from a 'transaction perspective' under the PRC tax treatment principles", and "Accordingly, when extracting the core elements of 'transfer of assets' and 'payment of consideration' of the relevant arrangement for tax treatment according to the method of 'common factor consolidation', if the relevant transaction could meet the conditions of special tax treatment required by the PRC tax system, it can be processed according to special tax treatment; if not, it can be processed according to general tax treatment".

In addition, the above mentioned situation also shows that from a technical perspective, with respect to the demerger or merger of foreign enterprises resulting in the transfer of equity of PRC resident enterprises, the demerger or merger should not be assessed as "a pure equity transfer activity" so as to determine whether the special tax treatment is applicable to the demerger or merger. That is to say, to determine whether demerger or merger qualifies for special tax treatment, one shall either see if it meets the conditions of special tax treatment for "equity acquisition" or "asset acquisition" as stipulated in Circular 59, or see whether it meets the conditions of special tax treatment for "demerger" or "merger" as specified in Circular 59, and there is no special tax treatment mechanism for a "pure equity transfer". On this basis, since Circular

59 has a series of specific provisions (rules) for demergers and mergers that differ from “equity acquisition” and “asset acquisition”, the specific provisions for demergers and mergers shall be applied.

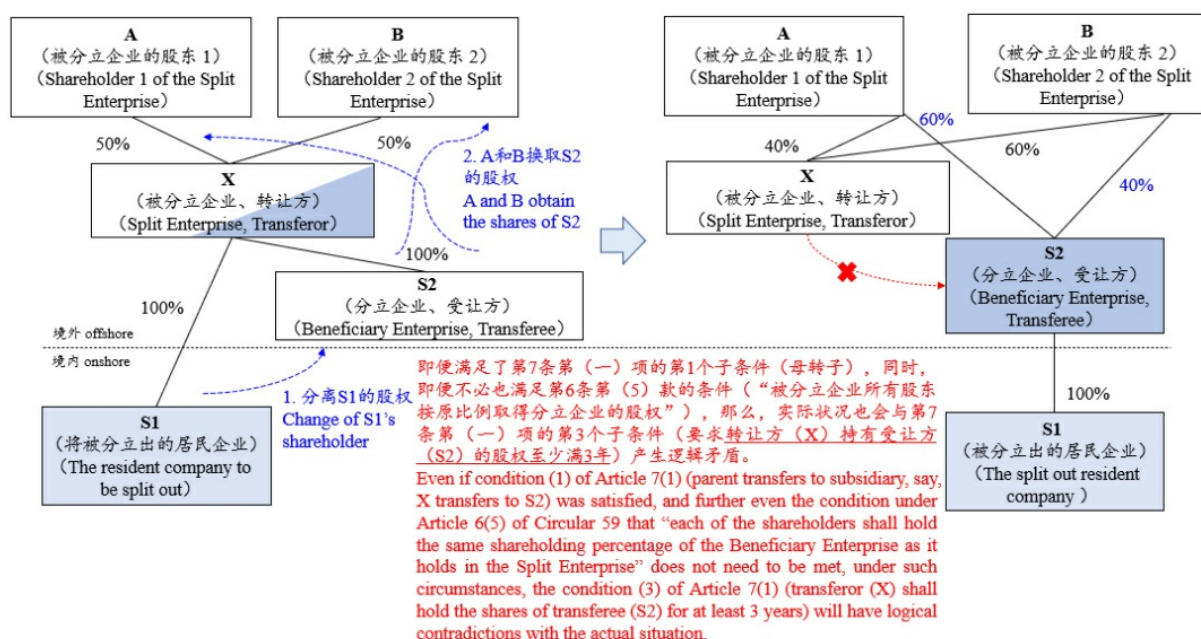
For this, we can do a further clarification and let’s look at this from another perspective: since A and S2 were initially separated by an intermediate company (X), say, A holds X which in turn holds S2, so, in order to achieve the goal (as soon as possible) that A directly holds equity shares in S2 (so that the demerger could be as soon as possible completed, and this is also among the intents as per the provision in Article 6(5) of Circular 59), then X must as soon as possible transfer the shares of S2 to A (this is one of the transitional steps of this kind of “demerger”). However, due to the restriction (prohibition) on such transfer within 3 years (this is the requirement of condition (3) of Article 7(1) of Circular 59), such restriction will cause the goal of such type of “demerger” could not be achieved, say, it could not meet the definition of a “demerger”.

Besides, let’s go another angle: if the demerger is blocked by the aforementioned restriction rule, and thus A could not directly hold the equity interests in S2 within 3 years but it needs to wait until 3 years later, then, given the significant time gap to achieve the commercial purpose, this will not only seriously interfere with the execution of the normal business plan, but also will create some new issues when X transfers equity interests of S2 to A after 3 years. Say, this will make a simple business scenario into complicated scenarios, and is neither reasonable nor necessary.

Regarding the previously mentioned “cross application” scenario between “equity acquisition” and “asset acquisition” in the “reinvestment” case, we will not conduct a detailed analysis as it is not directly related to the main theme of this article. The issue of relevant rules’ cross-application within the tax rules system deserves separate analysis in another article.

Following the above analysis, similar to the situations in Picture 1-2 and Picture 1-4, even if it is not required to meet the condition specified in Article 6(5) that “each of the shareholders of the Split Enterprise holds the same share percentage of the Beneficiary Enterprise as the share percentage it holds in the Split Enterprise”, as long as “the shareholders of the Split Enterprise need to hold the equity shares of the Beneficiary Enterprise (whether as the proportion as their original shareholdings or not)”, which is required by the definition of demerger in Circular 59, then, it will also conflict with the requirement that “the transferor non-resident enterprise shall undertake that it will not transfer the equity interest in the transferee non-resident enterprise for a period of 3 years”.

The specific situation is illustrated by the example in [Picture 2-2](#) below:



△ Picture 2-2

Moreover, in such a situation, similar to the example in Picture 2-1, if X could not transfer S2's equity to A and B until after 3 years, then, according to the provisions of Article 10 of Circular 59, the several steps occurring in 3 years can hardly be deemed together as "one single" demerger transaction in the sense of the tax rule.

Based on the above Pictures and analysis, even in the so-called case of "parent-transfer-to-subsidiary" cross-border enterprise "demerger" (which is in fact a "reinvestment", i.e., the situations in Pictures 2-1 and 2-2), it is impossible to simultaneously satisfy all the conditions for applying special tax treatment as stipulated in Circular 59, and thus could not achieve the commercial purpose as well, not to mention the situation that we discussed earlier where "sibling-style" demerger (i.e., the situations in Pictures 1-1, 1-2, 1-3 and 1-4) could not simultaneously meet the conditions for special tax treatment as specified in Circular 59.

In summary, the relevant rules conflict will cause the term "demerger" in Bulletin 72's provision "the situations stipulated in Article 7(1) of Circular 59 **include** the cases where the equity interest of a PRC resident enterprise is transferred due to the **demerger** or merger of foreign enterprises" to lose its intended target. In other words, it could not correspond to the specific "foreign enterprise demerger" arrangements, resulting in a "vacant (missing) provision" situation.

According to Article 4 (Implementation and Improvement of Fiscal and Tax Policies) of the *Opinions of the State Council on Further Optimizing the Market Environment for Enterprise Mergers and Reorganizations* (Guo Fa [2014] No. 14), its Item (7) provides that "to **revise and improve** the policies for special tax treatment regarding EIT on mergers and reorganizations, ... **expand** the scope of application of special tax treatment". However, as described previously, **due to the inherent logical contradictions between the conditions stipulated in Circular 59 and Bulletin 72 as caused by adding the supplementary provisions of Bulletin 72 into Circular 59, a mechanical understanding and implementation of such rules will not only "narrow down" the scope of application but may "eliminate" the possibility of application of the special tax treatment, and thus could lead to an adverse expectation that all the cross-border enterprise demergers might be deemed ineligible for special tax treatment. If this is the case, it would run counter to the guiding principles of the national policy.**

We noted that some local tax authorities may have been aware of the afore-mentioned conflicts of rules, and therefore have adopted a flexible approach in their taxation practice, allowing relevant cross-border enterprise demerger arrangements to apply special tax treatment.

(2) Under the Scenarios of Cross-border Mergers

As provided by Article 1 of Circular 59, a merger refers to a transaction where one or more Merged Enterprises transfer all its/their assets and liabilities to the Merger Enterprise, and the **shareholders** of the Merged Enterprise(s) receive the equity or non-equity payment from the Merger Enterprise. According to the rules and practice of enterprise merge, the Merged Enterprise(s) will **cease to exist** after the completion of the merge, therefore, it is impossible to satisfy all the 3 conditions set out in Article 7(1) of Circular 59, especially the condition (3) under Article 7 (1) (i.e., the transferor (the Merged Enterprise, rather than the shareholders of the Merged Enterprise) shall hold equity interests in the transferee (i.e., the Merger Enterprise) for at least 3 years). This means that, there is an inherent logical contradiction between the relevant conditions of Circular 59, and even between the rules of Circular 59 (after introducing the rules of Bulletin 72) and the definition of merger, thus making it impossible to satisfy them simultaneously under the cross-border merger scenario.

Specifically, let's analyze different scenarios of cross-border mergers respectively, that is, we will analyze in sequence the cases of the **"absorbed by an existing entity"**, which includes (a) vertical absorption merger (which can be further divided into 2 sub-scenarios: (1) the reverse absorption merger (i.e., subsidiary absorbing parent) and (2) the forward absorption merger (i.e., parent absorbing subsidiary)) and (b) the horizontal absorption merger, and also the cases of **"all merged parties being merged into a new entity"**.

Among them, under the scenarios of the **"absorbed by an existing entity"**, there do not involve the creation of a new enterprise, and the Merged Enterprises cease to exist after the merger, while the originally existed Merger Enterprise continues to exist after the merger; on the other hand, under the scenarios of the **"all merged parties being merged into a new entity"**, there will create a new enterprise (the Merger

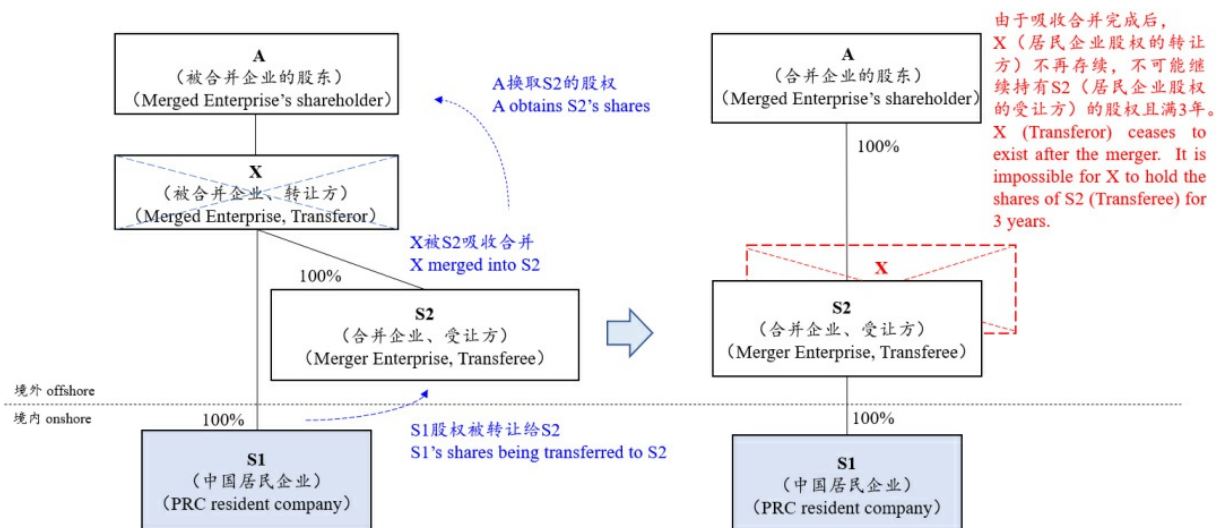
Enterprise, which survives upon completion of the merger), while all the Merged Enterprises cease to exist after the merger.

■ Vertical absorption merger - Reverse absorption merger (i.e., subsidiary absorbing parent)

In the case of a **vertical absorption merger**, for the scenario of the “subsidiary absorbing parent” (i.e., a subsidiary company (a non-resident enterprise) absorbs its parent company (another non-resident enterprise), and accordingly the parent company transfers the equity interests in the resident enterprise held by it to its subsidiary, such arrangement is also referred to as “**reverse absorption merger**”), according to the definition of “merger” under Article 1 of Circular 59, where the Merged Enterprise is the parent company (a non-resident enterprise) and the Merger Enterprise is the subsidiary company (another non-resident enterprise), the shareholder(s) of the Merged Enterprise (i.e., the parent company’s shareholder(s)) will obtain the equity payment (or non-equity payment) from the Merger Enterprise (i.e., the subsidiary, the another non-resident enterprise).

According to Article 2 of Circular 59, “equity payment” includes the scenarios that the Merger Enterprise uses its own equity interests and/or the equity interests of a company controlled by it as a means of payment to the shareholders of the Merged Enterprise. According to Article 6 (4) of Circular 59, a payment consideration is not required for a “merger under the same control”.

Since the parent company will dissolve upon the completion of “reverse absorption merger”, and the merger will cause the equity interests held by the parent company (a non-resident enterprise) in the resident enterprise to be held by the subsidiary company (another non-resident enterprise), therefore, as presented in **Picture 3** below, although such “subsidiary absorbing parent” arrangement (S2 absorbing X) satisfies condition (1) of Article 7(1) of Circular 59, it **fails to satisfy** condition (3) of Article 7(1) (i.e., the transferor non-resident enterprise holds the equity interests in the transferee non-resident enterprise and promises not to transfer it in 3 years), because the parent company (X, as the transferor of the equity interests of the resident enterprise S1) ceases to exist after the absorption merger is completed, and it is impossible for the parent company (X) to continue holding equity interests of the subsidiary company (S2, the transferee of the equity interests of the resident enterprise S1) (let alone holding for 3 years). **Thus, under such a situation, Article 7(1) of Circular 59 conflicts with the definition and common practice of a merger.**



△ Picture 3

Some people believe that, among all the circumstances of cross-border demergers and mergers, there is only one situation, which is the abovementioned “subsidiary absorbing parent” scenario, that could satisfy all the conditions for the application of the special tax treatment.

Some of them argue that the term “transferor non-resident enterprise” in Article 7(1) of Circular 59 refers to the “shareholder(s) of the Merged Enterprise”, and accordingly conclude that the “shareholder of the Merged Enterprise” could fulfill the requirement of “not transfer the equity interests in the transferee non-resident enterprise held by it within 3 years”.

We could not agree with such technical position.

We believe that, from a practical and realistic perspective, the “transferor non-resident enterprise” specified in the condition (3) of Article 7(1) of Circular 59 could not and should not refer to “the shareholders of the merged enterprise”.

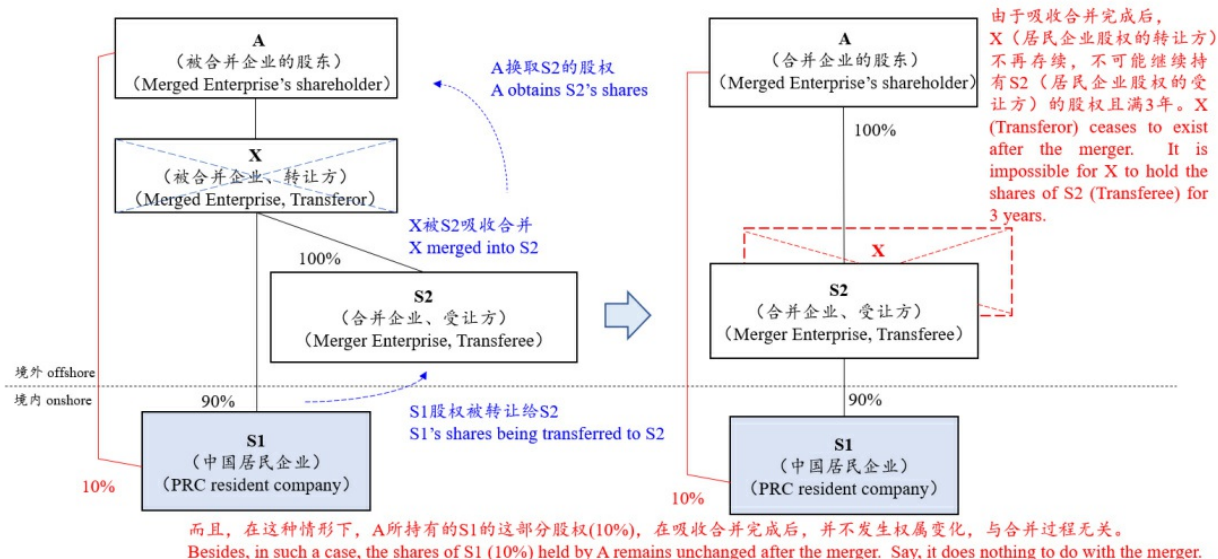
Our detailed analysis is as following:

Firstly, the “shareholder of the Merged Enterprise” (i.e., A in the Picture above) does not hold equity interests of the resident enterprise (i.e., S1 in the Picture above) prior to the merger. Both in substance and in form, the equity interests of the resident enterprise (S1 in the Picture above) are held by the Merged Enterprise (X in the Picture above). Therefore, the “shareholder of the Merged Enterprise” (A in the Picture above) is impossible to be the “transferor” of the equity interests of the resident enterprise (S1 in the Picture above).

Secondly, the situation that **“shareholders of the Merged Enterprise get the equity payment by the Merger Enterprise”** as explicitly mentioned in the definition of “merger” in Article 1 of Circular 59 refers to the situation that the shareholder(s) of the Merged Enterprise (X in the Picture above) loses the equity interests that (originally) it (A in the Picture above) held in the Merged Enterprise (X in the Picture above) to in return **exchange for** the equity interests of the Merger Enterprise (the survived enterprise after the merger, say, S2 in the Picture above) as the consideration (as the payment method). The “equity payment” could be the equity interests of the Merger Enterprise (S2), or the equity interests in a company controlled by it prior to the merger. While as we can see in the Picture above, none of such “equity payment” includes the equity interests of S1 (the resident enterprise). Therefore, **it is the case that the “shareholder (A) of the Merged Enterprise” exchanges the equity interests that it held in the Merged Enterprise (X) for the equity interests in the Merger Enterprise (S2) or in a company controlled (prior to the merger) by the Merger Enterprise, and throughout the whole process, A has never directly held the equity interests in S1, let alone it transferred or paid with S1’s equity interests. In other words, since the Merged Enterprise (X) itself is the “non-resident enterprise” that holds (and then “transfers”) the equity interests of the resident enterprise (S1), there is no such scenario where the “shareholder of the Merged Enterprise” (A) loses (transfers) the equity interests in the resident enterprise (S1) through a “cross-tier” transfer manner. That is to say, “the shareholder of the Merged Enterprise” (A) can never be the transferor of the equity interests of the resident enterprise (S1).**

Taking a step back, if the “shareholders of the Merged Enterprise” did hold equity interests in the resident enterprise prior to the merger, then, such holding relationship will not change due to the Merged Enterprise being absorbed during the merger, that is to say, the shareholder of the Merged Enterprise will continue holding the equity interests in the resident enterprise that it previously held.

This specific situation is presented in **Picture 4** below (in particular, for illustration purpose, we assume A holds 10% of the equity interests in S1, and X holds 90% of the equity interests in S1).



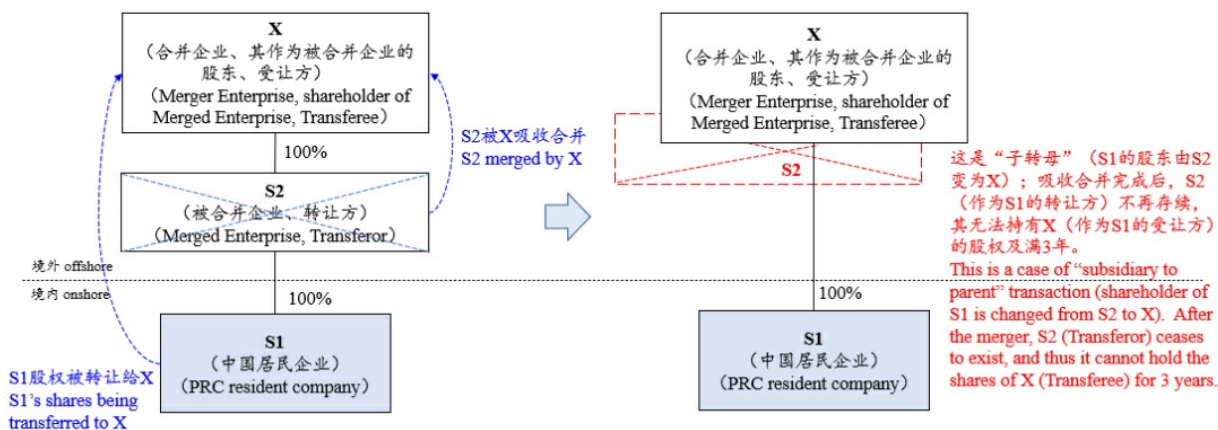
△ Picture 4

Some people think that among the 3 conditions stipulated in Article 7(1) of Circular 59, the condition (3) can be implemented in a “flexible” approach. We disagree with this view. As we analyzed earlier, even taking a step back, if there is one condition among the 3 conditions is indeed “more indispensable”, it should be the condition (2) (“there shall be no change in future for the PRC withholding income tax burden on the taxable income of the equity transfer which may occur in future”) that plays this role.

■ Vertical absorption merger - Forward absorption merger (i.e., parent absorbing subsidiary)

By reversing the direction of the merger, as presented in **Picture 5** below, for the “parent absorbing subsidiary” arrangement (i.e., a parent company (a non-resident enterprise) absorbs a subsidiary company (a non-resident enterprise, which is referred to as “**forward absorption merger**”, and the subsidiary company transfers the equity interests in the resident enterprise held by it to its parent company), if the conditions for special tax treatment were mechanically interpreted and implemented, it not only would **fail to satisfy** condition (1) of Article 7(1) of Circular 59 (i.e., parent company transfers resident enterprise to subsidiary company under the case “subsidiary absorbing parent”), but also would **fail to satisfy** condition (3) of Article 7(1) of Circular 59 as well, since the subsidiary (transferor) ceases to exist after the absorption merger is completed, say, it is impossible for X to hold S2 that no longer exists after the merger, let alone holding for 3 years.

Thus, under such a situation, Article 7(1) of Circular 59 also conflicts with the definition and common practice of a merger.



△ Picture 5

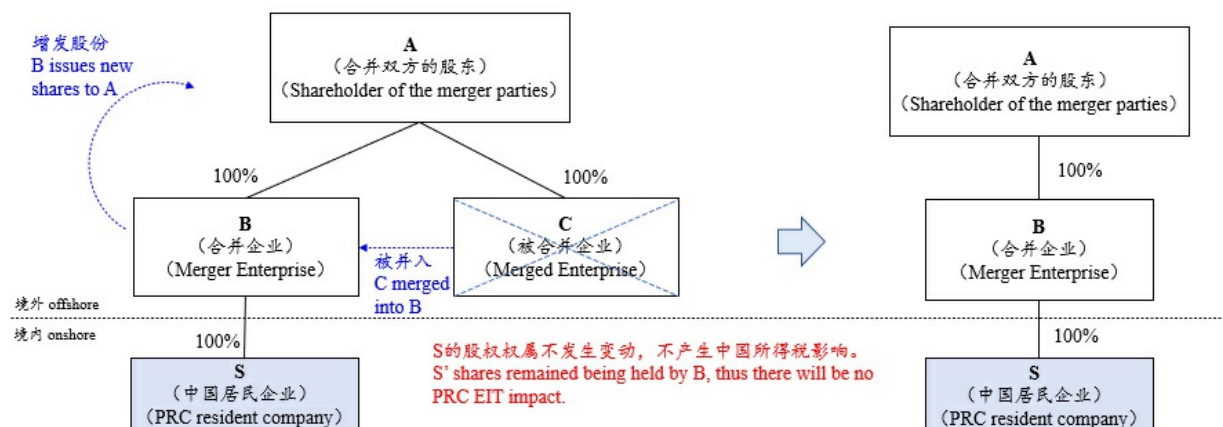
Furthermore, let's do a further analysis: if only “reverse absorption mergers” (subsidiary absorbing parent) are allowed to apply special tax treatment while “forward absorption mergers” (parent absorbing subsidiary) are not allowed, wouldn't that contradict with the commonly

happened situation in the business practice? In the business practice, the subsidiary company is generally established later than the parent company's establishment (except for the case where the subsidiary is acquired later from others). And thus the parent company has operated for a longer period and has developed more business resources such as business contracts, while the subsidiary company generally has a shorter history and fewer resources. In such a case, considering the consequence of an absorption merger is the dissolution of the Merged Enterprise, it is commercially obvious which type of merger carries less adverse business impacts. Say, generally, the dissolution of a subsidiary company (under a forward absorption merger) carries less adverse business impacts than the dissolution of a parent company (under a reverse absorption merger) does. Therefore, it goes against business logic to claim that only the "reverse absorption mergers" (subsidiary absorbing parent) are eligible for special tax treatment. And such a stance would seriously violate the principle of tax neutrality as well.

If the position that only the "reverse absorption mergers" (subsidiary absorbing parent) could qualify for special tax treatment is specifically targeted for the arrangement where a newly established special purpose vehicle (SPV) acquires a long-time-existed target company and then the target company absorbs the SPV, then, we will ask a question: comparing it to the pure intra-group reorganization arrangement as mentioned in the paragraph above, which type of arrangement is more "natural", or less "artificial" (less tax planning purpose)? For this, we further infer that, if the tax authorities believe that only the "subsidiary absorbing parent" could qualify for all the conditions for applying special tax treatment, wouldn't this position encourage the reorganizations that are more "artificial" (of tax planning purpose) and it is to against the reorganizations that are more "natural"?

■ Horizontal absorption merger (existing enterprise(s) being merged by another existing enterprise)

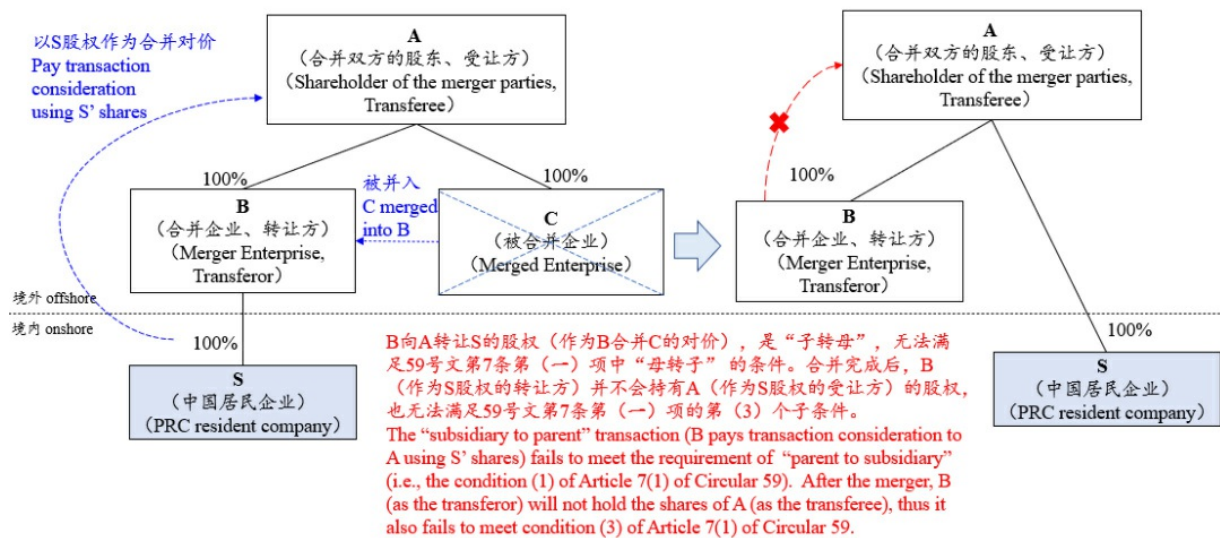
In the case of a **horizontal absorption merger**, (1) as presented in **Picture 6** below, if the "shareholder of the resident enterprise S" (i.e., B, which is a non-resident enterprise) is the Merger Enterprise, then, the equity interests of the resident enterprise (S) held by the Merger Enterprise (B) normally will not change. This is because the Merger Enterprise (B), as the party accepting the assets and liabilities of the Merged Enterprise (C), itself (B) will not transfer the resident enterprise (S) held by it. The Merger Enterprise (B) issues new shares to the "shareholder of the Merged Enterprise C" (i.e., A) (say, capital increase by the shareholder of the Merged Enterprise into the Merger Enterprise) or pay it cash consideration. As a result, there will be no PRC EIT impact, let alone whether special tax treatment applies.



△ Picture 6

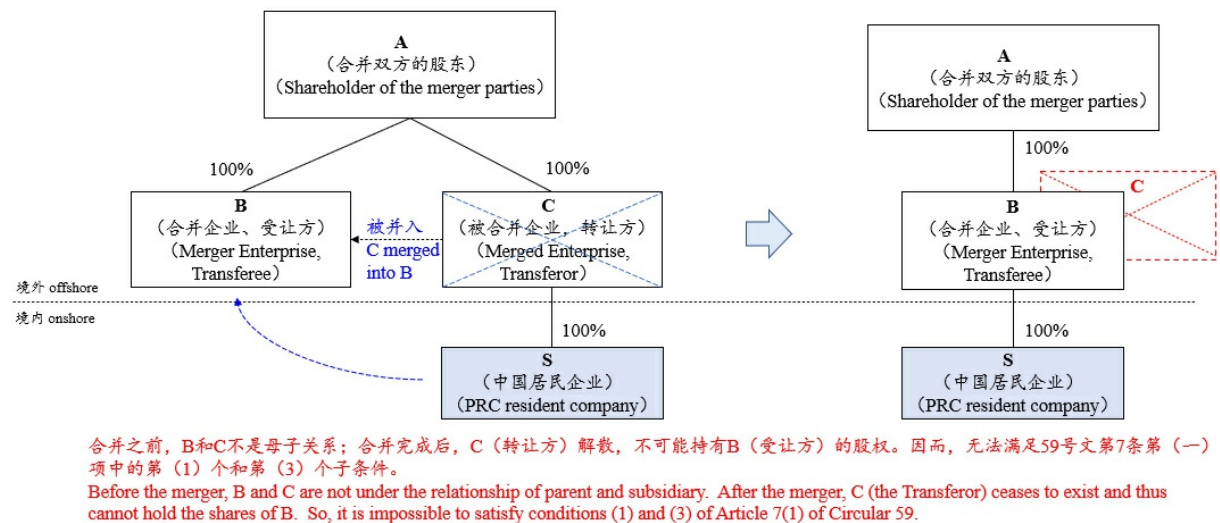
(2) Even if the Merger Enterprise B needs to transfer the equity interests of the resident enterprise S as a part of the consideration paid to the "shareholder of the Merged Enterprise C" (i.e., A) in exchange for acquiring the assets of the Merged Enterprise C, in such a case, the transfer path of the equity interest held by the Merger Enterprise B in the resident enterprise S will be "from the subsidiary to the parent company". Consequently, after the transaction is completed, the transferor (Merger Enterprise B) will not hold the equity interest of the transferee (A, shareholder of the Merged Enterprise C) (please refer to the **Picture 7** below). As a result, this also **fails to meet** the requirements of the condition (1) (it requires "parent company transfers resident enterprise to subsidiary company") and condition (3) (it requires B holds A and

lasts for 3 years, which are impossible to achieve) of Article 7(1) of Circular 59.



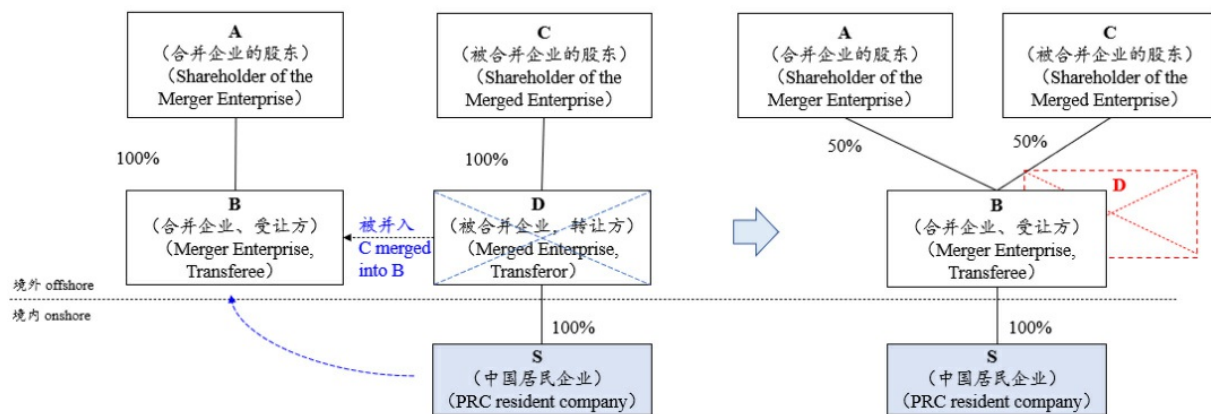
△ Picture 7

(3) Under another scenario, as shown in the below **Picture 8-1**, the “shareholder of the resident enterprise S” (i.e., C, a non-resident enterprise) is the Merged Enterprise, and after the absorption merger is completed, the equity interests of the resident enterprise S held by the shareholder C will be transferred to the Merger Enterprise B. In this case, since the Merged Enterprise C and the Merger Enterprise B do not have a “100% parent-subsidiary equity interests holding relationship” (but rather a sibling-companies relationship), and since the Merged Enterprise C (transferor) ceases to exist after the absorption merger, it also **fails to satisfy** the requirements of the condition (1) (it requires “parent company transfers resident enterprise to subsidiary company”) and condition (3) (it requires C holds B and lasts for 3 years, which are impossible to achieve) of Article 7(1) of Circular 59. **Thus, under such a situation, Article 7(1) of Circular 59 also conflicts with the definition and common practice of a merger.**



△ Picture 8-1

In the case that the enterprises are not under the same control, as shown in **Picture 8-2** below, the shareholder of resident enterprise S (i.e., D, a non-resident enterprise) is the Merged Enterprise. After the absorption merger is completed, the equity of resident enterprise S held by D will be transferred to the Merger Enterprise B. In this situation, since it is **even more impossible** for the Merged Enterprise D and the Merger Enterprise B to have a 100% parent-subsidiary relationship, and the Merged Enterprise D (the transferor) will cease to exist after the absorption merger is completed, therefore, it also **could not meet** the conditions (1) and (3) stipulated in Article 7(1) of Circular 59.



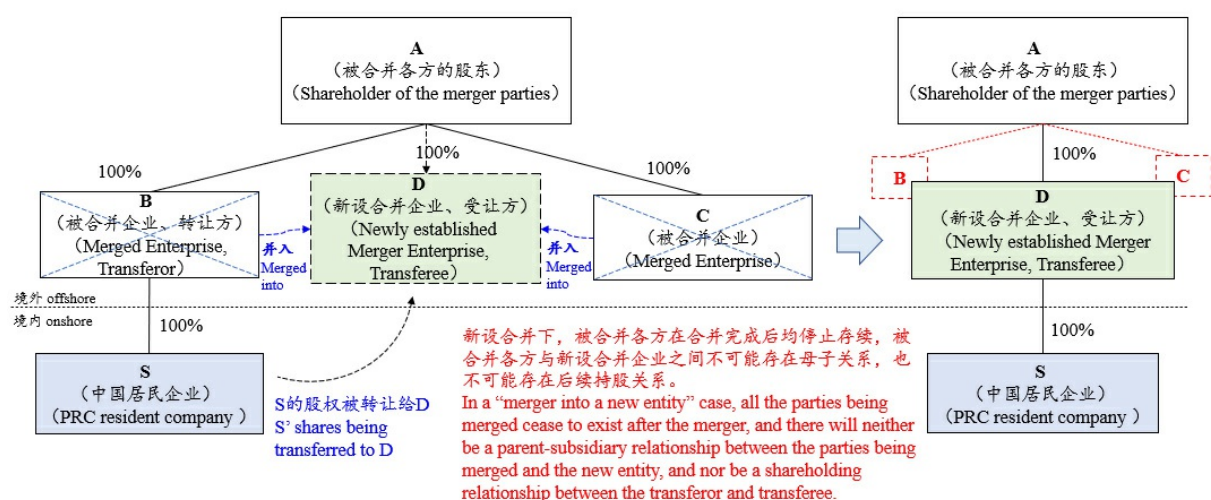
合并之前，B和D不是母子关系；合并完成后，D（转让方）解散，不可能持有B（受让方）的股权。因而，无法满足59号文第7条第（一）项中的第（1）个和第（3）个子条件。

Before the merger, B and D are not under the relationship of parent and subsidiary. After the merger, D (the Transferor) ceases to exist and thus cannot hold the shares of B. So, it is impossible to satisfy conditions (1) and (3) of Article 7(1) of Circular 59.

△ Picture 8-2

- All merged parties being merged into a new entity (i.e., existing enterprise(s) being merged by a newly established enterprise)

In the case of the “all merged parties being merged into a new entity”, as presented in **Picture 9** below, all the parties being merged (B and C) cease to exist after the merger, and there could not be a parent-subsidiary relationship between the parties being merged (B and C) and the new entity D (as required by the condition (1) of Article 7(1) of Circular 59), nor could there be any subsequent shareholding relationship between them, let alone a commitment not to transfer the shares of the acquiring entity (D) within 3 years by the transferors (B and C) (as required by the condition (3) of Article 7(1) of Circular 59). This means that the conditions (1) and (3) of Article 7(1) **could not be met simultaneously**. Thus, under such a situation, Article 7(1) of Circular 59 also conflicts with the definition and common practice of a merger.



新设合并下，被合并各方在合并完成后均停止存续，被合并各方与新设合并企业之间不可能存在母子关系，也不可能存在后续持股关系。
In a “merger into a new entity” case, all the parties being merged cease to exist after the merger, and there will neither be a parent-subsidiary relationship between the parties being merged and the new entity, and nor be a shareholding relationship between the transferor and transferee.

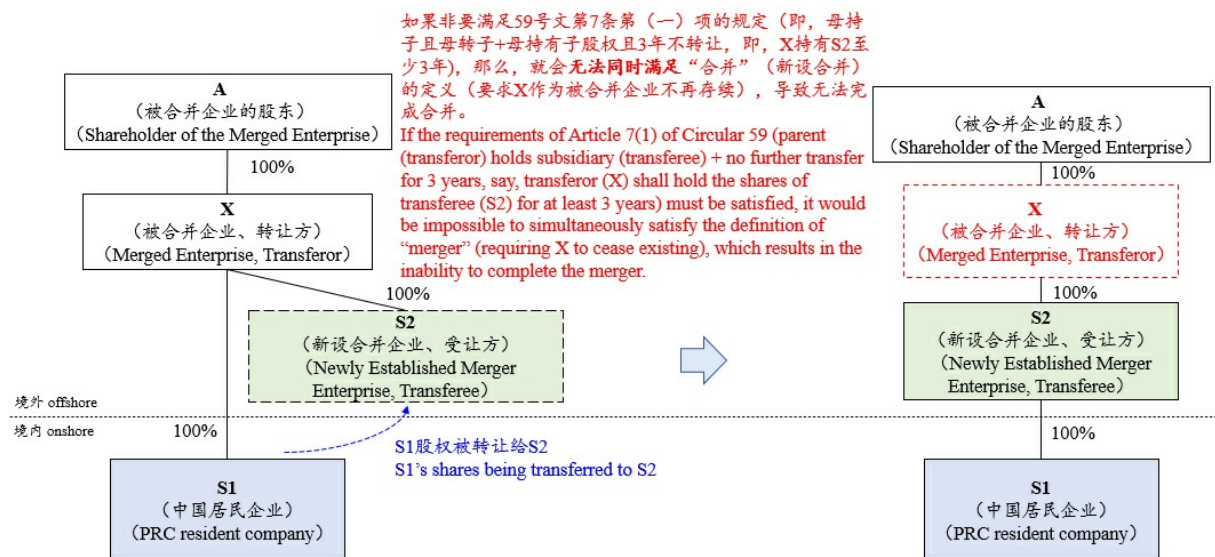
△ Picture 9

- Others

As presented in **Picture 10** below, if conditions (1) and (3) of Article 7(1) must be met, i.e., to meet the requirement that parent (transferor) holds subsidiary (transferee) and parent (transferor) transfers to subsidiary (transferee) the equity shares in a resident enterprise (say, X holds S2, and X transfers the shares of the resident enterprise S1 to S2) plus to meet the requirement of no further transfer for 3 years (say, transferor (X) shall hold the shares of transferee (S2) for at least 3 years), then, it would be **impossible to simultaneously meet** the definition of “merger”.

That is to say, the requirement that “transferor (X) shall hold the shares of transferee (S2) for at least 3 years” will result in that X shall not be deregistered and accordingly result in the inability to complete the merger, which would seriously undermine the commercial effect of the

contemplated instant merger of X and S2. In other words, even if a certain form of “cross-border enterprise merger” could meet the requirements of Article 7(1) of Circular 59, it will still not meet the definition and common practice of a “merger”, resulting in the conflict of rules, and violate the principle of tax neutrality.



Moreover, if X and S2 do not merge within 3 years, this step is actually that X makes a capital contribution to S2 by using S1’s equity interests (also a form of reinvestment). Similar to our analysis in the “demerger” section, according to Article 10 of Circular 59, if the relevant transaction is divided into several stages and can only be completed after 3 years, then, from a tax rule perspective, it would be difficult to combine and view them as “one single” enterprise merger transaction.

Looking at this from another perspective: after 3 years, when S2 absorbs and merges X, X will be deregistered and A will hold S2’s equity, resulting in X indirectly transferring the equity of S1 (a resident enterprise) to A. Some people argue that, at this time, the “safe harbor rule” of the *Announcement on Several Issues concerning EIT on the Indirect Transfer of Property by Non-Resident Enterprises* (Announcement No. 7 of the SAT in 2015, “[Announcement 7](#)”) could be applied, meaning no tax would need to be paid, thus could achieve a “roundabout success” effect.

However, we think that, even if the “safe harbor rules” of Announcement 7 could be applied reluctantly, it could not be ignored the fact that Announcement 7 was issued in 2015, while Circular 59 and Bulletin 72 were issued in 2009 and 2013 respectively. Thus, taxpayers could not have anticipated in 2009 and 2013 that there would be a rule providing relief in the future, and therefore they could not have waited since 2009 and 2013 to only complete first half of the proposed merger (say, X transferring S1’s equity to S2) while to leave the second half (say, S2 absorbing and merging X, with X being deregistered) undone until more favorable and clear rules were issued. Conversely, from the perspective of the issuers of Circular 59 and Bulletin 72, it would have been impossible for them to “foresee” the relevant rules of the then (by that time)-unissued Announcement 7 when drafting these 2 regulations, let alone to plan for the coordination with the relevant rules of Announcement 7.

Besides, even if the safe harbor provisions of Announcement 7 could be coordinated with Circulars 59 and Bulletin 72 after 2015 to facilitate a “3-years + 2-steps” subsidiary-parent merger scenario, thereby achieving both the tax-deferral treatment for the direct transfers (under Circulars 59 and Bulletin 72) and avoiding “look-through” treatment for the indirect transfers (not being deemed as direct transfers under Announcement 7) through the “combined protective framework” of these 3 regulations, we think that this approach will unnecessarily complicate what should have been a straightforward process. It is worth noting that Announcement 7 is fundamentally designed as an anti-tax avoidance measure, therefore, utilizing its safe harbor rules in conjunction with Circulars 59 and Bulletin 72 to make complex, time-consuming tax planning will contradict with the original intent of enabling qualified cross-border enterprise mergers to be completed efficiently within a reasonable

timeframe and to benefit directly from tax deferral treatment in a straightforward manner.

It should be noted that, in the Pictures above, we mainly presented examples of the mergers between related parties. In the case of unrelated parties' mergers, it is even more unlikely for them to be compatible with the contradictory conditions as mentioned above. This is because that the condition (1) of Article 7(1) in Circular 59, say, "the non-resident enterprise transfers equity interest in the resident enterprise to another non-resident enterprise in which it has **100% direct control**", especially restricts the possibility of its application for the mergers between unrelated parties.

Based on the above, similar to our analysis in the previous Sub-Section (1) ("Under the Scenarios of Cross-border Demergers"), **mechanically interpreting and implementing Circular 59 and Bulletin 72 would lead to an adverse expectation that all the cross-border mergers would be deemed ineligible for special tax treatment, and cause the term "merger" in Bulletin 72's provision** "the situations stipulated in Article 7(1) of Circular 59 **include** the cases where the equity interest of a PRC resident enterprise is transferred due to the demerger or **merger** of foreign enterprises" **to lose its intended target. Further, it will be against the business logic, and violate the principle of tax-neutrality.**

We noted that some local tax authorities may have been aware of the aforementioned conflicts of rules, and therefore have adopted a flexible approach in their taxation practice, allowing relevant cross-border enterprise merger arrangements (including the arrangement where the foreign parent company absorbs the foreign subsidiary) to apply special tax treatment.

In our previous discussion regarding cross-border enterprise demergers, we analyzed how the phrase "including demergers" in Bulletin 72 would lose its target. Combined with our analysis in this section regarding cross-border enterprise mergers, where we found that the phrase "including mergers" in Circular 72 will similarly lose its corresponding target, we conclude that the "3-year no transfer" rule stipulated in Article 7(1) of Circular 59 effectively prevents the inclusion of foreign enterprise "demergers and mergers" for the special tax treatment, thus resulting a "vacant (missing) provision" situation.

3. A simulated restatement of the conflicting rules based on the rule-based interpretation approach under the statutory taxation principle.

As previously discussed, Article 7(1) of Circular 59 is not compatible with the definitions of "merger" and "demerger" under Circular 59 and the related common business practice, as well with the provisions of Article 6 of Circular 59. Considering such an embarrassing situation, the reasonable interpretation approach to resolve the aforementioned incompatibility is to conduct a reasonable simulated restatement when embedding the supplementary rule of Bulletin 72 ("the situations stipulated in Article 7(1) of Circular 59 **include** the cases where the equity interest of a PRC resident enterprise is transferred due to the demerger or merger of foreign enterprises") into the provisions of Article 7(1) of Circular 59.

With regard to the conflicts between Circular 59 and Bulletin 72, we suggest that the unclear or inconsistent rules should be interpreted, restated and implemented based on the statutory taxation principle, rather than being mechanically interpreted and implemented. Specifically, when conducting a reasonable simulated restatement when embedding the supplementary rule of Bulletin 72 into the rules of Article 7(1) of Circular 59, the relevant rules shall be restated as the following:

"Where enterprises are engaged in equity acquisition or asset acquisition transactions between China and a foreign country/region, [as well for the demerger or merger as described in item (1) below,] in addition to the conditions prescribed in Article 5 [and Article 6] of this Circular, the following conditions shall also be satisfied for the application of the special tax treatment: (1) [For the case that a] A non-resident enterprise transfers equity interest in a resident enterprise to another non-resident enterprise in which it has 100% direct control, [as well for a demerger or a merger of foreign enterprises which leads to the change of equity interest in a resident enterprise,] there shall be no change in future (comparing current tax burden) for the PRC withholding income tax burden on the taxable income of the equity transfer which may occur in future [;] and, [except for the case of the demerger or merger of foreign enterprises], the transferor non-resident enterprise shall undertake in writing to the competent tax authority that it will not transfer the equity interest of the transferee non-resident enterprise for a period of 3 years

(including the 3rd year); [with respect to the demerger or merger of foreign enterprises, the shareholder(s) of the transferor non-resident enterprise shall undertake in writing to the competent tax authority that it (they) will not transfer the equity interest of the transferee non-resident enterprise that it (they) owns as the result of a demerger or merger transaction for a period of 3 years (including the 3rd year); especially, with respect to the case that the foreign parent company absorbs its foreign subsidiary under the merger scenario of foreign enterprises, the shareholder(s) of the foreign parent company shall undertake in writing to the competent tax authority that it (they) will not transfer the equity interest of the foreign parent company for a period of 3 years (including the 3rd year);]”.

In the paragraph above, the contents in “[]” are the specific rules corresponding to those provided in Bulletin 72 that we suggest be embedded into the rules which need to be restated in Circular 59.

We believe that, the underlying reason of the necessity to do the foregoing simulated restatement is that, there are significant differences in the legal nature and operational practices of the “equity acquisition” and “asset acquisition” from those of the “demerger” and “merger”. Say, they share less common factor of rules in the special tax treatment rules system for reorganizations. Specifically, among the 3 conditions provided in Article 7 (1) of Circular 59, only the 2nd condition (“There shall be no change in future (comparing current tax burden) for the PRC withholding income tax burden on the taxable income of the equity transfer which may occur in future”) is their common factor of the rules.

Therefore, if the relevant rules are not restated as above, then, the relevant rules of Article 7 of Circular 59 will be in fact “suspended” (undermined) and accordingly will be meaningless for the cross-border demerger and merger of foreign enterprises.

IV. Mechanically interpreting and implementing Circular 59 and Bulletin 72 is contrary to the “non-discrimination” provisions of the Tax Treaties (Agreements) signed by China.

China has concluded the agreements or arrangements for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income (collectively referred to as “**Tax Agreements**”) with many countries/regions. As a common practice, the non-discrimination clauses are usually stipulated in the Tax Agreements. Taking the China-Spain Tax Treaty as an example, under Article 26 (Non-discrimination), the first paragraph stipulates that, “Nationals of a Contracting State **shall not be subjected** in the other Contracting State **to any taxation or any requirement connected therewith**, which is other or **more burdensome than** the taxation and **connected requirements** to which nationals of that other State in the same circumstances, **in particular with respect to residence, are or may be subjected**.”

In addition, according to Article 91 of the *Tax Collection and Administration Law of the PRC*, where there are different provisions in the tax treaties or agreements concluded between the PRC and a foreign country from those in this Law, the provisions of the treaty or agreement shall prevail. Besides, according to Article 58 of the *EIT Law of the PRC*, in case where the provisions under the agreements on taxation between the Chinese government and the foreign government differ from the provisions stipulated in this Law, the provisions prescribed in the agreements shall prevail.

According to the above, if the rules outlined in Circular 59 and Bulletin 72 indeed should be interpreted as “there is only one scenario (i.e., the cross-border ‘subsidiary absorbing parent’ scenario) that could satisfy all the conditions for special tax treatment” (in fact, as we discussed previously, even the “subsidiary absorbing parent” case could not meet all the conditions), then, because the conditions to be met for mergers and demergers for the pure domestic reorganizations to satisfy the “full set of conditions for special tax treatment” are much easier than those for cross-border mergers and demergers, and the domestic applicable scenarios are much wider comparing to the cross-border enterprise reorganizations, therefore, it will lead to a situation where foreign companies will face a more stringent situation and they shall “fulfill additional (heavier) requirements (conditions) than the pure domestic reorganizations have to do. It is not imaginable that the SAT, as one of the leading PRC authorities in negotiating the Tax Agreements with other countries/regions, has any discriminatory intention to impose “additional (heavier) requirements (conditions)” on foreign companies for applying the special tax treatment when it formulates the rules related to Circular 59 and Bulletin 72.

V. Conclusion

In conclusion, with respect to the cross-border demergers and cross-border mergers, it is necessary and reasonable to interpret, restate and implement the unclear or inconsistent rules based on the statutory taxation principle and the legislative purpose of the rules. When there are multiple interpretations on the tax regulations, priority shall be given to the interpretation that is favorable to taxpayers so as to protect their legitimate rights and interests. On the other hand, if Circular 59 and Bulletin 72 are mechanically interpreted and implemented, it will result in the inapplicability of special tax treatment for all the cross-border demergers and mergers. Blocking the possibility of these 2 major types of reorganizations from enjoying the tax-neutral treatment shall by no means be the purpose of issuing the relevant tax regulations. Otherwise, the SAT could simply issue a tax rule stating that neither the cross-border demergers nor the cross-border mergers are eligible for special tax treatment, without the need for Bulletin 72 to state that “the situations stipulated in Article 7(1) of Circular 59 include the cases where the equity interest of a PRC resident enterprise is transferred due to the demerger or merger of foreign enterprises”. Therefore, since the SAT has explicitly mentioned that the case “transferred due to the demerger or merger of foreign enterprises” is included in special tax treatment circumstances, it indicates the intention to consider granting special tax treatment to such reorganization arrangements.

Facing the contradictions and conflicts between relevant rules of the cross-border reorganizations in the tax regime, in the taxation practice, we noticed that some local tax authorities are generally flexible with regard to the application of special tax treatment for cross-border enterprise demergers and mergers. For the cross-border demergers and mergers other than the “subsidiary absorbing parent” scenario, such tax authorities accept the record-filing documents for the application of special tax treatment or gave tacit consent to the non-taxable treatment at the time of relevant transactions.

However, some other tax authority accommodates conflicting views even among its different teams on whether special tax treatment is applicable to the specific cross-border enterprise demergers and mergers. And certain tax authority in different periods of time even presented completely different positions on the application of special tax treatment for specific cross-border enterprise demergers and mergers.

Given that the MOF and the SAT have not yet clarified or “officially restated” the relevant rules with respect to the above-mentioned doubts and confusions, there is a significant uncertainty in the implementation of such rules in current tax administration practice at different locations in China. This leads to an adverse expectation of uncertain tax treatment for the internal reorganization transactions of multinational enterprise groups, and this also increases the legal enforcement risks for relevant tax authorities.

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