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Client Alert

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China: Tax Updates | New Company Law

In brief

On December 29, 2023, the Standing Committee of the National People's Congress of the People's Republic of China promulgated the amended Company Law of the People's Republic of China ("**PRC**" or "**China**") (the "**2023 Company Law**"), after its deliberation of four versions of draft amendments in the past three years. The 2023 Company Law will come into force on July 1, 2024.

Compared with the 2018 Company Law (i.e. the version currently in effect), over 200 articles are added and amended in this round of overhaul, including substantial amendments to over 100 articles. Following the comments on these amendments from a commercial law perspective in our client alert dated 10 January 2024[1], we cover certain key tax implications in relation to the changes made in the 2023 Company Law.

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1. Capitalization Requirements

1.1 Registered capital of a LLC shall be paid up within 5 years after establishment of the company

[1] See the client alert issued in January 2024 for further details, available at https://insightplus.bakermckenzie.com/bm/mergers-acquisitions_5/china-releases-new-company-law.

One of the most significant changes made in the 2023 Company Law is that shareholders of a LLC should inject subscribed capital within 5 years after establishment of the company. The 5-year statutory term applies to companies incorporated after the 2023 Company Law enters into force, and companies incorporated before the effective date shall "gradually adjust" their capital contribution schedule to conform to the new requirement. It is expected that the State Council will issue detailed rules[2] in this regard, for example, by providing a grace period to the existing companies as of the effective date.

The mandatory capital contribution requirement may have tax implications in various perspectives. Pursuant to Guo Shui Han [2009] No. 312 ("**Circular 312**"), where investors of a company fail to fully pay up their capital contribution within the specified time limit, interest accrued from the company's loans attributable to the unpaid portion of capital contribution does not qualify as the company's "reasonable expenditures", and should not be deducted from the company's taxable income for enterprise income tax ("**EIT**") purposes.[3]

Under the 2018 Company Law, the "specified time limit" under Circular 312 should be interpreted as the deadline of capital contribution according to the company's articles of association. After the 2023 Company Law enters into effect, the "specified time limit" may be capped at 5 years or 8 years under the Draft Regulations. As such, the shareholder and the investee may need to better reconcile the capital injection timing and debt financing schedules, if there is unpaid registered capital and outstanding loans. It remains to be seen whether the State Taxation Administration ("**STA**") would issue any further guidelines on the application of Circular 312 during the transition period after the 2023 Company Law enters into effect.

Additional attention should also be paid to potential tax liabilities that may arise in a capital reduction, if the company chooses to reduce its registered capital to meet the 5-year (or 8-year under the Draft Regulations) time limit. In a capital reduction, the proceeds received by the shareholder are divided into three categories and subject to different tax treatments respectively: (1) the portion equivalent to initial investment should be recognized as recovery of investment and not subject to tax; (2) the portion equivalent to retained earnings and surplus reserve should be recognized as dividends ; (3), the remainder should be recognized as capital gains from equity transfer.[4] The tax rules providing such tax treatment does not specify how the categories may be split, whether there should be a pro-rata allocation, or whether the investor can choose the specific category. Due to the lack of specific guidance on the categorization, local practice may vary.

1.2 In-kind capital contribution of equity interests and creditors' rights is allowed

The 2023 Company Law expressly confirms that shareholders can make capital contribution to companies in equity interest and creditor's rights, among other forms. Though not specifically listed in the 2018 Company Law, the local Administration of Market Regulation ("**AMR**") has generally allowed capital contributions to be made in such forms. It remains to be seen to what extent the 2023 Company Law may change the current regulatory landscape on capital contribution and corporate restructuring.

In this section, we will discuss the tax implications incurred by in-kind contribution in equity interests and debts under the current tax regime and also other considerations relevant to this process.

A. In-kind contribution of equity interests

For capital contribution of equity interests, it can apply general tax treatment, or special tax treatment. Under general tax treatment, in-kind capital contribution should be subject to EIT as deemed equity transfer from the contributing shareholder to the investee company. Taxable capital gains equal to the difference between fair market value of the contributed equity and tax basis in the contributed equity. Pursuant to Cai Shui [2014] No. 116, the contributing shareholder is entitled to pay the EIT on

[2] On February 6, 2024, the State Administration for Market Regulation of the People's Republic of China issued the draft Regulations of the State Council on Implementing the Registration and Management of Registered Capital under the Company Law of the People's Republic of China ("**Draft Regulations**") for public consultation. Pursuant to the Draft Regulations, existing companies established before the Effective Date, are granted a grace period of three years from the Effective Date (i.e., from July 1, 2024 to June 30, 2027, "**Grace Period**"), during which companies shall make adjustment to their current capital contribution terms to the effect that all the outstanding capital will be contributed within five years after such adjustment. If a company fails to make the aforesaid adjustment by the end of the Grace Period, the local AMR may order it to make such adjustment within 90 days. In such case, the capital contribution term after adjustment shall be no longer than five years after the end of the Grace Period.

[3] STA Reply on the Deduction of Interest Expenses Incurred due to Underpaid Capital Contribution, Guo Shui Han [2009] No. 312, dated 4 June 2009.

[4] STA Bulletin on Several EIT Issues, Bulletin [2011] No. 34, dated 9 June 2011 and effective from 1 July 2011.

capital gains in instalments within a period of no more than 5 years.[5] The contributing shareholder's tax basis in the investee company should also be adjusted on a yearly basis corresponding to the instalment plan.

The contributing shareholder can also choose to adopt the special tax treatment provided that the prescribed conditions are satisfied. Pursuant to Cai Shui [2014] No. 109, equity contribution from the parent company to its wholly owned subsidiary is entitled to special tax treatment, where neither the transferor or transferee recognizes income, and the transferee can carry over the original tax basis of the transferred equity.[6] Specifically, a company injecting or increasing capital to its established wholly owned subsidiary needs to satisfy the following conditions to apply special tax treatment: (i) both the parent company and subsidiary are PRC resident enterprises; (ii) the equity contribution is supported with reasonable commercial purposes, and its principal purpose is not the reduction, exemption or deferral of tax payment; and (iii) substantive operation activities of the contributed equity should not be changed within the 12 consecutive months following the contribution.

Capital contribution between two resident enterprises that do not have the above 100% shareholding relation can also apply special tax treatment by structuring the capital contribution as an equity transfer, where the transferor receives the transferee's newly issued capital as consideration. Under Cai Shui [2009] No. 59 ("**Circular 59**"), the deemed equity transfer needs to satisfy certain additional requirements on the contributed equities, percentage of share-based payment, etc. besides the above three conditions. Capital contribution made by non-resident investors to a resident enterprise is subject to even more stringent requirements.[7]

Overall, general tax treatment will incur EIT liabilities in capital contribution, but can ensure tax basis step-up on any future equity transfers; while special tax treatment defers the tax payment liability until the capital gains are actually realized. Enterprises contemplating to make capital contribution or relevant corporate restructuring should comprehensively consider the group's shareholding structure, overall financial status, subsequent transaction arrangements to determine the specific approaches.

B. In-kind contribution of creditors' rights

A typical capital contribution of creditors' rights is debt-equity swap, in which the company’s creditor contributes its creditor rights to the company in exchange for shares in the company. Circular 59 provides two options for the tax treatment in a debt restructuring, i.e. the general tax treatment and special tax treatment. Under general tax treatment, debt-equity swap is deemed as a transaction involving two steps, debt repayment and equity investment; the creditor and debtor recognize debt restructuring losses and gains, respectively equal to the difference between the actual debt repayment amount and tax basis of the debt. Under special tax treatment, the creditor and debtor do not recognize debt restructuring losses or gains, and the creditor's tax basis in the original debt is carried over to become tax basis of the newly acquired equities in the debtor company. The debt-equity swap needs to satisfy prescribed requirements to satisfy special tax treatment.

Besides the different tax treatments, foreign investors considering debt-equity swaps also need to take into consideration China's foreign exchange control regime . Only debts that have been registered with the State Administration of Foreign Exchange is qualified for debt-equity swap. Unregistered foreign debts cannot be converted as paid-in capital. . It remains to be seen whether further adjustments will be made on the prevailing foreign exchange control regime after the 2023 Company Law enters into effect, to allow foreign investors more opportunity to convert debt into equity in PRC companies on a broader scale.

1.3 Shareholder(s) shall indemnify the company for unpaid paid-in capital

Under the 2018 Company Law, a shareholder failing to make capital contribution before the deadline according to the provisions in articles of association will be held liable for breach of contract to other shareholders who have paid up their subscribed capital. The 2023 Company Law deleted the defaulting shareholder's liabilities for breach of contract to other shareholders, and provides that the defaulting shareholder should be liable to indemnify investee for losses caused by its

[5] The Circular on Policy regarding Enterprise Income Tax for Non-monetary Asset Investments, Cai Shui [2014] No. 116, dated 31 December 2014 and retrospectively effective from 1 January 2014.

[6] Circular regarding the EIT Treatment to Facilitate Enterprise Restructuring, Cai Shui [2014] No. 109, dated 25 December 2014 and retrospectively effective from 1 January 2014.

[7] Circular on Issues on EIT Treatment in Enterprise Restructuring, Cai Shui [2009] No. 59, dated 30 April 2009 and retrospectively effective from 1 January 2008.

underpayment of capital contribution. The shareholder's indemnification may include, for example, compensation for the non-deductible interest costs under Circular 312, or other compensation agreed in the articles of association, etc.

The nature of the shareholder's indemnification is not yet clear from both tax and accounting perspective. At the level of the investee, shareholder's indemnification could be recorded as (1) capital reserve; or (2) income of the company from an accounting perspective. The indemnification may be treated as the investee company's taxable income. At the level of the shareholder, it is also not yet clear whether the indemnification could be counted as part of the shareholder's tax basis in the company or simply an accounting loss which may be subject to further tax deductibility assessment.

1.4 JSC can issue shares of different classes and shares without par value

Under Article 142 of the 2023 Company Law, a JSC can issue non-par value shares or par value shares, but it cannot issue both types of shares in the same company. If the company chooses to issue non-par value shares, more than 50% of the proceeds from share issuance should be recorded in registered capital.

Under Article 144 of the 2023 Company Law, a JSC is allowed to issue different classes of shares in terms of the order of dividend distribution and liquidation proceeds, voting rights, restrictions on transfer, etc.

After the 2023 Company Law enters into effect, it is expected that the different classes and types of shares issued by JSC could give rise to new tax-related questions in various aspects. For instance, issuing shares of different classes may pose challenges on assessing fair market value in equity transfers. Where the JSC shares are not publicly traded, it remains to be seen whether and to what extent the tax authority will recognize that priority in dividend distribution, restricted voting rights or restrictions on transfer would justify deviation from the price per share determined based on the principle of same share for same right.

2. Appraisal Right of Dissenting Shareholders

2.1 Shareholders of a LLC or JSC can require the company to acquire their equities at a reasonable price in prescribed circumstances

The 2023 Company Law also amends the provisions regarding dissenting shareholders' appraisal right. Under 2018 Company Law, shareholders of a LLC can require the company to repurchase their shares at a reasonable price if they vote against the shareholder's resolution regarding no dividend distribution in 5 consecutive years, merger, division, transfer of main property or amendment on articles of association to extend duration of the company. Under the 2023 Company Law, besides the above scenarios, LLC shareholders can also exercise their appraisal right where the company's controlling shareholder abuses its shareholder right and causes serious damage to the interests of the company or other shareholders. Similarly, shareholders of a JSC can also require the company to repurchase their shares in similar prescribed circumstances.

The amendments made in the 2023 Company Law represents a step forward on enhancing the rights and protection for minority shareholders. From a tax perspective, special attention should be paid to the assessment of "reasonable price". In the cases where shareholders ask the company to repurchase their equities due to significantly different positions on the company’s future business operation, it is generally expected that shareholders and company may also drive a hard bargain over the repurchase price. As such, the final agreed price may deviate from the arm's length price determined by reference to the company's net asset value or effective valuation report.

In the event that the dissenting shareholders' exiting price is significantly low, it is uncertain whether the tax authority would deem the exercise of appraisal right a justifiable reason for the low price. In case the contractual repurchase price is captured and challenged by the in-charge tax authority, the seller will need to prepare sufficient evidence and detailed documents on the price negotiation process to support that the price is reasonable.

3. Creditors' Right and Protection

The 2023 Company Law has provided a series of provisions enabling the company's creditor to go after the company's shareholders or affiliates for outstanding debts in certain exceptional scenarios. Tax authority, as taxpayer's creditor, may also be covered under such protection on creditors. In this section, we will discuss the possible legal basis in the 2023 Company Law that the tax authority may invoke to extend the tax liability to third parties other than the taxpayer, and analyse application of such rules in tax collection and administration based on available real cases.

3.1 The tax authority can pursue tax from the taxpayer's shareholder or affiliate

- Disregard of legal personality

Under Article 23 of the 2023 Company Law, a shareholder that abuses the company's independent legal personality and shareholder's limited liability to escape debt, and causes serious damage to the interests of company's creditors, should be jointly and severally liable for the company's debts. Besides, if a shareholder conducts the above behavior utilizing two or more companies under its control, such companies should be jointly and severally liable for each other's debts.

Article 23 also provides that where the only shareholder of a company is unable to prove that the company's assets are independent of the shareholder's assets, it should also bear joint and several liability for the company's debts.

- Shareholder's liability to contribute capital prior to agreed timeline in prescribed circumstances

Under Article 54 of the 2023 Company Law, if the company is unable to repay its debts, the company or company's creditors is entitled to require the shareholder to pay up their subscribed capital, even if the capital is not yet due. Article 54 is a newly added provision in the 2023 Company Law. It remains to be seen whether there would be further clarifications on how to determine whether the company is "unable" to repay its debts.

- Shareholder's liability after deregistration of company

The 2023 Company Law formalizes the simplified company deregistration regime, and also includes the shareholder's post-deregistration liability previously provided under Supreme People's Court Interpretation on Company Law (II) ("**Judicial Interpretation II**"). Under Article 240, where all shareholders of a company make a commitment that the company has not incurred any debts during its existence or has settled all outstanding debts, the company can be deregistered through a simplified procedure. However, the deregistered company's shareholders will be held liable for the company's debts incurred before deregistration if they make a false commitment on the company's debt repayment status.

3.2 Practical observations

We have observed in a few cases that the Chinese tax authority tended to invoke civil law provisions to go after the taxpayer's shareholders in case the taxpayer is unable to repay its own underpaid taxes. In July 2022, Qingdao tax authority claimed against a deregistered enterprise's legal representative and actual controller to recover the enterprise's unsettled value-added tax during its existence. According to the Notice of Tax Matters issued by the tax bureau, the enterprise was deregistered through a simplified procedure with the shareholders committing that the enterprise has settled all taxes.

There are also judicial cases upholding that the shareholder should take the company's outstanding tax liabilities after company deregistration on the basis of Judicial Interpretation II, which has similar provisions as Article 240 of the 2023 Company Law. In the case *Ding Haifeng v. Beijing Municipal Tax Bureau Audit Bureau*, the court held that by confirming in writing that "the company has settled all outstanding taxes" in the company deregistration procedure, the shareholder cheated the authority to deregister the company by submitting false materials.[8] Therefore, the shareholder was held liable for the company's outstanding taxes.

It is not uncommon in practice for the PRC tax authority to go after the taxpayer's shareholders for underpaid tax after the taxpayer is deregistered. Enterprises should be aware that their potential tax risks may continue to exist even if their legal personality has been deregistered, and the shareholder will be held liable to pay the tax in replacement of original taxpayer.

Further, under the 2023 Company Law, it is also expected that the tax bureau's authority to pursue underpaid tax against the taxpayer's shareholders (or affiliates) will be further enhanced by the regimes such as disregard of legal personality or advanced capital contribution. However, it is still unclear whether and to what extent the tax payment liability can be deemed and protected as the "debts" in civil relations.

Some may hold a position that the tax authority needs to satisfy all the substantive and procedural requirements in the applicable civil law and rules if they wish to claim a creditor's right in private sector. It is a fundamental principle of company law that the company's independent legal personality could only be disregarded in limited circumstances (such as confusion of legal personality, shareholder's excessive domination and control, and significant capital shortage, etc.) as determined by a competent court. As such, the tax authority also needs to bear the burden of proof in front of judges to evidence that the shareholder's misconduct has been severe enough to meet the threshold of legal personality being disregard under applicable company law and rules. Meanwhile, others may hold a different position that tax bureau, as an administrative body with law enforcement authority,

[8] *Ding Haifeng v. Beijing Municipal Tax Bureau Audit Bureau*, (2020)J.02 X.Z. No. 1464

should have more discretion in applying such company law rules, and that certain requirements under company law are not necessarily applicable in tax collection in public sector.

There still lack clear judicial or administrative guidelines or precedents explaining the application of Article 23 or Article 54 of the 2023 Company Law in tax collection scenarios. It remains to be seen whether there will be further clarifications in this regard after the 2023 Company Law takes effect.

4. Dividend Distribution

4.1 Company is entitled to make discretionary dividend distributions

The 2023 Company Law restates that both LLC and JSC can choose to make dividend distribution as per the ratio of paid-up capital or otherwise agreed by shareholders (for LLC) or provided in the articles of association (for JSC). Discretionary dividend distribution allows for more flexibility for the capital redeployment within a group company.

However, from a tax perspective, dividend distributed to different types of shareholders will be subject to different tax treatments. Generally speaking, dividend paid from PRC resident enterprise to another resident enterprise is exempted from EIT; dividend paid from PRC resident enterprise to non-resident enterprise is subject to a 10% withholding tax or preferential dividend withholding tax rate under applicable tax treaties. For individual shareholders, dividend income from resident enterprise is generally subject to a 20% individual income tax. A PRC partnership does not pay income tax in China, dividend income received by a partnership shareholder will only be taxed at the partner level. There are also other preferential tax policies applicable to dividend income that meet certain qualifications.

As such, where shareholders of a company are under the same control and subject to different tax rates for dividend income, there could be planning opportunities by adopting discretionary dividend distribution. That said, it may also give rise to potential tax adjustment risks. The tax authority may recharacterize a company's discretionary dividend distribution arrangement under the substance over form principle. Therefore, companies contemplating to distribute dividends that deviates from the shareholding ratio should conduct careful analysis and retain sufficient documents to evidence the reasonable commercial purposes of such arrangement.

4.2 Dividends should be distributed within 6 months after the shareholder resolution

Article 212 of the 2023 Company Law requires the board of directors to make dividend distribution within 6 months after the shareholder resolution is made. Previously, under the Supreme People's Court Interpretation on Company Law (V), the dividend distribution shall be made no later than one year after the shareholder resolution.

The new rule under the 2023 Company Law shortens the time limit for dividend distribution, therefore requires the company to better align its cash flow with the agreed dividend distribution plan, and also limits potential tax planning opportunities.

5. Loss Make-up

5.1 Company can make up loss by capital reserve conversion and through capital reduction

The 2023 Company Law amends the original loss make-up regime significantly by providing that capital reserve can be used to make up losses after using up the mandatory and discretionary surplus reserve. Further, the 2023 Company Law also expressly confirms that the company can make up losses by capital reduction, during which the company should not make distribution to shareholders or waive shareholder's outstanding capital contribution obligation. After the company reduces registered capital to make up losses, no dividend should be distributed until the aggregate amount of mandatory and discretionary reserve reaches 50% of registered capital.

Under the 2018 Company Law, only surplus reserve is expressly allowed to be used to make up losses, and no tax implications are incurred in this process since the surplus reserve is set aside from the company's after-tax profits. However, the same tax treatment may not necessarily be applied to loss make-up by capital reserve or registered capital.

Main source of capital reserve includes the shareholder's contribution in excess of payable registered capital, stock premium, appreciation of asset valuation, etc. From the accounting perspective, making up loss by surplus reserve involves transferring funds from capital reserve to retained earnings. It remains unclear whether the said increase in retained earnings should be recognized as income of the company for tax and accounting purposes.

Similar uncertainty also exists in the process of loss make-up by capital reduction. Technically, loss make-up by capital reduction could be divided into two steps: (1) capital reduction to the shareholder; and (2) shareholder contributing the reduced capital to the company, which then should be recognized as the company's income, and the shareholder's tax basis in the company should also be adjusted accordingly. However, there are also other viewpoints that neither the shareholder nor the company receives any economic benefit by making up losses, therefore no tax implications should be incurred, and the shareholder's tax basis should also remain unchanged.

Amendment on the loss make-up regime represents a big breakthrough in the original company capital system. It is expected that the STA may issue further guidelines to clarify the tax treatment in more detail.

Key Takeaways and Outlook

As one of the most fundamental commercial legislation in China, the 2023 Company Law will impact enterprises in various perspectives. Besides the contents covered in this article, the 2023 Company Law has also made noticeable changes to the AMR registration procedure, corporate governance structure, etc. For example, the 2023 Company Law provides a simplified procedure for company merger that no longer requires a shareholder resolution, which is applicable to mergers that happen between a company and its subsidiary with more than 90% shareholding, or that involve consideration of no more than 90% of the company's net asset value. As such, the updated shareholder resolution requirements may help to simplify the timeline in enterprise restructuring transactions.

The 2023 Company Law brings both benefits and challenges to investment in China. The new regimes introduced in this amendment, such as the permission of non-par value shares, may allow more flexibility for financing arrangement on one hand, while may also pose challenges on the enterprise's tax management and planning on the other hand. Multinational enterprises are advised to take this opportunity to revisit their governance structure and financing system.

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