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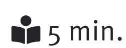
Selling my Business in China: Navigating Cross-Border Taxation and Unpacking US Tax Implications

 5 min.

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United States (US) corporations, in particular, have been actively investing in Chinese entities, leading to intricate tax implications when these companies decide to divest these assets. The US Tax Cuts and Jobs Act (TCJA) of 2017 profoundly changed these tax dynamics. One such change was the introduction of a tax deduction for dividends received from certain foreign subsidiaries that are at least 10 percent owned. This has raised questions for US corporations with investments in China regarding how these provisions interplay with the tax implications when selling the stock of a Chinese subsidiary. In this article, Marcum LLP delves into the complexities of US tax rules and illustrate through two examples of how sections 1248 and 245A can affect the overall income tax effect of selling Chinese subsidiaries.

Before the TCJA, US corporations that received dividends from its foreign subsidiaries were subject to US tax on the dividends received. Foreign tax credits were allowed to offset US tax on such dividends.

The application of section 245A can also be relevant to sales of foreign subsidiary stock by a US corporation.

Under US tax rules, when a US corporation sells stock of a greater than 50 percent owned subsidiary, section 1248 generally recharacterizes the gain realized on sale as a dividend, to the extent of the foreign corporation's post-1962 earnings and profits that were accumulated while the US corporation controlled the foreign subsidiary. Section 1248 applies to any US person who owned 10 percent or more of the foreign corporation's voting stock at any time during the five years before the sale when the foreign corporation was US controlled.

US corporations that sell shares of a Chinese subsidiary should consider the tax impact in China and how that interplays with the US tax consequences of such a sale. China generally imposes capital gains tax on selling a Chinese entity's stock.

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Consider the following examples:

Scenario 1: Dividend Recharacterization and Tax Deduction Implications

Assume a US corporation owns 100 percent of the stock of its Chinese subsidiary. The stock has been owned since the inception of the Chinese entity. The US corporation's tax basis in the stock is US$5M, and the Chinese subsidiary has accumulated earnings of US$10M. The US corporation sells the stock for US$20M and realizes a gain for US tax purposes of US$15M (US$20M sales price, less US$5M of basis). China imposes a tax of US$1.5M on the gain realized on the sale.

From a US income tax standpoint, section 1248 will generally recharacterize US$10M of the gain as dividend income (up to the Chinese subsidiary's earnings and profits). The difference of US$5M (US$15M gain, less US$10M recharacterized) will be treated as US source capital gain.

The amount treated as a dividend (US$10M) will generally be governed by section 245A, and the US corporation will be allowed a deduction of US$10M in computing its US taxable income. The US$5M treated as US source capital gain will be subject to US federal tax of 21%, resulting in US federal tax of US$1,050,000 before applying any foreign tax credits. In determining the amount of the creditable Chinese tax, the amount of tax attributable to the section 245A deduction will need to be determined. The rules surrounding this determination are complex. However, simply stated, 10/15 of the Chinese tax (i.e., the ratio of dividend treatment to total gain recognized) would be allocated to excluded income for which no foreign tax credit will be granted. As such, US$1M (10/15 * US$1.5M) of Chinese tax would not be eligible to offset US tax on the non-dividend portion of the gain. The remaining US$500,000 of Chinese tax can be taken as a credit to offset US tax on the non-dividend portion.

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The US corporation would need to rely on provisions of the US-China tax treaty to obtain a tax credit for the portion of the Chinese tax deemed creditable.

In summary, in this case, US$10M of gain will be excluded from US tax under section 245A, and US federal tax of US$550,000 (US$1,050,000 – US$500,000) would be due on the portion of the gain not governed by section 245A.

State income taxes are generally not offset by foreign tax credits; however, state income tax implications are outside the scope of this article.

Scenario 2: Navigating Taxation Without Accumulated Earnings and Profits

Assume the same facts, except that no earnings and profits are accumulated in the Chinese subsidiary at the time of sale. In this case, the entire US$15M gain will be treated as US source capital gain, subject to federal tax of 21%. The corporation will need to rely on the US–China tax treaty to obtain a tax credit for the Chinese tax im-

As a result, US federal tax on US$15M of gain would be US$1,650,000 (US$15M *21%, less US$1.5M tax credit).

In the labyrinth of international tax rules and regulations, corporations with investments in Chinese entities must tread carefully, considering both the tax implications that arise from the sale of these foreign subsidiary stocks. The intricacies surrounding Sections 1248 and 245A of the Inland Revenue Code (IRC) can significantly influence these transactions' overall income tax effect. It is paramount to thoroughly understand these tax provisions and seek professional guidance when planning to sell their Chinese subsidiaries.

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