Taxation & Other Investment Issues Arising from Mergers and Acquisitions in China

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Interpretation of Order No. 10

Types of M&A transactions allowed:

- Equity acquisition
- Asset acquisition

Interpretation of Order No. 10

General principles:

- Guideline on Foreign Investments can be applied to four categories: encouraged, restricted, prohibited, permitted
- The foreign capital should be over 25% , so that the company qualifies as a foreign investment enterprise ("FIE") and is eligible for tax incentives
- Tightened control on anti-monopoly transactions
- Full remittance for equity or asset acquisition within 3 months after the business license is issued

Interpretation of Order No. 10

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Endorsement for share swap:

- Order No. 10 is the first PRC regulation to set out the regulatory framework for cross-border share swap as a form of payment for share acquisition of domestic enterprises
- The foreign investor (except for Special Purpose Vehicles) should be an overseas listed company
- Engagement of an M&A advisor is a must. The M&A advisor should be a reputable agency registered in China and has to perform a due diligence review on the foreign investor

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PRC Tax Implications for M&A in China

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Applicable PRC taxation on M&A:

Types of M&A	PRC Tax
Transfer of equity / shares	• For the China entity, 33% enterprise income tax ("EIT") on capital gains • For the foreign enterprise, 10% foreign enterprise income tax ("FEIT") on capital gains
Transfer of assets / transfer of business operations	• Value added tax ("VAT") on tangible assets • Business tax ("BT") on immovable and intangible assets • Import duties on fixed assets under supervision • EIT

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PRC tax implications for equity acquisition:

Types of Tax	Tax Rate	Tax Basis	Transferor	Transferee
EIT	33%	Capital gain	v	×
FEIT	10%	Capital gain	v	×
Stamp duty	0.05%	Execution of the share deal agreement	v	v

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PRC tax implications for asset acquisition:

Types of Tax	Tax Rate	Tax Basis	Trans-feror	Trans-feree
BT	5%	Transfer of immovable or intangible assets	v	×
VAT	17% 0% - 2%	Transfer of inventory Transfer of used equipment, boats, vehicles and motorcycles	v v	× ×
Land appre-ciation tax	30% - 60%	Gain on disposal of land-use rights and buildings	v	×
Deed tax	3% - 5%	Purchase of land-use rights or real estate property	×	v
Stamp duty	0.05%	Execution of the asset deal agreement	v	v

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PRC Tax Implications for M&A in China

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Other PRC tax concerns for mergers / spin-offs:

- Asset valuation
- Tax preferential treatment
- Loss to be carried forward
- Taxable income attribution

Due Diligence Review on The Target Company

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Three levels of due diligence review:

Stage of M&A	Purpose of Due Diligence
Pre-acquisition	The target's current tax, financial, legal and human resource positions
During acquisition	Actual transaction taxes that arise from acquiring the target
Post-acquisition	Potential tax and other cost benefits that result from acquiring the target

Due Diligence Review on The Target Company

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Common tax due diligence issues in China:

- The target may have maintained multiple sets of accounting records for tax reporting and management purposes
- The use of offshore tax haven entities for booking profits overseas without proper justification and substantiation
- Under-reporting / withholding of taxable compensations of employees to the tax authorities
- Adopting aggressive tax schemes or relying on verbal special arrangements / tax concessions with local authorities without any legal basis
- Claiming fraudulent expense deduction
- Potential heavy penalties and late payment surcharges in relation to any late or under-payment of taxes

Tax Structuring of M&A in China

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Significant M&A tax considerations:

- Whether the deal should be structured as an equity deal or an asset deal
- What type of acquisition vehicle should be used, and for cross-border deals, whether the acquisition vehicle should be formed in a tax treaty or non-tax treaty jurisdiction
- Whether the transaction can be consummated on a tax-free basis
- How old and new debts can be structured into the acquisition structure for tax objectives

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Thank You

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