Outbound M&A tax planning for Chinese companies

2013 edition
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Introduction

With an ever-increasing number of Chinese enterprises engaging in business ventures abroad, China has rapidly emerged as a significant player in the overseas investment market. The heightening demand for expansion abroad from both state-owned enterprises and companies from the private sector follows close on the heels of rapidly growing economic power. Engaging in the outbound M&A market is undeniably a major shortcut to meeting this demand. Today's Chinese investors remain green in the international M&A market, with less experience than key international competitors. Complicated and unfamiliar international regulatory systems may leave many unaccustomed with such systems at a loss. In this context, a majority of the Chinese investors have jointly recognised the acute need for a thorough study of interrelated domestic and international policies prior to engagement. Only by understanding the cumulative effects of these relations can an integrated and concise M&A plan come to fruition. In discussing major M&A costs, tax expense planning emerges as one of the chain's most integral links. Proactive tax planning is necessary to not only help companies minimise tax risks, but also improve operational efficacy. This in turn also serves to help promote the realisation of a group's business goals. Approaching tax planning lightly or missing opportunities to plan for future tax obligations could raise total costs, directly obstruct M&A transactions, and even plague post-M&A business operations.

This publication offers Chinese investors a key to understanding tax planning for outbound M&A. Also included is a discussion of fundamental approaches to common technical issues. We hope you find this introduction both helpful and insightful in all your future M&A endeavours.

According to the statistics from China Enterprise Confederation/China Enterprise Directors Association, the top 100 Chinese companies with multinational operation scored an average of 12.93 percent Transnationality Index (TNI) rate in 2012, which is far below the average TNI of 62.25 percent of the top 100 multinational companies worldwide. Facing an era of high cost, the operating capacity of China's enterprises is still relatively weak, and most Chinese enterprises have not yet "gone global" or implemented global resource deployment.
**Overview**

**Where do I start?**
You should start by clearly thinking through how you intend to turn a profit on your investment.

**A good place to start is to review your goods/services (supply chain):**
Supply chain planning aims at exploiting synergies within the company’s supply chain in order to increase the profitability of your goods/services. In this regard, you should be clear on where the additional value will arise:

- Within the group you are acquiring, and/or
- In the current group.

**If the additional value arises within the group you are acquiring, you may extract that value through a combination of any of the following:**

1. Dividends (shares of the parent company of the group you are acquiring, or the acquisition company through which you are making the acquisition): receiving dividends.

2. Interest (debt - funds which you lend to the group you are acquiring, or the acquisition company through which you are making the acquisition): receiving interest, as well as the proceeds from the repayment of the debt.

3. Payment for the use of intellectual property (IP) (which you license to the group you are acquiring): receiving payments for the use of IP, which is currently owned by the group you are acquiring, and which you intend, post-acquisition, to extract out of the group.

4. Services (which you provide to the group you are acquiring, including technical services, payments which are not royalties): receiving payments for services you provide to the group you are acquiring.

5. Gain on exit (the sale of the shares of the parent company of the group you are acquiring, or the acquisition company through which you made the acquisition): receiving the proceeds from the sale of shares in excess of the amount you paid for them.
Each of the above "flows" has an impact on your pre-acquisition and post-acquisition considerations:

<table>
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<tr>
<th></th>
<th>Pre-acquisition considerations</th>
<th>Post-acquisition considerations</th>
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<tr>
<td><strong>Dividends</strong></td>
<td>Acquisition structuring: holding structure for shares acquired</td>
<td>Post-acquisition reorganisation to enhance tax efficiency</td>
</tr>
<tr>
<td><strong>Gain on exit</strong></td>
<td>Financing structure: how to introduce debt into the group</td>
<td>Post-acquisition reorganisation to enhance tax efficiency;</td>
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<td>Funding structure for additional post-acquisition funding requirements</td>
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<tr>
<td><strong>Interest</strong></td>
<td>IP holding structure</td>
<td>Post-acquisition reorganisation to enhance tax efficiency, often undertaken as part of supply chain planning</td>
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<td><strong>Payments for the use of intellectual property (IP)</strong></td>
<td>Anticipation of post-acquisition considerations</td>
<td>Arrangements in respect of the provision of intra-group services</td>
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<tr>
<td><strong>Services</strong> (including technical services)</td>
<td></td>
<td>Supply chain planning: re-alignment of the overall supply chain, including transfer pricing. Often, IP considerations are key.</td>
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</table>
First, separately examine each of the considerations above in sequence, identifying the options which are available to you together with the costs, benefits and risks associated with each:

<table>
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<th>Timing</th>
<th>Consideration</th>
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<tr>
<td>Pre-acquisition</td>
<td>1. Acquisition structuring</td>
</tr>
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<td></td>
<td>2. (Debt) funding structure for acquisition</td>
</tr>
<tr>
<td></td>
<td>3. IP holding structure</td>
</tr>
<tr>
<td>Generally post-acquisition</td>
<td>4. Supply chain planning</td>
</tr>
<tr>
<td>(although you should, during the acquisition stage, start to consider and keep in mind your post-acquisition strategies)</td>
<td>5. Arrangements for the provision of intra-group services</td>
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<tr>
<td></td>
<td>6. Other post-acquisition considerations</td>
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You should then review the results thereof and, from the tax perspective, select your course of action by measuring the respective tax-related costs, benefits, and risks against your own particular objectives and preferences. For example:

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<th>Acquisition Structure 1</th>
<th>Acquisition Structure 2</th>
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<tbody>
<tr>
<td>Dividend</td>
<td>Withholding tax rate 10%</td>
<td>Withholding tax rate 5%</td>
</tr>
<tr>
<td>Gain on exit</td>
<td>Exempt</td>
<td>Taxed</td>
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If you were a strategic investor looking to derive most of your profits through dividends, you would prefer Acquisition Structure 2 to Acquisition Structure 1. If, however, you were a private equity investor looking to derive most of your profits through the sale in the medium term of your investment, you would prefer Acquisition Structure 1 to Acquisition Structure 2.
In the remainder of this document, we address some frequently asked questions concerning "acquisition structuring", "debt funding for acquisition structures", and "impact of Chinese foreign tax credit regime on acquisition structure". Our answers are for general information only and are not intended to form the basis for decisions concerning transactions you intend to undertake.

**1. Acquisition structuring**

1.1. Why shouldn’t I just directly acquire the parent company of the group I am acquiring?

Setting aside business considerations, from a tax perspective, there are broadly three reasons why you would choose an intermediate holding company to acquire the parent company of the group ("the Target") you are acquiring:

- Using an offshore intermediate holding company to acquire the Target may give a better tax result by reducing, or eliminating, withholding tax on dividends paid and/or the tax imposed on the gains arising on a future exit;

- Using an offshore intermediate holding company allows you to retain flexibility in respect of the timing when dividends, as well as gains on exit, are received by you in China from your underlying investments; and

- Effective "debt push-down" strategies (refer below) may require a new appropriately capitalised (from the debt/equity mix viewpoint) acquisition company to acquire the parent company of the group.

1.2. How does the use of an intermediate holding company reduce or eliminate withholding tax on dividends and tax on gains on exit?

Many countries, which levy withholding tax on dividends, have entered into double tax treaties ("treaties") under which the rate of withholding tax levied on qualifying dividends, received by taxpayers who are residents of the respective treaty partner, is reduced.

Further, the rates provided for in the treaties which a country has entered into vary from treaty to treaty. For example, the withholding tax on qualifying dividends paid by Swiss companies to Chinese companies is reduced to 10 percent (from 35 percent) under the China/Switzerland Double Tax Treaty. However, qualifying dividends paid by Swiss companies to Luxembourg companies are exempt from tax in Switzerland. Accordingly, it might well be advantageous to hold your Swiss investment through a Luxembourg holding company.

The same consideration applies in respect to gains on exit. For example, most foreign investments into India are held via Mauritius holding companies because, under the India/Mauritius Double Tax Treaty, gains on such investments would, subject to meeting qualifying conditions, be exempt from tax in India.
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