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M&A in China – Structuring and compliance considerations

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M&A in China – Structuring and compliance considerations

The second in a three-part series addressing the challenges of M&A in China, this paper covers issues confronting foreign buyers when structuring an acquisition and laying the foundation for ongoing operations. The first issue discussed deal-breakers and pricing considerations while a final issue will take up post-merger integration.

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In the first installment of our M&A series, we explored a range of issues surrounding the early stages of a cross-border M&A deal in China. In identifying common deal-breakers and critical pricing factors, we illustrated many of the considerations that a company must face when deciding whether to pursue a given deal in China and if so, at what price.



Once the decision to pursue a deal has been made however, the buyer's attention turns to structuring and compliance. The objective of any M&A structuring exercise is to provide the acquired assets with a foundation for growth and to free management to focus on achieving the intended synergies. Poor structuring decisions can expose a new business to crippling legacy issues or place it in non-compliance with key regulations. They can also rob the enterprise of the flexibility it will need to compete effectively over the long-term. Wise structuring decisions, on the other hand, typically reflect an acute understanding of the acquired business' present circumstances, its place in the wider organization and where the business will be years down the road. No two structures are exactly alike, but the best typically share three key features — they contain legacy risk, they comply with all relevant regulations and they provide the new entity with lasting competitive advantages.

The “Three Cs” of M&A Structuring

- **Contain**

Insulate the investment from hidden or contingent liabilities associated with previous operations or from potential liabilities created during the transaction itself.

- **Comply**

Ensure that the terms of the deal and subsequent operations are in compliance with pertinent regulations from the outset, both in China and in the home country.

- **Compete**

Create a sustainable business model that minimizes the net global tax position and maximizes flexibility of cross-border capital deployment.

Decisions made during the structuring process can reverberate throughout the life of the investment. To help buyers navigate the uncertainties, the pages that follow recount some of the more costly errors that practitioners of the Deloitte Touche Tohmatsu member firms in the U.S. and China have seen committed by foreign buyers in China's M&A market. We hope it will help you prepare for the challenging yet rewarding prospects for cross-border M&A in China today.



China M&A challenges – Placing the deal in context

While the process for conducting cross-border M&A in China is similar to doing deals elsewhere, China's very specific commercial, regulatory and cultural environment adds an extra layer of complexity at each stage. In this installment of **China Issues: M&A Series** we will look at the third and fourth of five key questions that potential buyers will need to ask themselves if they are to create value in China through M&A.

- At what point should we walk away from a deal?
 - What is an acceptable price to both parties?
 - How should the deal be structured?
 - Does the deal present a compliance risk?
 - How can the acquisition be integrated into the global organization?
-

The five questions as an iterative M&A checklist

Buyers should be careful not to delve into the third and fourth questions too early. Companies have been known to spend significant time and effort on structuring the transaction and subsequent operations, only to discover that a deal breaker was “hiding” in plain sight.

Our practitioners have discovered that with solid boundary conditions in place and a reliable stream of information, companies can often detect most deal breakers before they over-commit. The most successful buyers will also arrive in China with a price range in mind but a willingness to be flexible given prevailing market conditions.

As a deal progresses, however, answering the five questions becomes part of a much more iterative decision-making process. As the buyer gathers intelligence, a feedback loop is set in motion and the deal process becomes an exercise in continually revisiting the checklist in light of new information. For instance, an unpleasant discovery during the due diligence process can lead a buyer to structure the deal as an asset rather than equity acquisition. This obviously affects the purchase price and, depending on the severity of the problem, the buyer may choose to walk away from the deal entirely.

So new findings need to be continually set against boundary conditions and investment objectives, while expectations for the acquisition may also have to be adjusted to reflect the buyer's heightened understanding of the deal environment.

China M&A structuring challenges

Contain – first of the “three Cs”

tr. v. Con•tain (kən-tān')

Insulate the investment from hidden or contingent liabilities associated with previous operations or from potential liabilities created during the transaction itself.

It goes without saying that any type of investment in China entails the assumption of risk, but M&A involves a level of exposure that greenfield investments do not. Foremost among these additional risks is the liability assumed by the buyer for the actions and decisions of the previous management. Failure to insulate from legacy risks can result in financial damages, tarnished reputations, even criminal proceedings — not only in China but in the home jurisdiction as well. The M&A transaction process itself also raises the potential for liabilities, from over-reliance on personal relationships to overlooking the consequences of making overseas payments for Chinese assets.



Mistakes our practitioners have seen in China include:

1. Failure to detect legacy liabilities and adjust structuring accordingly

Legacy liabilities can arise from a wide variety of sources in China, including but not limited to unpaid taxes, regulatory violations, non-compliant transfer pricing arrangements, customs violations and undocumented pledged assets that the seller fails to mention. Extensive due diligence is required to identify, as best as possible, any and all such liabilities, after which an appropriate acquisition structure can be settled upon. Among the most fundamental decisions a buyer must make is whether an asset or equity deal would make more sense, given the results of the due diligence process and the buyer's tolerance for risk. (see *chart*)

Cases:

- i. A U.S. firm considering the purchase of a majority equity stake in a Chinese consulting company was extremely pleased with the three years of financial data presented by the seller. Still, the potential buyer's due diligence advisers found the virtually flawless financial statements suspicious and advised delving back several more years. It eventually came to light that the seller had enhanced the most recent accounts and buried significant unpaid taxes in the preceding years. The buyer avoided the liability for those taxes by executing an asset deal rather than an equity deal.
- ii. A foreign investor purchased assets from a Chinese company, including machinery originally imported duty and VAT free under a national incentive program to promote technology acquisition. The buyer conducted a full tax due diligence investigation and, due to the contingent liabilities uncovered, chose to pursue an asset acquisition. However, the scope of the due diligence process did not encompass customs issues. Unbeknownst to the buyer, customs regulations required the Chinese company to retain ownership of the imported machinery for at least five years in order for the tax-free status to stand. By transferring the assets prematurely, the tax-free status was lost and customs liabilities fell to the current owner, who was forced to pay the original duty on a pro-rated basis.
- iii. A U.S. firm acquired a local electronics company in Guangdong with the intention of taking the entire organization public. Following the acquisition, and in preparation for the IPO, it was discovered that the general manager of one of the firm's manufacturing facilities had purchased fake VAT invoices in an attempt to dress up the company's performance. When regulators learned of this, the general manager was jailed and a flurry of bad publicity ensued. As a result, the new owners were forced to pay large sums in legal fees and had to spin off the manufacturing facility at a heavily discounted price before it could proceed with the IPO.

Acquisitions: By equity or asset transfer?

Potential legacy liabilities such as delinquent tax payments, unmet social security obligations and previous regulatory violations can impose significant unexpected costs on a buyer. Purchasing specific assets from the target rather than taking an equity stake helps the buyer to insulate itself from these risks. However, asset acquisitions are more costly and time-consuming than equity acquisitions and since Chinese sellers often face overall higher tax costs for asset sales, they tend not to prefer such arrangements.

| M&A options | Pros | Cons |
|-----------------------------|--|---|
| Equity acquisition | <ul style="list-style-type: none">• Clients, networks, licenses (in most cases) and goodwill all transfer to the buyer• Partial equity acquisitions allow access to the full breadth of a target's business without having to purchase it outright• Easier and faster than an asset deal | <ul style="list-style-type: none">• Buyer invests in all aspects of the target's business, including undesirable components• Buyer assumes all legal, financial and tax obligations and liabilities of the target• Partial equity sales are subject to the consent of all shareholders• It is not possible to achieve a step up in basis |
| Asset acquisition | <ul style="list-style-type: none">• Buyer can carve out specific assets• Insulation from existing or contingent legal, financial and tax obligations and liabilities of the target is possible• It is possible to achieve a step up in basis | <ul style="list-style-type: none">• Acquisition process is more complex and time consuming• Creditor approval may be required• Seller may face higher taxes, thereby raising the purchase price• Target may be unwilling to relinquish key clients, networks or licenses• Acquisition must be carried out by a Foreign-Invested Enterprise (FIE) in China; separate approval will be required if a new FIE must be established• Preferential tax treatment may be subject to claw-back if the transfer of assets violates the terms of a tax holiday |
| Offshore acquisition | <ul style="list-style-type: none">• Transfer of control occurs outside China, circumventing the government approval process and facilitating an easy exit• Avoids Chinese taxation on the sale | <ul style="list-style-type: none">• Asset acquisitions cannot be undertaken; nor can equity acquisitions of purely domestic companies• Buyer indirectly assumes all existing or contingent legal, financial and tax obligations and liabilities of the target |

China M&A structuring challenges

Contain – first of the “three Cs”

2. Failure to uncover improper related-party transactions

The complexity of corporate structures in China and the growing volume of inter-company trade means that related-party transactions are attracting the attention of Chinese tax officials. As a consequence, transfer pricing issues have emerged as a leading source of legacy liabilities for buyers in China.

Case:

- i. A U.S. toy producer considered purchasing what appeared to be a highly tax-efficient manufacturing and trading company through an equity acquisition. The target's structure consisted of a Hong Kong holding company that owned a manufacturing facility in Guangdong. The Guangdong facility sold the majority of its products to a trading company in the British Virgin Islands (BVI), which was also owned by the Hong Kong entity. The BVI firm then sold the goods on to customers, taking advantage of the favorable tax treatment in that jurisdiction.

After investigating the structure more thoroughly, however, the due diligence team found that the Guangdong facility registered almost zero profit on its books, while the BVI company was extremely profitable. Recognizing that the transactions between the related parties were not conducted at arm's length, the buyer feared it would be held liable for tax evasion in China. The buyer therefore opted to purchase only the productive assets associated with the Guangdong facility and then formed an offshore trading company of its own to execute sales. Transactions between the two entities were then conducted according to the arm's length principle, ensuring that earnings attributed to the entities would be justifiable in the eyes of Chinese tax authorities.

3. Assuming unnecessary risk in a seller's market

The growing popularity of M&A in China and the expanding role of well-funded financial investors means that buyers — particularly first-time foreign buyers unfamiliar with the business environment — may pay a higher premium for their acquisitions. In such an environment, buyers can be tempted to use structuring to hold down the acquisition price, despite the potential for regulatory violations.

Case:

- i. In what has become a common misunderstanding between Chinese sellers and foreign buyers, a Chinese company expected to be paid a net-after tax price for its assets while the foreign investor assumed the price on the table was a gross sum. To avoid Chinese taxes on the sale and thereby narrow the price gap, the seller came up with a plan to transfer its shares at cost to an off-shore holding company in Hong Kong and resell the shares to the U.S. buyer at full value. The seller would thereby retain the entire sum as Hong Kong has no capital gains tax. The buyer wisely declined the arrangement, suspecting that Chinese authorities would consider it tax evasion.



China M&A structuring challenges

Contain – first of the “three Cs”



4. Over-reliance on personal relationships

Personal connections are without question a critical part of China’s business culture, as little gets done without them. Yet relying too heavily on relationships when doing deals in China raises additional risks, particularly when the verbal assurances of a trusted adviser, sympathetic local official or negotiating partner take the place of a written contractual agreement.

Case:

- i. A Chinese enterprise selling a trucking fleet to a U.S. transportation company leveraged a relationship with local tax authorities to secure highly preferential treatment on its capital gains obligations before persuading the buyer to bear the entire tax burden for the transaction. The buyer agreed and the deal went forward, but the arrangement was never documented in writing. At a later date, tax authorities at a higher level of jurisdiction reviewed the transaction and demanded that the outstanding taxes be paid retroactively. Without written certification of the exemption, the buyer had no choice but to pay the sum in its entirety.

5. Failure to assess the consequences of offshore payments

Before making overseas payments for Chinese assets, it is critical to determine three things:

- Is there sufficient basis to warrant an overseas payment?
- Is the overseas payment compliant with foreign exchange and tax regulations? (see Case 5 under Comply)
- And from the buyer’s perspective, is it economical to do so given the inability to apply the sum to the paid-in capital of its Chinese entity or offset any expenditures paid offshore against future taxable revenue in China?

Cases:

- i. A seller of real estate assets in Beijing wanted to receive payment overseas. To facilitate this, the assets were transferred to an offshore company and then sold to a Hong Kong investment group. While beneficial to the seller, making the payment offshore meant the buyer could not apply the purchase price to its paid-in-capital requirements for the China-based operation. The buyer therefore had to inject additional funds to bring registered capital up to the required minimum. Moreover, since payments for associated architectural and consulting fees were also made offshore, the company was unable to deduct these business expenses from their income tax in China.
- ii. A U.S. company seeking to purchase a Chinese e-commerce firm was asked to make the majority of the payments offshore. The seller therefore transferred the intangible assets to an overseas holding company, which was then sold to the buyer. Following the acquisition, the buyer realized that none of the amortization expense associated with the offshore purchase could be used to offset revenue in China. This was a costly mistake for the buyer because while most of the purchasing price was paid overseas, all the revenue would be generated in China.

China M&A structuring challenges

Comply – second of the “three Cs”

intr. v. Com•ply (kəm-plī')

Ensure that the terms of the deal and subsequent operations are in compliance with pertinent regulations from the outset, both in China and in the home country.

After more than 25 years of rapid economic liberalization, China's multi-tiered regulatory system is highly complex and continues to evolve. To further complicate matters, it is not unusual to come across business practices that are in technical violation of the rules, which themselves might be enforced in a discretionary manner. Foreign investors are also likely to encounter a good deal of “friendly” advice – from negotiating partners, industry peers and other sources – on how to navigate these gray zones. It is critical, however, to distinguish between practices that are accepted merely because they are common and those that are in strict compliance with Chinese law. Furthermore, foreign buyers will need to carefully consider the potential impact of their China acquisitions on home country compliance.

Mistakes our practitioners have seen in China include:

1. Following common business practices without a full understanding of their legal basis

Foreign investors are often tempted to conclude that because a practice is firmly rooted in the local business culture, it is either legal or too widespread to attract scrutiny. Yet regulatory crackdowns can be swift and severe in China, and it is not unusual for foreign-invested enterprises to attract a disproportionate share of the attention.

Case:

- i. A U.S. buyer considering the acquisition of a Chinese pharmaceutical company discovered during the due diligence process that the target's sales force consisted of independent individuals paid on a commission basis. Despite not being formally employed by the target, the sales force regularly expensed transportation and hotel costs to the target. Although it is common for Chinese companies to assist their commissioned sales forces in this way, the practice technically violated the terms of their contracts. Much more seriously, the target was claiming tax deductions on business expenses incurred by these individuals, although they were not employees of the company.

The target justified this scenario to the buyer by saying this was common practice in China and failure to abide would adversely affect business and make it difficult to retain the sales force.

To address the issue, a two-pronged strategy was devised. First, an asset deal was structured to minimize the buyer's exposure to the target's accumulated tax liability. Second, a new and independent legal entity was established for the sales force, allowing it to legally claim tax deductions for operating expenses while providing sales services to the pharmaceutical enterprise under contract.



China M&A structuring challenges

Comply – second of the “three Cs”

2. Failure to recognize the potential for inconsistent regulatory interpretation between local and state-level officials

Despite its reputation for centralization, China’s regulatory system will often give local officials considerable discretion over how national directives will be applied in the local context. While local officials will sometimes bend the rules to benefit one or more parties, there are also instances where they either misinterpret national regulations or apply them incorrectly. Unfortunately, for the foreign investors involved, central government interpretations will always take precedence if discrepancies are discovered, leading to back-taxes and possibly, severe penalties.

Case:

- i. A U.S. manufacturing company purchased assets from a Chinese firm with the intention of relocating the assets to a nearby Special Economic Zone (SEZ) to take advantage of preferential tax treatment. Because the assets would be costly to move, local authorities allowed the physical manufacturing operation to remain at the original location while the business was legally domiciled inside the SEZ. The buyer was thus able to enjoy the SEZ’s tax holiday without incurring the cost of relocation. After several years of operation, a State-level audit found the arrangement to be in violation of national tax laws. The foreign investor was required to pay back taxes and penalties totaling US\$10 million.

3. Failure to anticipate and adapt to changes in the regulatory environment

In China’s rapidly evolving regulatory environment, foreign investors must continuously monitor the rules and regulations that underpin their structuring decisions. Companies need to build in flexibility, try to anticipate the direction of change and be prepared to adjust their China structure as new circumstances require.

Case:

- i. A U.S. internet company set up a wholly foreign owned enterprise (WFOE) to conduct internet services in China, but later learned that foreign enterprises were not permitted to obtain a Value Added Telecom Services (VATS) license. Unable to operate, the WFOE signed an alliance agreement with a



Chinese firm holding a VATS license. Under the agreement, the WFOE made royalty payments to the U.S. firm for use of its domain name and trademark license and paid fees to the Chinese firm for use of its VATS license. In time, the Chinese government issued a new regulation requiring companies with VATS licenses to hold their domain name and trademark directly. In the end, the U.S. company was forced to transfer the domain name and trademark license to the Chinese company in order to continue operations.

4. Ignoring industry-specific regulations

Many businesses in China are subject to highly-specific industry regulations, some of which can escape the notice of a hasty buyer.

Case:

- i. A U.S. investor seeking to acquire a stake in a Chinese bank established an off-shore holding company to make the acquisition. The company was unaware, however, of a critical sector-specific regulation — only parent companies are permitted to invest in Chinese banks, and therefore the intermediate holding company was precluded from making the investment. Had the company sought proper counsel and gained a better understanding of the regulations beforehand, it could have conserved the resources associated with establishing an ultimately superfluous holding company.

China M&A structuring challenges

Comply – second of the “three Cs”

5. Violation of foreign exchange (forex) rules

Foreign investors are accustomed to looking at China’s forex regime in terms of its effect on financial flexibility and repatriation strategies. But some fail to recognize that making overseas payments for assets legally held in China violates the country’s forex regulations. For such payments to be made, the seller must first transfer the assets offshore and pay all capital gains taxes, VAT, stamp duties and other applicable fees in connection with that transfer.

Case:

- i. A U.S. company seeking to acquire Chinese assets was asked to make payment to the seller’s offshore subsidiary. The offshore subsidiary, however, was not the legal owner of the assets. Furthermore, the seller refused to transfer the assets to the offshore subsidiary prior to the sale to avoid taxes and fees. The buyer chose not to make the purchase because doing so would have been tantamount to a back-door currency conversion in violation of forex regulations. In addition, the buyer would have been complicit in the seller’s attempt to avoid tax payments to the Chinese government.

6. Misunderstanding the circumstances under which a license can or cannot be transferred

M&A is occasionally used as a shortcut to acquire business licenses that are otherwise difficult to secure for various reasons. While this approach can work, there are instances in which licenses cannot be transferred until key conditions are met. In other instances, licenses cannot be transferred at all.

Cases:

- i. A U.S. real estate management firm set out to acquire a Chinese counterpart in Shanghai. The buyer purchased all the equity of the target company with the expectation that its real estate management license would automatically transfer with the equity. However, after the sale was completed, the buyer learned that the license could not be transferred until certain prerequisites had been met and additional paperwork submitted. Meeting the prerequisites for transferring the license delayed commencement of operations by more than three months.

- ii. A Canadian enterprise sought to acquire the exploration rights from a gold and platinum mining facility in southwest China. After making payment to the seller, the buyer was informed by the central government that the exploration rights were non-transferable. To resolve the situation, the buyer was forced to invest an additional US\$8 million to set up a joint venture with the Chinese company, through which the two parties could then cooperate in exploiting the mineral deposits.



U.S. Compliance Issues for China M&A

Where do home-country regulations fit in?

Foreign buyers are faced with many novel cultural, regulatory and operational challenges when pursuing M&A deals in China, but they must also be mindful of how their China investments will effect home-country compliance. For U.S. companies, Sarbanes-Oxley (SOX) and the Foreign Corrupt Practices Act (FCPA) are among the most important regulations from a compliance risk perspective. Steering clear of trouble requires U.S. buyers to heighten their awareness of both regulations at each stage of the deal process.

Sarbanes-Oxley

Enacted in 2002, SOX is currently the most comprehensive law governing internal controls in the U.S.. It holds the management of U.S.-listed companies responsible for establishing and maintaining adequate internal control structures and procedures for financial reporting, and carries severe penalties for noncompliance.

To manage the SOX compliance risks arising from M&A activities in China, a U.S. acquirer will need to determine the degree to which the new assets or revenues will effect the company's consolidated financial statements. If the total assets or revenue of the target make up less than 5% of the consolidated totals — as is often the case when large U.S. companies acquire assets in China — the acquisition is likely to be immaterial for the purposes of SOX compliance. If the acquisition is determined to be material, U.S. buyers will need to perform an assessment and elevate internal controls as necessary. Even if the entity is deemed immaterial, many U.S. buyers still launch this process almost immediately to set the stage for SOX compliance.

If a buyer's exit strategy involves listing the acquisition on a U.S. stock exchange — as is often the case with venture capital and private equity investors — it may be necessary to devote more attention to SOX compliance up front. Although newly-listed firms enjoy a one-year grace period, it is unlikely that the necessary compliance systems can be implemented so rapidly. As a result, buyers in China with a U.S. IPO in mind will tend to turn their attention to SOX compliance at a very early stage in the deal process.

Case:

- i. A U.S. company was planning to eventually list its China acquisition in the U.S.. As the due diligence on the target revealed that achieving SOX compliance would be excessively difficult, the company opted to pursue an asset acquisition rather than equity. The company then proceeded to hire new managers for the operation. Both measures went a long way toward alleviating the potential barriers to compliance presented by the original target's management culture.



Foreign Corrupt Practices Act

Under the FCPA of 1977, payment to a foreign official by a U.S. person or entity for the purpose of gaining business advantage is a federal offence, regardless of whether or not the recipient is in the U.S. at the time of the occurrence. The act also obligates companies to maintain meticulous records and internal control systems, and requires them to report any failures or suspected violations, including those stemming from overseas operations.

In the case of an acquisition, a buyer can be held liable for violations committed by the target or its employee prior to the sale (subject to a statute of limitations). In instances where potential buyers have uncovered such FCPA violations, disclosure of the infraction to U.S. authorities and the execution of prescribed remedies has been sufficient to absolve the buyer of culpability and allow the deal to go forward. While the cost of identifying and remedying a legacy FCPA infraction can be high, it goes without saying that failing to do so would be more costly.

For potential U.S. buyers in China, the business environment creates some very vexing compliance challenges. At the broadest level, determining precisely who qualifies as a "foreign official" in an economy still heavily dominated by the state can be difficult. For example, the Chinese Communist Party (CCP) has more than 70 million members that are highly integrated into every level of the economy. Furthermore, certain business practices prohibited under the FCPA simply do not carry the same stigma in China. Lastly, buyers in the U.S. may find it quite difficult to adequately oversee the behavior of their new employees from afar, a challenge exacerbated by the fact that few if any of them will be familiar with FCPA compliance policies and procedures.

Clearly, sensitivity to FCPA violations — past, present and future — needs to be a central consideration for U.S. buyers at every stage of the deal process in China.

Cases:

- i. A U.S. company acquiring one of its suppliers in China conducted a pre-acquisition FCPA risk review as part of its M&A due diligence process. Upon uncovering a history of bribery that would have put the buyer in direct violation of the FCPA, it chose to forego the deal and seek out an alternative acquisition target.
- ii. A U.S. medical equipment firm surrendered US\$2 million in profits to settle a case with the U.S. authorities after its Chinese subsidiary paid US\$1.6 million in bribes to doctors and state-owned Chinese hospitals to generate business.

China M&A structuring challenges

Compete – third of the “three Cs”

intr. v. Com•pete (kəm-pēt')

Create a sustainable business model that minimizes the net global tax position and maximizes flexibility of cross-border capital deployment.

To achieve long-term competitiveness, structuring must ensure that the newly-acquired assets are well integrated in a tax-efficient business model — both within and beyond China’s borders. Buyers will need to select the appropriate Chinese legal entities with sufficient scope of business to perform their intended functions and establish them in optimal locations. Offshore entities integral to the business model, particularly intermediate holding companies, will also need to be located in the right jurisdictions. The interaction between these entities then needs to be carefully mapped out to reduce tax on a global basis and optimize the cross-border flow of goods, funds and services. The challenge, of course, is putting the right entities and relationships in place without letting the initial structure become an obstacle to seizing future opportunities.

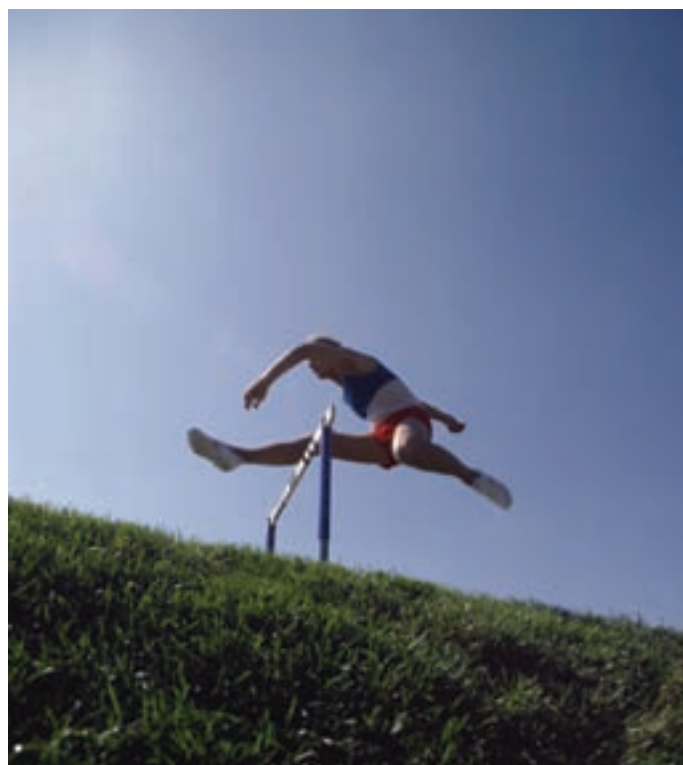
Mistakes our practitioners have seen in China include:

1. Failure to use an offshore intermediate holding company or forming one in a sub-optimal jurisdiction

As described in the business model above, opting to establish an offshore intermediate holding company can have a very real impact on the investment’s internal rate of return. China has signed bilateral tax treaties with over 80 countries, each with different implications from a tax optimization perspective. This treaty network continues to evolve, however, and foreign investors need to keep pace with any changes that have the potential to effect their investments.

Cases:

- i. A U.S. company with extensive M&A experience in Europe leveraged its existing holding company in the Netherlands to execute an acquisition in China. Using the existing holding company saved time and money by eliminating the need to establish a new entity, but the strategy was not cost effective from a long-term tax perspective. A more tax-efficient solution would have been to form a new holding company in one of several jurisdictions with more favorable tax arrangements with China. The savings generated would have been more than sufficient to offset the cost of establishing and maintaining the new holding company.
- ii. A private equity firm established a holding company in Mauritius to acquire assets associated with a nonperforming loan in China. At the time of the deal, the bilateral tax treaty between China and Mauritius would have allowed the firm to exit the investment without paying a capital gains tax to the Chinese government. In 2006, however, China’s bilateral tax treaty with Mauritius was renegotiated, exposing the private equity firm to capital gains taxes upon exiting the investment.



China M&A structuring challenges

Compete – third of the “three Cs”

2. Giving insufficient consideration to exit strategies

Offshore intermediate holding companies are also extremely useful when looking to exit an investment by facilitating the sale of equity outside China. As such, Chinese government approvals are not required and neither party is subject to Chinese capital gains tax or stamp duties. As with the previous discussion, the location of the holding company could have implications over the long-term. For instance, if an investor plans to take the acquired assets public on an overseas market, the ideal jurisdiction for the holding company will change depending on where that IPO is to occur.

Some buyers fail to recognize how decisions made at the time of structuring will limit options and impose tax costs when attempting to exit an investment. Others simply do not know if or how they will eventually exit and therefore cannot know which structures to put in place. In either case, it is wise to build in the necessary flexibility from the start as an ill-considered decision can raise the cost of exiting an investment precipitously.

Cases:

- i. A U.S. parent company seeking a quick deal did not establish an intermediate holding company to acquire assets in China, choosing to purchase the target directly instead. The company later decided to exit the investment via a trade sale. Yet because no offshore intermediate holding company was in place, the transaction had to take place on Chinese soil. As a result, the deal was subject to Chinese regulatory approval (costing time and money), capital gains tax and stamp duties (reducing the investment's internal rate of return). Had an offshore holding company in an optimal jurisdiction been inserted at the time of the initial transaction, the sale could have been executed entirely outside the purview of Chinese regulators and tax officials.
- ii. A U.S. company sought to take its China acquisition public. For various business reasons, it was important that the IPO take place on the Hong Kong stock exchange. However, at the time of the initial investment, the parent did not realize that only companies incorporated in Hong Kong, Mainland China, the Cayman Islands and Bermuda are “generally acceptable” candidates for listing on Hong Kong's stock exchanges. Because the U.S. parent held the Chinese company directly, it would have to spend time and resources to transfer the ownership to an intermediate holding company in one of these jurisdictions prior to an IPO in Hong Kong.

The principal structure in China: An approach to global business model optimization

Increasing numbers of foreign buyers are employing offshore intermediate holding companies as the core of a so-called “principal structure.” In this business model, activities such as toll/contract manufacturing, domestic distribution, procurement and contract R&D are carried out by China-based operations, including newly acquired entities, existing subsidiaries and or third-parties.

High value-added business functions such as sales and marketing, global supply chain management and international distribution are handled by the offshore holding company, or the “principal”, which is incorporated in a low tax jurisdiction. At the same time, the principal assumes most of the financial and business risk, justifying maximum profit allocation.

In sum, the parent company's overall tax costs associated with China operations can be reduced while allowing the company to avail itself of the many benefits of operating there. The principal structure is especially attractive to those companies who might not enjoy preferential tax treatment under the latest tax reform initiatives.

3. Using legal entities that are incompatible with the business model

Foreign investors can now choose from a variety of legal entities to facilitate their business models in China. Procurement, for example, can be managed centrally by an intermediate holding company acting as principal, while the actual sourcing function can be carried out in China by either a representative office (RO) or one of several types of wholly-foreign owned enterprises (WFOE), each with a specific scope of business. Highly flexible WFOEs such as the Foreign-Invested Commercial Enterprise (FICE) have business scopes broad enough to combine multiple manufacturing, sourcing and selling functions. The key is to select the minimum number of entities that still facilitate the business model while maximizing capacity to respond to emerging opportunities.

China M&A structuring challenges

Compete – third of the “three Cs”

Cases:

- i. As part of a global acquisition, a U.S. financial company acquired the China RO of another U.S. group. The target's RO had been engaged in a lucrative consulting practice focused on the Chinese aviation sector, despite the fact that such activity was outside the limited business scope of an RO. Naturally, the buyer wanted the office to continue this work, but the transfer of assets brought the compliance issue to light. The new owner was forced to restructure the operation as a wholly-foreign owned consulting firm – an entity with the legal right to conduct the work at hand.
- ii. A U.S. firm acquired a contract manufacturing facility in Shenzhen to assemble final products from imported components and export the finished goods to overseas markets. The company's structure was intended to minimize the Chinese tax burden and, as such, was precluded from selling directly in to the Chinese market. Later, as local demand for the company's products grew, the firm sought to sell domestically. To do so, the company had to export and re-import its products, incurring customs and shipping costs, and thus making the product prices uncompetitive vis-à-vis domestic competitors.

4. Failure to capture specific tax incentives

Like most governments, China has made ample use of tax and other incentives to encourage desired forms of investment. These incentives, which are subject to change, can be based on criteria such as geographic location, industry or nature of the business to be performed.

Case:

- i. A foreign company acquired an auto components manufacturer in Fujian province. By acquiring more than 25 percent of the Chinese firm, the target legally became a Foreign Invested Enterprise (FIE), qualifying it for preferential tax treatment under the rules then in effect. Due to a lack of awareness on the part of its management, the buyer failed to leverage the target's new status as an FIE to reduce its tax rate. The new Japanese owners also purchased equipment for the operation valued at US\$10 million, of which 40% could have been claimed as a deduction against income taxes. The company eventually discovered its errors during an external audit, but it was too late to claim either the preferential tax benefits or the deductions related to the equipment.



5. Failure to correctly estimate the long-term capital needs of the China operation

Chinese law requires investors to declare “total investment” in the Articles of Association and inject a percentage of it as “registered capital” (see the chart below). Overestimating total investment can be a problem because reducing registered capital ex-post is subject to regulatory approval that can be time consuming and difficult to obtain. Underestimating it, on the other hand, is far less problematic but approvals will be necessary to increase total investment once a business license has been issued.

Total investment and minimum registered capital

| Total investment amount (US\$) | Minimum registered capital (US\$) |
|--------------------------------|--|
| 0 to 3 million | 70% of total investment amount |
| 3 million to 10 million | 50% of total investment amount or US\$2.1 million, whichever is higher |
| 10 million to 30 million | 40% of total investment amount or US\$5 million, whichever is higher |
| Over 30 million | 33.33% of total investment amount or US\$12 million, whichever is higher |

China M&A structuring challenges

Compete – third of the “three Cs”

Cases:

- i. A high-tech company from Silicon Valley acquired an R&D facility in China. As part of the deal, a significant capital injection was made. Following the acquisition, the buyer decided that the China entity would provide R&D services by contract so that the resulting intellectual property (IP) would accrue to the parent under the protection of U.S. IP laws. Under this arrangement, the Chinese entity would not require as much financing for its operation as originally estimated. Naturally, the parent wanted to retrieve the capital from its Chinese subsidiary, but they decided to forego the application in view of the potential difficulty.
- ii. A U.S. company established a subsidiary in southern China to undertake an asset acquisition. During the planning stage, the parent did not adequately anticipate the subsidiary's long-term capital requirements. Additionally, because it misunderstood the distinction between total investment and registered capital, the parent was reluctant to declare a higher total investment value, believing it would be required to account for the entire value in equity. One year following the acquisition, the parent set out to lend additional capital to the subsidiary but found it could not because the total investment declared in the Articles of Association had already been met. As a result, paperwork had to be submitted to increase the company's total investment, a process that delayed plans by two to three months and imposed additional application and service fees.



6. Inability to repatriate cash in excess of dividend capacity

Many investors use repayment of inter-company loans as a means of repatriating cash in excess of dividend capacity. It is therefore advisable to contribute as much debt as is allowed to the FIE's total investment. It is also possible to use arm's length transactions such as royalty payments and fee-based inter-company services as repatriation strategies. But because these channels can be difficult to set up retroactively, it is important that they be put in place when an FIE is first incorporated and that all relevant regulations are taken into consideration.

Cases:

- i. A Hong Kong investor set up a China-based subsidiary to make an asset acquisition. Because it had ample cash on hand, the parent chose to fund 100% of the subsidiary's total investment through a single cash injection and repatriate earnings solely through dividends. Although after-tax income was readily repatriated through dividend payments as planned, cash flows associated with depreciation and amortization expenses became trapped in the subsidiary's coffers. In a subsequent acquisition, the parent was careful not to repeat the mistake and funded a portion of the total investment through an inter-company loan. This opened a channel to repatriate cash in the form of interest and principal payments on the loan, in addition to the allowed dividend payments.
- ii. A U.S. company was planning to acquire all of the equity of a Chinese firm with valuable real estate assets but severe operating losses. The initial strategy was to revamp operations to quickly generate profits and then repatriate those profits. Under Chinese law, however, repatriation cannot occur unless a company has positive retained earnings. Had the buyer made an equity acquisition, it would have also acquired the target's legacy losses. The company was advised that ten years of profitable operations would be required before those losses could be overcome and repatriation could begin. As a result, the deal was ultimately structured as an asset acquisition.

Concluding Thoughts

In this second installment of China Issues: M&A Series, we explored the third and fourth of five key questions that potential buyers will need to ask themselves if they are to create value in China through M&A.

- ___ At what point should we walk away from a deal?
- ___ What is an acceptable price to both parties?
- ✓ How should the deal be structured?
- ✓ Does the deal present a compliance risk?
- ___ How can the acquisition be integrated into the global organization?



Successful M&A structuring provides the acquired assets with a foundation for growth and frees management from legacy issues that might prevent it from achieving the intended synergies. While no two structures are exactly alike, the best typically share three key features — they contain legacy risk; they comply with all relevant regulations; and they provide the new entity with lasting competitive advantages.

“Three Cs” of M&A structuring and common errors seen in china

Contain

Sufficiently insulate the investment from hidden or contingent liabilities associated with previous operations or from potential liabilities created during the transaction itself.

Mistakes our practitioners have seen in China include:

- Failure to detect legacy liabilities and adjust structuring accordingly
- Failure to uncover improper related-party transactions
- Assuming unnecessary risk in a seller's market
- Over-reliance on personal relationships
- Failure to assess the consequences of offshore payments

Comply

Ensure that the terms of the deal and subsequent operations are in compliance with pertinent regulations from the outset, both in China and in the home country.

Mistakes our practitioners have seen in China include:

- Following common business practices without a full understanding of their legal basis
- Failure to recognize the potential for inconsistent regulatory interpretation between local and state-level officials
- Failure to anticipate and adapt to changes in the regulatory environment
- Ignoring industry-specific regulations
- Violation of foreign exchange rules
- Misunderstanding the circumstances under which a license can or cannot be transferred

Compete

Create a sustainable business model that minimizes the net global tax position and maximizes flexibility of cross-border capital deployment.

Mistakes our practitioners have seen in China include:

- Failure to use an offshore intermediate holding company or forming one in a sub-optimal jurisdiction
- Giving insufficient consideration to exit strategies
- Using legal entities that are incompatible with the business model
- Failure to capture specific tax incentives
- Failure to correctly estimate the long-term capital needs of the China operation
- Inability to repatriate cash in excess of dividend capacity



Further information:



To learn more about Deloitte's approach to tax planning in China, please contact us for a copy of *Cross Border Tax Strategies for China Investment*, compiled by our International Tax Services practitioners in China.

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Looking for more on M&A?

For additional information on cross-border investment with China, including the publications below, please visit www.deloitte.com/us/csg:

- **China M&A Digest**
A comprehensive weekly review of M&A activity in China
- **China Issues: Dbriefs**
CSG webcast series on China-related topics
- **China Issues: Monthly Commentary**
Insight into major issues shaping the cross-border investment environment

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