KPMG

Our view

KPMG China, Deal Advisory

September 2017

A robust SPA: curbing historical tax risk in China M&A

Despite potential historical tax non-compliance of M&A targets being a key issue when doing deals in China, the appetite for transactions (whether equity or asset deals) in the PRC – in our view – has not let up. And consequently, as deal structures in China have also become more complex, the need for sophisticated tax-related clauses within respective SPAs (sales and purchase agreements) has in turn become more critical than ever.

In a tax context, the SPA should aim to: 1) provide protective mechanisms for both the buyer and seller on historical tax issues; and 2) clarify on the rights and obligations of both the buyer and seller regarding settlement of the relevant tax-related matters prior to or post closing of the transaction.

In recent years, the most common tax-related disputes between buyers and sellers that we've heard of in the market have typically concerned items that were simply overlooked or not clearly stipulated. In this regard, it's worth highlighting some of the key tax-related issues that you should consider when drafting and negotiating the SPA.

Tax remediation-related clauses

What can often be easily overlooked is the definition of "tax" as different jurisdictions can have different applicable taxes and terminologies. Further, formulating thorough, sophisticated tax warranties/indemnities regarding historical tax risk is not only beneficial to the buyer but equally relevant for the seller in terms of limiting potential future payments.

Typically, consideration should be given regarding limiting the warranty period. While China has a statute of limitations of generally 5 years, in practice this period might often be quite fluid depending on local tax bureau practice. Consideration should also be given, following due diligence, to ensure any tax exposures identified are appropriately covered and to understand whether any limitations exist as to how much of the tax indemnity/warranty might be enforced.

Transfer-related taxes

A common issue regarding share transfer-related taxes has often been who should be the with-holding agent given several permutations could apply (e.g. whether the seller is a corporate or individual, or resident or non-resident company). Such complications have been exacerbated in recent years given the China tax authority's release of *Announcement 7* – a notice considered contentious by some in the market as it stipulated the buyer has the withholding obligation on potential capital gains tax. This gave rise to a perception of vested interest (in context of the buyer) in ensuring the SPA has sufficient flexibility to enforce such capital gains tax liability and secure future tax cost base on exit. As such, core issues that should be clarified in the SPA include:

- Who has the tax reporting obligation?
- Which party is to liaise with authorities?
- What is the time schedule for the tax reporting/filing obligation?
- How to settle the tax payment?
- What documentation shall be provided as evidence?

. Credit: Johnny Deng (Director, Tax, KPMG China)

Escrow arrangements

Escrow arrangements are commonly adopted for offshore transfer. In some cases such escrow arrangement is to protect the buyer from certain historical tax exposure of the target wherein the buyer and seller agree on a practical releasing schedule for the escrow. Given the prior-mentioned statute limitation of taxation, and local practice of tax audit in China, often a gradual release of escrow over a 3-5 year period might be used.

Escrow arrangements may also be adopted to withhold the seller's potential transaction tax costs (e.g. income tax) – especially in cases of indirect transfer of a PRC company – to facilitate relevant tax reporting (whether buyer or seller) or tax filing/ payment in line with *Announcement 7*. This is a common arrangement as typically while the tax reporting for *Announcement 7* is due within 30 days of signing the SPA, in practice PRC tax authorities have no fixed timeframe to revert to the taxpayer with a tax basis position. To accommodate for such uncertainty, the escrow period would also need to be negotiated.

Earn-out arrangements

Another common arrangement of recent years concerns earn-out arrangements, which are typically used to incentivize seller-related personnel to remain in the company. Also, given that very often (especially with privately owned targets) the level of historical tax compliance might be low – and that it is generally unlikely sellers would voluntarily settle the tax payments with the PRC tax authorities pre-closing – an earn-out (and escrow) arrangement would be useful to ensure the sellers retain an economic interest in the target within the statute of limitation period.

Other conduct clauses

Subject to the merit of the deal, other tax aspects recommended to be covered in the SPA include:

- the level of tax-relevant information to be delivered at completion
- clarification on who files tax returns for pre-completion tax periods
- the right to review tax returns
- the right to participate in tax disputes
- agreement on tax invoice issuance for the transaction (relevant for both share and asset deals).

Given the conduct and review tax clauses in the SPA usually require specialized knowledge and insight arising from the due diligence process, it is recommended from both seller and buyer perspectives to involve tax professionals in reviewing the SPA to help ensure a full compliance and reduce any PRC tax risks.

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