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KPMG China, Transactions & Restructuring

A taxing concern: equity or asset deal?

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When it comes to doing deals in China, deciding on either an equity or asset deal when buying a PRC entity is often the topic of intense debate and scrutiny – this is partly because different acquisition structures may lead to distinct tax outcomes for the buyer and the seller.

Generally in cases we come across where a Chinese target company may not have fully complied with tax, social, legal or other obligations. The buyer may typically be reluctant to acquire the shares in the target – given the historical contingent liabilities that may be inherited – and thus may prefer an asset deal. However, the seller may well prefer an equity deal as an asset deal could give rise to additional sell-side taxes (especially where the sellers are individuals).

Under an asset deal, gains derived by the selling company would be subject to Corporate Income Tax, in addition to potential indirect taxes (depending on the nature of assets). In China, broadly the sale of most tangible assets would be subject to Value-added Tax (VAT), deemed a creditable tax, whereas the sale of intangible property (including Land Use Rights) would be subject to Business Tax (BT), which is a non-creditable tax.

Given the inequality between VAT and BT, China began a significant VAT reform in 2012 intended to slowly phase out BT so VAT would be the only indirect tax applicable going forward. The reform is still underway, with industries that are still subject to BT (financial services, real estate sector etc.) expected to be subject to VAT within 1-2 years.

In this regard, while the VAT reform measures may have already to some extent reduced inefficiencies apparent under the old BT regime (e.g. arising from intangible type assets), an asset deal could still lead to significant tax burden for the seller especially where real estate is involved (Land Appreciation Tax, BT, Deed Tax etc.) In addition, if the seller was an individual and sought his or her funds, the company would need to distribute the after-tax income (most likely via dividends) to the individual shareholder, giving rise to additional Individual Income Tax. In this regard, from a PRC tax perspective, an asset deal could still be much more costly to the seller.

Other non-tax related issues detracting from the appeal of an asset deal include the timeframe and administrative burden to implement (transferring assets, receivables, contracts etc.) and instances – in some cases – of difficulties in transferring licences (e.g. certain manufacturing, agricultural licences).

As such, detailed due diligence is vital to assess contingent tax risk in the underlying target so that management can determine whether such risk could be mitigated or resolved over time. While legal protection and price adjustment mechanisms are important to consider when signing the Share Purchase Agreement, failure to fully understand the historical risks prior to the deal could lead to heavy tax exposure and added penalties post acquisition.

In light of this, we increasingly see hybrid deals where buyers are willing to acquire the equity shares but prior to acquisition, certain assets may be carved out or others brought in to scope. In any case, the increasingly complex nature of doing deals in China means a clear-cut answer as to whether an equity or an asset deal would be preferable no longer exists. In deciding which deal type or combination to pursue, the following – at minimum – should be addressed:

- What assets are being transferred? Is it legally feasible to acquire certain assets/licences?
- What are the contingent liabilities and how likely is it such risks would be realised?
- What are the tax implications for both the seller and buyer under both options and what structuring alternatives might minimise such exposures?
- How long would it take to implement an asset deal versus an equity deal (direct or indirect acquisition)?
- What are the local tax filing practices / requirements?
- What staffing and HR issues are apparent?

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