Agenda

• Investment Environment in China
• Inbound M&A Tax Considerations
• Outbound M&A Tax Considerations
• Q&A
Investment Environment in China
Chinese M&A activities

Foreign Direct Investment – 2008 to 2016

Unit: In million dollars

Overseas Direct Investment – 2008 to 2016

Unit: In million dollars

Source: National Bureau of Statistics of China
Less restriction on sectors for foreign investments

外商投资准入门槛放宽

Main modifications
- Further open Service industry and general manufacturing industry, reduce restricted and prohibited items in service and general manufacturing industries
- Relaxation on equity requirements on Joint Venture, Sino-foreign cooperation and PRC holding

Foreign Investment Catalogue (2015)

March 2015

Draft Foreign Investment Catalogue (2016)

December 2016

Main modifications
- Further reduced restrictive measures from 93 to 62
- Further open various sectors in service and manufacturing industries such as road passengers transportation, automobile electronics and new energy automotive batteries, motorcycle and etc.,
- Integrate the negative list for market entry: Encouraged items with equity requirement, Restricted and Prohibited items

Less restriction on sectors for foreign investments

外商投资准入门槛放宽
Government policies encourage foreign investments

政府政策鼓励外国投资

Government policies on Investment in China

- Change of pre-approval to recordal filing for foreign investment out of the negative list

- Further opening to and encourage foreign investment involving in various industries such as service, finance, Infrastructure, manufacturing and etc.

- Create fair competition environment for foreign investors
In 2017, the State Council announced 7 new Free Trade Zones: Liaoning, Zhejiang, Henan, Hubei, Chongqing, Sichaun, Shanxi.

Tianjin: Tianjin Port Area, Tianjin Airport area, Tianjin Binhai CBD Area

Shanghai: Waigaoqiao Free Trade Zone and other in total 7 areas

Fujian: Pingtan Area, Xiamen Area, Fuzhou Area

Guangdong: Nansha Area, Qianhai Shekou Area, Zhuhai Hengqin New Area
Inbound M&A Tax Considerations
Common buy-side issues in China

- Future exit strategy (e.g. direct vs indirect sale)
- Integration process
- Pre closing reorg for Target
- Enforcement of SPAs (indemnities, reps and warranties)
- Holding / financing structure
- Tax due diligence findings (Impact on future earnings)
- Assess risks in the event of Tax audits
- Acquisition strategy (e.g. asset deal vs Share deal)
• Transition from old Circular 698

• PRC tax rules on offshore indirect transfer of Chinese taxable property

• Broader range of “Chinese taxable property”

• Tax withholding obligation on buyer

• Extensive guidance on “reasonable business purposes”

• Introduces “negative factors” – automatic deeming provision

• Expanded “safe harbor” rules, including restructuring relief provision

• Formal filing receipts issued by tax authorities

• Clear levy of penalty/interest for late tax payments / withholding
Unresolved Issues under Announcement 7

7号公告尚未解决的问题

When will the decision of the tax officials become last and final?
— Will any formal notice of decision be issued?
— Will the case, once settled, be re-opened in the future?

How will the decision become last and final?
— How does buyer withhold without knowing the tax basis of the seller?
— Any mechanism for refund if the final tax liability is less than the tax withheld?

How to weight the “reasonable business purposes” testing factors?
— Do they have equal weighting?

Any mechanism for refund if the final tax liability is less than the tax withheld?

Uncertain on tax calculation
— What is the tax cost base?
— How to split the gains if multiple Targets involved in the sale?
— What is the appropriate allocation basis among different Targets? Onshore vs offshore allocation?

Application to individuals?

Does share issuance (dilution) or share redemption fall within Announcement 7?
### Location of Holding Company - Dividend repatriation

<table>
<thead>
<tr>
<th>Dividend repatriation</th>
<th>Offshore</th>
<th>Onshore (e.g. CHC)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>PRC WHT</strong> - generally 10% or 5% with treaty relief</td>
<td></td>
<td>Exempt</td>
</tr>
</tbody>
</table>

- **Offshore HoldCo**
- **PRC Target**
- **WHT @10%/5% on dividend repatriation**

- **Onshore CHC**
- **PRC Target**
- **CIT exempted**

**Fund flow**
### Location of Holding Company - Cash-trap

#### 境外或境内持有控股架构对比 - 法定公积金

<table>
<thead>
<tr>
<th>Cash-trap</th>
<th>Offshore</th>
<th>Onshore (e.g. CHC)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>10% of its after-tax profit</td>
<td>Double cash trap</td>
</tr>
</tbody>
</table>

#### Diagram

**Offshore**
- Offshore HoldCo
- PRC Target
  - Cash-trap 1: 10% of its after-tax profit

**Onshore (e.g. CHC)**
- Offshore HoldCo
- Onshore CHC
  - Cash-trap 2: 10% of its after-tax profit
- PRC Target
  - Cash-trap 1: 10% of its after-tax profit
# Location of Holding Company - Re-investment in China

<table>
<thead>
<tr>
<th>Re-investment in China</th>
<th>Offshore</th>
<th>Onshore (e.g. CHC)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Deemed distribution subject to WHT</td>
<td>Tax-free recycling of cash</td>
</tr>
</tbody>
</table>

**Offshore:**
- Offshore HoldCo
- PRC Target
- WHT @10%/5% as distribution
- Fund flow

**Onshore (e.g. CHC):**
- Offshore HoldCo
- Onshore CHC
- PRC Target
- Tax free
- Fund flow
### Location of Holding Company - Exit in future

<table>
<thead>
<tr>
<th>Exit in future (to 3rd parties)</th>
<th>Offshore</th>
<th>Onshore (e.g. CHC)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>PRC WHT on capital gains</strong></td>
<td>Offshore HoldCo</td>
<td>PRC CIT at 25% on the capital gain</td>
</tr>
<tr>
<td><strong>typically 10% unless exempt under treaty)</strong></td>
<td>3rd Party</td>
<td>3rd Party</td>
</tr>
<tr>
<td><strong>Exit in future (to 3rd parties)</strong></td>
<td>PRC Target</td>
<td>Onshore CHC</td>
</tr>
<tr>
<td><strong>WHT @ 10% on capital gains</strong></td>
<td><strong>CIT @ 25% on capital gains</strong></td>
<td>PRC Target</td>
</tr>
</tbody>
</table>

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### Recent Development in China’s DTA Network

近期中国双边协定发展

<table>
<thead>
<tr>
<th>Country</th>
<th>Belgium</th>
<th>UK</th>
<th>Netherlands</th>
<th>Switzerland</th>
<th>France</th>
<th>Germany</th>
<th>Russia</th>
<th>Chile</th>
<th>Taiwan</th>
<th>Romania</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Effective date</strong></td>
<td>2014 (BE) to 2017 (GE)</td>
<td>2017</td>
<td>2017</td>
<td>2018 (exp.)</td>
<td>2018 (exp.)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Dividends</strong></td>
<td>5% (direct shareholding ≥ 25%); otherwise 10%</td>
<td>10%</td>
<td>5%/10%**</td>
<td>3%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Interests</strong></td>
<td>10%</td>
<td>5%</td>
<td>4%/10%</td>
<td>7%</td>
<td>0% (banks) / 3%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Royalties</strong></td>
<td>7% / 10%</td>
<td>6% / 10%</td>
<td>9%</td>
<td>6% / 10%</td>
<td>6% / 10%</td>
<td>6%</td>
<td>2%/10%</td>
<td>7%</td>
<td>3%</td>
<td></td>
</tr>
<tr>
<td><strong>Capital Gains</strong></td>
<td>0% (shareholding &lt; 25% overs 12-month period and non-land-rich); otherwise 10%</td>
<td>0%/10%*</td>
<td>0%/10%*</td>
<td>0% (non-land-rich); otherwise 10%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

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*Subject to beneficial ownership test. **5% (direct shareholding ≥ 25%); otherwise 10%

*Alienation of shares/other rights/interests representing the capital of a company OR more than 50% of value of shareholding is directly or indirectly from immovable property the 36 month preceding the disposal

^Disposed shareholding should be exempt from source taxation and exceeds 25% in the 12 month preceding the disposal
Choice of Transaction Structure - Share deal

### Direct Transfer

- **Offshore / onshore Seller**
- **Offshore Buyer**
  - WHT @10% / 25%
  - PRC Target

### Indirect Transfer

- **Offshore Seller**
- **Offshore Buyer**
- **Intermediate Holding Co.**
  - WHT ???
  - Potential tax treaty benefit (Beneficial owner test in China – Circular 601)
  - PRC Target

Offshore / onshore Seller

Offshore / onshore Buyer

Offshore holding co.

Potential tax treaty benefit (Beneficial owner test in China – Circular 601)
### Choice of Transaction Structure - Asset deal

#### Option I

<table>
<thead>
<tr>
<th>Step 1</th>
<th>Option II</th>
</tr>
</thead>
<tbody>
<tr>
<td>PRC Seller</td>
<td>Offshore Investor</td>
</tr>
<tr>
<td>Existing Co./ New Co.</td>
<td>New Co.</td>
</tr>
<tr>
<td>Assets</td>
<td>Assets</td>
</tr>
<tr>
<td>Transfer taxes (VAT, CIT etc. on asset value gain)</td>
<td>Transfer taxes (VAT, CIT etc. on asset value gain)</td>
</tr>
</tbody>
</table>

#### Option II

<table>
<thead>
<tr>
<th>Step 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>PRC Seller</td>
</tr>
<tr>
<td>New Co.</td>
</tr>
<tr>
<td>CIT on capital gain (25%)</td>
</tr>
</tbody>
</table>

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## Choice of Transaction Structure - Asset deal

### 收购资产架构

<table>
<thead>
<tr>
<th></th>
<th>Option I</th>
<th>Option II</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Timing</strong></td>
<td>No additional time required if existing co is use, otherwise time consuming to set up New Co.</td>
<td>New Co. set up by domestic company is easier compared to being set up by foreign company</td>
</tr>
<tr>
<td><strong>Tax for seller</strong></td>
<td>Potential double taxation for seller on asset value gain at company level and dividend</td>
<td>Possible to transfer the Assets at cost in Step 1 and minimize CIT for seller</td>
</tr>
<tr>
<td><strong>Assets cost</strong></td>
<td>Tax cost base of assets stepped up for buyer</td>
<td>No step up in tax cost base of asset leads to lower depreciation</td>
</tr>
<tr>
<td><strong>Property tax</strong></td>
<td>Potential significant taxes for real estate transfer</td>
<td>Possible to inject land as registered capital to minimize LAT</td>
</tr>
</tbody>
</table>
Comparison of Assets Deal versus Equity Deal

资产交易与股权交易对比

### Asset deal

- A “clean start” for the new entity in terms of its opening balance sheet; exclusion of unnecessary assets and liabilities
- Mitigation of the Entity’s pre-existing contingent liabilities and tax exposures
- Relatively higher tax costs on asset transfer (e.g. VAT, LAT, deed tax, capital gains tax, etc.)
- Longer to establish the New Entity to hold assets and then do a share transfer
- Need to obtain new licenses and permits

### Equity deal

- Pre-existing liabilities and tax exposures
- Indemnification offers little protection to the buyer as enforcement could be difficult, especially if Targets are POEs
- Carve-out of business and assets afterward may become too late
- Relatively lower tax costs associated with the transaction
- Relatively simpler and quicker execution, relatively fast to conclude deal
- No need to transfer licenses
Tax Considerations On SPA

Holding structure
- Jurisdiction to invest from
- Any pre-closing re-org enforced on Seller

Indemnity
- Historical tax liability
- Specific clauses based on the results of TDD

Transaction Taxes
- Applicable transaction taxes
- Which party will bear the transaction taxes
- Tax filing obligation
- Withholding liability
- Tax reporting obligation

Supporting documents
- Tax invoices for asset deal
- Tax filing return/tax payment receipts
- Tax reporting documents and official receipts

Global deal
- Price allocation that is supported by commercial considerations
- Local SPA for PRC approval purposes
### Treasury considerations for remittance of funds out of China

<table>
<thead>
<tr>
<th>No.</th>
<th>Option</th>
<th>Costs</th>
<th>Issues to consider</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Offshore bank loan to foreign affiliates guaranteed by domestic entities</td>
<td>Interest charged by bank</td>
<td>Registration with SAFE (State Administration of Foreign Exchange) required</td>
</tr>
<tr>
<td>2.</td>
<td>Provision of loan to foreign affiliates by domestic entities</td>
<td>6% VAT on interest; PRC CIT, generally 25%</td>
<td>Principal of such underlying transaction may not surpass 30% of the domestic lender’s then ownership equity; Registration with SAFE required – recently this may be restricted in practice</td>
</tr>
<tr>
<td>3.</td>
<td>Dividend</td>
<td>WHT on fund repatriated, 5% or 10% based on DTT</td>
<td>Only available at the end of one fiscal year, unless there is accrued but un-distributed profits</td>
</tr>
<tr>
<td>4.</td>
<td>Service &amp; license fees</td>
<td>CIT or WHT on service &amp; royalty paid</td>
<td>Strict review trend by PRC tax authorities; Recent TP rules which may lead to double tax (WHT plus loss of CIT deduction)</td>
</tr>
<tr>
<td>5.</td>
<td>Capital decrease</td>
<td>No CIT (equal to initial capital contribution)</td>
<td>1) Approval/consent from authority and external creditors; 2) Practically not welcomed by local government</td>
</tr>
<tr>
<td>6.</td>
<td>Liquidation</td>
<td>25%/15% CIT (liquidation gain); 10% WHT on residual assets distribution or reduction</td>
<td>1) Lengthy / complicated procedures; 2) Potential tax audit</td>
</tr>
</tbody>
</table>
Outbound M&A Tax Considerations
## Chinese outbound M&A activity – top sectors and countries and regions in 2016 (Jan-Oct)

### Top 10 countries and regions

<table>
<thead>
<tr>
<th>Disclosed value (USD billion)</th>
<th>Number of announced deals</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 United States</td>
<td>138</td>
</tr>
<tr>
<td>2 Switzerland</td>
<td>49</td>
</tr>
<tr>
<td>3 Brazil</td>
<td>44</td>
</tr>
<tr>
<td>4 Germany</td>
<td>29</td>
</tr>
<tr>
<td>5 Israel</td>
<td>26</td>
</tr>
<tr>
<td>6 Finland</td>
<td>25</td>
</tr>
<tr>
<td>7 UK</td>
<td>21</td>
</tr>
<tr>
<td>8 France</td>
<td>19</td>
</tr>
<tr>
<td>9 Australia</td>
<td>18</td>
</tr>
<tr>
<td>10 Netherlands</td>
<td>16</td>
</tr>
</tbody>
</table>

### Top 10 sectors

<table>
<thead>
<tr>
<th>Disclosed value (USD billion)</th>
<th>Number of announced deals</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Chemicals</td>
<td>120</td>
</tr>
<tr>
<td>2 Computer and electronics</td>
<td>64</td>
</tr>
<tr>
<td>3 Utility and energy</td>
<td>43</td>
</tr>
<tr>
<td>4 Real estate (incl. dining and lodging)</td>
<td>32</td>
</tr>
<tr>
<td>5 Financial services (incl. insurance)</td>
<td>28</td>
</tr>
<tr>
<td>6 Consumer products</td>
<td>27</td>
</tr>
<tr>
<td>7 Leisure and recreation</td>
<td>26</td>
</tr>
<tr>
<td>8 Machinery</td>
<td>23</td>
</tr>
<tr>
<td>9 Healthcare</td>
<td>23</td>
</tr>
<tr>
<td>10 Professional services</td>
<td>21</td>
</tr>
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Key tax consideration of structuring outbound investment

Dividend Withholding Tax upon dividend repatriation

Capital Gains Tax upon disposal

Availability of Foreign Tax Credit in China – try to maintain an effective tax of 25%

Other transaction taxes upon disposal
Q&A?
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