

# Chinese Tax Reform and Risk Reduction of SME M&A

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## Abstract

Although China has developed into one of the world's leading economies, its inbound M&A market appears to be losing attractiveness. The number and volume of transactions have decreased for about a decade and multi-national corporations still note the difficult institutional framework leading to an uncertainty whether their investment will lead to economic success. A weak enforcement of law, widespread corruption as well as informal agreements between enterprises and authorities, often lead to business conditions that cannot be maintained by foreign investors post-acquisition. With the new tax-reform effective January 1, 2019, China, however, enables the taxation system to play a more supportive role in state governance. Thus, taxation & social insurance compliance is expected to improve which might influence the uncertainty and attractiveness of M&A investments in China as well. The paper at hand aims at summarizing the origin of tax-related risks in Chinese M&A-transactions as well as reflecting whether the recent tax reform will have an impact on the uncertainty of the investor.

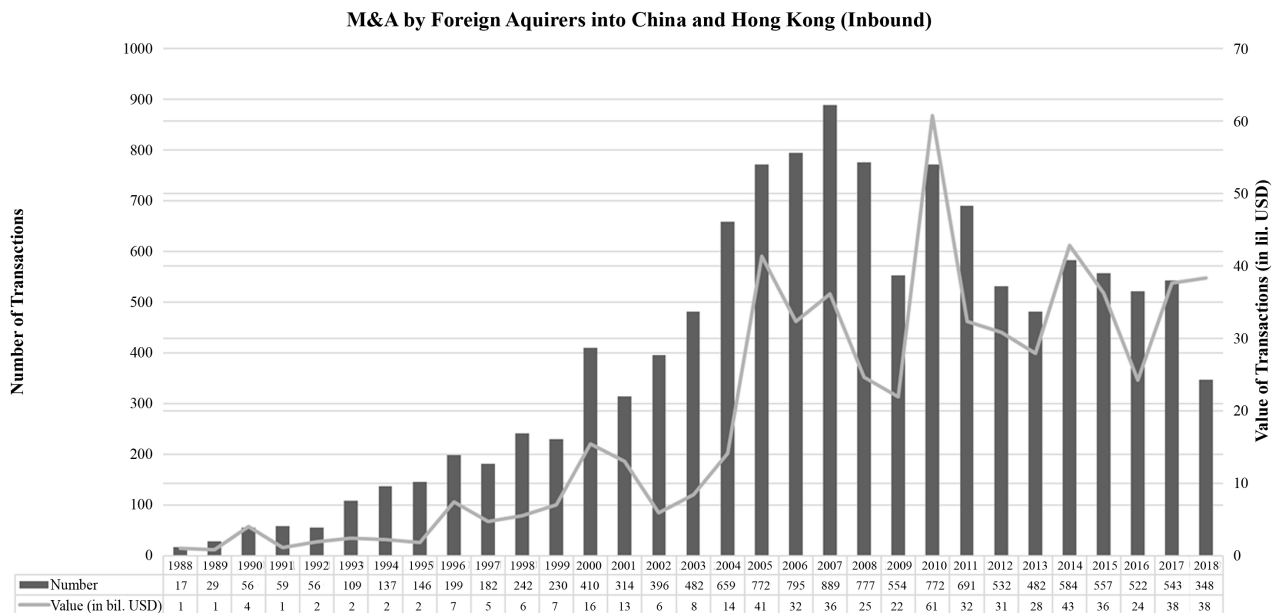
## Keywords

M&A China, Inbound M&A China, Tax Due Diligence China, Tax Risk China, Guanxi, SME China

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## 1. Introduction

Over the past year, China once again sustained its position as the world's second largest economy [1]. In terms of M&A target markets, the Middle Kingdom is at least the third most attractive following the USA as well as the UK [2]. As seen from data of the Institute of Mergers, Acquisitions and Alliances in **Figure 1**, the volume as well as the number of transactions between Western investors and Chinese target-companies have increased significantly in the period between



**Figure 1.** Inbound M&A market PR China [3].

1988 and 2007. The financial crisis (2008), however, put an end to this development. Since worldwide transactions increased due to lower interest rates [2], China's market has been showing a different trend and fewer mergers & acquisitions with foreign investments for almost a decade.

There are different reasons for these conditions. First, there is a proven statistical context between the development of salaries and wages and foreign invested M&A activities in China, leading to fewer acquisitions owing to increasing personnel costs [4]. Moreover, the weakening interest to acquire Chinese companies is driven, for instance, by challenges in the post-merger integration process or due to risks associated with the targets. Corporate practice indicates that many Western investors still have concerns about the legal and tax certainty in China as well as the related compliance how local shareholders and managers run business. Thus, they are not sure whether they can maintain operations in the same fashion post-acquisition a target company. The paper at hand aims to reflect such inherent risks in the context of tax matters as well as to assess whether recent legal changes will have an impact.

## 2. Framework Conditions for Conducting Business in China

Most regular purchase agreements can be characterized by an information asymmetry between seller and buyer. These circumstances also apply for an M&A transaction. Accordingly, with the exception of a management buy-out, a seller has significantly more information about the target company than the potential investor [5]. In order to decrease their uncertainty, the investor will try to screen further information about the object they are going to acquire. Since the seller also has an interest to close the deal, they share an interest in reducing the asymmetry and mostly likely will provide further information to the buyer [5].

The seller, however, might not necessarily provide true and correct data about the target but choose to mislead the business partner and make them pay a higher purchase price. In the following paragraphs, we will briefly address this setting in regards to the business conditions in mainland China and refer to the institutional framework that could enforce a proper exchange of information.

### **2.1. Resolving Information Asymmetry in M&A Transactions and Investment Uncertainty**

Recent empirical research has shown that conducting mergers and acquisitions in China is significantly more challenging compared to transactions in Western countries since investors experience a lack of transparency in terms of the target company. Firstly, Chinese sellers seem to be less willing to provide information about their companies. Secondly, provided data is often manipulated or incorrect due to miscellaneous reasons [6]. Thus, (Western) investors cannot fully rely on the information they have obtained about the target. This produces a high level of uncertainty as to the evaluation of the investment and increases the risk to overpay for the company that is to be acquired. Due to the legal framework conditions in China, most Western investors do not perceive representations and warranties to be sufficient means to protect their interests as well [6]. Since law enforcement is still a critical issue in China, guarantees might neither help the investor to claim their rights on basis of the purchase agreement, nor might company operations be based on the actual legal provisions. The widespread phenomenon of corruption, for instance, documented by the non-profit organization Transparency International, is still nourishing improper agreements between company-management and government officials. Thus, a business license or an operating permit might merely be the result of such a “gentlemen’s” agreement but not be in compliance with the Chinese law. After closing the M&A transaction, an investor faces the risk of being unable or having additional expenses to operate the business in the same fashion as the former owner. Consequently, this will also lead to a lower enterprise value and eventually mismatch the price the buyer originally paid for the target company. By the time the buyer discovers the shortcomings of the target enterprise, it is most likely too late to hold back some of the payment since the right to retain (parts of) the purchase price (*i.e.* earn-out agreement) is limited to a period of 3 - 6 months, or in case of a governmental approval, to 12 months maximum [7] [8]. These circumstances specifically apply to matters of corporate taxes. Due to its abstract and ambiguous nature, tax legislation is interpreted in an inconsistent and arbitrary way which promotes informal agreements with authorities leading to a significant level of tax evasion [9]. However, investors cannot place any confidence in such granted privileges being either compliant or enduring post-acquisition.

Other critical topics might be identified, for instance, within a financial due diligence: as an example, it is not completely uncommon to find target companies that maintain separate accounting books for different purposes (*i.e.* shareholders, banks & authorities) to alter the basis for credit rankings, tax payments

or distribution of dividends. In some cases, clarifying the true ownership of assets might be a challenging task as well.

Research by Büttner & Meckl (published 2015-2017) has shown that about one third of all M&A transactions in China will not be finalized because of a lack of transparency about the target, even though investors try to cover the insufficient information by creating scenarios, making assumptions or sometimes even ignoring the fact of missing data [9]. Thus, the origin of the information asymmetry between Chinese seller and buyer is leading to a different screening behavior by (Western) investors trying to find alternative sources of data and evidence. Touring factories and offices is—compared to Western target markets—a more dominant strategy for conducting due diligence in China since it provides a rather direct impression of manufacturing sites and operational processes [5]. Building interpersonal trust between seller and buyer might be another key to decrease the information asymmetry between both and mitigate the risk of the investor of being exploited. For hundreds of years, mutual trust and reciprocity in personal networks, which are known by the expression “guanxi”, have been the pillars of the Chinese people maintaining social order while (civil) law has only been a weak institution [10]. Büttner & Meckl [9], however, pointed out, that such viable trust can hardly be established within a short period of time as given in a common M&A deal [11]. In consequence, investors might have included lump-sum and risk-related purchase-price discounts in their offers or alternatively avoided Chinese M&A markets.

## 2.2. The Meaning of Chinese Guanxi-Networks

Guanxi reflect complex networks which have been built on traditional ethical values that can be described by *reputation, trust and reciprocity* [10]. Guanxi have been the basis for China’s civil society throughout its history and even experienced a strong revival during political changes and times of decaying moral norms. In essence, guanxi are a Chinese form of social capital defining relationships between people sharing the same origin (like family or hometown), similar experience (e.g. school) or social adherence like the membership of the political party [12]. It forms cohesive forces between its members. At the same time, while there is a strong bond between the members that form any such kind of network, people seem to be rather indifferent about the well-being of any stranger that is outside their network. In order to strengthen the ties, moreover, it is quite common to exchange gifts and favors, which is not necessarily perceived as corruption but seen as a personal obligation and meant to cultivate and honor the relationship.

Since civil law has hardly ever played a significant institution enforcing social order in China, culturally defined interpersonal relations as incorporated in the concept of guanxi-networks have been an essential foundation of its society. Sociologists trace these circumstances back to Confucian norms and values, which determine proper manners and behavior mostly in the context of specific human

relations. Moreover, China's ancient immobile and rather isolated village collectives established a kind of interpersonal trust and morality that was exclusive to its members and has shaped the Chinese mind even up to today [13].

Guanxi plays an extremely important part in the social and business life of today's Chinese people. It might determine if and how to get a loan, an approval from the authorities, an order, a job or critical information in making a (business) decision [14]. Thus, it is not a surprise to find many informal agreements among business partners and/or authorities that might not be in compliance with the law since interpersonal obligation can sometimes be perceived stronger than any legal adherence.

### **2.3. Empirical Tax Risk-Analysis of Chinese SMEs**

The practical findings on hand are the result of 9 due diligence reports, that have been compiled within the last 12 months in connection with foreign invested M&A transactions in mainland China and are focused on financial, legal and taxation matters. Though all 9 target-companies can per definition of the EU [15] be considered as an SME, the sizes of the enterprises, industries, number of employees or miscellaneous key performance indicators are quite heterogeneous. Moreover, each transaction was quite individual since the objectives of the companies, frame conditions or external and internal factors differed significantly as well. As a result, we have obtained a risk profile independent of any industry lines, but still showing a substantial intersection of tax-related topics (leaving special cases like HTNEs (high and new technology enterprises) aside).

Our research mainly follows an explorative approach, based on the Grounded Theory, to avoid excluding unconditional new findings from the results. We have partitioned the qualitative evaluation of above-mentioned reports into two parts: At first, we have analyzed the semi-structured reports and clustered characteristics, which describe the inherent risks of these targets.

Secondly, based on the topics of this paper, we have pre-defined tax categories and matched whether the reports on hand mentioned explicitly or implicitly such issues. Thereafter, we have measured the frequency of these occurrences in order to prioritize topics with relevance to M&A transactions of SMEs. We basically focused on the issues listed below:

- Tax evasion of individual income tax (shareholder(s) or employee(s)).
- Evasion of social insurance.
- Evasion of housing fund.

Eight out of nine reports (equaling 89%) revealed findings regarding the above-mentioned topics, which underlines the importance of the subject matter of this paper. Fiscal risks are of high relevance for M&A transactions as they might even lead to consequences threatening the existence of the company. Since tax evasion does not become time-barred and any misconduct will still be associated with the legal entity, a share deal, in particular, causes a material risk exposure to any investor.

Reasons that promote such wrongdoing are manifold. For instance, small and

privately-owned Chinese enterprises maintain different financial accounting methods, manipulating the financial figures for different purposes and addressees (*i.e.* management accounting, tax accounting/tax authorities, banks etc.).

Compared to tax regimes of other nations, China's tax system does have a quite specific characteristic. Business expenses are not only processed by commercial invoices. In addition, China is operating with a uniform governmental tax invoice (named "fapiao") documenting the business transaction as well as being mandatory to prove its tax deductibility in a company's accounts. Occasionally, the tax authorities, refuse to accept the *fapiaos* being tax deductible due to formal reasons. However, it would not be uncommon to find that a good relationship with the local government might simply solve such an issue [16]. Despite the fact this paper does not focus on how to establish and maintain good ties with the authorities, it becomes obvious that building a close network with Chinese governmental officials could be beneficial and a competitive advantage for any enterprise. Since such behavior is outside any regulated market order, it is definitely distorting fair and transparent competition.

Moreover, it is not unusual for authorities to grant tax incentives and subsidies that are non-compliant with the relevant laws and are based as well on a gentlemen's agreement between influential local government officials and the management of an enterprise [16] resulting in a personal and temporary stipulation. Illegitimate grants, however, can be reclaimed by the government and eventually charged with interests or even penalized. In such cases, the pending loss depends on the judgement of the Chinese authorities, which have a wide scope of discretion: penalties can range from 50% to 500% of the due tax amount or charged with a daily interest of 0.05% [16]. Based on these circumstances, a share deal, in particular, might expose an investor to unpredictable risks. Thus, an investor should assess whether the benefits of a share deal transaction outweigh the risks of the above-mentioned misconduct and potential penalties. If the share deal is not more beneficial, just for this reason, the potential buyer is already facing a deal-breaker.

Beside tax evasion, China is facing a decrease of its tax revenue growth rate since its economy is slowing down and businesses all over the country are exposed to competition pressure on their margins due to an increase of salaries and wages that first and foremost impact the prosperous Eastern part of the country. Thus, China's government might be incentivized compensating any shortfall in tax revenues, by enforcing the tax and social security legislation much more strictly.

On January 1, 2019, a new tax reform as adopted by "General Office of the Communist Party of China Central Committee and the General Office of the State Council" came into force. In essence, the reform aims at harmonizing the tax collection by re-allocating the governance from local to the provincial authorities [17].

The People's Republic of China is a pioneer in the field of automatized data processing. By centralizing all competencies, the tax authorities bundle all rele-

vant information to uncover misconduct promptly. It can be assumed, that all of the existing heterogenous IT-systems will gradually be transferred into a harmonized and homogenous landscape that can conduct plausibility checks and validate any information as submitted by an enterprise. Last but not least, the notification of China's State Council shows that aspects of efficiency, cost savings and transparency are becoming more important and will be improved further [17].

The organizational changes on the part of the Chinese tax authorities have material consequences for SMEs that contain tax risks as discussed in this paper. Enterprises that exhibit such irregularities are likely to be subject to a tax audit by the fiscal authorities investigating the past tax payments and social security contributions. Missing amounts will be collected and penalized.

Although China's overall organizational development by the authorities has not kept pace with the economic growth, the above-mentioned changes lead to a material collateral impact on a due diligence process. Mid-term, (foreign) investors can have more systemic trust, and since social networks and gentlemen's agreements will lose their impact on approvals that are not in compliance with the law, there will also be reductions in the time and resources consuming examinations on their targets avoiding conflicts with the seller.

### 3. Conclusions

The paper on hand highlights that gathering information about a target company during M&A transactions in China is more difficult compared to Western markets. Thus, Western buyers comparatively fail to reduce the information asymmetry between the seller and themselves and most likely remain with a significant level of uncertainty about their investment. Current empirical studies have already verified this assumption.

The weak enforcement of tax & social security legislation paired with the strong persistence of social and personal networks has facilitated an arbitrary interpretation of the legislation. Though business managers make informal arrangements with government officials, however, they still might violate Chinese laws. Thus, investors, couldn't "*place any trust in these granted (...) privileges (...) enduring post-acquisitions*" [9].

With the tax reform effective January 1, 2019, however, China has consolidated the collection of national & provincial level taxes enabling the taxation system to play a more supportive role in state governance. Thus, taxation compliance is expected to improve [17]. In a similar fashion, the responsibility of monitoring and collecting of social insurance premiums will be solely with the tax bureau, which will facilitate the tracking of illegal practices since the control systems of the tax department are more sophisticated [18].

### Conflicts of Interest

The authors declare no conflicts of interest regarding the publication of this paper.

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