Global Private M&A Guide - Limited External Content - People's Republic of China

Quick reference guide

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# Due diligence, pricing and closing

**Typical due diligence issues**

In the People's Republic of China (PRC, or China), regulatory noncompliance used to be very common but we see a growing trend of improvement. Regulatory noncompliance examples generally include the underpayment of social insurance for employees, violations of overtime policies and breaches of environmental laws. Often, these issues will mean additional costs for rectification and operations post-closing. In certain sectors, e.g., energy and resources, healthcare and telecommunications, noncompliance issues in business practices such as bribery can be prevalent. These issues may erode deal value and, in some situations, may lead to the buyer walking away. For buyers from certain countries, this may also trigger obligations to report to regulators in their home jurisdictions.

In some jurisdictions, asking the seller to clean up before closing will be the norm. However, this is not necessarily the case for every situation in China. Coming up with an appropriate solution requires detailed due diligence and a deep understanding of the local practice and practical risks involved. Seeking protection via a reduction in the purchase price or a holdback of the purchase price may also be advisable.

**Pricing and payment**

*Independent appraisal*

Where there is an onshore acquisition in China, and the target is a domestic Chinese entity, an independent appraisal will be required for tax filing purposes. In practice, the parties will often negotiate the price and work together to ensure the appraised value is aligned with the agreed price to the extent possible. Where the seller is a Chinese entity, it is common for the seller to ask for payment outside of China to minimize the Chinese taxes payable. They may also seek to create structures that could be exposed to tax and regulatory risks. From the buyer's perspective, accommodating such structures and weighing such accommodation against the risks involved is a balancing act.

*Payment*

Where the seller is a Chinese party and the buyer is a foreign party, the purchase price will need to be paid into a designated account in China opened in the seller's name.

Where the buyer is a Chinese party and the seller is a foreign party, the timeline for closing is typically longer as the Chinese buyer will need to present evidence of payment (or exemption) of Chinese capital gains tax, if any, before it can apply to its bank to remit the purchase price to the foreign seller. As such, it is common to request that the purchase price (or part thereof) be paid into an onshore escrow account upon signing the share purchase agreement.

In case of a direct acquisition of a Chinese company (shares or assets), a regulation issued by the Ministry of Commerce (MOFCOM) in 2009 (“**M&A Regulation**”) requires that the purchase price be paid in full within one year of closing. This makes the structuring of any deferred or earn-out payment challenging. However, with the Foreign Investment Law (FIL) having come into force as of 1 January 2020, the effectiveness of the regulation has been placed into question. There are generally no restrictions in the case of an indirect acquisition.

**Signing/closing**

*Share sale*

As government approval and/or registration is required for a direct transfer (onshore acquisition) of shares in a Chinese company to a foreign buyer, there is normally a gap between signing and closing.

On the other hand, where the Chinese company is owned by a special purpose vehicle (SPV) outside China, it is common for the deal to be transacted as an offshore transfer of shares in the SPV. Apart from a Chinese merger control filing (which may apply if thresholds are met) and/or a national security review filing (if applicable), the transfer of shares in the SPV is not subject to Chinese government approval or registration (except for a post-completion reporting of a change of beneficial owner) and a simultaneous sign and close is possible.

*Asset sale*

Unless the foreign buyer already has existing entities with the requisite business scope in China to acquire the assets, normally there will be a gap between signing and closing.

# Approvals/registrations

**Foreign investment restrictions**

China has a mandatory and suspensory foreign investment screening procedure, which means that transactions that meet the relevant criteria need to be notified to the relevant authority and cleared before they can be completed.

The foreign investment review regime is targeted at foreign investments in certain sectors. For further information, see the more detailed section on "Foreign investment restrictions".

**Antitrust/merger control**

Merger control in China is mandatory and suspensory. The thresholds for filing are based on the combined worldwide turnover and domestic turnover of the parties involved. It is generally recommended that notifications be made after transaction agreements have been signed and before implementation. For further information, see the more detailed section on "Antitrust/merger control".

**Other regulatory or government approvals**

If the target is state-owned, approval or recordal may be required from the State-Owned Assets Supervision and Administration Commission or its local counterpart. A public listing of the shares or assets in question at an authorized property rights exchange would also be required with limited exceptions to apply.

For acquisitions in certain sectors, such as telecommunications and the financial sector, approval from the relevant industry regulator is also required.

For targets that engage in infrastructure projects, approval by or recordal with the National Development and Reform Commission (NDRC) or its local counterpart is required.

# Employment

In case of share transfers, as there is no change of employment relationship, consent from employees or labor unions is not required. However, it will still be important to manage employee issues, as there are examples where employees may make additional demands (e.g., payment of severance or signing of new agreements) even though these demands are not supported by law.

In case of business transfers, employees will need to be terminated and rehired. Severance is either paid at the time of the termination/rehire or deferred by recognizing the previous years of service of the employees.

# Tax

Stamp duty of 0.05% of the consideration is payable by each party in the case of a share sale (a total of 0.1%). Stamp duty of 0.05% (real estates) and 0.03% (other assets) applies in the case of an asset sale. Stamp duty should be borne separately by the buyer and seller but they can contractually agree otherwise. By way of illustration, in respect of transfer of real estates, the buyer and seller are each separately liable to pay stamp duty at 0.05% on the contract value. In other words, a total of 0.1%.

For Chinese corporate sellers, capital gains will form part of their profits and will be subject to enterprise income tax (EIT) at the rate of 25%. For Chinese individuals, Chinese capital gains tax is 20%. For foreign sellers of shares, capital gains are subject to 10% withholding tax, unless reduced by a tax treaty.

**OECD's Two Pillar Solution**

The OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting has put forward a so-called Two-Pillar Solution to address the tax challenges arising from the digitalization of the economy. Pillar Two is intended to introduce a global minimum effective rate of tax of 15% for large businesses in each jurisdiction where they operate and will lead to fundamental changes in the international tax system. It is currently being implemented in a large number of jurisdictions.

Groups will need to consider how the Pillar Two rules could impact on the life cycle of M&A transactions from the pre-acquisition phase (including transaction planning (such as the choice of acquisition structure and financing) and due diligence of the target group), the acquisition phase (such as contractual risk allocation around Pillar Two) to the post-acquisition phase and the impact of Pillar Two on any post-acquisition integration.

# Post-acquisition integration

For information on post-acquisition integration matters, please see our [Post-acquisition Integration Handbook](https://www.bakermckenzie.com/en/insight/publications/resources/post-acquisition-integration-2023).

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