Typical Tax Risks of Overseas M & A of Enterprises and Their Countermeasures

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Abstract: In recent years, the proportion of Chinese enterprises participating in overseas M & A has increased year by year. Accordingly, tax disputes caused by mergers and acquisitions are not uncommon, and the disputes are followed by heavy tax fines, resulting in unprovoked losses. The reason is that it ignores the different risk points brought by different stages of M & transactions. Based on the perspective of the M & A stage, this paper makes a comprehensive analysis of the tax-related risk points of enterprises that are easy to be ignored and destructive in the process of M & A. Tax due diligence is a very important impact which could influence the entire activity. At the same time, in order to avoid such tax risks, this paper puts forward preventive measures. In the decision-making and management of overseas mergers and acquisitions of Chinese enterprises, we should constantly strengthen the awareness of tax risk prevention, and effectively integrate tax risk prevention and control into the daily work of enterprise management and financial personnel. At the same time, enterprises should establish domestic and foreign tax risk control systems, so as to better deal with the opportunities and challenges brought by economic globalization.

Keywords: enterprise, tax risk, risk control.

1. Introduction

Among overseas direct investment of Chinese enterprises, it is one of the investment methods frequently used by Chinese enterprises to acquire assets, technologies, brands, customers, and markets through mergers and acquisitions of overseas companies. In recent years, China's large-scale overseas M & A cases have occurred frequently. On November 12, 2019, the Globalization Report of Chinese Enterprises (2020) released by the globalization think tank pointed out that Chinese enterprises are increasingly important in global investment, and mergers and acquisitions are the preferred way for Chinese enterprises to invest overseas [1]. However, overseas M & A is an action with both opportunities and risks, including double taxation [2]. In the context of the "Belt and Road" initiative, many enterprises strive to go abroad and carry out overseas investment business. Transnational mergers and acquisitions have undoubtedly become the most effective way to "go global". However, it also has its own limitations. Due to different backgrounds, markets and policies, and even sometimes related to foreign systems, Chinese enterprises face huge risks and challenges [3]. For many Chinese enterprises that have just set foot in this field, whether they can accurately identify and control risks while seizing opportunities is the key to successful M & A.

With the transformation of China from a capital importing country to a capital exporting country, it is of self-evident importance for enterprises to correctly identify and effectively control overseas tax risks for reducing overseas M & A risks, improving investment returns, and improving the good reputation of Chinese enterprises. Tax related risk management of overseas M & A analyzes the tax risk planning of overseas M & A from the perspective of cases [4]. Research on tax issues of cross-border investment and M & A of enterprises try to systematically explain the tax issues that Chinese enterprises need to pay attention to. They are three main parts. Firstly, tax planning of Chinese enterprises when carrying out overseas M & A. Secondly, tax due diligence of Chinese enterprises in overseas mergers and acquisitions. Thirdly, tax and post-merger integration [5]. Based on the perspective of different stages of overseas M & A, the Tax risk analysis of overseas M & A analyzes the tax risks that enterprises may face and puts forward preventive measures. M & A activities are usually divided into four links: project initiation, negotiation, integration and withdrawal, and tax risk exists in each of the above links [6]. This paper intends to analyze the tax risks frequently encountered or easily ignored by Chinese enterprises in all aspects of overseas M & A, such as unreasonable equity structure, analyze the reasons for tax risks, and propose corresponding countermeasures.

2. Common Tax Risk Points in Overseas M & A of Chinese Enterprises

2.1. Unreasonable Equity Structure May Lead to Additional Tax Costs When Profits Are Remitted Back to China

The tax risk of cross-border M&A refers to that domestic enterprises may be subject to tax penalties because they are unfamiliar with the tax laws and regulations, tax mechanisms and tax procedures of the target country during the implementation of cross-border M&A [7]. In the process of overseas M & A of enterprises, the establishment of an investment equity structure is one of the important means to improve investment income and is also one of the most concerning aspects of Chinese "going global" enterprises in various stages. A reasonable equity structure not only helps to reduce the tax cost when overseas profits are remitted back to China but also provides some flexibility for the overall layout, regional business management, cross-border capital allocation, future business integration, and divestiture of Chinese enterprises abroad. In the process of designing the investment holding structure, the coordination between the overseas tax law and the Chinese tax law must be considered at the same time.

Firstly, overseas tax laws and bilateral tax treaties (arrangements) have an impact on M & A activities. The international tax environment of cross-border M & A enterprises is very different from the domestic tax environment. The tax policies around the world are complex and changeable, and the tax collection and management environment and level are uneven. There are often differences and uncertainties in the implementation of tax procedures and the implementation of tax regulations, leading to tax disputes from time to time [8]. The overseas tax impact involved in the equity investment structure mainly depends on the tax laws and regulations of the country where the acquired operating company is located and the country where the intermediate holding company is located, as well as the bilateral or multilateral tax treaties signed by the relevant countries. In the process of overseas investment, Chinese companies usually choose Singapore, Luxembourg, the United Kingdom, and other countries as the location of the intermediate holding company. From the perspective of Taxation, these countries generally do not levy or levy relatively low-income tax on some eligible passive income, and often have a wide network of tax treaties (arrangements).

The above countries are the locations of intermediate holding companies selected by many Chinese companies. However, if intermediate holding companies are blindly established in the above countries to acquire overseas target companies, it may bring additional tax costs to Chinese companies.

Secondly, the impact of changes in international tax rules. It is also very important in the process of foreign investment to maintain continuous attention to the tax laws and regulations of the host country and the dynamics of global tax rules. Against the background of the latest work results of tax base erosion and profit transfer (BEPS) released by the organization for economic cooperation and development (OECD) in September 2014, countries around the world are constantly strengthening cross-border tax management to curb the erosion of transnational corporations on their taxes. For example, the work results of the second action plan of BEPS "mix and match arrangement" are aimed at cracking down on enterprises' use of mixed tools to evade their tax obligations. In the following few months, France, Germany, and other countries began to take corresponding unilateral actions. In addition, the United Kingdom, Japan, New Zealand, and other countries have also started to consider revising the tax laws and regulations involving hybrid tools [9]. In the field of global M & A, many transaction teams have considered making necessary adjustments to the transaction structure according to the latest international tax trends. If the investment team still refers to the ideas before the BEPS action plan to incorporate the traditional hybrid instruments into the transaction arrangement during this period, it will not only fail to achieve the effect of tax saving but may also generate unnecessary structure construction costs and bring tax risks.

Thirdly, the impact of China's domestic tax law on the equity structure. In the process of overseas M & A, enterprises often fall into such a misunderstanding that the tax risk of overseas M & A is completely equal to that of overseas tax risk. In practice, enterprises put all their energy into the assessment of overseas tax risk but ignored the assessment and management of China's tax risk.

For example, when a Chinese enterprise acquired a large overseas group, it made detailed structural planning for the target group's operating entities outside China. However, it did not pay attention to the Chinese subsidiaries under the target group. After the acquisition, it formed a "sandwich" structure of "Chinese parent company - foreign subsidiaries - Chinese subsidiaries". Among them, both the Chinese parent company and the subsidiary company are subject to the enterprise income tax rate of 25%. The Chinese subsidiary company can enjoy the preferential income tax rate of 5% for dividend withholding when paying dividends to its foreign subsidiaries. Foreign subsidiaries (i.e. intermediate holding companies) do not need to pay income tax locally when receiving and paying dividends.

According to Article 24 of the enterprise income tax law of China and the notice of the Ministry of Finance and the State Administration of Taxation on issues related to tax credit for overseas income of enterprises (CS [2009] No. 125), the enterprise income tax paid by the Chinese subsidiaries in China does not belong to the "income tax actually paid outside China" [10]. Therefore, the Chinese parent company obtains profits from its subsidiaries in the form of dividends. These profits need to pay 25% of the corporate income tax and cannot enjoy the tax credit treatment, which leads to an increase in the overall tax burden. If the domestic enterprise has paid attention to this tax impact when determining the acquisition structure, it may consider directly acquiring Chinese companies within the target group through Chinese domestic companies without affecting other business arrangements. In this case, after the acquisition, the domestic parent company will directly hold the acquired Chinese subsidiary. According to the provisions of China's enterprise income tax law, the dividends paid by Chinese resident enterprises are usually tax-free items and do not need to pay enterprise income tax in China. The actual tax burden difference between the two M & A schemes is about 20%.

2.2. Failure to Pay Sufficient Attention to the Representations, Warranties and Indemnities in the Acquisition Agreement

The representations, guarantees, and compensation clauses in the acquisition agreement are important means to protect the rights and interests of investors. The tax risk of the target company found in the tax due diligence stage can be reduced by adding the seller's statements, guarantees, and compensation clauses in the acquisition agreement to reduce the buyer's tax risk after the acquisition. At the same time, it can also be agreed in the acquisition agreement to freeze part of the transaction consideration in the form of an escrow account until the relevant tax risks are properly handled, to protect investors from potential historical tax risks.

In the process of "going out", Chinese enterprises often pay insufficient attention to the statements, guarantees, and compensation clauses in the acquisition agreement. In the course of certain transactions, the tax experts hired by the enterprise have suggested that the enterprise should include statements, guarantees, and compensation clauses related to tax risks when signing the acquisition agreement, but the acquirer still ignored the addition of the above clauses when signing the agreement finally. In one case, the following year after the acquisition of a Chinese company, the overseas tax authorities conducted a tax audit on the acquired enterprise, found relevant tax problems, and required the company to pay back taxes and accept corresponding penalties. Since these tax costs cannot be compensated by the seller, they will ultimately be borne by the Chinese acquisition company.

2.3. The Parent Company Failed to Effectively Manage Overseas Tax Matters

A successful acquisition not only depends on the wise decision of the acquisition time point but also has a long-term and far-reaching significance for the acquisition project and whether the target company can be effectively integrated after the acquisition is completed.

For example, after the acquisition is completed, the related party transaction involved in the daily operation is one of the issues that the enterprise should consider. As mentioned above, tax base erosion and profit transfer are hot issues in recent international taxation, and related party transactions are one of the focuses of tax base erosion and profit transfer. After a domestic high-tech enterprise completed a merger and acquisition transaction in the United States, according to its business development needs, some transactions between domestic related companies and American companies occurred. In the fifth year after the M & a transaction, the transfer pricing arrangement of the related party transactions of the US company was questioned by the tax authorities in the United States, which led to the US subsidiary making tax adjustments on the related party transactions in the past three years and paying the corresponding taxes and late fees.

According to the analysis of enterprise management personnel, although there are insufficient supporting materials in the transaction pricing between domestic companies and American companies, according to the functional risk positioning of American companies, American companies should not retain a large number of profits, and the tax adjustment proposed by American tax authorities is unreasonable. Although the group has paid back the tax in the United States according to the tax adjustment requirements put forward by the tax authorities, the domestic company is unable to make corresponding adjustments and reductions on the domestic taxable income, so the group essentially bears double taxation. The main reason for this phenomenon is that "taxpayers need to pay taxes within the territorial scope, but must pay certain taxes to the institutions with personal jurisdiction, resulting in legal double taxation" [11]. To solve this problem, it is generally a matter of friendly negotiation and mutual adjustment between different countries to avoid double taxation [12]. The management of the enterprise is helpless about this and hopes to avoid possible re-adjustment by improving the quality of information documents. If the management of the enterprise pays enough attention to overseas tax matters after the acquisition, conducts in-depth research on relevant transfer pricing issues, and prepares sufficient supporting materials and documents, the possibility of the above-mentioned risks causing the company to bear additional tax costs will be greatly reduced.

3. Reasons of Tax Risk Points

3.1. Failure to Carry Out Detailed Tax Due Diligence Is an Important Inducement for Overseas Tax Risk

At the initial stage of an M & A activity, investors usually need to conduct due diligence on the invested company. The scope of the investigation may cover finance, taxation, commerce, legal affairs, and other fields. The purpose of the investigation is to identify the potential risks during the historical operation of the target company and to help investors evaluate the operation status of the target company. Especially in an equity acquisition transaction, the buyer may inherit all the historical tax risks of the acquired company. At the same time, the results of due diligence are often one of the bargaining chips for the buyer and the seller to negotiate the terms and prices of the purchase agreement.

The identification and control of tax risk of overseas M & A by Chinese investors depend on whether to conduct detailed tax due diligence on the target company. In practice, many managers of Chinese enterprises often neglect the importance of tax due diligence due to their weak awareness of tax risk prevention. As a result, before the transaction has entered the formal delivery stage, there is already a tax risk that may lead to the loss of future economic benefits.

For example, if a Chinese company wishes to acquire an American company, it cannot understand the tax liability of the limited liability company in the United States only according to the tax treatment of the limited liability company in China. Otherwise, it may ignore the relevant tax impact and lead to potential compliance risks. The most common legal forms of American companies include limited liability companies (LLC) and corporations. From the perspective of the tax attribute of the US federal income tax, generally, LLC does not directly bear the tax liability of the US federal income tax, and Corporation defaults to paying tax as an independent tax entity. The tax attribute of the LLC itself depends on the number of its shareholders. Generally, the LLC of a single shareholder is regarded as "a distinguished entity" from the perspective of the United States federal income tax, that is, the LLC and the parent company belonging to the same tax entity, and the parent company makes the declaration of the United States federal income tax. If there are two or more shareholders in an LLC, from the perspective of US federal income tax, the LLC shall be deemed as a "partnership" for tax payment. That is, the LLC shall submit relevant tax returns according to the provisions of the US federal income tax law on the partnership, apportion its taxable income to the partner level according to the agreed proportion and the partners shall pay tax. However, LLC can also choose its U.S. federal income tax attributes, that is to say, it can choose to make a U.S. federal income tax declaration according to the attributes of an independent tax entity similar to the corporation.

It can be seen from the above that the tax attributes of American companies will have different effects on the US federal income tax payment and declaration obligations of Chinese companies after the acquisition. If Chinese companies directly acquire American LLCs, Chinese companies may directly incur tax liabilities in the United States.

On the other hand, the acquisition of an LLC can also bring corresponding tax benefits. For example, when a Chinese company wholly purchases an American LLC, if the financing problem is solved through the acquisition loan of the bank, part of the interest expenses incurred can be used to offset the taxable income of the LLC and thus reduce the tax burden in the United States. At the same time, from the perspective of United States federal income tax, the acquisition of an LLC with the tax attribute of "tax penetration" or "partnership" will be regarded as the acquisition of assets. The relevant Acquisition Premium can be allocated to different types of assets to improve the tax base of the US federal income tax on the assets. After acquisition, depreciation, and amortization can be accrued and deducted before tax according to the tax basis of the assets after appreciation. If goodwill is formed by the acquisition, the goodwill can also be amortized over a period of 15 years and deducted before tax in the calculation of US federal income tax.

If Chinese enterprises are not aware of these provisions and fail to accurately declare the pre-tax deduction, they will lose their due benefits, thus leading to an increase in tax costs. Therefore, it is a necessary step to do a good job of tax due diligence before acquiring foreign companies.

3.2. Internal Problems of the Enterprise

There is a lack of a global unified tax strategic plan. A clear tax strategy can provide clear guidance for enterprise managers and tax personnel, such as how to allocate limited tax resources? What tax matters should be given priority? What is the annual tax target? Only when the overall tax strategic plan is clear can the enterprise further refine the objectives and methods of tax reporting, management and planning [13].

Enterprises lack of a clear tax function framework. The tax function structure should match and support the objectives of the enterprise, and at the same time closely follow the daily operation of the project, merger and acquisition plan, business expansion and the actual situation of the business, rather than exist separately from the business of the enterprise. At present, the global tax management of many Chinese enterprises is a two-tier management model, that is, the "headquarters project company" model. However, the management and communication between these two levels are very limited, and there is no clear reporting channel, and the division of tax management functions between the headquarters and overseas institutions is not clear enough.

There are not enough full-time tax personnel. In terms of the overall business scale of enterprises overseas, at present, the arrangement of personnel responsible for taxation in many enterprise headquarters is relatively insufficient. The situation of each project company varies according to the size of the project, but in most cases, there are not enough full-time tax personnel, and many of them are part-time tax personnel.

Enterprises lack of adequate risk control and management. For the control and management of tax risk, many enterprises are in a passive management state. The management and control of tax risk in daily operation is insufficient. They can't actively and effectively discover tax risk. They don't have a strong awareness of tax risk prevention. At present, many enterprises lack a set of internal tax control system, that is, they lack the effectiveness of tax functions. Until the tax authorities check and find tax problems, enterprises do not realize the existence of tax risks.

Enterprises lack of tax process with tax efficiency. Many enterprises have not formulated a unified tax information reporting system and approval and processing mechanism, resulting in the inability of the headquarters to properly monitor the tax data of each project company and mobilize existing tax resources to discover potential tax risks.

4. Phased Tax Risk Control Strategy for Mergers and Acquisitions

4.1. Conduct Detailed Tax Due Diligence Before Merger and Acquisition

Before M & A, due to information asymmetry and information blind spots between the acquirer and the acquiree, tax risks may occur before the M & A process has entered the formal delivery stage. The tax related scope of M & A projects covers capital and asset status, financial management level, financial statement information disclosure, as well as business contract relationship, trade and

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supply chain relationship, related party relationship, pending legal proceedings, etc., which will imply tax risks [14]. The purpose of carrying out tax due diligence is to obtain the tax information of the target company, so as to identify the possible tax risks of the target company before M & A transactions, and prepare for M & A management, M & A planning and M & A structure design in the process of M & A. Therefore, it is an indispensable and important link to conduct detailed tax due diligence on the target enterprise before merger and acquisitions.

According to the common practice at home and abroad, the four steps of tax due diligence are detailed. Including: First, identify the tax related risks in the daily tax treatment of the target enterprise. Determine the risk points, and then derive the risks arising from other major transactions that may be relevant, such as whether major investment transactions and capital operation projects will generate significant tax risks. Secondly, the operability of the risk is assessed quantitatively. Third, the enterprise sets the risk level according to the scope and size of the risk. Fourth, enterprises should collect as much information as possible to further improve tax issues. For the problems that can be clearly listed, detailed control measures shall be formulated. For problems that cannot be clearly listed, it is necessary to add safeguard clauses and supplementary representation or guarantee regulations to the merger and acquisition agreement.

4.2. Building an Effective and Flexible Tax Structure in M & A

Whether it is a cash merger or an equity merger, the tax structure should be considered as one of the key factors when designing the merger plan. Because tax is faced with many problems, including those in China, those in the other country, and those involving intermediary companies. In the final analysis, the goal of M & A is to obtain the operation and management rights of the target company, that is, its equity.

How to save taxes while acquiring equity? At least two factors should be considered, namely effectiveness and flexibility. Generally speaking, the general principle for evaluating the effectiveness of mergers and acquisitions is to maximize profits while minimizing risks. However, you can't have both fish and bear's paws, and high profits must be accompanied by high risks. Then, through an effective tax structure, collecting the financial interest of mergers and acquisitions in countries with low tax burden and deducting the interest expense as a pre tax deduction item in countries with high tax burden will undoubtedly reduce the tax as a whole, and ensure that the future profits will be made and the tax will be low from the system design. As for flexibility, that is to say, the tax structure set up, whether it is used for daily operations after mergers and acquisitions or for capital operations facing profit withdrawal, can be flexible. If it is a daily long-term operation and long-term holding, it should be ensured that the corresponding tax on dividend payment is relatively small, then it should be considered to register intermediary companies in Switzerland, Luxembourg and other places to merge and acquire American assets, because the income tax accrual rate agreed between these countries and the United States is 5%. If it is only used as a premium short-term profit, and the acquired assets are sold by capital operation within 1-2 years after the acquisition, it should be ensured that the tax on equity transfer is relatively favorable during the IPO. At this time, asset restructuring can be considered to package and improve the overall value, or investors can be found locally to operate alone.

4.3. Give Full Consideration to the System of “Controlled Foreign Enterprises”

According to China's tax law, if the actual tax burden set by domestic controlled overseas companies is lower than 50% of the income tax rate, and it is not normally necessary to make profit distribution or reduce profit distribution, the current profits shall be included in the overseas business income and the corresponding income statement shall be paid. This undoubtedly puts

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forward higher requirements for enterprises that adopt the establishment of intermediate links for mergers and acquisitions. On the one hand, improper selection of intermediate places may lead to the failure of effective distribution of overseas operating profits after mergers and acquisitions, resulting in unreasonable undistributed profits. On the other hand, long-term non distribution of profits will lead to the situation of controlled foreign enterprises and forced to pay income tax. Therefore, for the purpose of identification, it is necessary to consider whether the actual tax burden of the place where the intermediate company is located is lower than 50% of the current income tax rate, that is, 12.5%, and also consider the legality of retaining profits in the intermediate company for a long time. As for how to define "abnormal needs", China's income tax law and relevant laws have not made clear provisions on this. In practice, the usual practice is that if an intermediary company registered in a tax avoidance place does not engage in substantive business activities after audit, it can be identified as a controlled foreign enterprise with tax avoidance as its main purpose of existence. Therefore, if the intermediate company is registered as a local investment company, and part of the investment income or profit is used for the investment in the tax shelter to form the actual operation of the tax shelter, it may be recognized as "normal business needs". There is no need to pay this part of income tax when repatriating profits.

4.4. Standardize the Signing of Merger and Acquisition Agreements

The M & A agreement is the key legal element to regulate the rights and obligations of both parties to the transaction. It has the M & A transaction terms, relevant representations and warranties, commitment terms, agreement termination terms and other annexes. It is the most critical legal contract document for M & A. The fundamental purpose of all the measures taken to control tax risk is to embody the measures to control tax risk in the merger and acquisition agreement, which should be standardized by professional tax agents on the basis of their own financial and tax personnel. The tax related clauses shall be concise, intuitive and clear in form, content and statement without objection. On this basis, try to reach an agreement with the other party's target company on relevant tax treatment opinions. Because foreign companies do not necessarily have a special tax department, they may also be held by legal affairs or even administrative departments, and their tax declaration process is different from that in China. In this case, full communication must be conducted in advance. If consensus is reached through communication, it must be reflected in the merger and acquisition agreement. In case of major differences, the settlement method shall be indicated in the agreement. If no agreement can be reached, the Supplementary Clauses in the agreement can be used to make a prior agreement for control as a supplementary explanation.

5. Conclusion

This paper mainly puts forward the tax risks that enterprises will encounter in overseas M & A under the background of globalization, analyzes the causes, and proposes how to prevent and control the tax risks in the process of M & A by stages. From the current global tax situation, on the one hand, countries around the world are reducing domestic tax rates to adapt to the international tax environment. On the other hand, they have also strengthened tax supervision and tax collection to varying degrees to make up for the financial losses caused by the reduction of tax rates. From the perspective of cross-border transactions, the focus of investigation by tax authorities in various countries includes the pricing of related party transactions and whether the established holding and operating structure has sufficient commercial substance to support its rationality. Unreasonable and illegal tax avoidance has become the focus of the tax authorities of various countries [15]. If an enterprise wants to go abroad and become bigger and stronger, it must be broad-minded, broaden its vision, and establish a global perspective, which is also true in tax management. In the face of many

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challenges, a reasonable mechanism to release power, clarify responsibilities and share benefits for overseas tax executives will help Chinese enterprises highlight their own advantages, integrate upstream and downstream resources and deploy global resources in the complex international competitive environment.

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