



People's Republic of China

China's economy and M&A activity are picking up from Q1 lows as stimulus measures begin to have an impact



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Current Environment

Declining exports, which started in the fourth quarter of 2008, continued in the first half of 2009 with June being the eighth consecutive month of decreased year-on-year exports. With a 21.8% decrease in exports, the first half of 2009 showed the sharpest decline in exports in a decade. This contraction in trade was matched by a decline in imports during the same period. As a result, China's foreign exchange reserves continued to grow to US\$2.13 trillion, a 17.8% increase at the end of June 2009 compared to June 2008. Over US\$800 billion of these foreign exchange reserves were held in US Treasury bonds, the highest level ever.

Since the beginning of the financial crisis, US Treasury bonds were issued to fund the US government's stimulus expenditures. The Chinese government has been a significant purchaser of these Treasury bonds. The strong demand for US government paper has so far helped to maintain the value of the US dollar. Although the US dollar to RMB peg was lifted in 2005, the RMB has remained relatively stable at about US\$1 to RMB6.83 for the last 12 months. During the G20 summit at the end of March 2009, Russia and China mentioned their desire to become less dependent on the US dollar as a reserve and trade settlement currency. Despite some relatively minor steps, including the memorandum of cooperation with Hong Kong on RMB-trade settlement, the process of liberalising China's foreign exchange regime looks set to be a long-term process.

While many countries around the world suffered from the global recession, China's economy showed remarkably strong growth with a GDP increase of 7.1% in the first half of 2009, which surprised markets. After a GDP growth of 6.1% in the first quarter of 2009, China's GDP grew by 7.9% in the following quarter.

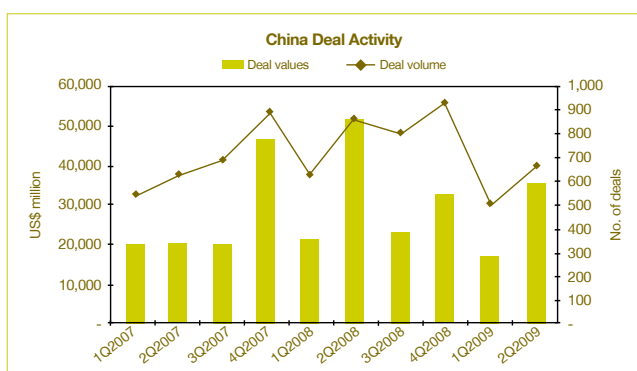
In the past, inflation has spiked to over 8% when the Chinese economy experienced double digit economic growth. However, the Chinese Consumer Price Index was down 1.1% in the first half of 2009 from the same period in 2008. Time will tell if the stimulus measures lead to significant inflationary pressures.

The main drivers of China's economic growth were the recently introduced stimulus measures, such as government spending and eased monetary policies. Under the relaxed credit policies,

RMB7.37 trillion of new bank loans were extended in the first half of 2009, which was approximately 50% more than in the same period of 2008.

It seems that the stimulus money is not only being spent on fixed asset investments and domestic consumption, which are the other main drivers of the Chinese economy besides exports. There are reported concerns that some stimulus money may be indirectly invested in the stock market. The Shanghai Composite Index rose from 1,821 at the beginning of the year to 2,959 at the end of June 2009.

Deal Activity



Source: Thomson Reuters, based on total domestic, inbound and outbound deals announced as of 30 June 2009

There has been a modest recovery in M&A activity in China in the second quarter of 2009 from the lows of the first quarter. Although foreign-backed activity remains depressed, announced domestic transaction volumes increased to 618 deals in the second quarter compared to 473 deals for the first quarter of this year. Domestic deal activity levels increased mainly as a result of confidence in the stimulus measures and ongoing government policy to support consolidation in industries such as cement, steel and financial services.

Overall activity in the first half of 2009 was lower than in the same period in 2008 as the global economic crisis continued. Announced deal volumes in China decreased by 22% to 1,091 deals in the first six months of 2009, down from 1,399 deals in the same period last year and 1,632 deals in the second half of 2008. Activity levels were down for both domestic and foreign-backed transactions.

Foreign corporate and financial investors saw the sharpest decline in activity. For many foreign corporations, visibility surrounding their global earnings potential was so low at the beginning of the year that deal activity was put on hold. As a result, the number of transactions announced involving foreign buyers declined by 35% from 344 announced deals in the second half of 2008 to 225 deals in the first half of 2009.

To a lesser extent, domestic investment levels are still down. Total domestic-to-domestic deal volumes fell from 703 deals in



the last quarter of 2008 to 368 deals in the first quarter of 2009, and up to 498 deals in the second quarter of 2009.

The largest announced domestic transaction was Ping An's acquisition of 30% of the shares of Shenzhen Development Bank for US\$3.2 billion, while the largest announced inbound acquisition was Hong Kong-listed GCL-Poly Energy Holdings Ltd's acquisition of Jiangsu Zhongheng Polysilicon Technology Development Holding Co. Ltd for US\$3.4 billion. This solar power transaction is in line with the Chinese government's strategy to encourage investments in carbon emission reduction as outlined in the stimulus plan.

Japan's Asahi's acquisition of 19.98% of Tsingtao Brewery from Anheuser-Busch-InBev, valued at approximately US\$670 million, is the largest inbound acquisition not involving a Hong Kong-based acquirer.

Financial Buyers

For foreign financial investors, the combination of the credit crisis reducing available funding (with many funds returning capital to stretched investors), an uncertain valuation outlook and problems in existing portfolio companies has led them to put new investments on hold.

Domestic financial investor activity held up better and has now overtaken foreign financial investor-backed activity as an increasing number of Renminbi-denominated funds were launched and rushed to make their initial investments.

The increased interest and appetite for domestic financial buyer transactions is also illustrated by the 16 new domestic Chinese industry funds that were launched in the first half of 2009. This brings the country's total to 41 industry funds. These funds, which are mainly sponsored by local governments or provinces, have an aggregated target fund pool of approximately RMB400 billion. So far, only RMB13.7 billion is known to have been committed.

In the first six months of 2009, Chinese domestic financial buyers have announced two transactions valued at over US\$250 million - Bohai Fund and CDH Management's acquisition of a 20% stake in Chery Automobile Company Ltd, and Zhonghai Trust's 5% investment in Panzhihua Steel. This clearly shows that the local funds that entered the private equity arena first, such as the Bohai Fund, have matured rapidly and are able to compete with foreign funds on more sizable transactions.

As in prior years, the financial buyer transactions are dominated by growth capital deals for minority stakes rather than leveraged buy-outs.

Outbound

The volume of announced outbound acquisitions (excluding mainland Chinese companies acquiring Hong Kong- or Macau-based companies) increased from 59 in the first half of 2008 to 65 in the first half of 2009. At US\$14.7 billion, deal value was more than three times as high as in the first six

months of 2008 mainly due to the US\$8.9 billion offer by Sinopec for Addax Petroleum.

Outbound investments from mainland China were around US\$10.8 billion in the second quarter of 2009 (compared to US\$3.9 billion in the first quarter of 2009). Deal volumes increased by 17% in the second quarter of 2009, compared to the first quarter. 40% of the announced transactions related to acquisitions in Australia, as Chinese metals companies secured iron ore to protect themselves from further price hikes.

Most outbound investments were related to acquisitions in the traditional sectors such as oil and gas, mining and metals. Besides these traditional industries, transactions have also been announced in the industrial manufacturing sectors for Chinese companies to achieve economies of scale, access to foreign markets, capture technology or expertise, obtain ownership of certain foreign brands, gain control over a supply chain or increase market share. For example, Shanghai Electric's printing and packaging division announced acquisitions in the United States and Japan, and Haier Group announced a strategic investment in Fisher & Paykel Appliances Holdings Ltd of New Zealand.

Outlook

After having downgraded their GDP growth forecast to 6.5% from 7.5% in March 2009, the World Bank revised their full year 2009 growth forecast for China upwards to 7.2% in June. The main reasons for this revision were the signs of stabilisation in global economies and financial markets, the strong government-influenced investment and resilient domestic consumption.

Looking forward to the rest of 2009, overall M&A activity levels are expected to remain at or slightly above second quarter levels, with domestic deal makers taking the lead as foreign corporates and financial investors remain cautious.

As confidence seeps back into the domestic economy with better-than-expected GDP figures being announced, stock market gains, and the IPO window being re-opened in China, domestic buyers will gain confidence as time passes, but we expect activity levels will remain below those of 2008, only recovering to this level in 2010.

Foreign buyers will remain more cautious, although there are already signs of a recovery in deal activity as the focus shifts from survival to growth. The pipelines are now at a low and even as the market returns, there will be a delay while deals are put together. For these reasons, we do not see a return to 2008 levels of activity until 2011 for foreign buyers.

Outbound investment is expected to remain a bright spot, but as the global economy stabilises there may be fewer distressed opportunities available. Chinese outbound investment still faces resistance in host countries as shown by the aborted Rio Tinto - Chinalco deal, but China's leadership seems determined to pursue the 'go global' strategy which should support outbound activity into the foreseeable future. ■

China: Promulgation of New Tax Implementation Rules for Corporate Restructuring



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The PRC Ministry of Finance (“MoF”) and State Administration of Taxation (“SAT”) jointly released the rules for corporate restructuring (“Restructuring Rules”) under the Notice entitled “Several Questions about Corporate Income Tax (“CIT”) Treatments for Corporate Restructuring” on 30 April 2009.

These Restructuring Rules will affect foreign investors when carrying out any merger, acquisition or corporate restructuring activity in China.

We have summarised the salient points of the Restructuring Rules, and highlighted several key features:

Sailent Points of Restructuring Rules

- *Forms of restructuring covered*

The Restructuring Rules cover and define each of the following forms of restructuring which will be subject to the tax treatments set forth in the Rules:

- Changes in legal form
- Debt restructuring
- Equity acquisition
- Asset acquisition
- Merger
- Spin-off

- *General tax treatments*

The general principle is that enterprises undergoing corporate restructuring should recognise the gain and loss from the transfer of the relevant assets and/or equity at fair value when the transaction takes place, and the tax basis of the relevant assets in the hands of the transferee should be revised according to the transaction price. The Restructuring Rules, based on this general principle, provide the detailed tax treatments for each of the above types of designated corporate restructuring.

In summary, the tax consequences to the parties involved in the corporate restructuring are instantly recognised.

- *Special tax treatments*

However, if some prescribed conditions are satisfied, the Restructuring Rules allow the parties involved in the corporate restructuring to opt for special tax treatments.

• *Prescribed conditions*

The Restructuring Rules allow special tax treatments for corporate restructuring that fulfill all of the following five conditions:

1. The corporate restructuring has to have reasonable commercial reasons and the main purpose of the corporate restructuring is not for tax reduction, avoidance or postponement of tax payment;
2. The equity or assets being acquired, merged or spun-off have to reach a certain prescribed ratio to reflect the significance of the corporate restructuring. In an equity acquisition deal, the equity



1. acquired should not be less than 75% of the total equity of the enterprise being acquired; whereas in an asset acquisition deal, the assets acquired should not be less than 75% of the total assets of the enterprise that disposes of the assets;
2. No change in the original actual business activities within 12 consecutive months after the restructuring (“compulsory operating period”);
3. The deal consideration should mainly be comprised of equity (or shares) and the portion of equity-payment has to exceed 85% of the total consideration. In other words, the non-share equity (commonly known as “Boot”; which includes cash, bank deposits, receivables, tradable securities, inventories, fixed assets, other assets and undertaking of liabilities, etc.) cannot exceed 15% of the total consideration; and
4. The original shareholder who received the equity payment from the corporate restructuring has to commit not to transfer the equity received within 12 consecutive months after the corporate restructuring (“compulsory holding period”).

- **Special tax treatments - tax deferral**

For a corporate restructuring that satisfies all of the above mentioned conditions, the parties involved may elect for special tax treatments which are essentially a tax deferral treatment. It is important to note that it is not compulsory for the parties involved to elect for special tax treatments – it is a choice.

The general principle is that the recognition of a gain or loss by the transferor on the transfer of assets or equity (shares) can be deferred with respect to the equity-payment portion; and the transferee shall take over the transferor’s tax basis for the transferred assets or equity (shares).

However, the transferor still has to recognise any taxable gain or loss with respect to the Boot portion, where relevant, which is calculated as follows (the tax basis of the relevant assets are adjusted accordingly):

$$\left(\begin{array}{l} \text{Fair value of} \\ \text{transferred} \\ \text{assets} \end{array} - \begin{array}{l} \text{Tax basis of} \\ \text{transferred} \\ \text{assets} \end{array} \right) \times \frac{\text{The amount of Boot}}{\text{Fair value of} \\ \text{transferred assets}}$$

- **Cross-border corporate restructuring**

It is good news to taxpayers that special tax treatments are also included in the Restructuring Rules for cross-border corporate restructuring. However, eligibility is specifically limited to the following types of cross-border corporate restructurings:

Type 1: A non-tax resident enterprise (“non-TRE transferor”) transferring the equity interest in a tax resident enterprise (“TRE”) to another non-TRE (“non-TRE transferee”) in which it has a 100% direct ownership. Moreover, such transfer must not result in changes in the withholding tax burden on the capital gains arising from the subsequent transfer of the equity interest of the TRE in the hands of the non-TRE transferee; and the non-TRE transferor undertakes not to transfer the equity of the non-TRE transferee within three years after the transfer of the TRE.



Type 2: A non-TRE transferring the equity interest in a TRE to another TRE in which it has a 100% direct ownership.

Type 3: A TRE using its assets or equity investment to invest in a non-TRE in which it has a 100% direct ownership. The special tax treatment available includes the ability to spread the gain on the transfer of assets or equity investment to taxable income over a 10-year period, i.e. a tax deferral. However, for this type of transaction, the Rules require the gain to be recognised upon execution of the deal but provide a concession for the gain to be subject to tax on a prescribed deferral basis.

Type 4: Other circumstances that are approved by MoF and SAT.

It is obvious that Types 1 and 2 are for inbound-China investments, whereas Type 3 is for outbound-China investments. Type 4 is simply a “window” allowing flexibility to the authorities to address any special situations which are not considered under the current Rules. It is noteworthy that even if a cross-border corporate restructuring falls into one of the above specific types, it still has to fulfill the five prescribed general conditions mentioned above (the prescribed conditions for special tax treatments) before the parties involved in the corporate restructuring can elect for special tax treatments.

- **Effective date of the Restructuring Rules**

The Restructuring Rules have been applied retrospectively to 1 January 2008, same as the effective date of the CIT Law and its Detailed Implementation Regulations (“DIR”). This is a sensible approach because if the Restructuring Rules were only effective from the date on which they were promulgated, there would be a “legislative vacuum” and all corporate restructuring in that interim period would be taxable under the general principle (in accordance with Article 75 of the DIR), regardless of whether or not the restructuring qualifies for special tax treatments under the Restructuring Rules.

Conclusion

The new Restructuring Rules represent a milestone in the development of the Chinese tax system. It is important for all companies who have either undergone corporate restructuring after 1 January 2008 but before the promulgation of the Restructuring Rules, or are planning to go through a corporate restructuring, to observe these new Restructuring Rules and take the required action to ensure both tax compliance and appropriate tax planning.

The rules to qualify for such tax deferred reorganisations for a foreign shareholder appear to be unambiguous to a foreign or non-TRE shareholder undertaking this. However, it remains to be seen whether there remain opportunities for effective tax planning for any future exits at holding company levels above this and outside China.

For example, where a sale is undertaken within the three-year moratorium of a holding company that is two-tiers or more above the non-TRE shareholder, would this run afoul of the provisions? Or would it in any case run into other exit risks as recently evidenced in a China tax case that seeks to bring any extra-territorial gains outside China into her tax net? We believe time will tell for those who choose to venture but it is likely that China will introduce tax rules to address that. ■