

Research on Corporate Tax Issues in Overseas Mergers and Acquisitions by Chinese Enterprises

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Abstract. As the international environment continues to evolve and enterprises' demand for expanding themselves through mergers and acquisitions (M&A) increases, companies must conscientiously carry out due diligence on target companies, seek consultations on relevant laws, plan M&A matters, and other preparatory work during the M&A transaction process to guard against tax risks that may arise from corporate M&A and restructuring. During the M&A process, companies should pay attention to selecting appropriate M&A methods and structuring the M&A framework reasonably. When uncertain matters are identified, they should make good use of supplementary agreements to prevent potential tax risks. After the completion of an M&A, when faced with multiple taxation, it is important to communicate promptly with government authorities to ensure their own rights and interests. When engaging in related-party transactions with subsidiaries, enterprises should adhere to the arm's length principle to prevent tax penalties that may arise from such transactions. Companies should also promptly monitor changes in the tax laws of relevant jurisdictions to prevent tax leakage. Moreover, with international anti-tax avoidance policies and tax supervision becoming increasingly stringent, Chinese enterprises still face the risks of tax audit and retrospect after M&A activities. Therefore, it is essential for enterprises to establish and improve mechanisms for preventing and controlling tax risks, ensuring the compliance of M&A transactions and maintaining control over tax risks.

Keywords: Overseas mergers and acquisitions; Tax risks; Chinese enterprises.

1. Introduction

Since the reform and opening up, with the rapid development of China's economy and the acceleration of globalization, an increasing number of Chinese enterprises have begun to consider expanding into overseas markets. However, constrained by limitations in technology, distribution channels, brand recognition, and other resources, the process of entering new markets has not been smooth for these enterprises. Corporate mergers and acquisitions (M&A) represent an effective method for a company to acquire emerging technologies, integrate advantageous resources, enhance core competitiveness, achieve rapid expansion, and thereby capture market share. Consequently, overseas M&A holds significant importance for Chinese enterprises aspiring to go global. Research findings indicate that tax issues can significantly impact aspects such as the pattern of foreign acquisitions by enterprises and production efficiency [1]. Against this backdrop, in-depth research on the tax implications of M&A for Chinese enterprises is crucial. By summarizing relevant theories and literature, this study aims to provide insights and references for researchers in related fields and offer decision-making support for enterprises intending to conduct overseas M&A.

2. Current situation and trend of overseas M&A

According to data published in the "2023 Statistical Bulletin of Outward Direct Investment" by the Department of Foreign Investment and Economic Cooperation of the Ministry of Commerce, China's outward direct investment (ODI) in M&A reached its peak at 135.33 billion US dollars in 2016. Afterward, it rapidly declined, falling below 40 billion US dollars in 2019. After 2019, China's annual ODI M&A amount stabilized, maintaining a level similar to that of 2010 for three consecutive years (figure 1). In addition, Asia has been the most favored region for Chinese enterprise M&A over the past five years. The investment M&A amount in manufacturing has ranked in the top two

continuously for five years. Thanks to the growing maturity of Chinese enterprises in cross-border M&A and policy guidance from the Chinese government on corporate cross-border M&A, China's cross-border M&A activities have become more rational [2].

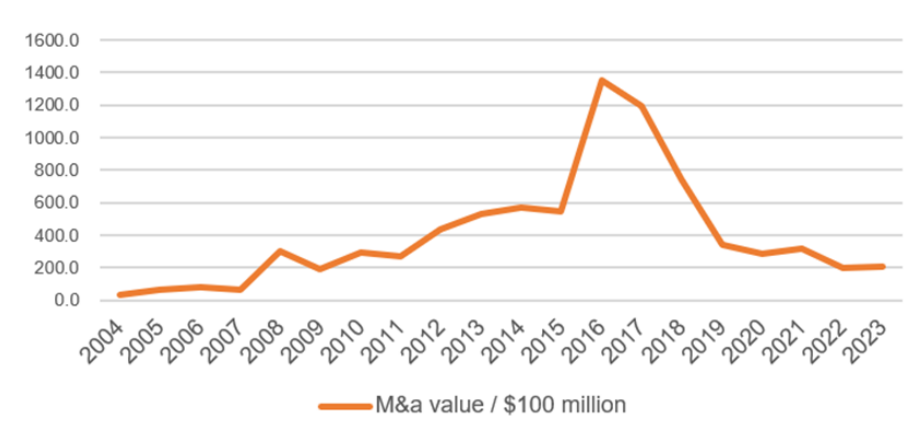


Fig. 1 Amount of China's outbound direct investment mergers and acquisitions, 2004-2023

3. Overseas M&A tax issues

3.1. Pre-merger tax risks

3.1.1. Historical tax risk

Corporate tax management systems often differ from the tax policies of the country in which the enterprise is located. For various reasons, this can easily lead to unmet tax matters in practice, thereby objectively forming tax risks at different stages [3]. Influenced by factors such as information disclosure by the acquired company and local tax policies, it is easy to create information asymmetry for the acquiring party. Information asymmetry between tax authorities and taxpayers is a cause of tax risks [4]. In the case of equity acquisitions, if the acquired company has undetected historical issues such as fake invoices, non-compliant tax filings, tax evasion, or unpaid taxes, due to the existence of succession relationships, the consequences will be borne by the shareholders of the acquiring company. If the acquirer fails to detect these issues in detail before the M&A, it will result in potential tax risks.

3.2. Historical tax risk

3.2.1 Transaction path risk

Due to the differences in tax policies across countries (regions) involved in cross-border M&A, variations in tax burdens may differ based on the structure of the acquisition [5]. If convenience in transactions is prioritized while ignoring the tax matters caused by the choice of transaction method, it may result in tax risks. Taking the acquisition of Syngenta by ChemChina as an example, to address the high tax burden associated with a full-cash acquisition, ChemChina utilized differences in tax treaty clauses between countries to establish a multi-regional tax structure spanning Mainland China, Hong Kong, Luxembourg, and the Netherlands. However, such actions can lead tax authorities to focus on companies that engage in excessive tax planning, resulting in investigations and evidence collection. This could ultimately lead to special tax adjustments deemed invalid or illegal, causing penalties, fines, and reputational and economic losses for the company.

3.2.2 Transaction mode risk

General methods of corporate M&A are divided into equity acquisitions and asset acquisitions. Tax issues are one of the critical factors determining whether an M&A can be successfully completed. The choice of transaction method in M&A transactions has significant impacts on both the acquiring party and the target company [6]. Through equity acquisition, the acquirer can directly take over all

assets, business relationships, employees, etc., of the target company, ensuring strong continuity of operations. However, the tax risks inherent in the acquired company are also inherited, potentially causing tax risk. Asset acquisition allows for selective purchases, effectively isolating risks. However, asset acquisitions may result in varying amounts of transfer taxes, income taxes, real estate taxes, and other fees due to regional differences. Meanwhile, mechanism analysis indicates that biases in M&A asset valuations can simultaneously increase information asymmetry between the company and external investors [7]. This means that in cross-border M&As involving asset acquisitions of companies with concentrated shareholdings, the acquirer may bear additional capital gains tax. If the appreciation rate is too high, it could trigger investigations and penalties from tax authorities.

3.2.3 Regional tax risk

Tax policies are an important means for a country to regulate its macroeconomy; therefore, the economic environment of a country is to some extent determined by its value orientation, which in turn influences the formulation and adjustment of relevant tax structures, rates, and tax incentives [8]. Therefore, it is crucial for the acquiring party to maintain comprehensive and continuous attention to the host country's tax regulations and global tax rules during the process of foreign investment when collecting information on tax incentives available for M&A transactions [9]. Taking stamp duty as an example, China's stamp duty typically ranges from 0.005% to 0.1%, varying depending on the type of transaction; whereas in the United States, stamp duties usually range from 0.1% to 2%, primarily concentrated in the real estate sector and vary by state. If not fully understood and budgeted according to domestic standards, this could result in paying several times more in taxes, thereby increasing financial pressure.

3.2.4 Supplementary agreement

Failure to adequately emphasize the representations, warranties, and indemnity clauses in an acquisition agreement can lead to investors suffering losses after the acquisition. The representation, warranty, and indemnity clauses in an acquisition agreement are crucial for protecting the acquirer's interests. The acquirer can request that the seller make factual statements regarding the business operations, financial condition, assets, liabilities, legal compliance, and other aspects of the company in the representation clause. Through the warranty clause, the acquirer can secure guarantees against potential tax risks that concern them. By virtue of the warranty clause, the acquirer can require the target company to compensate for any losses caused by unfulfilled representations or warranties. If the acquirer does not sufficiently focus on these clauses, they may be unable to obtain compensation from the seller, ultimately leaving the Chinese acquiring company to bear all the consequences.

3.3. Tax risk after merger

3.3.1 Multiple taxation risk

Taxation came into being with the emergence of states, and international taxation arose alongside the internationalization of income. National tax sovereignty is part of economic sovereignty; thus, it is reasonable and legal for countries to exercise their tax jurisdiction within their jurisdictional scope. One specific form of multiple taxation resulting from overlapping national tax sovereignty includes withholding taxes on non-resident dividends levied by the target country/region and corporate income taxes imposed by the acquiring country/region [10]. Compared to state-owned enterprises, multiple taxation has a greater impact on non-state-owned enterprises [11]. Studies also show that high taxation can lead to an increase in the minimum productivity level required after M&A, thereby increasing the failure rate of overseas M&A strategies [12]. To eliminate multiple taxation, most governments have signed tax treaties with each other, although the content of specific treaty clauses varies. In exceptional cases, when an enterprise after M&A receives deferred recognition tax treatment in one country but is taxed immediately in another, the time difference may render traditional methods of eliminating multiple taxation, such as the credit method, exemption method, or deduction method, ineffective, potentially plunging the enterprise back into a situation of double taxation [13].

3.3.2 Related party transaction risk

After cross-border mergers and acquisitions, multinational enterprises typically engage in related-party transactions between the parent company and subsidiaries (such as internal sales, technology licensing, and allocation of management fees). In these transactions, companies can often set unreasonable prices to transfer profits from high-tax countries to low-tax countries, thereby achieving tax avoidance objectives. The transfer pricing in such related-party transactions can lead to a loss of national tax revenues. Therefore, tax authorities in various countries closely review these transactions to prevent profit shifting through artificial pricing and erosion of the tax base. Taking China as an example, in 2009, the State Administration of Taxation (SAT) issued the "Implementation Measures for Special Tax Adjustments (Trial)," which specifically addressed issues related to related-party relationships, the arm's length principle, cost sharing, and other relevant matters. Following this, in 2016, the "Announcement on Improving Related Party Reporting and Contemporaneous Documentation Management" further updated and refined requirements concerning related-party transactions. If the tax authority determines that related-party transactions do not comply with the arm's length principle, it may adjust the transfer prices of related-party transactions and require the enterprise to pay additional taxes accordingly. The authority may also demand that the enterprise pay corresponding late fees and fines.

4. Countermeasures for tax risk management of overseas M&A

4.1. Due diligence

Before finalizing a target company, it is crucial to conduct comprehensive and in-depth tax due diligence on potential target companies to identify any potential tax issues that existed in the past. This includes, but is not limited to, verifying tax filing records, payment of taxes, results of tax audits, and whether there are any unresolved or potential tax disputes. On the other hand, from the start to the completion of the M&A process, the target company may engage in related-party transactions during this period, which could leave hidden risks for the buyer after the acquisition is completed. Therefore, the buyer should also regularly monitor the transaction activities of the target company during the M&A process. Additionally, it is essential to clearly stipulate in the M&A agreement that the seller is responsible for the truthfulness and completeness of the information provided and to set corresponding warranty and indemnity clauses. This ensures that if any tax issues before the completion of the M&A are discovered later, the buyer can receive appropriate financial compensation.

4.2. Consult a consulting company

For most companies, building a stable and reliable business team is not something that can be accomplished in a short period. Therefore, within a short timeframe, the activity load of the company is limited. Consequently, a company with less experience in cross-border M&A may consider collaborating with consulting firms that have extensive experience in overseas acquisitions. For a given activity load, as product diversity increases, the complexity of the target company also increases, leading to an increase in the number of advisors required for focused transactions. In contrast, acquiring specific environmental experience within the company can substitute for the role played by specialized consultants, thereby weakening the relationship between activity load and the number of consultants [14]. Therefore, when relevant experience is lacking, collaborating with specific consulting firms allows the company to systematically learn from the consultant's experience on one hand, and on the other hand, it can avoid issues such as insufficient or excessive activity load that can affect the efficiency and operations of the newly formed overseas M&A business team.

4.3. Put in place the right tax structure

Chinese enterprises typically adopt one of three common tax structure setups for cross-border M&A: direct investment in the target company by the parent company within China; first investing from the Chinese parent company into an intermediary company, which then invests in the target company; or the Chinese parent company reaching the target company through multiple intermediary companies. After determining the target company, the enterprise should first choose between cash or stock as the funding method for the cross-border M&A based on its own level of tax aggressiveness [15]. Following this, it is essential to gain a deep understanding of the tax laws, policies, and international tax treaties in the region where the target company is located. Subsequently, plans should be preset according to need. The specific tax matters included in each plan depend on the relevant regulations in China, the regions where each intermediary company is located, and the region where the target company is located, as well as the bilateral tax treaties among them. Finally, after comparing the various plans, the scheme that best meets the company's needs should be selected.

5. Conclusion

Overseas mergers and acquisitions are an important means for multinational enterprises to go global, expand market share, and achieve a globalization strategy. However, the complex international tax issues that accompany the M&A process have increasingly become key factors influencing whether the M&A strategy will be successful. At the same time, many studies on Chinese enterprises' overseas M&A do not address tax-related aspects such as the company's tax structure, regional tax policies, related-party transactions, etc. Furthermore, current case analysis research on tax-related risks in China is relatively weak. In the future, as domestic experience accumulates, this area will gradually be strengthened.

For companies intending to or currently undergoing M&A, on one hand, they should enhance their internal tax risk management capabilities through training and the introduction of specialized talent to promptly address complex and ever-changing tax regulations. To better tackle tax challenges, Chinese enterprises should conduct comprehensive tax due diligence before M&A, identifying and evaluating historical tax risks of the target company, while regularly monitoring the commercial activities of the target company during the M&A process to ensure the smooth progress of the transaction. On the other hand, achieving tax savings through reasonable tax planning is indispensable, which includes but is not limited to establishing an appropriate tax structure and effectively utilizing tax incentives. When signing the M&A agreement, attention should be paid to the content of supplementary agreements to avoid leaving potential risks where the tax situation of the target company is unclear and lacking proper protection.

As China's competitiveness continues to strengthen, the country has gradually shifted from being a capital-importing nation to a capital-exporting one. An increasing number of Chinese enterprises are opting for overseas mergers and acquisitions to expand their global business footprint. In recent years, in the face of a complex international tax environment and various associated challenges and risks, China's annual overseas M&A amount has stabilized. This stabilization indicates that Chinese overseas M&A activities have become more rational and stable, suggesting that Chinese enterprises will proceed further and better on the path of overseas M&A.

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