The top 10 mistakes made during IBR restructuring projects (and how to avoid them)

January 2023

Introduction

A corporate group may have many objectives in mind when it embarks on a solvent corporate restructuring, also known as an International Business Reorganisation (**IBR**) project. IBR projects may be undertaken to achieve operational changes, tax-optimised structures, entity rationalisation/simplification, business separation, pre-IPO tidy-ups, to accommodate changes in law or tax rules or indeed for many other reasons.

As a result, many advisors and disciplines are likely to be involved. In addition to tax and accounting input, legal support is likely to be needed from various advisory teams to support the project, not only in different jurisdictions but also in different areas of specialisation (corporate, finance, intellectual property (IP), employment, etc.). Whilst all those involved in an IBR project strive to ensure the reorganisation proceeds smoothly, this article explores the darker side of what can go wrong and the mistakes that may haunt the unwary (particularly those who determine not to appoint advisors). Some of these mistakes entail minor hiccups and inconvenience, but others may lead to major headaches. Crucially, we also consider how such mistakes can be avoided, as those forewarned are thereby forearmed.

1. Failing to take adequate tax advice and produce a restructuring steps plan

Typically, a tax (and later legal) structuring paper or steps plan forms the basis or ‘road map’ of an IBR project. The steps plan will set out the objectives of the restructuring together with the relevant legal entities involved as well as document, in chronological order, the proposed implementation steps to be undertaken. More importantly, it will set out any material tax implications or tax leakage expected from the proposed steps (and in due course legal implications) – this is critical for assessing the risks of effecting the restructuring or otherwise considering any alternative steps that may be able to reduce or mitigate relevant risks.

Common tax issues resulting from an IBR project could include capital gains tax (on direct or indirect transfers of assets), transaction and transfer taxes (including stamp duties) that arise when transferring assets/shares, indirect taxes (GST / VAT) and even withholding taxes arising on any cash or other distributions to be made through the corporate structure.

Without a proper tax and legal steps plan (be it a short-form strawman or a detailed restructuring analysis paper), the project team may struggle to easily identify the documentation required to effect and implement the project or to anticipate potential difficulties with its implementation. Further, absent a thorough consideration of tax and legal issues and risks, there could be unexpected exposure in the future, which may need to be rectified or be further negotiated if, for example, the business is later divested (noting that rectification mechanics can often end up being more complicated than simply effecting a correct implementation from the get-go).

2. Failing to do a legal feasibility assessment

Not involving legal advisors or involving them too late in the process can have major implications on the proper finessing of steps and the timeline to implement them. Some examples follow:

(a) **Failing to check the provisions of important contracts and of constitutional documents.** A change of direct/indirect control or shareholding in the course of a restructuring could potentially trigger a change of control clause which automatically terminates or grants the counterparty a right to terminate the relevant contract. Likewise, the existing constitutional documents of a relevant entity may not allow for intended steps such as capital reductions, distributions of assets as dividends in specie / in kind, alterations to share capital or may prohibit certain borrowings. Failure to act in accordance with the requirements prescribed by constitutional documents or the law can lead to void or voidable transactions and expose the entities and directors involved to the risk of claims from shareholders and third parties such as creditors.

(b) **Failing to address minority shareholdings in the structure**, in particular where the IBR project involves a distribution of assets/shares up through a chain of entities and one or more entities in the chain has a minority shareholding. It is also necessary to check the rights of the parties under any shareholders' agreement, joint venture agreements or other similar shareholder governance documents and accommodate those rights and/or obtain any required or advisable consents.

(c) **Providing for insufficient or improper consideration/value for transfers of non-cash assets.** Transfers as a gift or without adequate consideration can also often cause tax and legal issues. Where consideration is given, the advisory team will also need to consider in advance how assets are to be valued (for example, net book value or fair market value) and whether there are any other requirements to be met. Getting this wrong can cause directors to be in breach of their corporate duties and result in issues if there is any subsequent entity insolvency. The consideration used for transfer will also potentially have an impact on the amount of tax on gains (if relevant) as well as the amount of any applicable transfer taxes.

Further detail on this topic is available in an earlier article on the importance of legal feasibility assessments in IBR projects.

3. Failing to take local law input in each relevant jurisdiction

Parties sometimes assume that legal systems are broadly similar. This is not necessarily the case, particularly where the systems' ancestry differs. The key factor is whether the legal system derives from the common law system or the civil law system (or indeed, a hybrid system). However, even where the systems have the same underlying basis, the respective rules in play can still be quite different. Some examples follow:

(a) **Some legal systems may require certain documents to be executed and formalised in a specific way.** Failure to comply with requisite formalities may affect the validity of execution (e.g. for documents executed as deeds and/or with seals or chops).

(b) **Likewise, some jurisdictions require share sale and purchases (or other documents/transactions) to be formalised in a notarial deed signed in person before a notary, often under a power of attorney.** This can entail unexpected notarisation / apostille / legalisation requirements for the transferor and transferee entities that can cause potentially major practical headaches and unexpectedly scupper project timelines. It is therefore of paramount importance to understand whether any requirements of this kind apply to a restructuring and, if so, how they may impact the timing and practical arrangements for the project.

(c) **Changes to share capital and capital maintenance rules.** When planning for a capital reduction, it should be noted that some jurisdictions may have thin capitalisation rules (for example in terms of minimum required capital, statutory reserves and/or debt to equity ratios) which require the share capital be maintained relative to the assets of the company and effectively prohibit the reduction of share capital to a nominal value. In some jurisdictions, such as China, capital reductions can be problematic.

In a well-administered IBR project, the lead legal team usually coordinate input from each relevant local jurisdiction as part of the legal feasibility exercise, and make sure local law issues are properly reflected in the steps plan.

4. Providing for unnecessarily complicated restructuring steps

Unnecessary complexity can result in additional time and cost during the implementation phase. The basic rule is to always use the simplest restructuring steps possible to achieve the final structure, and complexity should be added only as required to address a particular concern (be it a practical concern, a tax concern, a legal concern, an accounting concern or otherwise). Sometimes the determination of what is the 'simplest' approach is not without its own challenges.

Piecemeal advice from different advisors can also result in an overly complex restructuring plan, which can then be difficult, costly and time consuming to implement, or worse, may result in conflicting steps. It is therefore important to instruct advisors who can collaborate and to appoint a lead advisor who can manage the overall planning and implementation of the restructuring exercise (and it should not be underestimated how much work is involved in this kind of legal project management or how much value an experienced IBR lead-team can add to a project – see the next top mistake which discusses this point directly).

5. Underestimating the amount of project management work

It is all-too-easy to see an IBR project as a series of steps, each of which is, in and of itself, simple; *ergo* an IBR project should be simple. Unfortunately, this is rarely the case. The reality is that as the number of steps, entities, jurisdictions and advisors increase, an IBR project often gets exponentially more complicated with each addition. This misconception can sometimes lead to an in-house team seeking to run IBR projects themselves or alongside corporate secretarial teams rather than using lawyers specialising in IBR.

It is not uncommon for a medium-sized IBR project to entail a hundred (or several hundred) legal implementation documents, each governed by different laws and drafted by different teams. Albeit that many of these documents may be simple, managing the comments from the client teams and each relevant advisor (such as tax, legal, accounting and any relevant sub-specialisms and jurisdiction-specific advisors) and ensuring a consistent approach that is based on the agreed steps plan is **always** a major workstream in and of itself. Underestimating the amount of project management work can be a recipe for disaster, as it can lead to deadlines being rushed or missed (and these deadlines can sometime be hard deadlines, for example, where they are driven by changes to tax rules with an impending effective date).

In a similar vein, sometimes corporate groups overlook the possibility of supporting a project with technological and/or scaled delivery solutions to enhance project management, delivery standards and/or efficiencies.

6. Making changes to proposed steps part-way through the restructuring

Making last-minute changes can have unexpected knock-on repercussions. If changes are proposed mid-way, careful consideration should be given as to whether they affect any of the steps already implemented (or planned for implementation) and how they impact the timing and requirements of the remaining objectives of the IBR project's implementation. Sometimes it is simpler and easier to go ahead with the original plan and bear the consequences rather than trying to chase a moving target.

An example we often see would be in a string of asset contributions for consideration shares, some contributions may need to occur first/earlier than others to avoid a build-up of value in the entity issuing consideration shares (as this can increase the amount of transfer taxes involved in some jurisdictions).

7. Underestimating the time required for 'simple' steps such as the incorporation of a company or vehicle

In comparatively 'simple' jurisdictions like the British Virgin Islands or the Cayman Islands, incorporation may just take a few days, but it can take weeks in some other jurisdictions, and in some highly regulated jurisdictions like China or Dubai incorporation and related applications for licenses routinely take months to complete.

Similar concerns apply to the opening of new bank accounts (for example if the restructuring involves cash transactions, particularly as payment for share issuances or transfers). Even simple wire transfers, particularly cross-border transfers, can take longer than expected and can lead to unexpected delays in implementation.

The time taken to clear know-your-client (KYC) checks by third party incorporation providers, advisors and banks is also routinely (and sometimes dramatically) underestimated. Using an advisor team with a presence in all or most relevant jurisdictions can help simplify such requirements.

8. Failing to ensure timely reporting, filings and registrations

Such issues may lead to penalties and jeopardise the timing for the effective implementation of the remaining steps in the restructuring.

For example, there are often prescribed timing requirements for reporting matters such as stamp duty/transfer tax submissions, changes to a company's share capital, amendment of articles of association or other constitutional documents, changes of directors or other officers and so on. In some jurisdictions, changes may only be effective upon filing or even upon confirmation of registration or settlement of stamp duties. Filings may also need to be accompanied by a series of supporting documents which should usually be prepared in advance (and which can be voluminous or time consuming to prepare).

If parties intend to rely on a company secretarial provider to support or perfect any step(s), it is important to ensure the company secretary is on the same page in terms of timing and what they need to do at each stage of the implementation.

9. Reusing documents from previous transactions or projects

After a complex and well-advised IBR project completes, parties may believe that they can simply take the set of final-form documents and clone them for their next restructuring exercise without additional professional support. Even if the nature of both restructuring exercises appears to be similar on its surface, there may be specific characteristics or provisions in the documents or steps which may warrant changes in drafting or even to the whole structure. Also, both tax and legal considerations are subject to change from time to time (sometimes in material respects). It is therefore important to seek tax and legal advice early on the planning phase of every project, even repeated projects, to identify any red flags.

10. Failing to consider the accounting treatment of transactions

Although this is sometimes seen as an afterthought or a post-transaction requirement (which is why we list it last!), failing to consider the accounting treatment of transactions can result in transactions that work from a legal and tax perspective but are not accounted for properly from an accounting perspective, or which may have unintended implications in the future. As mentioned above, failure to properly consider accounting guidance around distributable profits can result in the breach of the relevant companies legislation, particularly for transactions that are characterised as 'deemed' or 'de facto' distributions from an accounting or legal perspective. A particular example we have seen would be issues with potentially inappropriate allocation of 'grandparent contributions' (i.e. from a company to its indirect subsidiary) to share capital, share premium or merger reserve accounts. This can potentially leave cash trapped in entities and cause ongoing confusion, necessitating corrective advisory work and incurring further costs. Where helpful, we are able to involve PwC's accounting advisory teams to advise on the proposed accounting treatment for reorganisations in advance (before accounts are formalised and submitted for audit). Otherwise, once the audit cycle following a restructuring has completed, it can be extremely difficult to make corrective changes to address such issues.

Takeaways

It may seem obvious, but the key solution to the above problems is to ensure proper feasibility work is carried out at an early stage of the project (covering legal, tax, accounting advisory and valuation, each to the extent necessary). If you are interested in exploring this topic further, you can read an earlier article on legal feasibility assessments in IBR projects.

Tiang & Partners is an independent Hong Kong law firm that works closely with PwC. PwC's Legal Business Solutions (LBS) network covers 90+ territories and can enlist PwC's class-leading tax, valuation, accounting, corporate secretarial and other advisory capabilities as well as service delivery / paralegal resources. The PwC team is ideally placed to service these kinds of complex and highly cross-jurisdictional IBR projects under one engagement letter, and to provide clients with a single point of contact whilst doing so.

We are always happy to discuss potential IBR projects with prospective clients, and to work towards preventing the kind of mistakes discussed in this article to ensure that your IBR project is a roaring success.

News Flash

Let's talk

For a deeper discussion of how this impacts your business, please contact us.

PwC Mainland China and Hong Kong

Andrew D'Azevedo
Tax Partner
PwC Hong Kong
+852 2289 5697
andrew.f.dazevedo@hk.pwc.com

Anuj Puri
Accounting Advisory Partner
PwC Hong Kong
+852 2289 2705
anuj.puri@hk.pwc.com

Jing Wang
China Tax & Business Advisory – Corporate & Regulatory Partner
PwC China
+86 10 8553 1566
jing.jm.wang@cn.pwc.com

Liang Jiang
China Tax & Business Advisory – Corporate & Regulatory Partner
PwC China
+86 21 2323 8873
liang.l.jiang@cn.pwc.com

Tiang & Partners

Martin Robertson
Partner, Hong Kong IBR Leader
Tiang & Partners
+852 2833 4948
martin.robertson@tiangandpartners.com

Nicholas Cook
Counsel, Global Co-Chair of PwC IBR Emerging Leaders Network
Tiang & Partners
+852 2833 4906
nicholas.cook@tiangandpartners.com

Felix Chan
Senior Solicitor
Tiang & Partners
+852 2833 4904
felix.chan@tiangandpartners.com

www.pwc.com
www.tiangandpartners.com

pwc

Tiang & Partners
程偉賓律師事務所