Re-structuring FDI in China

Alfred K.K. Chan
China Tax & Investment Consultants Limited, Hong Kong

The aim of this article is to make a comparison of legal rules on stock transfer between China and Hong Kong, examine the latest legal rules regarding the stock transfer in China, and point out the inconsistency among the rules that may hinder the implementation of corporate re-structuring in China. A comparison is also made to show the differences between companies in China and those in common law regions regarding the requirement for legal address and place of business. Finally, by quoting some examples, the article gives some tax-efficient proposals to get around the possible setbacks.

I. Recent legal development in China on stock transfer

The PRC State Administration of Industry and Commerce (the SAIC) announced under administrative order no. 39 (2009) the "Administrative Measure for the Registration of Capital Contribution by Equity Stock" (the Administrative Measure), which is effective as from March 1, 2009. The PRC Company Law provides that "stockholder can contribute capital to the Company by cash, tangible assets, intellectual property rights, land use rights, and non-monetary assets that are valued in dollar terms and transferable in accordance with the law". [1] The provision of equity stock in capital injection in the Administrative Measure falls under the scope of "non-monetary assets" as mentioned above.

The Administrative Measure shall apply in the following situations whether or not they are stocks of private limited liability companies or joint stock limited liability companies:

1. the equity stock to be used by the investor for purpose of capital injection to another company should be the equity stock of the companies that are incorporated in China, and
2. the companies that receive the stock as capital injection should be incorporated within China.

Put differently, the Administrative Measure shall apply where equity stock of one domestically incorporated company is exchanged for the equity stock of another domestically incorporated company.[2] The Administrative Measure shall also apply in the situation that a company acquires new equity investment by issuing additional stock to the stockholders of the invested company, resulting in an increase in the capital of the investing company. However, there are some exceptions. Different legal rules shall apply under the following situations:

1. where a foreign investor listed outside China acquires the equity interest of PRC domestically funded companies with the consideration being settled by the shares of the non-PRC listed company, and
2. where an FIE acquires a domestically funded company in China.[3]

The invested company shall complete the procedure for amending the registered and paid up capital in the company's Articles of Association and business license respectively.[4]

The PRC law does not divide the equity capital of the foreign invested enterprise (the FIE) into shares, but the FIE is created in China with limited liabilities and thus the FIE falls under the scope of domestically incorporated companies. Therefore, the Administrative Measure is applicable to the FIE. The FIE here includes the Sino-foreign equity joint venture enterprise, Sino-foreign co-operative joint venture and wholly foreign owned enterprises. But there is an exception. Where the parties of a Sino-foreign co-operative joint venture do not opt for establishing the joint venture as a legal entity, the Administrative Measure shall not apply.[5]

The Administrative Measure says that the property used for capital contribution purpose should have clear legal title, be free from encumbrances and transferable in accordance with the law. The Administrative Measure further provides that the following equity stocks are prohibited from being used in capital contribution:

- stocks in any companies the capital of which has not been fully paid up,
- stocks that have been pledged,
- stocks that have been frozen under the law,
- stock in the companies the article of association of which restrict any stock transfers,
- stock of the companies whose equity capital cannot be transferred without obtaining the approval from the administrative authority in accordance with the law or regulations and rules, and

- stocks that are banned from being transferred under the law or regulations and decrees as promulgated by the State Council.[6]

The Administrative Measure provides that the promoters of the new company must bring in the equity stock within one year and that the company should complete the procedures for the registration of the paid up capital. Where the Company increases the registered capital, the investors should bring in the stock capital before the company submits application to increase the amount of the registered capital.[7]

The Administrative Measure also provides that the total sum for the amount of the equity stock and other non-monetary assets for capital injection purposes should not exceed 70 percent of the registered capital of the invested Company,[8] and that the equity stock that is the subject of capital injection should be valued by a professional asset appraisal agency duly set up in accordance with the law.[9]

II. Legal and tax implications

There is a consideration in a business acquisition. The consideration can take the form of cash or non-cash, which can include equity stocks, intangible and tangible assets. Where the consideration is made up of equity stock of a particular company, three parties are involved in the stock transfer. The stock transfer is regarded as an exchange of equity stock by the stockholders in the acquired company for the equity stock in the acquiring company, an acquisition of investment by the acquiring company, and a change of the investors in the acquired company. In general, there is a difference between an indirect acquisition, where the acquisition results in a parent-subsidiary company structure, and a direct acquisition, where the acquiring company acquires the assets and assumes the liabilities of the target company. Stock transfer is an example of the indirect acquisition while business transfer is an example of a direct acquisition. A stock transfer can retain the corporate identity and the intellectual capitals including the human capital, customer capital and organisational capital of the acquired company. In a business transfer, the corporate name and identity of the target company ceases to exist after the company has been liquidated, and the value of the intellectual capital will be destroyed where a legal entity is put into liquidation. Intellectual capital as mentioned above must be transferred together with a business acquisition because there is no organised market for the trading of intellectual capital.

It is an accounting requirement that goodwill, measured as the excess of the consideration over the fair value of the identifiable net assets of the acquired company, is recognised in the financial statement in a business acquisition that result in change in control. Different accounting rules shall apply in a stock transfer that does not result in change in control. See Diagram 1.

The transfer of stock involves a change in legal ownership. But there is a distinction between a change of control before and after the stock transfer, and no change in control before and after the stock transfer. Normally merger and acquisition result in a change of control while a corporate reorganisation (restructuring) can result in no change in control before and after the stock transfer. Regardless of whether there is a change of control, a stock transfer brings along the following advantages:

1. the acquired company's tax losses can be carried forward regardless of the change in stockholder structure;
2. if the acquired company is receiving tax concession, it can be continued without interruption, and
3. there is no requirement to change the name of the operating licenses and business contracts.

Its benefit is enormous if the acquired company has a good stock of intellectual capital. The disadvantages are that:

1. the acquiring company indirectly assumes the liabilities of the acquired company,
2. share transfer requires the consent from all stockholders in the case of a private limited liability company; and
3. the acquiring company has to carry out due diligence to protect its interest.

One should consider the legal restrictions imposed on a stock transfer. In the first place, the total sum of the capital contribution that consists of equity stock and other non-monetary assets is capped at 70 percent of the registered capital in the acquired company. The contribution of capital to a newly incorporated company must consist of 30 percent cash as a minimum. The Administrative Measure here imposes a liquidity requirement on a stock transfer that is a restructuring within a group of companies, which involves no change in the ultimate ownership. Secondly, the PRC government classifies foreign investment projects into four categories: encouraged, permitted, restricted, and prohibited ones. Where the foreign investor would like to acquire the equity interest of a company operating in industry sectors under the restricted category, the stock transfer cannot take place due to a legal restriction imposed on the percentage of foreign ownership. Where the equity stock to be used for capital injection purpose is owned by the state, the transfer cannot proceed without the approval from the State Owned Assets Supervision and Administration Commission is obtained. Lastly the stock transfer should pass the test in the Anti-monopoly law.[10]

The Administrative Measure requires the stock transfer to be made at valuation. It clashes with the PRC accounting standards in a company reorganisation that takes place within a group of companies. The PRC accounting rules provide two accounting treatments for business acquisition: where the stock transfer between two companies in a group does not result in a change of control, the stock for the transfer should be measured at book value; where the change in control takes place before and after a stock transfer, the stock for the transfer should be measured at fair value.[11] It is noted that the rules of the Administrative Measure as issued by the State Administration of Industry and Commerce have not made a distinction between a change in control before and after the stock transfer, and no change in control before and after the stock transfer.

The PRC income tax rule provides that where the equity stock of one company is exchanged for that in another company, the stock transfer should be regarded as two separate transactions at fair value. On

Diagram 1

Firm value = Financial capital + Human capital + Customer capital + Organisation capital

the one hand, the stockholders of the acquired company are considered to have disposed of the equity interest and have to pay income tax on the gains that arise from the disposal. On the other hand, the company receiving the equity stock is treated as acquiring a long-term investment at fair value, which shall be used by the acquiring company as the base for income tax purposes in future. However, the PRC income tax rule provides for an exception. In a company organisation, the stock consideration can be measured at book value. That exception in tax rules is different from the rules of the Administrative Measure. Where the stock transfer takes place between two companies, the stock transfer could be treated as a non-taxable transfer, subject to the following conditions be satisfied:[12]

a. the transfer is a non-cash transfer (if there is a cash portion in the consideration, it does not account for more than 20 percent of the par value of the equity stock issued as consideration by the acquiring company); [13]
b. the taxpayer submits an application to the tax authority for tax-exemption; and
c. the tax authority approves the application.

If the conditions for tax-exemption are met, the transaction will have the following tax implications at the stockholder level and the company level:

a. the stockholder of the acquired company will not realise any gain from the disposal of the old stock. The same tax base is used for the new stock he receives from the acquiring company;
b. the tax loss of the acquired company can be carried over to the acquiring company for use over the unexpired period, in proportion to the fair value of the acquired assets to the fair value of the combined assets after the acquisition;
c. the acquiring company uses the book value as the tax base for the acquired assets.[14]

Presumably, the policy objective of the legal rules of the Administrative Measure is aimed to facilitate the efficient use and allocation of capital within China. It is observed that the new rules have not addressed the following issues in company re-organisations: avoiding the tax cost, reducing liquidity requirements, and achieving operability. The legal rules defeats its purpose in company reorganisations due to the fact that:

a. there is a requirement to perform a valuation on the stock being transferred,
b. the capital contribution should consist of a 30 percent cash portion, and
c. it is inconsistent with the accounting and tax rule requirement in a stock transfer that does not result in a change of control.

There are other legal obstacles for setting up a holding company in corporate re-structuring within China. It is noted that the threshold for the registered capital of a foreign funded investment holding company is USD30 million with no less than ten foreign investment enterprises having been set up in China[15] The PRC Company law imposes a requirement for a legal address.[16] The legal rules for the administration of company registration require that the investment holding company should have a legal address where the principle business operations are located, and that the legal address must be situated in the city (or the district of a large city) over which the local office of the State Administration of Industry and Commerce has the jurisdiction.[17] Here the law imposes two requirements for a company: one is the legal address and the other is the location of its social and economic centre. An ownership certificate of an office premises or a lease agreement for a physical office is needed to satisfy the requirement for a place of principle business. There is also a similar provision in the General Code of the Civil Law.[18] The legal requirement is evolved from the industrial age, in respect of which land and tangible assets are the major form of capital. It is found that the holding company created in China cannot take the form of a brass-plate company as it usually does in countries (regions) that adopt the common law system, where the registered office of the holding company can be kept at the same office of the parent company or that of a third party.[19] Further, the law imposes no restrictions on the location of the principle place of business, which can be situated anywhere outside the place of incorporations.

In China, the division of legal authority between the administration and the legislature over the incorporation of corporations and post-incorporation changes is set out in Table 1:

Table 1

	Law-making body	Company and registrations
a.	The National People's Congress	PRC Company law (See note below); PRC Law for Sino-foreign Equity Joint Venture Enterprises; PRC Law for Sino-foreign Cooperative Joint Venture Enterprises; PRC Law for Wholly Foreign Owned Enterprises
b.	The State Council	Regulations for the administration of companies registrations, Decree No. (1994) 156
c.	State Administration of Industry and Commerce (the SAIC)	Administrative measure for the registration of capital contribution by equity stock, issued under order [2009] 39

Note that Article 218 of the PRC Company Law expressly provides that in the absence of any provisions in the laws governing the Sino-foreign equity joint venture enterprises (EJV), Sino-foreign co-operative joint venture enterprises (CJV) and wholly foreign owned enterprises (WFOE), the PRC Company Law shall apply to the foreign investment enterprises.

Table 2 and Table 3 demonstrate that the source of the PRC legal rules not only comes from the legislature, but also from the highest level of the administrative body, the State Council and its subordinate ministries and institutions. The PRC legal framework is made up of different rule making bodies at different levels, as demonstrated in Table 4. Conflicts among the rules are not unusual.

TPAF ISSN 1478-5129

Table 2		
	Law-making body	**Accounting**
a.	National People's Congress	PRC Accounting law
b.	State Council	Not available
c.	Ministry of Finance	PRC Accounting Standard No. 2 – Long-term Investment PRC Accounting Standard No. 18 – Income Tax PRC Accounting Standard No. 20 - Business Combination PRC Accounting Standard No. 33 – Consolidated Financial Statements

Table 3		
	Law-making body	**Income tax rules**
a.	National People's Congress	Corporate Income Tax Law of the PRC, 16th March 2007
b.	State Council	Detailed Implementation Regulations of the CIT law, November 2007
c.	State Administration of Taxation	Circular Guo Shui Fa [2000] 119, issued on 10th December 2002

Table 4			
	Source of rules	**Criteria for using fair value**	**Criteria for using book value**
I.	Accounting rules	Change in control	No change in control
II.	Income tax rules	Adopting the fair value in general	Consideration is non-cash asset; if it consists of some cash, it cannot exceed 20% of the par value of the stock issued by the acquiring company
III.	Administrative Measure issued by the SAIC	Mandatory	Not allowed

The differences between the accounting rules and tax rules are set out in Table 5, where BV is the book value and FV stands for fair value. It is observed that the accounting rules and tax rules are different under case one and case four. In case one, the taxpayer initiates a company re-structuring without a change in control before and after the transfer. The inconsistency in case one can be avoided where the consideration all takes the form of stock. Case four is a stock transfer that results in a change in control. The accounting rule requires the use of FV but the tax rule allows the use of BV for reason that equity stock is non-cash assets. The inconsistence between the BV and the FV is dealt with in the following way: both the transferor and the transferee use the fair value for accounting purposes while the tax base of the stock remains unchanged. Specifically the transferor who disposes of the old stock in the acquired company accepts the new stock in the acquiring company using the same tax base as the stock in the acquired company. The transferee uses the same tax base as the transferor used before the transfer. The difference between the fair value of the acquired assets and the tax base for the acquired assets is recognised in the current period. But the income tax liability is deferred to future periods where the disposal of the assets takes place.[20]

Where the Administrative Measure prescribes a requirement for valuation for the equity stock in the stock transfer, the tax rules do not look at the valuation of the equity stock in an approved tax-exempt transfer. Instead, the tax rules look at the composition of the consideration for the transfer. If it consists of non-cash assets or if the consideration consists of cash and non-cash assets, the cash portion does not exceed a threshold percentage, it is okay for tax purposes. Where the Administrative Measure prescribes a requirement for a 70 percent cap on the maximum amount of equity stock in the stock transfer, the composition of the consideration may derail the stock transfer. As one can see in Table 6, there is conflict of legal rules. Given a mandatory requirement that the cash portion should be no less than 30 percent of the registered capital of the acquired company, the taxpayer who would like to implement a tax-exempt transfer could go nowhere.

Table 5			
		Accounting rules	
		No change in control	Change in control
Tax Rules	Cash consideration	FV / BV (Case 1)	FV / FV (case 3)
	Stock consideration	BV / BV (case 2)	BV / FV (case 4)

Table 6			
	Source of rules	**Mandatory requirement for cash consideration**	**Exception**
I.	Accounting rules	Not mandatory	
II.	Income tax rules	Not mandatory	(i) if there is cash in the composition of the consideration, cash is not exceeding 20% of the par value of the stock issued by the acquiring company (ii) Approval by tax authority
III.	Administrative Measure as issued by the SAIC	Mandatory. Cash is no less than 30% of the registered capital of the acquired company	Not available

Cases before and after corporate restructuring are set out below:

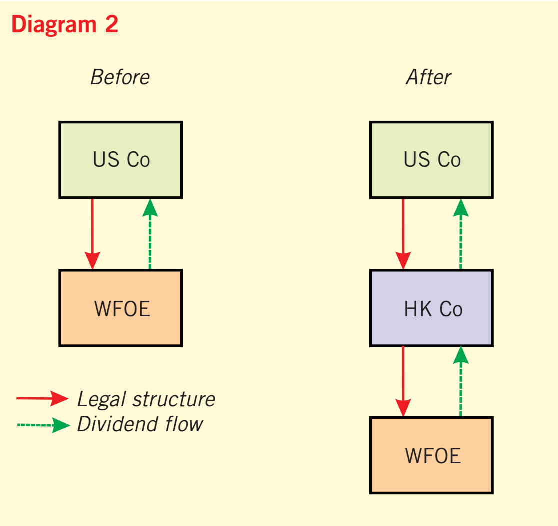
A. Case One

A US company sets up a WFOE in China. The WFOE pays a dividend to the US Co. Before the new corporate income tax (CIT) law took effect on January 1, 2008, the dividends are exempted from PRC corporate income tax. The US companies are used as the immediate investing company of the FIE. No income tax implications arise since the repatriation of dividends is exempted from income tax. After the new CIT law comes in to effect in 2008, the dividends are subject to a 10 percent CIT. There is a case for making a company restructuring to minimise the tax liabilities. The US Co should reorganise its corporate structure by interposing a Hong Kong Company as the intermediate holding company for the WFOE, illustrated in Diagram 2.

1. PRC Company

There are two types of tax implications for the stock transfer:

1. the taxes relating to the execution of the stock transfer in the WFOE from the US Company to the Hong Kong Company, and



2. the income tax on the distribution of dividends from the WFOE to the intermediate holding company after completing the execution of the stock transfer.

The PRC income tax rules allow the consideration to be measured at par value of the equity stock. The transfer would not give rise to income tax implication for the transferor, subject to the conditions being satisfied under tax rule Guo Shui Fa (2000) 119. Note that if the transfer is made at valuation as per requirement under the Administrative Measure effective as from March 1, 2009, the transfer will be a taxable transaction. There are two taxes in connection with the execution of the stock transfer: business tax and stamp tax. The stock transfer is exempted from business tax.[21] But the stock transfer will attract a stamp tax at 0.05 percent in China.[22] After the execution of stock transfer, the dividend paid by the WFOE to the intermediate holding company will no longer be exempted from income tax as from January 1, 2008, and it attracts a five percent income tax for the HK Company and 10 percent income tax for companies incorporated in other jurisdictions. The use of a Hong Kong Company as the intermediate holding company can reduce the withholding income tax from 10 percent to five percent.[23]

2. Hong Kong Company

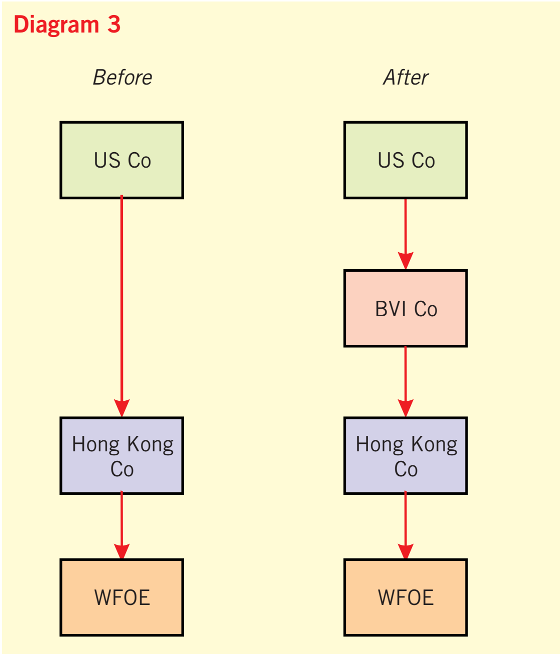
Hong Kong is part of China politically, but it has its own legal and fiscal system that operates separately from the Mainland of China under the provision of the Basic Law of the Hong Kong Special Administrative Region. There is a bilateral arrangement for the avoidance of double tax on income entered into between the Hong Kong government and the Central government of China. The bilateral arrangement provides that where a resident Company on one side of the agreement pays a dividend to the recipient who is a resident on the other side, the recipient shall be liable to a five percent income tax on the dividend, subject to the beneficial ownership in the dividend paying Company being not less 25 percent.

The Hong Kong intermediate holding company does not attract any Hong Kong tax as a result of the re-organisation. The exchange of equity stock in the WFOE for the shares issued to the US Company is a tax-free transfer in Hong Kong. The share exchange of the equity in the WFOE for shares in the Hong Kong Company will not attract any stamp duty. That is, the transfer of the equity stock in a non-Hong Kong entity does not give rise to liabilities for stamp duty.[24] After the stock transfer, the Hong Kong tax rule will not impose tax on dividend income received from investment in other companies whether it is established within or outside Hong Kong. The Hong Kong tax law will not impose tax on dividend at the shareholder level. Where the Hong Kong Company receives the dividend from the WFOE, it is not liable to profits tax in Hong Kong. When it distributes the dividend from the HK Co, there will also be no tax at the shareholder level. Hong Kong tax law imposes no tax on the capital gain that arises from the disposal of the equity interest in the Hong Kong Company where the taxpayer holds it as a long-term investment. Hong Kong Company is an efficient conduit.

B. Case Two

The US Company owns a Hong Kong Company, which again owns a WFOE in China.

The Administrative Measure, effective from March 31, 2009, prescribes that the stock transfer in the WFOE should be valued by a professional valuation agent. Consequently the stock transfer will attract income tax in China. The foreign investor has to use an intermediate Hong Kong Company to avoid the PRC income tax on stock transfer, illustrated in Diagram 3.



A tax-exempt transfer of equity interest in the Hong Kong Co, with no change of investors for the WFOE.

The use of Hong Kong Company as the intermediate holding company can also reduce the income tax on the dividends paid by the WFOE to the Hong Kong Company.

In general, a transfer of shares in Hong Kong Companies attracts stamp duty at 0.2 percent on the consideration (0.1 percent of the consideration for the transferor and the transferee respectively), or the value of the shareholders' funds as reported in the audited financial statements of the Hong Kong company, whichever is higher. The Hong Kong Stamp Duty ordinance (SDO) provides that if the transfer does not result in a change of ultimate ownership (a 10 percent or less change in the ownership is allowed), it could be exempted from stamp duty under section 45 of the SDO, subject to the condition that there should be no further change in the equity ownership within a period of two years commencing from the date of transfer. On the other hand, if the transfer results in a change in the ultimate ownership, it is a taxable transfer. Now the US Company would like to transfer its equity interest in the Hong Kong Company to the BVI Company, and its objective is to avoid the stamp duty on the transfer in Hong Kong stock.[25] A tax-exempt transfer can be structured by interposing a BVI Company between the US Co and the Hong Kong Company. The transfer will not attract any liabilities for the transferor and the transferee since it meets the conditions for relief under section 45 of the SDO.

The legal structure with the Hong Kong company as the intermediate holding company can reduce PRC income tax on dividends distributed by the WFOE, and avoid PRC income tax on the disposal of the equity interest in the WFOE. Where the Hong Kong Company is used as the immediate holding company for the PRC Company, the dividends paid by the PRC Company to the HK Company will be taxed at five percent on the gross amount received. If other non-Hong Kong Company (for example, a BVI or Cayman Islands Co) is to be used as the immediate holding Company, it will attract a 10 percent withholding income tax. The use of Hong Kong Company as the immediate holding company will serve other non-tax purposes: First, the PRC law provides that any change in the equity interest will require the approval from the approval authority on the one hand, and the notarisation of the equity transfer agreement on the other. That is time consuming and cumbersome. Lastly the parties to the transfer will incur notarisation fee of the transfer agreement in China. The Hong Kong Company is not subject to tax on capital gains or on the disposal of long-term investment. Second, if the transfer takes place in the stock/equity interest of the Hong Kong Company, the Hong Kong tax law does not impose any tax on the gain arising from the disposal of HK stock at the shareholder level. The change of equity shares in the Hong Kong Company will also attract stamp duty at 0.2 percent (0.1 percent for the transferor and the transferee respectively) on the amount of the consideration. To determine the taxable base for stamping purposes, the Hong Kong Inland Revenue Department will require the information of the audited financial statement for the Hong Kong Company. The tax base will be the net asset value or the agreed upon consideration, whichever is higher. It is time and tax efficient for the change to be effected at the shareholder level (the BVI Co) since there is no stamp duty and income tax for the transfer of stocks in the BVI. Third, the Hong Kong Company Ordinance provides that the directors of the Hong Kong Company are required to prepare the consolidated financial statements, have them audited, and tabled at the annual general meeting for consideration by the shareholders. However, this requirement for consolidated financial statement will be waived if the Hong Kong holding company is 100 percent owned by another legal entity. That is the other reason why the BVI Co is used as the immediate holding company. The BVI-HK Company structure can be used to circumvent the requirement for the preparation of consolidated financial statements as laid down by the Hong Kong Companies Ordinance. Fourth, there is no estate duty in Hong Kong.

1. BVI Company

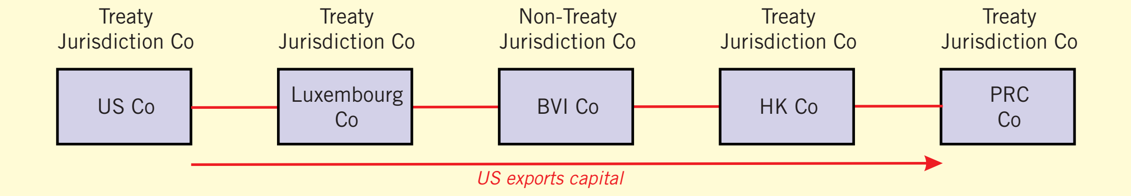
BVI Companies are incorporated in the British Virgin Islands where the law imposes no requirement for the management and control centre being located in the BVI. BVI companies are not liable to taxes on income arising from business activities taking place outside the BVI. There is no estate duty for the stockholders. There is no income tax at the shareholder level if the BVI Company pays a dividend. In addition, there is no stamp duty for the transfer of shares in the BVI Company, and no income tax for the capital gain arising from the transfer of shares in the BVI Company. The limitation for the BVI Companies is that BVI is not a treaty jurisdiction. Accordingly, there are no tax treaties entered into between the BVI government and the governments all over the world.[26] The BVI Company is an effective tool to carry out a tax-free transfer of equity stock. That is particularly useful for the BVI Company to be used in corporate restructuring within a group of companies, resulting in no change in control. That is particularly relevant for the corporate restructuring to get around the anti-tax avoidance rules made at the country levels.

III. Choice of different jurisdictions

Tax costs can be reduced by diverting the dividend flows from a high jurisdiction, through low jurisdiction to no-tax jurisdictions. The US investor cannot directly deal with no-tax jurisdictions, which are notoriously known as tax havens. The tax mitigation arising from tax rate saving or tax deferral in using the non-treaty jurisdiction entity is liable to tax in the home country. To achieve its purposes, the US investor can use a Luxembourg Company to own the equity stock in the BVI Company. The US investing company can minimise its tax costs in the following ways: reducing the tax cost for fund repatriations including dividend, interest and royalty payments from, and the tax on the disposal of, the PRC investment. In case that the US investor would like to sell its PRC investment, it can dispose of the shares in the BVI without attracting any tax liabilities. The disposal of a capital asset will not give rise to tax liabilities in Luxembourg if it is held for a period exceeding 12 months. Since the tax rate on dividend from the Luxembourg is five percent under the US-Luxembourg tax treaty, the US Corporation can legitimately reduce its tax cost by interposing a Luxembourg Company between the BVI and US Co.[27]

Illustrated in Diagram 4, the flow of capital runs from the left to the right. The fund repatriation from China goes from the right to the left. Where the PRC investors export the capital, the same structure can be used with the direction of capital flow and fund repatriation being reverted. Note that since Luxembourg and Hong Kong concluded a tax treaty which is effective from January 1, 2008 in Luxembourg and April 1, 2008 in Hong Kong respectively, the dividends paid by the Hong Kong Company and the gain from the disposal of the shares in the Hong Kong Company will not be taxable in Luxembourg subject to the same conditions as mentioned above being satisfied. The use of BVI Company is optional.

Diagram 4



BVI Company is incorporated in a non-treaty jurisdiction, which includes Bermuda or Cayman Islands.

IV. Conclusion

The PRC legal rules issued by different bodies at different levels may not be consistent among themselves. The inconsistency may hinder company re-structuring in China. The PRC legal system does not recognise an investment holding company that does not carry on business activities. The requirement for a place of business could trace its origin to the industrial era in which tangible assets and lands are the major forms of capital contribution, as opposed to the intellectual capital in the information era. Hence, the PRC legal framework is not business-friendly for corporate re-structuring planning purposes. Proceeding with corporate structuring in China without giving due consideration to the legal setbacks would be a leap into the dark. The management could find ways to get around the obstacles in corporate re-structuring by integrating offshore investment holding companies into the corporate re-structuring plan in China.

Alfred KK Chan is Director of China Tax & Investment Consultants Limited in Hong Kong. He may be contacted at:
phone: +852 2374 0067
email: alfred@china-tax.net

NOTES

[1] See Article 27 of the PRC Company Law.
[2] See Article 2 of the Administrative Measure.
[3] See Administrative Order No. 10 (2006) jointly issued by the Ministry of Commerce, State Owned Asset Supervision and Administration Commission, State Administration of Taxation, State Administration of Industry and Commerce, China Securities Regulatory Commission and State Administration of Foreign Exchange, and Administrative Order No. 6 (2000) jointly issued by the Ministry of Foreign Trade and Economic Co-operation and State Administration of Industry and Commerce.
[4] See Article 9 of the Administrative Measure.
[5] See Article 50 of the Detailed Implementation Regulations of the PRC Law for Sino-foreign Co-operative Joint Venture Enterprises.
[6] See Article 3 of the Administrative Measure.
[7] See Article 6 of the Administrative Measure.
[8] See Article 4 of the Administrative Measure.
[9] See Article 5 of the Administrative Measure.
[10] On March 18, 2009, the Ministry of Commerce rejected the application by Coca-Cola for taking over China Huiyuan Juice Group under the anti-monopoly law.
[11] See PRC Accounting Standard No. 20, as issued under decree Caihui [2006] 03 by the Ministry of Finance on February 15, 2006.
[12] See clause one in Circular Guo Shui Fa [2000] 119, as issued by the State Administration of Taxation.
[13] In August 2008, the State Administration of Taxation has been conducting a public consultation to amend the tax rules for company re-structuring, which provides that the fair value of the non-equity stock payment shall not exceed 15% of the book value of the equity stock.
[14] Actually there is a distinction between the book value and the tax base. The consultation paper has done away with the current practice of adopting book value.
[15] See Administrative Order No. (2004) 22 as issued and amended by the Ministry of Commerce on November 17, 2004 and May 26, 2006 respectively.
[16] See Article 25 of the PRC Company Law, as promulgated and amended by the Standing Committee of the National People's Congress on 29th December 1993 and 27th December 2005 respectively.
[17] See Article 12 of the Regulation for the Administration of Companies Registrations, as promulgated under decree no. 156 and amended by the State Council on 24th June 1994 and 18th December 2005 respectively.
[18] See Article 37 of the General Code of Civil Law, as promulgated by the National People's Congress on 12th April 1986.
[19] Some of the jurisdictions that adopt the common law system include Bermuda, Cayman Islands, British Virgin Islands and Hong Kong. Companies set up in Bermuda, Cayman, and BVI are just required to have a registered agent in the place of incorporation. A Hong Kong Company can keep the registered office and the business address at a firm of professional accountants or lawyers in Hong Kong.
[20] It is accounted for as taxable temporary difference under the PRC accounting standard No. 18 – Accounting for Income Tax.
[21] See Circular Cai Shui (2002) 191, as jointly issued by the Ministry of Finance and State Administration of Taxation on 10th December 2002.
[22] Note the stamp tax rate is different between stock transfer for unlisted companies and the stock transfer for listed companies.
[23] The 5% withholding income tax is imposed subject to the HK investor's equity interest being no less than 25% in the WFOE. Otherwise, the HK Company is liable to a 10% income tax on dividends paid by the WFOE. See the Arrangement between the Central Government and the Government of the HK Special Administrative Region for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion, effective from 1st January 2007.
[24] See section 2 of the Stamp Duty Ordinance. Note that where the PRC Company is listed in Hong Kong, the transfer is a taxable transaction under the SDO.
[25] The rate of the stamp duty is 0.1% for the transferor and the transferee respectively on the taxable base, which is ascertained by reference to the higher amount of professional valuation, and equity interest in the balance sheet and the consideration as stated in the sale and purchase agreement.
[26] Similar legal rules shall apply to Cayman Islands Companies and Bermuda Companies.
[27] The 5% withholding tax rate is subject to 10% ownership of voting stocks held in the Luxembourg Company. See Article 10(1) of the US-Luxembourg double tax agreement concluded in 2001.

TPAF ISSN 1478-5129