

China Investments & Operations: Advantages of Hong Kong Holding Structure Now Include Tax Preferences

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Structuring of foreign direct investments and operations in the People's Republic of China ("PRC") can be made more tax-efficient and flexible through a presence in the PRC's Hong Kong Special Administrative Region ("SAR"). The PRC continues to reform its complex regulation of foreign investments and activities, and the Hong Kong SAR continues to adjust its less-regulated economy in order to maximize its attractiveness as a PRC gateway. Cooperation between the PRC central and SAR governments has included, in recent years, a closer economic partnership agreement and will include, starting in early 2007, a preferential cross-border tax arrangement.

CROSS-BORDER TAX PREFERENCES

Hong Kong's newest attraction, as a location to hold investments and to support operations in the PRC, is that its residents who receive income from the PRC Mainland will soon enjoy relatively low rates of PRC withholding income tax, under the recently expanded *Arrangement for Avoidance of Double Taxation and Prevention of Fiscal Evasion with Respect to Taxes on Income*, signed on August 21, 2006 and to become effective (for Hong Kong residents) from April 1, 2007 (which is the start of the Hong Kong fiscal year).

A "resident of Hong Kong" entitled to benefit from this arrangement includes "a company ... if incorporated outside the Hong Kong SAR, being normally managed or controlled in the Hong Kong SAR". The "arrangement" follows the structure and wording of the "agreements" (treaties) entered into by the PRC with many countries. In comparison with them, the Hong Kong arrangement provides for lower tax rates (see: [tax treaty comparison table](#)). These lower rates will become increasingly valuable when the PRC rolls out its long-awaited tax reform, which is likely to increase the standard (non-treaty) rate of many types of tax.

A preferential withholding income tax rate limit of 7% will be enjoyed by Hong Kong residents on interest and royalties, and a rate of 5% enjoyed on dividends received from their PRC subsidiaries and, in some cases, from other PRC payers. For interest income, the new 7% rate compares with a typical 10% rate specified for most recipients covered by tax treaties. For royalty income, the new 7% rate compares with a typical 10% rate specified for most types of royalty to recipients covered by tax treaties. (For both royalty and interest income, where there is no tax treaty or tax arrangement, the rate currently specified by PRC policy is 10%, but a higher rate of up to 20% is likely in the future.) Dividend income (from a subsidiary owned 25% or more by the recipient) will be taxed at only 5%, in comparison with the more typical 10% rate specified under tax treaties. (For dividend income, even where there is no tax treaty or tax arrangement, PRC policy currently exempts foreign-invested enterprise ("FIE")-paid dividends from any tax, but a rate of up to 20% is likely in the future.)

Capital gains on the sale of a PRC company are treated differently, with a preferential zero withholding income tax rate applying only to portfolio investors who before the sale hold less

than 25% of the company (which does not hold assets substantially consisting of real estate), according to the apparent intended meaning of the tax arrangement. (For capital gains, where there is no tax treaty or tax arrangement, the rate currently specified by PRC policy is 10%, but a higher rate of up to 20% is likely in the future.)

For direct investors holding 25% or more of a PRC subsidiary, this lack of any preferential rate is not onerous. They can avoid PRC capital gains tax by selling ownership only in offshore companies (which themselves own PRC subsidiaries) rather than selling direct ownership in PRC subsidiaries. Tax planning of this type is a traditional reason for establishing an offshore holding company to hold each PRC direct investment that might later be sold. But there are other benefits to using this type of holding structure, for it can help address certain constraints, costs and risks, which are summarized below.

PRC ENTITIES – CATEGORIES & TRENDS

A wholly foreign owned enterprise ("WFOE" or "WFOE") has become the most popular type of presence in the PRC for foreign companies in recent years, supplanting foreign representative offices ("ROs") for provision of services related to sales and sourcing, and outnumbering Sino-foreign joint ventures ("JVs") for manufacturing and provision of other services. WFOEs and JVs have both long been categorized as "foreign-invested enterprises" ("FIEs") and covered by a different set of laws and regulations than those governing domestic-invested enterprises. Recently, however, most types of FIEs, now being referred to as "foreign-invested companies", have been brought under many of the same laws and regulations that govern domestic-invested companies.

Early Stage PRC Presence -- RO vs. WFOE

Until recently, many foreign companies established their initial non-manufacturing PRC presence in the form of a RO, mainly in order to avoid committing capital. But the alternative of establishing a WFOE (recently enjoying much lower minimum capital requirements) has gradually become more attractive. A RO's parent is liable for all of the RO's obligations, in contrast with the limited liability resulting from establishment of a WFOE or another type of FIE. Although an income tax exemption is available in theory for a variety of ROs, in practice very few of them qualify. Establishment of ROs has become easier in recent years, but their compliance with changing tax rules has entailed higher administrative costs and tax liability.

Permitted activities for a typical RO continue to be limited to "non-direct business activities". These activities are not comprehensively defined but are understood, in theory, to mean business liaisons, product introductions, market studies, technical exchanges and, in practice, to include product sourcing, quality control and marketing. After-sale service is not formally permitted but has long been tolerated.

Expatriate personnel can be employed directly by a RO, but employment of a PRC resident national by a RO is only permitted on an indirect basis through an authorized labor service company (commonly referred to as a "FESCO", the acronym of the original state-owned labor service company). The FESCO acts as the formal employer, with responsibility for maintaining personnel files. The FESCO also usually handles withholding of individual income tax and benefit plan contributions. The FESCO's fees for these activities are often cost-effective for a small RO that wishes to avoid responsibility for administering employee tax and benefits, but these fees can become a substantial expense when the number of RO employees grows larger.

An FIE is not subject to these restrictions. Establishment of an FIE to sell only self-made (or "self-processed") products, or "technical consulting" or similar services, can be approved by the local government, while provincial-level approval is required to engage in "commercial

activities" (reselling of purchased products), including wholesaling, retailing, franchising and sales/commission agency.

FIE Enterprise Income Tax

FIEs are subject to PRC Foreign Enterprise Income Tax on profits (net after deduction of operating expenses), calculated at a standard rate of 33%. Lower rates of 15% and 24% are available in a certain number of special zones, and local governments in many other locations routinely promise to match the lower rates through various type of rebates – which may be subject to eventual cancellation and/or penalties as central government authorities attempt to crack down on unauthorized local incentives. A "production-oriented" (mainly manufacturing or technology-related) FIE normally qualifies for a five-year income tax holiday, consisting of an exemption for the first two years, and a fifty-percent reduction for the next three years, beginning with the FIE's first profitable year. an FIE's losses in one year can be carried forward for five years to offset revenues and thereby to reduce taxable profits in future years.

Tax Efficient Supply Chain Management

The structuring of supply chains must take account of differences between Value-added Tax ("VAT") and Business Tax ("BT"). VAT is normally levied at 17% of the difference between goods sales price and cost of inputs (on which VAT has been invoiced and paid). BT is normally levied at 5% of gross revenue, mainly for services but also for certain asset transfers that are not covered by VAT. Total VAT on a product normally is the same regardless of how many times ownership changes hands in a domestic supply chain. In contrast, BT accumulates with each transaction, thereby increasing the aggregate tax burden of a supply chain that includes service fee-based outsourcing or subcontracting. Cross-border supply chains involve planning for Customs import duty (which is levied not only on goods prices but also on certain related royalties – other than for computer software) and export VAT refund (which has recently been reduced on certain product categories).

FIE Capital & Debt Restrictions

Up to 70% of an FIE's registered capital has recently been permitted to be contributed in the form of non-cash items such as equipment, intellectual property, other intangible assets or technical services. Foreign investors considering contribution of non-cash items must be attentive to the tax consequences in other jurisdictions. For example, if a contributor is subject to U.S. income tax, a taxable gain will often be deemed to result from the contribution. In contrast, Hong Kong normally does not tax gains from the sale or contribution of assets.

Investors normally benefit from keeping capital contributions as low as possible while funding an FIE with as much debt as possible, in order to retain maximum flexibility in returning cash to investors. Registered capital cannot (except with special approval based on strict criteria) be withdrawn from most types of FIE until the FIE is liquidated. This means that an FIE will eventually be left holding excess cash unless it periodically purchases additional capital assets with a value at least equaling the depreciation of its existing assets. This restriction on capital return is not a problem for investors that are satisfied for their FIE to invest its excess cash in other companies, because restrictions on the percentage of an FIE's asset value that it is permitted to use for this purpose have recently been removed.

FIE debt-equity ratio restrictions, along with the meanings of the related terms "total investment" and "registered capital", are somewhat confusing. The related regulations are written in an indirect manner that makes it difficult for an investor to answer the basic question: "After investment of a certain amount into an FIE, what amount will the FIE be

permitted to borrow?"

The answer depends on a sliding (and partially overlapping) scale of maximum ratios. Examples at key threshold levels are set out in the following table (all figures in US Dollars):

FIE's approved registered capital	FIE's maximum approvable total investment	FIE's resulting maximum debt limit
\$200,000	\$285,714	\$85,714
\$2,100,000	\$4,200,000	\$2,100,000
\$5,000,000	\$12,500,000	\$7,500,000
\$12,000,000	\$36,000,000	\$24,000,000

The above limits' applications to foreign guaranties, short-term debts, and medium to long term debts were all changed or clarified from 2003 through 2005. Implementation was initially uneven, but enforcement is continuing to strengthen. Foreign guaranties securing domestic debts do not count against an FIE's foreign debt limit until the domestic debt is actually paid off under the foreign guarantee (although several early-2005 government documents set out a different approach, they were subsequently cancelled). An FIE's current "balance" of short-term (one year or less) foreign debts is counted against the foreign debt limit. Also counted is the "cumulative" amount of medium to long term foreign debts. The effect of this "cumulative" approach is to permanently reduce the FIE's foreign debt limit by the amount of any medium to long term foreign debt principal repayments. To avoid this reduction, the simplest approach is to set a term of one year or less for all foreign debts. Upon expiry of this term, repayment can normally be omitted in favor of renewal or other disposition.

FIE Shareholder Relations & Exit

Investors' relations among themselves and exit from an FIE are subject to various constraints, costs and risks. Transfer of FIE equity requires government approval – raising questions about the enforceability of buyout agreements among investors. Allocation of FIE voting power, dividend distribution and capital return must normally correspond to the value of each investor's capital contribution. Liquidation of an FIE is subject to relatively non-transparent procedures, which do not ensure that foreign investors will recoup a proportionate share of the full value of the FIE's business.

HONG KONG PRESENCE IN SUPPORT OF PRC OPERATIONS

The longstanding attraction of a Hong Kong presence, even before the recent preferential tax arrangement was announced, is that such a presence can assist to address the above PRC structuring constraints, costs and risks. The forms available for a Hong Kong presence are introduced below.

Hong Kong Branch or Representative Office

Within 30 days of establishing a place of business in Hong Kong, a foreign company, like a Hong Kong company or an individual, must register its presence with the Hong Kong tax authorities. A presence may be considered a branch office, with liability for tax on Hong Kong-source profits. If Hong Kong-based personnel will handle only communications, purchasing, and/or limited administration and management of non-Hong Kong activities, then the company's Hong Kong presence will be considered a RO, which has no Hong Kong tax liability. Neither a branch nor a RO are separate entities from its parent, and neither of them will limit the liability of its parent. To limit the parent's liability, it is necessary to establish a Hong Kong company.

Hong Kong's Narrow Tax Net; Audits & Filings

A company conducting business in Hong Kong, whether through a RO or a branch or as a Hong Kong company, is liable for tax at a flat rate set in recent years at 17.5%, which applies only to profits from the carrying on of a business in Hong Kong, and in general does not apply to interest, dividends, or capital gains. A Hong Kong company, like a PRC FIE, must appoint a locally-qualified accounting firm to audit its annual accounts. Unlike a PRC FIE, a Hong Kong company must appoint a secretary with responsibility for maintaining the company's records and making government filings.

Hong Kong Employment

Employment issues are simpler in Hong Kong than in the PRC. Employers are not normally responsible to withhold employees' taxes. Employment contracts can be negotiated freely, although certain rights relating to maternity, disability and severance cannot be waived, and the enforceability of noncompetition covenants is subject to scrutiny under common law principles. Hong Kong's mandatory provident fund pension system, which requires employers to establish accounts and make contributions, is less complex than the PRC social welfare system. Salaries are higher in Hong Kong, reflecting its higher cost of living and its separation from the vast PRC labor market, although that difference is narrowing.

Flexibility of Hong Kong Companies

A Hong Kong company (or other offshore-incorporated company resident in Hong Kong) permits great flexibility in structuring relations among investors, employees and lenders, including issuing different classes of shares, bonds, warrants (options) and other rights to convert one type of equity or debt to another. As is the case with a PRC FIE, a Hong Kong company may not freely reduce its share capital, but recent changes have made this substantially easier for a private Hong Kong company. This issue is less important in Hong Kong because a Hong Kong company's share capital may initially be set as low as desired and its funding may be arranged almost entirely in the form of shareholder loans and/or other debt.

Exit from a Hong Kong company is largely unregulated and negotiable between shareholders. Transfer of shares in a private Hong Kong company, as in a PRC FIE, is subject to the consent, and typically also to pre-emption rights, of other shareholders. But no government approval is required, and all shareholders can enter into enforceable agreements to implement transfers upon satisfaction of pre-agreed conditions. Public offering, listing, and trading of shares are subject to much fewer conditions than in the PRC.

CEPA Privileges for Hong Kong Companies

Under the China-Hong Kong Closer Economic Partnership Agreement ("CEPA"), which was originally signed in 2003, expanded in 2004, and broadened again in 2005 and 2006, "Hong Kong service suppliers" (defined more strictly than the tax arrangement defines "Hong Kong residents") continue to enjoy a variety of PRC market access privileges. Preferences include import duty, reduced geographical, financial and ownership restrictions, lower entry thresholds for smaller players, more opportunities for Hong Kong service professionals, and a right for individual Hong Kong permanent residents to set up individually owned retail stores in Guangdong Province.

CONCLUSION

PRC business regulations are changing, mainly in the direction of deregulation, but they continue to be complex and to limit the flexibility of companies' financial structuring and tax planning. Hong Kong continues to provide potential solutions, and its attractiveness has been further increased by recent cross-border tax preferences. Foreign companies should expect more changes in both jurisdictions, creating occasional new risks along with new opportunities.

FOR MORE INFORMATION

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Key Comparisons: China Tax Treaties and Hong Kong Tax Arrangement

Payment Type	China Income Tax Withholding Rate	US Treaty Rate	Japan Treaty Rate	Korea (S) Treaty Rate	UK Treaty Rate	France Treaty Rate	Italy Treaty Rate	Germany Treaty Rate	Netherlands Treaty Rate	Mauritius Treaty Rate	Barbados Treaty Rate	HK Arr. Rate
Dividends	Zero (post-reform: possibly 20%)	10%	10%	5% ³	10%	10%	10%	10%	10%	5%	5%	5% ³
Interest	10% (post-reform: possibly 20%)	10%	10%	10%	10%	10%	10%	10%	10%	10%	10%	7%
Royalty	10% (post-reform: possibly 20%)	10% ¹	10%	10%	10% ¹	10% ²	10% ¹	10% ¹	10% ²	10%	10%	7%
Share sale gain	10% (post-reform: possibly 20%)	No Protection	No Protection	0% ⁴	No Protection	No Protection	No Protection	No Protection	No Protection	0% ⁵	0% ⁶	No Protection ⁷

Notes

1. The withholding tax rate is 10% but, for royalties paid for the rental of industrial, commercial, or scientific equipment, the rate is applied to only 70% of the royalties paid. Thus an effective rate will be 7% for such royalties.
2. The withholding tax rate is 10% but, for royalties paid for the use of, or the right to use, industrial, commercial, or scientific equipment, the rate is applied to only 60% of the royalties paid. Thus an effective rate will be 6% for such royalties.
3. 10% if less than 25% of the dividend-paying China company is owned by the recipient.
4. Except for the sale of shares in a China company that holds assets substantially consisting of real estate.
5. Except for the sale of shares in a China company that holds assets substantially consisting of real estate. Also, China and Mauritius signed income tax treaty protocol on September 5, 2006 to also exclude from this zero rate the sale of shares in a China company owned 25 percent or more by the seller.
6. A protocol similar to that between China and Mauritius may eventually restrict the scope of this zero rate.
7. Except that a zero rate would apply if (a) less than 25% of the China company in which shares are sold is owned by the seller, and (b) the China company does not hold assets substantially consisting of real estate.

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