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China Private Equity / Venture Capital Update

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New Enterprise Income Tax Law Diminishes Competitive Tax Advantages for Foreign Invested Enterprises

The regulatory environment applicable to private equity and venture capital ("PE/VC") investors in China has witnessed a radical transformation over the past eighteen months, evidenced by massive overhauls of the laws and regulations applicable to foreign exchange, mergers and acquisitions, and internet-related businesses.

Another tectonic movement was felt on March 16, 2007, when China adopted the new Enterprise Income Tax Law, which goes in effect on January 1, 2008 (the "New EIT Law") and will replace the tax regimes which have been governing foreign- invested enterprises ("FIEs") since the early 1990s. While Chinese law has traditionally favored FIEs, responding in part to China's accession to the WTO, the New EIT Law attempts to reduce the disparate treatment between FIEs and domestic-funded enterprises ("DEs"). As the changes will have a profound effect on PE/VC investors in China and the portfolio companies in which they invest, investors must make sure they are familiar with the major themes introduced by the New EIT Law.

Offshore Portfolio Companies with "Management" in China May Be Subject to China Taxation on Worldwide Income

The New EIT Law introduces the concept of a "resident enterprise." Under the New EIT Law, a resident enterprise will be subject to tax liability in China on its worldwide income. An enterprise is considered a China resident enterprise if it is incorporated in China pursuant to PRC law (including, for example, a wholly foreign-owned enterprise ("WFOE") incorporated in China) or if its place of effective management is in China. While the New EIT Law does not define "place of effective management," the location of meetings of the Board of Directors is, under common law principles, a relevant factor in determining an enterprise's place of effective management. Pending further guidance from the Ministry of Finance and the State Administration of Tax ("SAT"), PE/VC investors in offshore portfolio companies (particularly if such companies do not otherwise have a substantive presence outside of China) should consider conducting meetings of the Board of Directors outside of China to help minimize the risk of the offshore portfolio company being viewed as a China resident enterprise by the SAT.

New Deemed Dividend Rules Seek to Reach Dividends Parked in Offshore Portfolio Companies

PE/VC investors often invest in offshore holding companies formed by Chinese persons in low-tax jurisdictions such as the Cayman Islands or British Virgin Islands, which in turn form a WFOE that benefits from the favorable tax treatment traditionally granted to FIEs (a so-called "round-trip investment"). Dividends from the WFOE could traditionally be distributed to the offshore holding company without paying Chinese tax. Similar to the anti-deferral rules applicable to Subpart F income under the controlled foreign corporation (CFC) rules of U.S. federal income tax law, the New EIT Law adopts a deemed profit distribution clause, as well as a more discretionary “anti-tax avoidance” provision. Under this deemed profit clause, if an offshore company established with a round-trip investment structure has retained its profits or reduced its distribution of profits in the absence of a reasonable business need, its Chinese enterprise shareholders will be deemed to have received a distribution of such profits, and the Chinese enterprise shareholders will be taxed accordingly.

Enhanced Transfer Pricing Penalty Provisions May Result in Heightened Scrutiny of Transfer Pricing Transactions Utilized for Investments in Foreign-Restricted Enterprises

PE/VC investors invest in internet, gaming, wireless value-added service, and other enterprises in which foreign investment is limited, utilizing an offshore holding company and a WFOE subsidiary which has contractual control over a captive domestic entity. In these structures, the captive domestic entity often enters into contractual arrangements pursuant to which the domestic company transfers its profits to the WFOE. While SAT has traditionally focused on cross-border related-party transactions, the New EIT Law introduces penalty interest for non-arm’s-length transactions amongst related parties (currently a late payment penalty of about 18% per year is imposed on any outstanding tax payment) and SAT may expand its scrutiny to related-party transactions among FIEs and captive domestic companies. As a result, service agreements in companies operating in foreign-restricted industries may come under increased scrutiny and the subject to tax penalties to the extent such arrangements are not entered into on an arm’s-length basis.

2+3 Tax Holiday Enjoyed by Many Private Equity and VC Backed Companies to be Eliminated

Many technology FIEs in China (for example, a WFOE subsidiary of an offshore holding company) traditionally qualified for and utilized the “2+3 tax holiday” (a two-year tax exemption followed by three years of reduced tax rates) available to production FIEs. The New EIT Law abolishes the 2+3 tax holiday and other tax incentives previously granted to foreign investors for reinvesting income into China, and instead creates a new system of more narrowly tailored tax incentives focusing on encouraged industries and projects (high technology enterprises, small businesses with negligible profits, research and development, environmental protection) rather than the location of the enterprise. However, agrandfather clause is available for companies that were already enjoying the 2+3 tax holiday on or prior to March 16, 2007. In addition, the New EIT Law provides that newly established hi-tech enterprises in Special Economic Zones or the Pudong New Area of Shanghai are entitled to enjoy certain transitional tax benefits.As detailed implementation rules are promulgated, PE/VC investorsshould work with their legal and tax advisors to consider the eligibility of their portfolio companies to take advantage of the new body of tax incentives and the transitional or grandfather treatment.

EIT Standard Rate Reduced from 33% to 25%

The New EIT Law reduces the default EIT rate from 33% to 25%. While this would appear to be a positive development, given the widespread availability of tax holidays and other incentives to FIEs, the average effective EIT rate for FIEs is currently 15%. Therefore, the reduction in the EIT Standard Rate, coupled with the elimination of many tax holidays and incentives, may not result in as significant a reduction in average liability as might initially appear. In addition, while the New EIT Law retains the statutory 20% withholding income tax rate, which is applicable to PRC-sourced passive income of foreign companies including dividend, interest, rent, royalty, and gain from transfer of property, the New EIT Law has also authorized the State Council to provide for exemption or reduction of the withholding income tax. Currently dividends from FIEs to foreign investors are exempt from withholding income tax, while other passive income is subject to a reduced 10% withholding income tax. It is not clear whether those withholding income tax exemptions and reductions will remain unchanged. Details will be provided when the implementing regulations are promulgated.

While the State Council, Ministry of Finance, and SAT are expected to adopt more detailed implementation regulations and rules prior to the January 1, 2008 effective date of the New EIT Law, it is clear that yet another overhaul of a fundamental Chinese regulatory regime is underway, and PE/VC investors in China will need to remain vigilant and prepared to take account of such changes as they structure transactions and execute their investment strategies in China.