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Tax issues and legal obstacles Chinese companies face when seeking to capitalize overseas using a variable interest entity structure

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Abstract

This study is an analysis of the emergence of variable interest entity ("VIE") structures in China and the numerous regulatory, shareholder and tax risks they face. The VIE structure is commonly used by Chinese enterprises to circumvent China's foreign direct investment ("FDI") restrictions in certain industries in order to be able to list on overseas stock exchanges. Many popular Chinese companies such as Sina, Baidu and Alibaba have taken on FDI through this structure and successfully listed abroad. However, VIEs recently made a lot of negative headlines in China, due to fraud and regulatory intervention thus revealing numerous risks inherent to this type of investment structure. This study explains the nature of VIEs in China and discusses the risks and consequences of investing in Chinese enterprises using the VIE structure. In addition to regulatory and shareholder risks, the taxation of this structure is closely examined.

Keywords: Variable Interest Entities (VIE); Foreign Direct Investment (FDI); Taxation; Risk; Capital Market; China;

Abbreviations

BT	Business Tax
CIT	Corporate Income Tax
CSRC	China Securities Regulation Committee
DTA	Double Taxation Agreement
ETR	Effective Tax Rate
FDI	Foreign Direct Investment
GAAP	Generally Accepted Accounting Principles
GAAR	General Anti-avoidance Rule
GAPP	General Administration of Press and Publication
GDP	Gross Domestic Product
HNTE	High and New Technology Enterprises
IAS	International Accounting Standards
IFRS	International Financial Reporting Standards
IP	Intellectual Property
IPO	Initial Public Offering
MIIT	Ministry of Industry and Information Technology
MOFCOM	Ministry of Commerce
OIRE	Overseas-incorporated Resident Enterprise
PBOC	People's Bank of China
PPP	Purchasing Power Parity
PRC	People's Republic of China
SAFE	State Administration of Foreign Exchange
SAT	State Administration for Taxation
SCSC	Security Commission of the State Council
SEC	Security and Exchange Commission
SME	Small and Medium Enterprises
SPV	Special Purpose Vehicle
TP	Transfer Pricing
VAT	Value-added Tax
VIE	Variable Interest Entity
WFOE	Wholly Foreign-owned Entity
WHT	Withholding Tax

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Chapter 1: Introduction

This study reviews the emergence of variable interest entities in the private economy in China and describes how these investment structures have managed to muddle through internal and external challenges until the present day. The study covers the period from the founding of the People's Republic of China in 1949, over an era of radical political, ideological and economic reform with Deng Xiaoping as the initiator of China's opening up policy, to the emergence of private ownership, and argues that this rapid transformation from a centrally planned economy to a market oriented economy resulted in underdeveloped capital markets that lacked the institutions to support entrepreneurial companies. In their need for seed capital, private companies turned to international investors, creating offshore holding structures in order to be able to list on foreign stock exchanges. Particularly in the Internet and telecommunications industry, lawyers and accountants created VIE structures as a temporary solution to FDI restrictions.

Purpose of Study

In light of continuous globalization in the 20th Century and China's simultaneous rise to world economic power, foreign capital was a major source for private Chinese companies to fund their growth and still remains an important driving force. "China has become the second largest source of FDI, while remaining the second largest destination for the same" (Gillis, 2011). While foreign investment has been welcomed at the beginning of China's opening up policy, international investors face increasingly strenuous legal barriers today. The government's rising concern about the power of the Internet has led to tremendous limitations. Laws, regulations, and in particular the uncertainty about their interpretation by regulatory authorities has left most parties in a predicament. Today, common practice involves copying business practices from one another while hoping not to stand out of the mass. As long as the VIE is condoned by the Chinese government as a means to raise foreign capital in restricted sectors, this structure will continue to be common practice. However, there remains a certain tension among investors with regard to this practice, especially since regulators increasingly prevent the use of VIE structures and cases of fraud have indicated that structures are afflicted with high risks.

This study aims at providing a better understanding about the various elements that influence the use of VIE structures and how they create a large amount of risk with regard to regulatory scrutiny, misjudgement of structural unstableness and tax consequences. It is important because it depicts how the underdeveloped Chinese legal system and the political urge to maintain control over certain industries in China results in a large amount of uncertainty for investors, companies and entrepreneurs, and forces them to take illicit actions in order to survive under competitive market conditions.

The analysis and findings of this paper will be useful to a broad range of users. The study will be helpful for Chinese domestic regulators. The use of VIE structures as a means for foreign investors to participate in China's restricted industries is a matter of great concern for policy makers and regulatory authorities. Since China's capital markets are still in an early stage of their development, rapid regulatory and legal changes have created a grey area in the Chinese legal system. Chinese regulators will be able to understand the necessity to approach the issue of VIEs with caution and that further reforms are required in order to facilitate the process of raising capital in China for private enterprises. Investors will benefit from this study by gaining an understanding of the risks inherent in the VIE structure. Companies and entrepreneurs will gain a deeper understanding about the possible threats they face when taking on foreign investment, which structural conditions nurture them and which crucial measures they need to take when planning and setting up VIE structures.

The Research Question

This study addresses the major research question: what are the risks and consequences of investing into China using a VIE structure?

This question will be answered by answering three subsidiary questions: The first is: how did VIE structures arise as an investment vehicle into Chinese enterprises? Drawing on China's process of transforming from a centrally planned economy to a market orientated economy, this study determines that private companies took an increasingly important role in the Chinese economy. It will be argued that private companies experienced tremendous difficulties in raising capital because necessary institutions to facilitate them were not set up in time. As a result enterprises use offshore holding structures to take on foreign investments.

The second subsidiary question is: which regulatory and structural risks are inherent in the VIE structure? Used primarily as a workaround structure to Chinese foreign investment restrictions in certain industries, the VIE structure faces a lot of problems. Based on numerous Chinese laws and regulations that embrace VIEs and offshore holding structures with a strict legal framework, it will be argued that Chinese authorities have put all necessary arrangements in place in order to clamp down on these structures at their own discretion. Furthermore, the structure holds hidden risks with regard to their contractual ownership structure. Taking recent high profile cases as examples, it will be argued that planning and legal counselling is required in order to evaluate the possible breach of the contractual agreements and the subsequent loss of the entire China operations.

The third subsidiary question is: what are the tax consequences of setting up and operating a VIE structure in China? The main part of this study is the examination of the VIE structure with regard to taxation. While offshore structures have been used as means to take advantage of tax benefits arising through tax treaties, indirect disposals and similar behaviour in the past, Chinese authorities have increased scrutiny on tax avoidance. Taking operational and transfer pricing risks into account, this study finds that the VIE structure is tax inefficient.

Status of Research regarding Variable Interest Entities in China

Since VIEs were introduced to the Chinese market as a workaround structure, no significant attention has been paid to this topic in literature. Merely a decade has passed and no clear tendency on behalf of the Chinese government with regard to the VIEs' future treatment can be observed. Due to a lack of consistent data and uncertainty about the interpretation of laws, little effort has been made in this field to provide all parties with clear guidance. Only since the investment community was shook up by different cases of fraud and regulatory intervention in recent years, few professionals started to deal with the risks inherent in this investment structure. These high profile cases and actions by the Chinese government have been subject to many discussions in blogs and online forums. In particular lawyers and accountants have analysed every movement by the Chinese regulators to assess possible trends. The existing research has primarily focused on the legal and structural uncertainties of VIE structures in order to provide investors with better evaluation of potential risks. One of the few specialists in the field of VIEs is

Professor Paul Gillis[1], who conducted several studies and writes about this topic in his "China Accounting Blog". In 2011 and 2012, Gillis and Fredrik Öqvist[2] (2012) conducted several studies in which they investigated all Chinese companies listed on U.S. stock exchanges. Their research led to ground-breaking results, giving an overview of all Chinese companies using the VIE structure for the first time. Furthermore considerable research is conducted by the "Big Four" accounting firms in China and international law firms, which have paid particular attention to the legal aspects of the VIE structure. However, due to continuous changes in People's Republic of China ("PRC") laws and subsequent notices there remains much room for interpretation in this grey area of the Chinese legal system.

So far little research has ben conducted on VIEs and their tax treatment in China. Tax issues are repeatedly mentioned in connection with the legal and structural risks, yet nobody has really dealt with their implications. On the one hand, the reason for this could be that the underlying risks would not lead to the dissolving of the structure; on the other hand no case of tax authority intervention has been reported so far. In January 2012, Yongjun Peter Ni and Hao Jiang published a company newsletter in which they discussed key tax issues in regard to the VIE structure. However, their analysis did not exhaust the full range of problems and provided no further guidance.

Noting the limitations of prior research, this study aims to create a basic foundation for future studies. It is an attempt to structure the various risks identified in the literature and discuss their possible implications. In addition, special attention will be given to the various tax consequences surrounding the VIE structure in order to initiate further analysis and investigation in this area.

Structure and Methodology

This study is based on information and data taken from surveys, research papers and blog articles conducted by accounting and law firms, as well as industry experts. It takes

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[1] Paul Gillis is a Professor of Accounting at the Guanghua School of Management at Peking University. He was previously Asia-Pacific Tax Managing Partner at PriceWaterhouseCoopers for 28 years in the United States, Singapore, and China.

[2] Fredrik Öqvist is an independent analyst and consultant. He is considered one of the foremost experts on variable interest entity structures and his work has been featured on the Financial Times, Tilt, Bloomberg, The Wall Street Journal, CaiJing, among others.

a dialectic approach to examine the actions of the opposing forces of regulatory constraints and firms' creative reactions. This study critically assesses the various risks inherent in the VIE structure and evaluates the conflicting viewpoints of the numerous regulatory measures taken by the Chinese government and the evasive manoeuvres taken by companies and investors.

Whilst an imperative force in China's financial development, VIE information is currently not readably available. This paper begins by summarising regulations, opinions and events in order to create a thorough overview from a logical and historical prospective for the interested Chinese company or overseas investor. It then goes on to suggest that more attention needs to be given to VIEs and their tax treatment. A case study will present the results of the research conducted in this field. However, it is important to note that these are not the findings of an empirical research but rather the results of calculations and reasoning.

The remainder of this thesis is structured as follows: Chapter 2 explains China's economic development over the past 30 years laying emphasis on the capital markets and why they were mostly inaccessible to private enterprises. Chapter 3 will give a theoretical foundation on the concept of VIEs and describes the archetypal VIE structure. Chapter 4 through 7 explain the risks VIE structures face. Chapter 4 is subdivided into regulatory and shareholder risks. The former will be exemplified by means of analysing the most important laws and regulations and discussing their possible implications. The second issue will be illustrated with the help of recent high profile cases. Chapter 5 outlines possible tax implications that may arise when setting up a VIE structure, analysing relevant laws and regulations that effect business operations on a transnational level. Chapter 6 focuses on tax consequences when conducting business in China by means of a VIE. Chapter 7 presents a scenario analysis that illustrate the issue if residual profits remain within the VIE. Finally, Chapter 8 will conclude this study with a series of recommendations from an investor and regulator perspective.

Chapter 2: Historical background

Many observers regard the PRC as a prime example of an economy that, whilst maintaining a centralized political power structure, has made the successful transformation from a centrally planned economy to a market orientated economy. In the last three decades, China has drastically changed its social and economic landscape from one of communism and poverty, to one of capitalism and to becoming a world leading economy. As with many ideological reforms, political change did not come with ease and many adaptations had to be made so that this economy, comprised of some 1.35 billion people, could prosper again.

China had previously been one of the largest economies in the world. During the 1st Century A.D. China had a gross domestic product ("GDP") in terms of purchasing power parity ("PPP") that was one fourth of the total GDP worldwide. The economic historian Angus Maddison (2003) estimated that this number increased to one third of the total GDP worldwide by 1820. Following this economic prosperity, years of civil war, foreign incursions, China's lack of participation in the industrial revolution and the Second World War prevented a further economic boom in China and caused its GDP share to drop to a low of 4.6% in 1980 (Gillis, 2011a). However, only thirty years later China has reasserted its power in the world economy through far-reaching reforms. In 1978 the Communist Party of China decided to introduce market reforms and thereby initiated the transformation process. Over the following years China experienced a steady economic growth. Due to an average of 9.9% GDP growth rate over a 30-year period, a booming foreign trade and the slow opening of the Chinese domestic market, China attracted more and more multinational corporations, small businesses and billions of investments (Lin, 2010). Since 2009, China is the largest export nation with a trade surplus of USD 300 billion and in 2011 it was the second largest economy behind the U.S. (Barboza, 2010). According to the International Monetary Fund, China will have surpassed the U.S. by 2016 in terms of GDP by PPP (Weisbrot, 2011).

To understand how the Chinese government transitioned from a centrally planned economy into a market economy, it is necessary to look at the historical course of their reform measures more closely.

Economic Reforms

With Mao Zedong's proclamation of the PRC in 1949, a new era of economic policy was initiated. The overall aim was to reduce the country's backwardness compared to western countries. The Chinese government restructured the state and administrative system as well as restricted foreign influence in the economic sphere. All private enterprises were nationalized and the economy became centrally planned. Consequently, the state had a monopoly on foreign trade.

The radical agricultural reforms of 1956 led to the establishment of collective farming, which further suppressed entrepreneurial potential. Through the so-called "great leap forward"[3], two years after the launch of the agricultural reforms, the development gap between China and the industrialized nations was to have finally been eliminated. The specific objectives were to increase both agricultural and industrial outputs by manifolds (Ebrey, 1996). However, China's factor endowment at that time did not allow the heavy industry to compete under market conditions. In order to implement the Great Leap Forward, special institutions had to be implemented. Most notably the prices of capital (interest rate), labour (wage rate), and other raw materials were suppressed in an artificial way. Over the years more and more labour was pulled of the agricultural sector. Yet, with its focus on promoting heavy industry, China initially lost economic growth. Following the reforms, the country lapsed into a starvation crisis that would cost some 30 million people their lives in the long run (Kung & Lin, 2003).

After Mao Zedong's death in 1976 a fundamental transformation of the Chinese economy took place. Deng Xiaoping introduced political reforms and launched China's policy of opening up to the outside world in 1978. He advanced the politics of the "Four Modernizations", which focused strongly on agriculture, industry, national defence and science and technology. In order to achieve the defined objectives, it was necessary to reform the economic system thus China combined socialism with free market elements. For the first time since 1949, FDI was approved and industry, agriculture and manufacturing were modernized with a long-term perspective. China pushed to enhance productivity through gaining valuable knowledge and experience in production and engineering. (Mackerras, Taneja & Young, 1994). However, the implementation of these re-

[3] The *great leap forward strategy* was named because of the enormous gap between the industrial objective of the strategy and the industrial structures required by China's factor endowment.

forms and the development of necessary institutions took a lot of time.

This change resulted in a lot of opportunity and a great deal of difficulty. As China gradually opened up to the western world and foreign investors began to participate in China's economic success, local private enterprises slowly started to sprout. Over the following years China experienced steady economic growth and a rise in income per capita, however, the government now had to deal with an insufficiently developed banking sector. The strong dominance of state-owned banks, a lack of competition, widespread corruption, low equity ratios and significant deficiencies in internal control and external corporate governance all greatly reduced the effects of the ‘four modernisations’. It was not until the mid-1980s that tentative reforms in the financial and banking sector were initiated. China gradually realized that a competitively functioning banking system is an essential precondition for a fully functioning market economy.

Emergence of Private Ownership

In the 1980s and 1990s the emergence of the private economy took place. With the promulgation of the constitution of the PRC in 1982 a foundation stone for private ownership was laid. People were allowed to farm private land, engage in household side-line production and raise privately owned livestock (Shirai, 2002). These measures were aimed at balancing centralized economic planning with supplementary regulation by the market.

On June 4, 1989, the Chinese military violently suppressed demonstrations demanding political reforms and liberalization in Tiananmen Square and other areas of Beijing. Many government officials became concerned and demanded to retreat to their communist ideologies, pushing for a more state-controlled situation (Ebrey, 1996). Deng Xiaoping, on the other hand, analysed the situations in Eastern Europe and Russia which were falling apart at the time and feared that this could happen in China as well if the party couldn’t move forward quickly with political reforms. In Deng Xiaoping went on his famous Southern Tour and it was then that he launched the accelerated path forward to faster reforms in terms of opening up (Ash & Kueh, 1996). Soon the concepts of free market activities and private ownership were ideas that came into the Chinese social system.

Three different forces accompanied China's transition to a market economy. These drivers surmounted each other and changed over the course of China's development, although there were no hard borders between them. In terms of importance though, they changed significantly.

Cheap labour. During the 1980s and 1990s, China's economy was initially driven by cheap labour. Soon after China started opening-up, the government focused on gaining technical knowhow from the western world and exporting cheap products. The general trend at this time was for labour to move from the agricultural industry towards the manufacturing and services sector, which were very labour-intensive at the time.

Cheap capital. This trend began to change around the millennium. Industries were shifting from utilising cheap labour in labour intensive industries, to moving up the technology ladder into more capital-intensive industries such as communication technology products (Lin, 2010). Cheap capital was readily available from a variety of different sources to fuel China's rise. The stock market provided a lot of capital and the government supplied the banks with liquidity, which in turn allowed the banks to provide loans. Another seemingly inexhaustible source of capital came from state-owned land that was leased over time to large developers. However, a decade later China faces major challenges. Most of the valuable land in urban areas has been leased out. All metropolises have been fully developed and local governments are facing liquidity problems since their source of funds is running out. During the development phases they borrowed additional money to finance their infrastructure, however, years later they have leased out all of their valuable land and are facing a potential crises as their bills are becoming due (Nystrom, 2007).

Cheap intellectual property. In recent years, the economy has shifted from cheap capital towards cheap intellectual property ("IP"). The Chinese economy specialized itself in copying foreign technologies and adapting them to their personal needs (so-called counterfeiting). In part, the government also subsidises the development of such technologies. A good example is the high-speed rail industry. China initially bought existing technologies from Japan, France, Germany and Canada. In order to develop the Chinese railway, these companies were forced to enter joint ventures. This way China learned the technology, modified it to its specific needs and today produces its own technology without any royalty fees being due (Weisenthal, 2011). Foreign companies entered these joint ventures, as sharing IP was the price of gaining market access to

China. Another industry that was heavily subject to counterfeiting behaviour is the Internet sector. All leading Internet companies such as Renren (人人), Baidu (百度) and Dangdang (当当) are all copies of successful business models that have been brought to China from the western world.

The Opening of China's Capital Markets and Legitimization of Private Capital

Even after China started opening up the capital markets, enterprises still struggled to raise necessary capital. The institutions necessary to support the development of private enterprises were, at that time, either non-existent or took a lot of time to be set up. Private enterprises were not able to raise capital through the banking sector, since all banks were state-owned and did not loan to entities other than state-owned enterprise (Shirai, 2002). This was partly due to ideological reasons and partly due to the risks involved in lending to private enterprises. It was not until 1990 that China opened its stock markets in Shanghai and Shenzhen (Gillis, 2011a). However, these were used exclusively to reform and corporatize the state-owned enterprise sector. Only very few private enterprises managed to raise capital through the stock markets by masquerading as a state-owned enterprise. These so-called "Red Hats" were private enterprises that managed to be classified as part of the community and thereby seemed as though they were government run (Chen, 2007).

In the early 2000s a series of reforms were launched to better facilitate the capital needs of the private sector. First of all, China entered the World Trade Organization in December 2001. This event was the peak to China's opening-up policy and an important stimulus to foreign trade. China agreed to liberalize the domestic market and loosen restrictions on foreign companies wishing to enter the Chinese market. In return Chinese companies would have better access to foreign markets (Chen & Ravallion, 2004). The second change was achieved through Jiang Zemin's theory of the "Three Representations". During an inspection tour in Maoming, Guangdong province in early 2000, Jiang Zemin proclaimed his thoughts that had elements of considerable substance. While his first two representations were based on Mao Zedong's revolutionary thought and Deng Xiaoping's theory of the market, the third representation opened up the Communist Party membership to entrepreneurs, managers and private businessmen. These could now officially join the ranks of peasants, soldiers and workers, and become members of the Communist Party (Unger, 2002). With this the concept of private capital was legitimized. It followed that the private sector rapidly out-grew the other sectors and became a catalyst for economic growth.

Underdevelopment of China's Capital Markets

Although immense developments were initiated in order to facilitate private enterprises in the capital markets, private enterprises still had very limited possibilities to raise capital. All main institutions such as banks and stock exchanges remained state-controlled and were largely inaccessible to private businesses (Gillis, 2011a). Since the late 1990s successful private companies attempted to raise necessary capital. The problem was that China’s capital markets were not yet ready to support those companies the same way that overseas capital markets were able to. While the government focused primarily on providing state-owned enterprises with capital, institutions to support private companies were not set up in time.

In 2004 a SME board was launched in Shenzhen but it was not until 2009 that the Growth Enterprise Board (known as ChiNext) for SMEs opened (Gillis, 2011a). Yet, these measures were implemented too late. In their need to access funding, entrepreneurial companies were forced to go offshore and turned to foreign investors. In his article on iChinaStock.com Simon Fong (2011) proposed four main reasons why Chinese companies seek to raise funds through an initial public offering ("IPO") on overseas stock exchanges (preferably in the U.S.):

First, most companies do not qualify to list on China's A-share market due to their foreign investment structure. Chinese start-up companies mainly in the technology sector take on foreign investment at a very early stage. In order to receive foreign investments they set up offshore and VIE structures. In the majority, these "Chinese" companies are actually foreign entities incorporated in the Cayman Islands, British Virgin Islands or similar tax free jurisdictions, which control Chinese entities. However, this leads to the uncomfortable side-effect that these companies may not list on China's A-share market because certain industries are restricted or even prohibited to foreign investment.

Second, entrepreneurial companies are not able to meet the strict financial standards required to list on China's stock exchanges. Compared to the U.S. requirements they are mostly of quantitative nature. "The minimum IPO criteria for the Chinese Small and Medium Cap A-Shares Market, where net profit in the recent 3 fiscal years must be positive and the sum exceeds 30 million RMB; aggregate cash flow from operational activities in the recent 3 fiscal years exceeds 50 million RMB, or aggregate operating revenue in the recent 3 fiscal years exceeds 300 million RMB" (2011). However, most entrepreneurial companies, the typical example being the Internet sector, are barely profitable at the time they want to go public, thus not meeting the necessary requirements to list on domestic stock exchanges.

Third, although the IPO process in the U.S. is much more rigorous and demands much stricter disclosures, this seems to be the preferred option for Chinese companies compared to China's lengthy and opaque IPO registration process. In the U.S. this goes much faster and has lower implicit costs. Furthermore, technology companies have historically obtained the highest valuations on NASDAQ. The post-IPO equity sales seem to be very difficult in China and secondary offerings of stocks or setting up a warrant incentive policy requires a similar complicated procedure as the IPO procedure.

Fourth, China's regulatory authorities tend to overregulate the stock markets instead of letting the market decide. As an example Fong names stock market crashes, to which the authorities reacted with a hold on IPOs so that investors' capital would not be diluted. These counter measurements indicate the authorities' concerns about investors. In order to prevent them from buying low quality stocks and losing money in the secondary market, they implement strict review processes for IPOs. These mechanisms can either be downward and upward limits, or adjustments to the IPO rhythm. The negative effect of this is that overregulation distorts the natural market rhythm and furthermore drives young enterprise into overseas markets.

Problems with Overseas Listings

Chong and Su (2006) point out that there are two possible ways for Chinese enterprises to list on foreign stock exchanges, namely the direct and indirect listing. The direct listing is the listing of shares directly on a foreign stock exchange and is subject to regulation by the China Securities Regulation Committee ("CSRC"). The indirect listing takes place through corporate restructuring, which will be explained in this paper in more detail. However, Chinese companies were historically confronted with several problems in their attempt to list overseas. On August 4, 1994, the Security Commission of the State Council ("SCSC") issued the *Special Regulations of the State Council Concerning Issuing and Listing of Shares Overseas by Company Limited by Shares* ("SCSC Regulations"). Article 5 of the SCSC Regulations requires every company that wishes to list overseas to file an application together with relevant documents to the SCSC for approval (Security Commission of the State Council, 1994). Prior to this, the first H-share, Tsingtao Brewery, was listed on the Hong Kong Stock Exchange in 1993. H-share companies are companies incorporated in Mainland China, which conduct an offshore listing in Hong Kong. H-share offerings were mainly used to privatize state-owned enterprises. By March 2012, 138 enterprises have successfully listed on the Hong Kong Stock Exchange (Hong Kong Exchange and Clearing Ltd., 2012). However, private companies struggled with the SCSC Regulations. Currently there are no records of any private company having requested approval to list overseas. Gillis (2011a) believes the reason why no company has ever tried to do so is because the request would most likely be refused by the SCSC.

As a result, lawyers and accountants created a way that would enable companies to list offshore without the obligation to gain SCSC approval. The solution to this problem was an offshore holding structure allowing the company to indirectly list offshore. A company preferably incorporated in the Cayman Islands would be listed on a foreign stock exchange, which means that they become foreign companies. Since PRC authorities have no jurisdiction over companies incorporated overseas, authorization by the SCSC was no longer required. Nonetheless investors buying shares of the listed company want to participate in the economic success of the Chinese domestic company. To make this possible, the listed company needs to hold a controlling interest in the Chinese domestic entity, thereby being able to consolidate it in its financial statements. This controlling interest is customarily achieved through direct equity ownership in the form of a subsidiary that is located in China.

Foreign Direct Investment Restrictions

The problem with direct equity ownership in a Chinese firm is that various sectors in China are restricted or even prohibited to FDI. According to Rocky Lee's[4] interpretation of the *Foreign Investments Industrial Guidance Catalogue* published by the Ministry of Commerce ("MOFCOM"), "*restricted* sectors (…) are subject to strict examination by government authorities, and the investment structure options may be limited such that a majority Chinese partner may be required. Restricted investment sectors commonly

[4] Rocky T. Lee is Asia Managing Partner and Head of the China Corporate Practice at US law firm Cadwalader, Wickersham & Taft LLP

include banking, insurance, securities services, certain manufacturing sectors, and investments in areas that are technologically undeveloped, or belong to certain sectors that are gradually opening up in China. *Prohibited* sectors are not open to foreign investors and include industries that may threaten the public interest and/or national security, or may cause serious environmental damage" (Lee, 2010, p. 2).

The most notable industries restricted to FDI in China are Internet, e-commerce, telecommunication, media, advertising, online gaming and private education (Hoo & Wang, 2009). In particular, the Internet sector is a major concern to the Chinese government due to its possible threat to national security. This agitation has intensified since the emergence of international companies such as Facebook and Twitter, which have been used to organize protests and distribute information among revolutionaries in the Middle East. The Communist Party became seriously worried when real-time data and pictures of the disastrous high-speed train collision near Wenzhou in July 2011 leaked over "Weibo" and other Twitter-like Chinese websites before the authorities could figure out how they wanted that information released (The Economist, 2011). This and other incidents left the Chinese government concerned over the security of the Internet industry and how well they could control it. This is one of the reasons why foreign ownership is prohibited in these sectors.

Furthermore, the *Provisions on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors* ("M&A Rules") were issued in August 2006. The M&A Rules require every cross-border acquisition of Chinese assets or equity (so-called "red-chip restructuring") to obtain approval by the MOFCOM and CSRC. "A Red Chip company commonly refers to a foreign incorporated company that is formed, owned and controlled by Chinese investors, and mainly used as a listing vehicle in overseas stock markets, e.g. Hong Kong. The main assets of a Red Chip company are the shareholding of the Chinese operating investee companies" (Ni & Ng, 2009, p. 5). Domestic and foreign parties involved in such a transaction must disclose whether they are related to each other and additionally specify the purposes of the transaction and prove that the valuation represents a fair market value. Roberts and Hall (2011) point out that very few offshore restructurings actually have been approved by the MOFCOM since enactment of the M&A Rules.

The primary reason these rules were promulgated was to avoid round-trip investment structures. Chinese domestic companies took advantage of tax and other incentives awarded to non-Chinese companies in order to stimulate foreign investment. A round-trip investment refers to a situation in which a Chinese company acquires its own domestic operations or assets through an offshore special purpose vehicle ("SPV"). Chinese entrepreneurs especially profited from a red-chip restructuring because government approval was no longer needed for a change in ownership of the offshore holding company. Such a change takes place when a foreign entity invests in, or purchases the offshore holding company (Luk, 2009).

Chapter 3: Variable Interest Entities in China

In response to these restrictions and regulations, VIE structures are used to control domestic companies that operate in FDI restricted industries, thereby avoiding the necessary MOFCOM and CSRC approval. In this structure, the operating company is the VIE that will be controlled by an offshore holding company through a series of contractual agreements. Ever since the Chinese leading online media company and mobile value-added service provider Sina.com went public on the U.S. stock exchange NASDAQ in April 2000 (Sina Corporation, 2010), the VIE structure has proliferated in China. The so-called “Sina-model” structure helped numerous Chinese entrepreneurs raise international capital and foreign investors to participate in China’s burgeoning telecommunications and Internet sector. Many well-known companies such as Baidu (百度), Alibaba (阿里巴巴), Sohu (搜狐) and DangDang (当当) have replicated this investment structure in response to the substantial PRC regulatory restrictions on FDI.

Variable Interest Entities

In 1953, the Accounting Research Bulletin No. 51, *Consolidated Financial Statements*, was issued under the *United States Generally Accepted Accounting Principles* ("GAAP"), requiring entities to include subsidiaries in which they have more than 50% ownership of the entity’s voting interest in their consolidated financial statements. Over the years some companies found ways to control assets without a majority voting interest, thereby avoiding the consolidation of the entities, which in turn allowed them to keep respective losses and liabilities off of their financial statements. This kind of entity is referred to as a SPV, which is "created to engage in a specific transaction, most commonly for asset acquisition, leasing, and securitization. Various structures may be used, including corporations, trusts, partnerships, and limited liability companies (Lawler, 2011). Under the GAAP that were in place at that time, a lessee had the obligation to consolidate a SPV-lessor with its financial statements as long as independent third parties had no substantial equity interest in the SPV. Substantial equity interest referred to a minimum of 3% of the fair value of the SPV's assets. Consequently a lessee could avoid consolidation of a SPV's financial statements if no third party had a substantial equity interest in the SPV (Hartgraves & Benston, 2002). In late 2001, Enron was revealed to have used SPVs in the form of limited partnerships or companies created to fulfil a temporary or specific purpose in order to keep a substantial amount of debt off its balance sheet while retaining virtually all of the risk associated with that debt (Reinstein, Lander & Danese, 2010).

Enron exposed that the accounting treatment of SPVs did not reflect the true nature of relationships between related entities. Consequentially, the Financial Accounting Standard Board issued Interpretation No. 46(R), *Consolidation of Variable Interest Entities*, in 2003. In addition, to a direct ownership of more than 50% of the entity's voting interest, it determined a risk-and-reward model to identify controlling interests that are achieved through other means than voting interest and whether a holding company is required to consolidate it in its financial statement.

The term VIE refers to a "legal entity in which equity investors do not appear to have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance activities without additional subordinated support" (Gavin, 2010, p. 11). Whether or not an entity can be identified as a VIE, one needs to examine "the equity investors' obligations and rights and the amount and nature of the equity investments" (Reinstein, Lander & Danese, 2010, p. 11). In the case that the voting interest model does not apply adequately or does not determine the party with controlling financial interest, the risk-and-reward model sets specific guidelines on how to identify a VIE and whether it has to be consolidated by the party participating in the majority of the entity's economic impact.

An entity is considered to be a VIE if at least one of the following three characteristics apply. First of all, the total equity investment at risk is not sufficient to finance the entity's activities so that additional capital is needed. This subordinate financial support provided by any third party will constrain the equity investors to take actions that contradict their interests. Secondly, the equity investors lack one or more of the following attributes associated with a controlling financial interest: The right to make decisions regarding the entity's on-going activities through voting rights or similar rights. If this is the case, the true controlling financial interest holder may be a party other than the equity investors. Furthermore, if the obligation to absorb the entity's expected losses or the right to receive the expected residual returns is absent. The third and last characteristic is associated with the equity investors' voting rights. If these are not proportionate relative to the economic interest and the activities are conducted on behalf of an investor with disproportionally small voting interest, the entity is deemed to be a VIE (Financial Accounting Standard Board, 2003).

After determining that an entity is a VIE, the primary beneficiary of the VIE has to be identified. This is the "variable interest holder (e.g., a contractual counterparty or capital provider) deemed to have the controlling financial interest(s) in the VIE and therefore must consolidate it" (PricewaterhouseCoopers, 2007). FIN 46(R) defines a primary beneficiary as "the party that absorbs a majority of the entity's expected losses, receives a majority of its expected residual returns, or both, as a result of holding variable interests, which are the ownership, contractual or other pecuniary interest in an entity that change with changes in the fair value of the entity's net assets excluding variable interests" (Financial Accounting Standard Board, 2003, p. 6). Variable interest is an accounting term used in FIN 46(R) and basically expresses the means through which an entity provides a VIE with resources in exchange for an equity interest. This equity interest will increase and decrease in value as a result of the associated entity's economic risks and rewards. Therefore, any contractual arrangements or investments absorbing the variability of the entity's fair value are variable interests. This guidance was revised again in 2009 with FASB Statement No. 167, *Amendments to FASB Interpretation No. 46(R)* ("Statement 167"). Statement 167 intends to simplify the identification of a primary beneficiary by incorporating the concept of "power". While the old rules focussed solely on economics, Statement 167 requires the primary beneficiary to have both of the following: First, the power to direct the activities of the VIE that most significantly impact the entity's economic performance. Second, the obligation to absorb losses of the entity that could potentially be significant to the VIE or the right to receive benefits from the entity that could potentially be significant to the VIE (Deloitte, 2009a).

The Variable Interest Entity Structure

The following section explains the archetypal VIE structure that is used by most of the overseas listed Chinese companies. After an overview of the different entities involved, the necessary contracts that build the structure and the ideal way the structure works will be explained.

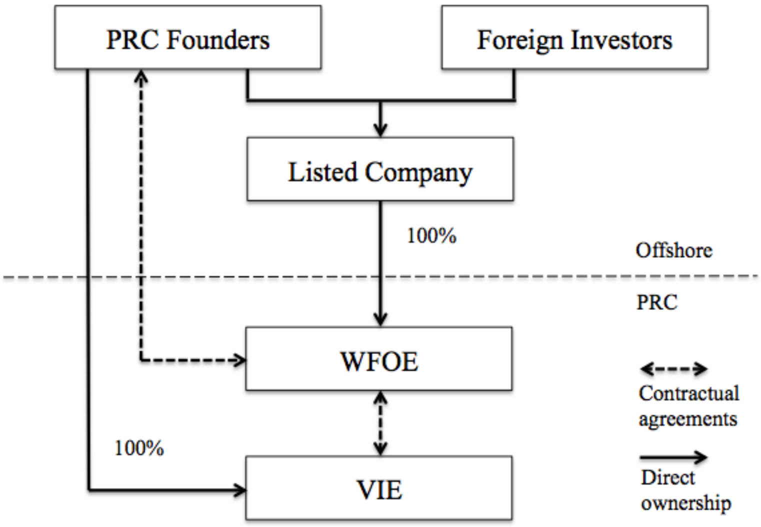
At the head of each VIE structure a foreign incorporated holding company is established which becomes the actual listed company. The PRC founders and foreign investors, which can be public shareholders and other funds, own this offshore holding company. Most favourable locations for the incorporation of these entities are the Cayman Islands, the British Virgin Islands and similar tax havens. These countries are tax-free jurisdictions charging no income, capital gain or corporate tax on resident companies. The costs of incorporating a company in those jurisdictions are very low and the regulatory frameworks are flexible since they are built on English law (Gillis, 2011b). In order to list the holding company on a foreign exchange it has to be able to consolidate the Chinese operations in its financial statements. Accordingly it needs to have control over the Chinese domestic company's operational activities and access to its residual profits for the benefit of the public shareholders. However, as a matter of FDI restrictions, the Chinese operating company – the VIE – cannot transfer its shares directly to the holding company to become a subsidiary (Gillis, 2011a). Consequently, no direct equity link exists between those two entities.

The core element of each VIE structure is a Chinese domestic company which is referred to as the VIE. The VIE often conducts a significant portion of the operational activities and makes most of the profits and cash flows, although some VIEs are structured to hold only the necessary business licences. The founders are Chinese citizens who own 100% of the voting shares and also have a stake in the listed company. Under PRC law Chinese citizenship is mandatory to hold the necessary business licenses that are essential to run the China operations. Due to foreign investment restrictions, these licenses cannot be legally owned by or transferred to a foreign owned entity (Roberts & Hall, 2011).

To circumvent the problem of FDI restrictions, the holding company sets up a wholly foreign owned entity ("WFOE") in China which is connected with the VIE through contractual agreements. The entity typically obtains a business license allowing it to conduct a consulting business. This entity contains intellectual property and related technical services capabilities, but it is not permitted to hold the necessary licenses to conduct certain operations (Gillis, 2011a).

The following diagram (Figure 1) illustrates the archetypical VIE structure with all required entities and the relationships among them. While some entities are tied by direct ownership, others are managed through contractual agreements. These legal agreements are the most critical elements within the VIE structure.

Figure 1
Archetypal VIE structure



Source: Own creation

In order to provide the offshore holding company with de facto control over the VIE certain contracts need to be in place:

The "exclusive option agreement" is signed by VIE founders, the VIE itself and the WFOE. The VIE shareholders agree to sell their shares at any time to the WFOE. The price being paid will be based on the amount of common stock or the lowest acceptable price under PRC law. The amount to be paid can be offset against the loan granted to the VIE. However, this agreement potentially violates current PRC laws and will not be enforceable unless FDI regulations are changed in the future.

Within the "equity pledge agreement", the VIE founders pledge their equity interest in the VIE to the WFOE as a security for their personal loan and the VIE's obligation arising in the VIE structure and its corresponding agreements. These equity pledge agreements need to be registered with the relevant Chinese authorities as required by the *Property Law of the People's Republic of China*. If a company fails to do so they will not be legally binding. Furthermore, it contains power of attorney signed by each pledger, which authorizes the WOFE's designee to transfer the pledged equity interest.

The "loan agreements" are integral parts of the VIE structure and are signed between the WFOE and the VIE shareholders. These agreements provide the VIE with the necessary funding. While loans from the offshore company would include dealing with the State Administration of Foreign Exchange, the loans from the WFOE are granted directly in RMB.

Under the “voting rights agreement” entered into by the VIE shareholder, the VIE and the WFOE, the VIE shareholders entitle the WFOE’s designee to exercise all of their equity interest rights. These include voting rights, inspection and information rights, signing rights and election rights among others.

In a second step further agreements secure the holding company with substantially all of the economic benefits from the VIE:

The “exclusive service agreement” that is in place between the WFOE and the VIE involves services provided by the WFOE to the VIE. These services vary depending on the industry, but typically include consulting, technical support and maintenance services. The WFOE sets its fees in a way that it can extract all of the VIE’s operating profits.

Under the “asset license agreement” the WFOE licenses certain assets to the VIE in return for annual royalty fees. These assets can be trademarks, technologies and other intellectual properties. This agreement provides the WFOE with additional control over the VIE since it may terminate the license at any time (Roberts & Hall, 2011).

Taken together, all of these contracts provide the offshore holding company with effective control over the VIE and its operating profits. Under prevailing U.S. and international accounting standards ("IAS") this enables the offshore holding company to consolidate the VIE in the group’s overall financial statements. The basic assumption underlying these operations is that the VIE operates as a shell company. The WFOE provides services for which it charges the VIE technical service fees and annual royalties. Assumed that all contracts are in place and work the way they are supposed to, the WFOE extracts ideally all of the VIE’s net income and passes it on to the holding company. This process is secured by the exclusive service agreements, also referred to as the technical service agreement and the asset license agreement. Furthermore, the foreign owners put a series of control agreements in place, which principally give the WFOE full operational control over the VIE (Gillis, 2011b).

Chapter 4: Risks in Variable Interest Entity Structures

Many Chinese companies have successfully adopted the Sina-model structure since its listing on NASDAQ in 2000 to attract foreign investors and file for offshore IPOs. A study conducted by Öqvist (2011) depicts that 42% of 230 Chinese companies listed on NASDAQ, NYSE and ASE used the VIE structure in April 2011 (Table 1).

Table 1

Usage of VIEs by U.S. listed Chinese companies

	NYSE	NASDAQ	ASE	Total
VIE	20	76	1	97
No VIE	50	67	16	133
Total	70	143	17	230
% VIE	29%	53%	6%	42%

Source: Öqvist, 2011

Furthermore, his analysis breaks the usage of VIEs down into industries. The following table shows that most VIEs are concentrated in the business services, electronic and electric equipment, chemicals and allied products as well as educational services sectors (Table 2).

Table 2

Usage of VIEs by U.S. listed Chinese companies by industry sector

Two digit SIC code	VIE	No VIE	% VIE
73 Business services	37	6	86%
36 Electronic and electric equipment	12	28	30%
28 Chemicals and allied products	5	20	20%
82 Educational services	8	2	80%
48 Communication	4	4	50%
65 Real estate	3	0	100%
59 Miscellaneous retail	3	0	100%
50 Wholesale trade - Durable goods	2	1	67%
35 Industrial machinery and equipment	2	4	33%
33 Primary metal industries	2	5	29%
01 Agricultural production	2	0	100%
Other	17	63	21%
Total	97	133	42%

Source: Öqvist, 2011

However, over recent years concerns have tightened over several risks inherent in the structure. In consideration of the fact that its main purpose is to bypass PRC law on foreign investment and heavily relies on agreements between different entities, there are numerous threats VIE shareholders and investors need to confront when setting up such a structure.

According to Lee (2011) a properly constructed VIE structure should include six necessary elements. It should

(1) Achieve tax efficiency for the purposes of cross-border transactions;

(2) Comply with all PRC central and local regulations, including and without limitation, regulations by the State Administration of Taxation ("SAT"), the State Administration of Foreign Exchange (“SAFE”) and the MOFCOM;

(3) Comply with all applicable U.S., Hong Kong and/or other international laws to permit for the future public listing of the holding company on an international stock exchange;

(4) Enable the holding company to obtain and maintain de facto control over the Domestic Licensed Co, directly or indirectly via the VIE contracts;

(5) Allow for consolidation of financial statements under the GAAP, the International Financial Reporting Standards ("IFRS") and the IAS; and

(6) Structurally align the interests of the investors of the holding company and the PRC founders or other entrusted nominee shareholders of the Domestic Licensed Co.

Investors should carefully examine the risks inherent in the VIE structure and take these into consideration when arranging entities and agreements. A conflict with or absence of one or more of these elements will lead to high risks within the company over the long run and may have substantial negative affect on the listed company as well as the WFOE and the VIE. At the same time other risks or factors, of which there is currently no knowledge, may be equally important and harmful to the VIE structure. Consequently, these risks affect the viability of a company considerably and investors could lose their invested capital.

Regulatory Risk

One danger posed by the VIE structure is regulatory risk. Since Sina went public in 2000, numerous Chinese companies have copied its VIE structure although it has never been officially or publicly legitimized by the regulatory authorities including MOFCOM, SAFE and the Ministry of Industry and Information Technology ("MIIT"). In addition, Chinese regulators have never expressed explicit prohibition, against the

VIE structure leaving them in a grey area of the Chinese legal system. Nevertheless, there have been increased disputes over the legality of the VIE structure for several years. First of all, these disputes have arisen because the VIE structure allows foreign investors to circumvent investment restrictions in restricted and prohibited industries in the PRC. Furthermore, the use of a VIE structure avoids the need to gain approval by the MOFCOM and CSRC with regard to the M&A Rules (Xu, 2011).

Domestic and foreign investors use the VIE structure mainly to bypass government reviews and regulations. PRC authorities dislike the use of indirect means by foreign investors to gain control of companies that are subject to foreign investment restrictions. Chinese regulators are well aware that VIE structures are used as a workaround for FDI restrictions, especially for offshore IPOs. Therefore companies run the risk that regulatory authorities declare the structure invalid at any time due to its violation of FDI restrictions and the M&A rules (Lewis, 2011a). In recent years, several attempts by Chinese government authorities have signalled their attitude towards restricting the use of the VIE structure. On the one hand, some attempts are aimed at prohibiting the use of VIE structures in certain industries while other attempts were designed to circumscribe its use completely.

The first Chinese counteraction against VIE structures was the *Circular on Strengthening the Administration of Foreign Investment in the Operation of Value-added Telecommunications Services* ("MIIT Circular") issued by the MIIT in July 2006. This regulation did not prohibit the use of VIE structures directly, but its aim was to ensure that all valuable assets such as trademarks, domain names and servers must be held by the company which contains the value-added telecommunication service provider license. This way the government wanted to prevent that VIEs were merely used as shell companies holding the necessary key-operating license. Instead VIEs should be in position of all key assets and not lease or license them from the WFOE (Roberts & Hall, 2011). The MIIT Circular was interpreted by the financial industry not as a prohibition of the VIE structure but rather a warning signal. Consequently its use continued in a more subtle form.

In September 2009, the General Administration of Press and Publication ("GAPP") prohibited the use of VIEs in certain industries when it promulgated the *Notice on Further Strengthening of the Administration of Pre-examination and Approval of Online Games and the Examination and Approval of Imported Online Games* ("GAPP Notice") together with the National Copyright Administration and National Office for Combating Pornography and Illegal Publications. This regulation stipulates that foreign investors cannot take control over or participate in domestic firms that are engaged in the online gaming sector via wholly owned, equity joint venture or cooperative joint venture investments. In fact, it prohibits foreign investors to gain de facto control over domestic online gaming companies through indirect means such as setting up a joint venture company or entering into contractual agreements (2011). While some industry observers argue that no companies utilizing the VIE structure have been penalized since the GAPP notice came effective, this notice is a clear sign that government authorities are tightening controls over the use of VIE structures and could enforce these rules when they consider a deal to be sensitive.

Another drastic intervention into the VIE structure and its prohibition took place, when reports leaked that the People's Bank of China ("PBOC") would not issue third-party payment service licenses to companies using a VIE structure. This license is required by non-financial institutions to conduct payment business and become payment institutions (Chow, 2011). On June 14, 2010 the PBOC promulgated the *Administrative Rules for the Payment Services by Non-financial Institutions* ("Payment Service Rules"), which spurred these speculations. "The Payment Service Rules, effective September 1, 2010, established detailed provisions on the scope of the third party payment service, the qualifications and requirements for paid-in capital that the service provider should satisfy" (Huang & Wang, 2011). However, the Payment Service Rules are unclear with respect to the appointment of third-party payment service license to companies that have any indirect foreign controlling interest. Reports stated that license applicants are required to disclose such relationships in order to meet the necessary requirements. If this were the fact the PBOC would not grant licenses to respective companies.

The most recent government attempt to constrain the use of VIE structures is the *Regulation on Implementing the Security Review Mechanism for Merger and Acquisition of Domestic Enterprises by Foreign Investors* ("Regulation") issued by MOFCOM in August 2011. The Regulation contains twelve articles mostly dealing with the scope of review, application documents and potential penalties. However, Article 9 of the Regulation emphasises that foreign investors cannot use any investment structures to evade the national review process when conducting a M&A in one of China's key sectors that have a bearing on national security. It specifically provides that "the issue of whether a

M&A transaction by foreign investors falls into the scope of security review shall be judged based on the substantial content and actual impact of the transaction. Foreign investors shall not circumvent the security review by any means, including, but not limited to, nominee shareholdings, trust, multi-tier re-investment, leasing, loan, contractual control and offshore transactions" (Chen, 2012). Although not mentioned directly, this Regulation aims directly at the use of VIE structures and may lead to a closer supervision.

In early 2011, Buddha Steel, Inc. withdrew its USD 38 million underwritten public offering in the United States. Buddha Steel, Inc. was a U.S. incorporated steel manufacturer organized like many U.S. listed Chinese companies through a VIE structure. It started off as a U.S. company that conducted a reverse merger with a Hong Kong based company. In September 2010, registration statements were filed with the SEC, disclosing the entire corporate structure. However, on March 28, 2011, the company reported in its Form 8-K that is was forced by local authorities in Hebei Province to terminate all of the VIE agreements since they "contravene current Chinese management policies related to foreign-invested enterprises and, as a result, are against public policy" (Buddha Steel Inc., 2011).

In September 2011, concerns over increased regulatory scrutiny peaked when Reuters published an article about an internal report allegedly written by the CSRC that was leaked to four different lawyers in China and Hong Kong (Alfred & Durfee, 2011). The report has not been published or officially authenticated; yet the severity of its content has caused a lot of discomposure among the financial community. The CSRC supposedly suggested a stricter prohibition of the VIE structure to the State Council by pushing the MOFCOM to take the lead in regulating these structures, which pose a major threat to China's national security. Only ten days after Reuters reported about the internal CSRC paper, more tangible information on its content was leaked onto the web. In detail the report mentions four key recommendations: First of all, it suggests that companies utilizing the VIE structure should be required to gain approval from the MOFCOM and the CSRC in order to list overseas. The focus here is laid upon new listings instead of existing ones. While regulations have been in place for a long time, enforcement has been inconsistent and widely avoided through the use of VIE structures. A possible solution to deal with this problem would be to work more closely with the SEC making sure that rules are followed (Gillis, 2011c). The second recommendation deals with the scope of application. While old companies should be treated with old rules, new rules should only be applied to new companies. Existing companies that already list overseas should be grandfathered in some form from new regulations. Third, the report suggests that Chinese Internet companies should be encouraged to list on domestic markets. In order to do so China's capital market would need further development. Finally further reforms are proposed so that Chinese companies that are unable to list on domestic markets should have the possibility to list directly abroad (Xing, 2011).

Whether this report was ultimately finalized and forwarded to the State Council remains unclear. Nevertheless, it becomes apparent that the Chinese government is increasingly concerned over the usage of VIE structures to circumvent FDI restrictions in particular industry sectors and avoid gaining permission to list offshore. Several instances deal with possible policy solutions and it is extremely important to the regulatory authorities to assert control over these structures and enhance transparency, especially in the aftermath of the financial crises. While financial sector participants are shook up by occasional regulatory clampdowns, however, there has been no clear indication that the PRC government is seeking to prohibit VIE structures generally or in particular industry sectors (Lewis, 2011b). All rules and regulations that have been put in place use an abstract language with no direct mentioning of the VIE term. As Li and Shang put it, "There are substantial uncertainties regarding the interpretation and application of PRC laws and regulations governing the enforcement and performance of the contractual arrangements. New laws may be applied retroactively or the interpretation of existing laws and regulations may change, as a result, this structure would be found to be in violation of any current or future PRC laws and regulations" (Li & Zhang, 2010).

The recent case of Buddha Steel, Inc. is a good example demonstrating the potential risks inherent in VIE structures and the rationale for government intervention in the future. For several years the Chinese government has tolerated the VIE structure as a means for China's well known Internet companies to raise necessary seed capital and list on overseas stock markets. Given the fact that Chinese regulators may prohibit or limit the use of VIEs in particular industries, investors will need to pay special attention to the risks arising from the necessary requirements and regulations posed by both national and local authorities. For instance, Chinese authorities may refuse to issue an operating license to a domestic operating company because it is part of a VIE structure. Therefore, investors should always be informed about which operating licenses are required for the current and future business activities of the domestic operating company, which regulatory authorities issue such licenses and what the requirements are for obtaining such operating licenses. The possibility that Chinese regulators can step in at any time at their own discretion to disallow the VIE structure or to revoke existing operating licenses violates the prerequisite of a properly constructed VIE structure. Such measures would indicate that the group’s structure does not comply with PRC central and local regulations. In addition, the possibility that the VIE agreements are declared invalid contradicts with international laws on listing requirements.

Shareholder Risk

Another major concern with the VIE structure is posed by the shareholder or nominee. It relates to the contracts that exist between the publicly listed company, the WFOE and the VIE, and occurs when there is a violation of Lee’s premises (4) and (6) to maintain de facto control over the VIE and align shareholder interests. As explained in the chapter "VIE Structure", all entities enter into contractual agreements, which enable the consolidation of the Chinese company in the group’s overall financial statements and beyond that grants the holding company the right to extract all of the VIE's profits through the WFOE. The risk underlying this concept bases on the fact that investors are entitled to the majority of necessary assets not through direct ownership but a series of contracts. The VIE is essential to the VIE structure without which the group is not authorized to run its business in China.

It is important to remember that the VIE founders are predominantly also the majority shareholders of the listed company. This basically means that their interests should be aligned with those of all the other investors to increase the value of their listed company’s shares by maximizing the VIE’s profits. However, situations may occur in which wrong incentives motivate the VIE founders to act contrary to the VIE agreements. A survey conducted by Gillis and Öqvist (2012) analysing Chinese companies listed on NYSE and the NASDAQ shows that assets held in the VIEs ranged from 0% to 100% of the consolidated assets with a mean of 33%. Yet, Gillis points out that for many companies it is hard to determine which assets are held within the VIEs and what proportion of income they generate. This creates a moral hazard for the VIE founders whose economic interests could prompt them to breach the agreements and steal the VIE with all its assets. Such situations could emerge when the listed company tries to replace the VIE owner or when too much capital is left within the VIE. The problem underlining this is a shift of valuable assets such as corporate chops, licenses and similar necessary items from the WFOE to the VIE that has taken place over the last few years, so that listed companies may end up without any assets.

What is left to the listed company is to take legal action against the VIE. It could file lawsuits against the VIE founders, call upon the agreements and claim its rights to buy the VIE. This might seem to be a safe resolution at first glance since all contractual agreements within a VIE structure are designed to prevent the WFOE from losing control over the VIE and the corresponding assets. Through the exclusive option and equity pledge agreements this should be enforceable. Looking closer one will realize that formal legal action could get quite tricky.

First of all, many companies fail to register the equity pledge agreements between the WFOE and the VIE with the relevant Chinese authorities. Since the equity pledge agreements are a kind of security interest, registration is obligatory without which they are not legally binding and unlikely to be enforceable in a PRC court.

Furthermore, the Supreme People's Court issued guidelines regarding the enforceability of nominee shareholder and beneficial ownership arrangements in early 2011. According to these guidelines contracts are enforceable as long as they do not contradict with Article 52 of the PRC contract law (Lewis, 2011b). Article 52 determines the validity of a contract. A contract shall be null or void if one of the following situations occurs (Zhang, 2006, p. 168):

(1) A contract is concluded under fraud or duress employed by one party to damage the interests of the state;

(2) Malicious collusion is conducted to damage the interests of the state, a collective or a third party;

(3) An illegal purpose is concealed under the guise of legitimate means;

(4) Social and public interests are harmed; or

(5) Compulsory provisions of the laws and administrative regulations are violated.

In the case of the technical service agreement the main purpose is exactly to circumvent Chinese restrictions on foreign ownership. Therefore, it contradicts with Article 52 and should be void. If so, the chances of enforcing them in a PRC court would drop to zero leaving the listed company with no valuable assets and no China operations.

Three high profile cases that occurred over the last twelve months have demonstrated the shattering power of shareholder risk to the VIE structure.

Alipay. The first case that cast a dark shadow over the industry was the dispute between Alibaba Group Holding Limited ("Alibaba") and its largest shareholder Yahoo Inc. ("Yahoo"). In May 2011, Jack Ma, the founder and CEO of Alibaba, spun-off its online payment company, Alipay, allegedly without informing the board of directors. As a result Alibaba had to deconsolidate Alipay from its financial statement, which was a Chinese domestic operating entity without actual or contractual foreign ownership. As an explanation for breaching the existing VIE agreements, Ma stated that he had no other choice but take the VIE in light of the recent actions by the PBOC. Rumours had it that the PBOC would not grant the required third-party payment service license to companies that have foreign ownership (Lee, 2011).

Following the spin-off, Alipay was granted the third-party payment service license by the PBOC. The ensuing public dispute between Alibaba and Yahoo was settled. As a compensation for its loss, Yahoo would receive a share in the future gains of Alipay through payments of royalties and license fees to Alibaba. In addition, Yahoo receives USD 2 billion but no more than USD 6 billion in the case that Alipay conducts an IPO or is disposed. The investment community conceived this resolution with mixed feelings. Some analysts argued that this settlement did not reflect the true value of Alipay (Dignan, 2011). It remains unclear whether the PBOC would have denied to grant Alipay the necessary license or whether Jack Ma used the statement as a deliberate act to breach the VIE agreements and take control of Alipay.

GigaMedia Limited. The second example is the company GigaMedia Limited ("GigaMedia") and its conflicts with the former China head of operations. GigaMedia is an online entertainment company based in Singapore, which conducted an IPO on NASDAQ in 2000. In 2006 GigaMedia acquired T2CN, a holding company incorporated in the British Virgin Islands. T2CN owns a 100% WFOE, T2 Technology, which has contractual agreements with various Chinese domestic VIEs.

In its Form 6-K filing with the U.S. Security and Exchange Commission ("SEC"), GigaMedia points out that it had failed to move its Chinese domestic executive director Wang Ji from his position to a senior consulting role in early 2010. As a result GigaMedia officially removed Wang Ji from his post as a director of T2 Technology and T2CN as well as terminated his employment contracts. Wang Ji on the other hand refused to cooperate and retained control of the company seals, financial chops and business registration certificates of the WFOE and the VIEs. Furthermore, he restrained all tangible property such as license agreements, trademark and domain name documentation (Gigamedia Limited, 2010). These certificates and licenses were essential for the respective entities to run operations, fulfil all contract agreements and pay service fees to GigaMedia. GigaMedia stated that no dividends or fees had been turned over by the VIEs or the WFOE since the dispute began and Wang Ji had usurped effective control over the WFOE's and VIEs' operations and accounts.

To regain control over their China operations, GigaMedia filed lawsuits against Wang Ji in several jurisdictions. In its attempt, GigaMedia sued Wang Ji of breach of fiduciary duty and conversion, as well as tried to recover their tangible property such as company seals, financial chops and business certificates. As disclosed in their Form 6-K, GigaMedia has failed to get the necessary equity pledge agreements between the GigaMedia WFOE and their VIEs registered with the relevant governmental authorities. Their statement concludes that these agreements would therefore not be enforceable which is why they withdrew from their lawsuits. The dispute was resolved when GigaMedia entered into a settlement agreement with Wang Ji in December 2011. All lawsuits were withdrawn and GigaMedia sold its subsidiary T2CN for merely USD 4.7 million (Seeking Alpha, 2012). As a result, GigaMedia had to deconsolidate the financials of the Chinese domestic company.

ChinaCast. The most recent case of structural problems in a Chinese company operating through a VIE is ChinaCast Education Corporation ("ChinaCast"). On April 2, 2012, the company's stock was halted from trading after it had failed to file its 10K Form for 2011 on time. In an open letter to the shareholders the board of directors explained that they had removed the chairman Ron Chan and some other senior people due to a highly contentious proxy fight in January 2012. However, Ron Chan and his accomplices showed resistance when refusing to provide financial information to the company's auditors and furthermore did not return key company property, including corporate chops which are necessary to run the China operations (ChinaCast Education Corporation, 2012).

The ChinaCast case is different from GigaMedia with respect to the ownership structure. ChinaCast also operates through a VIE, in which Ron Chan does not hold any equity in. It remains to be seen how the situation develops. ChinaCast has taken legal action against Ron Chan and his confederates in order to retrieve the necessary company chops to pursue the auditing process and continue their business in China.

Learnings from recent incidents. The cases of Alipay, GigaMedia and ChinaCast illustrate how badly a VIE structures can go wrong if they are not set up the right way and precautionary steps have not been put in place to guarantee de facto control over the VIE. This is especially true with regard to the VIE owners whose position is often misjudged. In the event of a dispute with the VIE owners, the contractual control mechanisms are likely to fall short of their aim. Even though these controls may be implemented correctly, a court dispute can be lengthy and cost the company dearly. With so much uncertainty and risk involved, investors and managers need to plan way ahead and be prepared for every possible situation when planning to act against the management holding the VIE.

Chapter 5: Setup Tax Issues

For many years foreign investors have carefully chosen their investment structures in order to profit from various non-tax reasons such as to minimize the impact of China's currency exchange restrictions and profit from flexible exit strategies, but also to take advantage of certain tax benefits accompanying them when investing in China (Gregur-as, Bassett & Zhang, 2008). Holding structures including SPVs located in Hong Kong, Mauritius and other tax preferential jurisdictions benefit from lower withholding tax ("WHT") rates on dividend income and other passive income under the *Mainland and Hong Kong Closer Economic* Partnership Arrangement and similar tax treaties. Foreign investors were also able to dispose their investment in China by selling shares in the SPV without having to pay income tax on their capital gain. "The resulting capital gain was considered to be outside the scope of Chinese tax as it was technically sourced outside China and arose to a non-resident" (KPMG, 2012, p. 3). In addition, if the SPV is established in a jurisdiction that charges no or little tax on capital gains, foreign investors could divest their shares at a marginal tax liability (Lee & Mauradian, 2010).

On March 16, 2007, the new PRC Corporate Income Tax Law ("CIT law") was passed and became effective on January 1, 2008. With its subsequent and numerous implementation rules and circulars, the CIT law unified two separate CIT regimes for domestic and foreign enterprises. In particular the circulars gave clear definitions, interpretations and application guidelines for the various provisions of the new CIT law. With respect to China's previous approach, these tax reforms represented a fundamental change in China's attitude towards foreign investment (Asia Briefing Ltd., 2011).

With its various provisions and regulations, founders and foreign investors now need to analyse more accurately, which short- and long-term tax consequences will result from a specific VIE structure setup so that they can plan the business establishment process accordingly. In doing so, special attention will need to be given to the place of effective management, the anti-avoidance rules, treaty shopping counter measurements, as well as taxes on capital gains from indirect sales, in order to keep the structure as tax effective and efficient as possible.

Place of Effective Management

The most notable impact for foreign investment structures was the introduction of a "tax resident" concept. Article 2 of the new general provisions categorises a company as either "resident" or "non-resident" enterprise. An enterprise that is established in China under PRC laws or an enterprise that is established under the laws of a foreign jurisdiction but has its effective management located in China is considered to be a resident enterprise. A non-resident enterprise, on the other hand, is an enterprise that is established under the laws of a foreign jurisdiction and whose effective management is located outside of China. The non-resident enterprise may have an establishment in China or may just derive income from sources within China (KPMG, 2008, p. 3). Different CIT rates will apply depending on the applicable category. While a resident enterprise pays CIT on its worldwide income, a non-resident enterprise with an establishment in China pays CIT on its China-sourced income as well as CIT on foreign-sourced income that is connected to its establishment in China. A reduced CIT rate of 20% will be granted to a non-resident enterprise that has no establishment in China and applies to its China-sourced income (KPMG, 2008, p. 4). Under the provisions of the old CIT law non-resident enterprises were only taxed on their China-sourced income, regardless of where their effective management was located.

These new regulations create a series of problems for the setup of VIE structures. Especially companies that are controlled by PRC enterprises through equity ownership, such as Red Chip companies could be subject to the new regulations and their subsequent tax consequences (Ni & Ng, 2009). Unlike the old provision, the listed company could now be classified as a resident enterprise from a Chinese tax standpoint depending on the actual location of its effective management. However, the uncertainty remained how Chinese tax authorities would determine the exact location of management. Neither the new CIT law nor its detailed implementation rules gave a clear definition on the "place of effective management".

On April 22, 2009, the SAT released the *Notice Concerning the Identification of Overseas-registered Chinese-capital Controlled Enterprises as Tax Resident Enterprises based on Place of Effective Management* ("Circular 82"), which retroactively came into effect on January 1, 2008 (Grant Thornton China, 2011). Circular 82 clarifies the "place of effective management" recognition criteria for overseas-incorporated enterprises controlled by PRC enterprises and furthermore emphasizes in Article 2 that the judgement is subject to the principle "substance over form". Hence a company is considered to be an overseas-incorporated resident enterprise ("OIRE") that is domestically controlled, if it complies with all of the following conditions:

(1) The place where the senior management and relevant bodies execute their daily responsibilities is mainly located within the territory of China;

(2) Strategic financial (e.g. money borrowing, lending, financing and financial risk management) and human resources (e.g. hiring, termination and compensation determination) decisions of the enterprise are made or need to be approved by offices or staff located within the territory of China;

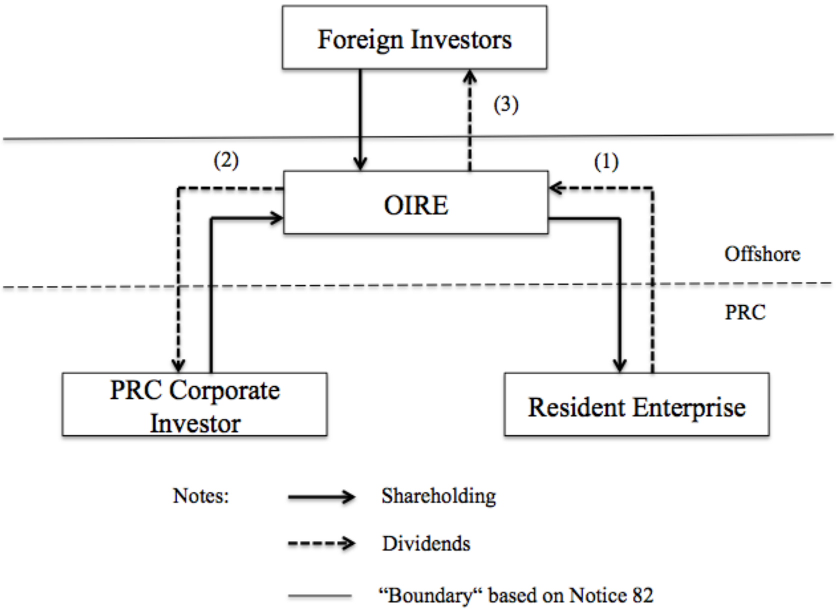
(3) All major properties, accounting books, corporate seals and minutes of board and shareholder meetings of the enterprise are maintained within the territory of China; and

(4) At least half of the board members with voting rights or senior management personnel habitually reside within the territory of China (Xie, Zhang & Liang, 2009).

Once these conditions are met, an OIRE will need to deal with several negative tax impacts. First, an OIRE will be subject to a 25% CIT rate on its worldwide income. Second, passive incomes (e.g. dividends, interest, royalties and capital gains) distributed to foreign shareholders will be considered China-sourced income. These payments will be subject to WHT at a rate of 10% and the OIRE will need to withhold the relevant CIT. On the other hand, if an OIRE receives dividends from another resident enterprise, these dividends will be tax free under China's new dividend-received exemption rule (Ni & Ng, 2009). The following diagram (Figure 2) illustrates possible equity relations among enterprises and investors as well as a possible flow of dividends. While dividends distributed from the OIRE to PRC corporate investors (2) as well as dividends the OIRE received from resident enterprises (1) are exempt from WHT, dividends paid to foreign investors will be subject to a WHT rate of 10% (Xie, Zhang & Liang, 2009).

The possibility that the offshore holding company is classified as an OIRE would implicate a fundamental change in the taxation of a VIE structure. Both income taxes on its worldwide income, as well as WHT on dividends to foreign investors would dramatically increase its tax liability. So far this poses no threat to companies controlled by Chinese or foreign individuals. Circular 82 only applies to enterprises that are controlled by Chinese enterprises, e.g. Red Chips (Ni & Ng, 2009).

Figure 2
CIT implications for a resident enterprise



Source: Xie, Zhang & Liang, 2009

Prior to Circular 82, investors such as PE funds have traditionally structured their investment into Red Chip companies through intermediate holding companies preferably located in a tax-privileged jurisdiction, e.g. Hong Kong. This allowed PE funds to dispose of their investment more easily, pool investor interests together through a common investor vehicle, and be able to list the company offshore. Furthermore, this structure had tax advantages over a direct investment into the Chinese target company. On the one hand, passive income distributions from the PRC company to the offshore holding company were subject to WHT and dividends paid to PRC investors were taxed at 25%, on the other hand, income in the form of interest, dividend, royalty or capital gain passed on to the PE fund were tax free. However, under the new rules it is difficult for Red Chips to maintain their non-residency status. As long as the majority owners of the PRC target company manage the offshore holding company from a location within the Chinese territory, the enterprise might be regarded a PRC tax resident (KPMG, 2009a).

Once the offshore holding company is determined as an OIRE several negative tax implications arise for foreign investors. All income derived from the investment vehicle would be regarded as China-sourced income and thus be subject to a WHT at a rate of 10%. In particular, capital gains achieved through the sale of respective company's shares would be classified as China-soured income and therefore be subject to WHT.

In order to avoid being classified as an OIRE and taxed on its worldwide income, foreign investors need to examine their investment structures more carefully. Although incorporated in foreign jurisdictions, enterprises may be treated as Chinese tax residents depending on the actual location of their management bodies. In order to avoid such classification, enterprises will need to locate their effective management outside of Chinese territory. This in turn means that most of the management personnel cannot habitually reside within the Chinese territory and all important board meetings should be held abroad. It remains to be seen whether Circular 82 will be extended in the near future so that entities controlled by Chinese or foreign individuals are included in the scope of application.

Anti Tax Avoidance Rule and Treaty Shopping Counter Measurements

VIE structures often deploy SPVs as intermediate holding companies to take advantage of preferential tax treaty provisions or align profits to a low-tax jurisdiction or tax haven (Dong & Zhang, 2010). Referred to as "treaty shopping", this has primarily been the case with Hong Kong, Singapore, Mauritius and Barbados holding companies that were set up to take advantage of preferential WHT rates under Double Taxation Agreements ("DTA"). Treaty shopping "essentially lies in the exploitation of the differences in the treaties concluded between the various countries, in particular, through the interposition of a resident entity in a third country or region, usually a country or a region characterized by a simple and favourable tax system" (Weng, 2011). In recent years, Chinese tax authorities have started to tighten controls on cross-border tax avoidance arrangements. These counter measurements consist of namely three different aspects.

First, the new CIT law covers a general anti-avoidance rule ("GAAR") and supplementary anti-abuse principles, such as the controlled foreign corporation rule, the thin-capitalization rule and transfer pricing documentation requirements (Liu, n.d.). Article 47 of the CIT law empowers tax authorities to adjust taxpayer's tax liability through reasonable means, "In case an enterprise makes any other arrangement not for any reasonable commercial purpose, which causes the decrease of its taxable revenue or income" (Order of the President of the People's Republic of China, 2007).

To further specify this ruling, Article 120 of the *Implementing Regulations of the Enterprise Income Tax Law* set out by the SCSC clarifies that "with no reasonable business purpose" means "the main purpose of the transaction is to reduce, avoid or defer the payment of taxes" (Zhang & Wang, 2011). This includes treaty shopping, abusive use of tax havens or abusive use of tax treaty benefits. On January 8, 2009, the SAT promulgated the *Implementation Measures for Special Tax Adjustments* ("Circular 2"), which further distinguish the application of the GAAR. In addition to the previous rulings, the Chinese tax authorities may disregard the existence of an enterprise that lacks "economic substance". This specifically applies to enterprises that are incorporated in a tax-free jurisdiction for tax-avoidance purposes and will be investigated on behalf of the "substance over form principle" (Liu, n.d.).

Second, the SAT released the *Notice on Issues Relevant to the Implementation of Dividend Provisions in Tax Treaties* ("Circular 81") on February 20, 2009. Circular 81 was a response to international taxpayers evading the applicable WHT rate of 10% on dividends when locating their company in a jurisdiction that enjoys tax benefits under its treaty with China. Article 4 constitutes that any arrangements or transactions established with the intention to acquire tax preference should not be a reason for application of the preferential dividend clauses of a tax agreement. Article 4 also grants tax authorities the right to make adjustments where transactions or arrangements have illicitly enjoyed preferred tax treatment (Weng, 2011). Circular 81 furthermore postulates conditions such arrangements need to meet in order to successfully claim treaty benefits. On the one hand, a recipient has to be a tax resident of the treaty jurisdiction, on the other hand it will need to be the beneficial owner. Furthermore the recipient or the withholding agent needs to provide documentation to prove all requirements are met (Liu, n.d.).

Moreover, a new Protocol that was signed by the PRC and Barbados in February 2010, revises the new CIT law on behalf of reduced WHT rates granted to Singapore, Ireland, Luxembourg, Hong Kong and Mauritius. The provisions provide a 5% dividend WHT rate to companies owning 25% or more equity interest of the Chinese company paying the dividend. If a 25% ownership level is not met, a 10% WHT rate will be applied. An exception is made with the China-Mauritius treaty where the 25% ownership level is not required (Khaw & Koh, 2010). This approach aimed at eliminating or reducing the differences between various tax treaties.

Third, the SAT issued the *Notice on the Interpretation and Recognition of "Beneficial Ownership" under Tax Treaties* ("Circular 601") on October 27, 2009, which defines the term "beneficial ownership" with respect to the tax treaty treatment of non-resident applicants (Liu, n.d.). Circular 601 determines whether an entity is eligible to the benefit of a reduced WHT rate on dividends, interests and royalties, and specifically aims at tracking down offshore holding companies that have no real economic substance. Article 2 defines the beneficial owner as an entity or person that owns or has control over the income or the rights, which may increase such income (Weng, 2011). The beneficial owner must be engaged in substantial business activities. "A pure conduit company or shell company that is formed merely to fulfil legal registration obligations in a foreign jurisdiction does not qualify for treaty benefit as a beneficial owner" (Sussman, Choi, Huang & Zhou, 2007, p. 2). Conduit companies are arrangements that were primarily set up to avoid paying tax twice on income arising in a country that has no tax treaty with the county in which the subsidiary is located. Conduit companies are set up in jurisdictions that have tax treaties with both countries and therefore have the purpose of evading or reducing tax (Liu, n.d.).

In addition, Article 3 provides that when determining whether or not a treaty resident is a beneficial owner, not only technical and domestic law aspects should be taken into consideration, but should also be based on the DTA and the principle "substance over form". Seven factors are set forth that violate a taxpayer's claim to treaty benefits (Liu, n.d.).

(1) The treaty resident applying for treaty benefits ("applicant") has the obligation to transfer or distribute all or a substantial part (e.g. more than 60%) of its income to a third country resident with a prescribed time (e.g. within 12 months from the date the applicant receives the income);

(2) The applicant has no or little business activities other than owning and controlling the assets or rights from which such income is derived;

(3) The applicant's assets, company size and personnel are relatively small, being not commensurate with the income it derives;

(4) The applicant has no or almost no rights of control or disposal over the assets and income, or rights from which the income is derived, and it bears no or almost no risks associated with the assets or rights;

(5) The applicants resident country levies no taxes on or otherwise exempts related income, or levies taxes at a very low effective rate;

(6) Apart from the loan agreement through which the applicant derives interest and on behalf of which interest is paid, the applicant has entered into other

loan agreements or deposit agreements with another party that contains similar terms;

(7) Apart from the agreement granting a Chinese entity to use copyrights, patents, technologies, etc. according to which royalties are paid, the applicant has entered into other agreements with another party for acquiring the ownership or the right to use the relevant intangible assets.

The GAAR and its supplementary principles, as well as the numerous treaty shopping counter measurements had far-reaching implications for VIE structures. Many companies have setup a Hong Kong intermediate holding company between the Cayman Islands company and the WFOE in order to take advantage of the tax treaty between the PRC and Hong Kong that applies to WHT. However, as it turned out these Hong Kong based companies did not have enough commercial substance and therefore could no longer claim preferential WHT rates.

Circular 698

In recent years regulatory and tax policies have tighten their scrutiny of offshore transactions, specifically with the promulgation of the *Notice of the State Administration of Taxation from the Administration of Corporate Income Tax on the Income from Equity Transfer by Non-resident Enterprises* ("Circular 698") by the SAT on December 10, 2009. Circular 698 applies retroactively from January 1, 2008, and provides a foundation for collecting CIT on capital gains deriving from direct or indirect equity transfers of Chinese tax resident enterprises by non-Chinese tax resident enterprises.

On the one hand, an indirect transfer takes place when a non-PRC tax resident enterprise sells its shares in a holding company, which owns shares of a Chinese tax resident enterprise, to another non-PRC tax resident enterprise. On the other hand, a direct transfer occurs when the PRC tax enterprise is sold directly to the offshore buyer. The direct sale of the PRC enterprise is uncomplicated and its proceeds result in a tax liability for the seller that transfers the shares. The crux lies within an indirect sale in which shares are transferred between two non-Chinese tax resident enterprises and no tax liability incurs on the capital gains (KPMG, 2012).

The main purpose of Circular 698 therefore aims at tightening scrutiny over the indirect sales of PRC tax resident companies through offshore vehicles in order to avoid paying taxes. Two issues arise in relation to the indirect transfer. First, the transaction triggers a reporting obligation. Circular 698 requires the seller to report this transaction to the SAT within 30 days of signing the equity transfer agreements, provided the offshore holding entity being sold is located in a jurisdiction that has a tax rate of less than 12.5% or imposes no tax on foreign income (KPMG, 2012). For this matter, necessary document need to be handed over to the SAT. These include

(1) the equity transfer agreement,

(2) the relationship between the offshore investor and the offshore holding company being transferred, with respect to capital, operational and sales and purchase activities;

(3) the business operation, personnel, accounts and assets of the offshore holding company;

(4) the relationship between the offshore holding company and China-resident enterprise, with respect to capital, operational and sales and purchase activities;

(5) a reasonable explanation (with commercial substance) regarding the establishment of the offshore holding company that is being transferred (Investment into China needs careful exit planning upfront).

The second issue concerns a possible tax obligation. As long as a company can prove that the offshore vehicle has a reasonable business purpose, no tax liability will be imposed. A reasonable business purpose exists as long as the offshore vehicle has "economic substance", which can be employees, assets, liabilities or operations other than holding the investment (Bowdern, Xing & Turley, 2010). If economic substance cannot be attested and proceeds have not been taxed at a rate of at least 12.5%, PRC tax authorities may impose a 10% tax on capital gains (Knowles, 2010).

The first reported case in which Circular 698 was applied involves a foreign PE fund that disposed of a Chinese investment in January 2010. The fund owned a 49% interest in a joint venture in Jiangdu, Jiangsu province through a wholly owned Hong Kong incorporated company. The PE fund transferred its shares in the Hong Kong company to an unrelated purchaser, who also was a non-Chinese tax resident enterprise. After obtaining enough information from the buyer and seller, local Chinese tax authorities in Jiangsu province determined that the Honk Kong company had no real economic substance due to its absence of employees, assets, liabilities or operations other than holding the investment. Therefore, the transaction was pursuant to Circular 698 so that the tax authorities treated the transaction under the GAAR as a direct disposal and imposed a 10% tax rate on the capital gain realized by the seller. The tax return filed on April 28, 2010, resulted in a tax liability of RMB 173 million (Bowdern, Xing & Turley, 2010).

The issuance of Circular 698 has far reaching implications for foreign investors into China. Regarding the VIE structure, Circular 698 does not apply directly and no clear impact can be observed so far. Leading up to the setup of a VIE structure, tax obligations may arise for PE and VC funds or similar investors who exit their investment in a Chinese domestic company by selling their shares in an offshore holding company. With regard to the VIE structure itself, the issue surrounding Circular 698 could become interesting once Chinese authorities consider the VIE arrangements to be the equivalent of equity ownership. Consequently, the VIE agreements would mean that the VIE was actually sold to the WFOE, which in turn could be classified as a taxable event. However, this discussion goes beyond the scope of this paper.

Chapter 6: Operational Tax Issues

When foreign investors structure their investments into China, they need to pay special attention to the variety of tax consequences that may adversely affect their business decisions. In order to understand the operational tax impacts on VIE structures better, it will be important to bear in mind that no single right norm exists. Each structure is affected by taxes differently according to its personal specifications. China's tax regimes levy several different taxes at different rates, depending on the entities location and its scope of business (Asia Briefing Ltd., 2011). Nevertheless, all VIEs are surrounded by the same regulatory framework and can therefore make their decisions based on similar assumptions. With the promulgation of the new CIT law in 2007, many fundamental changes in China's income tax treatment and payment took place. Mainly three corporate taxes and their subsequent changes have great influence on VIE structures.

Corporate Income Tax

The CIT is a tax that is levied on the net income in a fiscal year after reasonable business costs and losses have been deducted. This effectively resembles a tax on operating profits. The taxable amount is settled on an annual basis and the final tax liability is calculated at the year-end, however, it is mostly filed and declared on a quarterly basis with adjustments either refunded or carried forward to the next year (Asia Briefing Ltd., 2011). With the new CIT law the standard CIT rate of 33% was lowered to 25% for both domestic and foreign enterprises. A reduced tax rate of 20% may apply to small and low profit enterprises.

Table 3

Applicable Business Tax Rates

Tax rate		Applicable enterprises
Standard rate	25%	Most enterprises
Reduced rate	20%	Small and low-profit enterprises
Withholding income rate	20%	Foreign enterprises without permanent establishment in China but who derive income from

Source: Asia Briefing Ltd., 2011

Furthermore, the new CIT law abolished many tax incentives. The freedom for Economic Developing Zones and Free Trade Zones to issue their own tax incentives was limited. Merely industry-based incentives were granted and revolved around qualified advanced technology enterprise in 21 model cities and "encouraged" high and new technology enterprises ("HNTE") irrespective of their location. Enterprises that fall into this category are eligible to a reduced income tax rate of 15%.

Withholding Tax

WHT is imposed on overseas companies who provide services to China-based businesses including subsidiaries. Respective income will be regarded as China-sourced income and subject to WHT. The tax amount payable will be deducted from the total gross invoice amount and withheld by the Chinese client. Since January 2008, non-resident enterprises pay a 10% WHT rate on passive income (e.g. dividends, interest, rentals, capital gains, royalties, etc.) derived from China, unless a particular tax treaty with the recipient's jurisdiction supplements the CIT regulations. The total tax liability is calculated as the taxable income times the applicable WHT rate.

Turnover Tax

Turnover tax includes three main types of taxes, of which Business tax ("BT") and Value-added tax ("VAT") are important to VIE structures.

Business Tax. BT is an indirect tax levied on the gross transaction amount instead of the direct CIT that is imposed on the net amount. Compared to this, the BT is a turnover tax that is imposed on the provision of taxable services and no tax credit is allowed for taxes paid on business inputs. The amount payable is based on the income derived the provided services. These taxable services include communications, transportation, construction, finance and insurance, posts and telecommunications, culture and sports, entertainment and other taxable services, as well as the transfer of intangible assets and sale of immovable properties. BT rates range from 3% to 20% (Table 4). Licensing and consulting services will generally be subject to a 5% BT rate. The following table shows the applicable BT rates for different industries:

Value-added Tax. VAT is imposed on companies that are involved in production or trading activities. While BT applies to business service provider, VAT is imposed on manufacturing companies. Generally enterprises that have the status of "General Tax Payer" may issue VAT invoices at a tax rate of 17%. Enterprises that qualify for special treaty areas may apply a rate of 13%. Input VAT is calculated at a rate of 17% on the purchasing costs and output VAT is calculated at 17% of the sales value. The tax payable will be the difference between input and output VAT (Asia Briefing Ltd., 2011).

Table 4

Business tax rates

Industry	Tax rate
Transportation	3%
Construction	3%
Finance and insurance	5%
Post and telecommunications	3%
Culture and sports	3%
Entertainment	5% - 20%
Service agencies	5%
Transfer of intangible assets	5%
Sales of immovable properties	5%

Source: Asia Briefing Ltd., 2011

Taxation of the VIE

The VIE is usually subject to several different corporate taxes. These depend on the VIE's business scope and nature of enterprise. As long as the VIE operates in the Internet, telecommunications, education, or a similar industry, its turnover will be subject to BT at a rate of 5%. A company operating in manufacturing and trading will be subject to a VAT at a rate of 17% on its purchase and sales of goods. Both of these taxes cannot be avoided in any way. Additionally, CIT is levied on the entity's worldwide operating profits at a rate of 25%, where the entity does not qualify as a HNTE. In the case that the VIE distributes a dividend to the individual shareholders, these payments will be subject to Chinese individual income tax at a rate of 20%.

Taxation of the WFOE

The WFOE is subject to two main taxes in China. Quite similar to the VIE, the WFOE pays BT at a rate of 5% on its turnover from services. Since the WFOE typically only provides services, such as consulting, technical support and licensing of key technologies, no VAT payment is required. In addition a CIT at a rate of 25% is levied on its worldwide proceeds and in many cases the WFOE qualifies as a HNTE and thereby enjoys a privileged CIT rate of 15%.

Taxation of the VIE Structure

The basic setup of a VIE structure includes at least three entities, of which the VIE and the WFOE are located in China. On the one hand the VIE as the domestic operating company mostly provides services to the end consumer. In some cases, however, the VIE is established for the purpose of holding the necessary operating licenses and does not generate a significant amount of revenue. The turnover generated by the VIE will be subject to BT at a rate of 5%. The overall objective of the structure intends to extract all of the operating profits out of the VIE using the technical services agreements and intellectual property licenses. This means the VIE should obtain a CIT deduction on these payments and as a result should have no net income and pay no income taxes. Consequently, the income would be reported in the WFOE and subject to tax at the WFOE's tax rates.

The WFOE on the other hand collects its service fees and royalties for which it pays a 25% CIT on top of the 5% BT. In many cases the WFOE qualifies as a HNTE and thereby enjoys the privileged tax rate of 15%. Many companies (e.g. education companies) have taken advantage of this by taking the net income which would be taxed at 25% within the VIE and shift it into the WFOE, which is taxed at only 15%. Ideally a company will conduct as much operations allowed within its business scope in the WFOE.

The final step is the distribution of the WFOE's income to the holding company in the form of dividends. Since the holding company is located in a foreign jurisdiction this payment will be subject to a WHT at a rate of 10%.

Business Tax Issue

One of the major tax exposures concerns business taxation. Transactions within the VIE structure may potentially lead to a double taxation and consequently reduce the group’s overall profits. The primary issue lies within the technical services agreement and the intellectual property licence agreement that allow the transfer of the VIE's profits to the WFOE. From a tax perspective these arrangements are inefficient. VIE structures are confronted with the issue that BT liabilities occur twice, both in the operating entity as well as the WFOE.

In contrast, CIT applies to all business profits in the VIE and the WFOE. However, the VIE may deduct the fees and payments to the WFOE when calculating the business profits and thus the CIT so that only one layer of CIT occurs in a VIE structure (Ni & Jiang, 2012).

Compared with the CIT, a double layer of BT cannot be avoided within a VIE structure. Generally BT will be imposed if services are provided in China or rendered to recipients in China. The *Interim Regulations of the PRC on Business Tax* issued on December 13, 1993, provided that a service provider would only be subject to BT on taxable services that were provided in China. All services conducted by a foreign enterprise offshore would not be taxed in China. However, on December 15, 2008, the Ministry of Finance and SAT released revised *Implementation Rules for Provisional Business Tax Regulations*, thereby making some fundamental changes to the taxing principles of BT regulations. Under the new rules BT is levied regardless of where the service is actually rendered. As long as either the service provider or the service recipient is located in China, the service will be subject to BT (Asia Briefing Ltd., 2011).

In reference to the VIE structure both the VIE and the WFOE generate revenues which are generally subject to BT at a rate of 5%. These revenues derive from any form of licensing, provision of intangible assets or other technical services. On the one hand the VIE provides operational services to the end users. With respect to these services BT cannot be avoided. On the other hand the WFOE extracts ideally all of the VIE's operating profits through the technical services agreement. This agreement includes the licensing of technologies and patents as well as provision of technical services to the VIE. As a result fees and royalties that are transferred to the WFOE will be subject to BT too. Assumed that the WFOE and the VIE are one single entity, BT would only be imposed once. Thus this extra layer of BT is added on top of the BT levied on the VIE's revenues and equates the price to be paid for operating a business in China through a VIE structure. Di, Lai & Gong (2011) point out that "In order to establish a more "BT-effective" structure, the transactions concerned are often structured in a way that satisfies the BT exemption requirements or preferential BT treatment on the net (instead of gross) revenue. However, sometimes the way the transaction is characterized from a BT perspective may not reconcile with the transfer pricing structure."

Transfer Pricing Issue

Another problem arising within the VIE structure concerns the transaction prices between the VIE and the WFOE. Under the new CIT law and its supplementary implementation rules both entities may be treated as related parties and therefore subject to strict monitoring because of their contractual relationships. Chinese tax authorities have tightened scrutiny on transfer pricing, focussing on more complex transactions such as those involving IP and high value services (Di, et al., 2011). On January 8, 2009, the SAT issued the *Implementation Measures of Special Tax Adjustments (Provisional)* ("Circular 2"), which provide guidance on transfer pricing ("TP") enforcement and other so-called special tax adjustment provisions introduced in the CIT law. Circular 2 ascribes China's local and national tax authorities the right to adjust taxpayers' transfer prices to an arm's length level (Chi, Zhang & Ng, 2012). In order to evaluate the IP's and other intangible assets' value, taxpayers are obliged to provide tax authorities with necessary documents with regard to the nature of the business relations, determination of the approach to the key transactions, existence and valuation of the IP being transferred and sufficient substance to justify the new business model (Di, et al., 2011). Failure to comply may result in tax adjustments. Furthermore, China's TP regulations apply to all entities that fall within the definition of "related parties" (Chi, et. all, 2012).

Article 9 sets out rules on how to determine whether two parties are related. If two parties fall into one of the following eight categories they will be treated as related parties (2012):

(1) one party directly or indirectly holds 25% or more ownership in the other party, or 25% or more of the shares of both parties are directly or indirectly held by a third party;

(2) substantial inter-party loans;

(3) senior management personnel appointed by another enterprise (50% of senior management or one controlling board member);

(4) shared senior management personnel (50% of senior management or one controlling board member)

(5) control or dependency on other party's intellectual property or technical know-how;

(6) control over purchase and sales activities;

(7) control over services offered or received;

(8) other relations that involve actual control of the production, operation or transactions of the enterprise, or other affiliations in terms of interests, including relationships with family members or relatives.

Moreover, article 10 lists typical transactions occurring among related parties (KPMG, 2009b):

(1) The sale, purchase, transfer and use of tangible property;

(2) The transfer and use of intangible property, such as the right to use copyrights, patents, trademarks, client lists, marketing channels, brand names, business secrets, and proprietary technology;

(3) Financing, including all types of long-term and short-term loans and security;

(4) The provision of services, including management, administration, technical services, maintenance, consultancy, among others;

This regulation forms the basis on which entities within a VIE structure may potentially be classified as related parties. A closer look at the relationships between the VIE and the WFOE will reveal several congruencies with the criteria set forth in Circular 2. First of all most VIE structures have substantial management overlapping throughout the various entities. In fact the PRC founders often tend to manage the Chinese operating company while taking management positions in the WFOE and the listed holding company. Secondly, there is usually a strong relationship between the WFOE and the VIE with respect to IP. While the VIE holds the necessary operating licenses, the WFOE possesses key technologies, patents and trademarks among other things. Furthermore the various agreements that are in place between the parties depict the intense relationship. On the one hand specific agreements provide services in the form of consulting, management and administration; on the other hand they regulate interparty loans and give the listed company effective control over the domestic operating company. Last but not least, the Chinese authorities could perceive the VIE arrangements to be equivalent to direct or indirect ownership. It goes without saying that characteristics such as flow of funds and allocation of functions and risks vary among different companies and industries. However, it is most likely that transactions between the various parties will be treated as related party transactions.

Such a classification would lead to substantial TP scrutiny by tax authorities. In particular the prices agreed upon in the exclusive services agreement and the asset license agreement entered into between the VIE and the WFOE would need to be justified. The question surrounding this issue is whether or not tax authorities regard the payments of royalty fees and interest to be on an arm's length basis. In consideration of the purpose of the VIE agreements - to siphon ideally all of the VIE's operating profits and pass them on to the holding company - it becomes evident that the agreed prices and amounts of payments cannot be justified on an arm's length basis.

In order to investigate conspicuous pricing behaviour in related party transactions, respective companies need to disclose related-party transactions and provide PRC tax authorities with relevant information without refusal or concealment. Article 45 of Circular 2 clarifies that tax authorities may take transfer pricing tax adjustment measures should their investigation show that related-party transactions were not conducted in compliance with the arm's length principle (KPMG, 2009b). More specifically Article 41 of the CIT law provides that "As regards a transaction between an enterprise and its affiliated parties, in case the taxable revenue or income of the enterprise or its affiliated parties reduces by virtue of the failure to conform to the arm’s length principle, the tax organ may, through a reasonable method, make an adjustment. As regards the costs of an enterprise and its affiliated parties for jointly developing or accepting intangible assets, or jointly providing or accepting labour services, they shall, when calculating the taxable income amount, apportion them according to the arm’s length principle" (Order of the President of the People's Republic of China, 2007, p. 6).

However, there is one exception to TP requirements, mentioned in Article 30 of Circular 2. As long as transactions between domestic related parties whose effective tax burden is equal do not reduce the country's overall tax revenue, no transfer pricing investigation and adjustments will be carried out (KPMG, 2009b). Ni and Jiang (2012) point out that no clear definition of the term "effective tax burden" is given in Circular 2. While the income is taxed at a rate of 25%, the effective tax rate ("ETR") is calculated including a variety of tax breaks and losses on the ultimate tax amount. In order to determine whether a transfer pricing adjustment is necessary, tax authorities will need to calculate the ETRs of the involved parties both before and after the proposed transfer pricing adjustment.

The key challenge VIE structures face is to set transfer prices at a tax neutral level in order to avoid transfer pricing auditing. This, however, is contradictory with the aim of keeping the group as tax efficient as possible due to following reasons.

First of all, the primary target is to extract ideally all of the VIE's operating profits. The WFOE provides services such as consulting and technical support, as well as licensing intellectual property to the VIE, although this perhaps might not always happen on a level that justifies siphoning off all of the VIE's profits (Abrams, 2012).

Secondly, many companies operate in Internet related industries, which qualifies them as HNTE and consequently to a privileged CIT rate of 15%. This leads to further complications since different CIT rates within the VIE structure may lead to different ETRs and thereby exposes the group to transfer pricing risk (Di, et al., 2011).

A third challenge underlies the matter that entities are incorporated in different tax jurisdictions. In China different tax rates, levies or tax breaks occur among cities, regions and provinces. If the VIE and WFOE are incorporated in different jurisdictions this will add more complexity to calculating the ETR. All local tax authorities have the incentive to maximize the overall tax revenue within their administrative area. Under the provisions of the CIT law and its implementations rules, local and national tax authorities may take adjustment measures to a taxpayer's taxable income if the transactions do not comply with the arm's length principle or are executed without a bona fide commercial purpose (Deloitte, 2009b). Furthermore local tax bureaus may negotiate more appropriate allocation of CIT rates between them. Consequently the profit flow from the VIE to the WFOE would be harmed in a way that residual profits remain in the VIE.

Notwithstanding these obstacles, the group needs to maintain its focus on passing on all of the VIE's operating profits to the listed holding company so that it can be consolidated successfully. Should tax authorities deem the payments under the technical services agreement as non-compliant with the arm's length principle, they could step in and disallow some of these payments. Consequently the VIE would not be able to claim a deduction on the full technical services payments and the residual profits would be subject to CIT at a rate of 25%. This situation raises a whole new issue: How are residual profits removed from the VIE without causing an exorbitant tax liability?

Chapter 7: Removing Residual Profits

Another major issue to which little attention has been paid so far, relates to the risk of an exorbitant tax liability that may occur within the VIE structure. Some industry experts have argued that the structure is inefficient with regard to its taxation. However, not much research has been conducted in this field because the majority of companies have avoided addressing this issue until the present day.

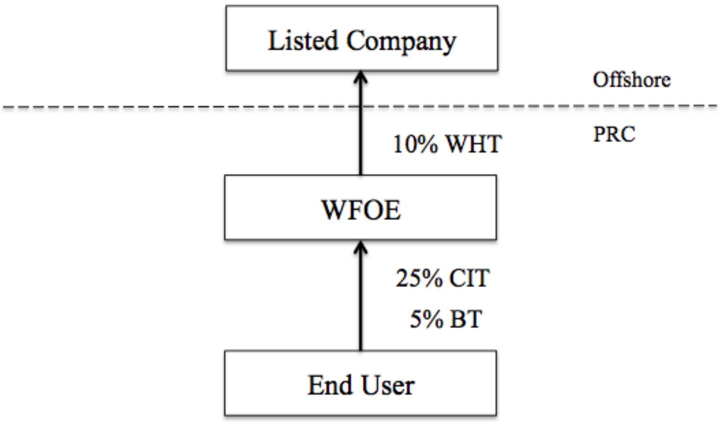
This chapter presents a case study of different scenarios that generate different tax liabilities depending on the way of cash flows, the number of entities involved and especially the tax authorities' treatment of the transfer pricing issue. This case study has the following objectives: First, it shows that the VIE structure is tax inefficient compared to its alternative - an offshore structure using only a WFOE. Second, it highlights the potential risk of an exorbitant tax liability, if the VIE's profits are transferred to the listed holding company by means other than the technical services agreements.

In order to illustrate the inherent tax risks better, four scenarios will be presented. The first scenario assumes a basic offshore structure, merely including the listed offshore holding company with a WFOE located in China. The second, third and fourth scenarios include a VIE in the structure, demonstrating alternative cash flows, ranging from the most preferable scenario to the worst case scenario. In order to make these scenarios comparable, revenues of RMB 1 million are assumed. Furthermore, the model disregards the possibility that the WFOE or the VIE potentially may be classified as HNTEs and thereby enjoy a preferential CIT of 15%.

Scenario 1

The basic setup (Figure 3) used by the majority of Chinese companies listed on foreign stock exchanges consists of a holding company incorporated in a foreign jurisdiction and a WFOE that is located in the PRC. The WFOE holds all necessary operating licenses and provides services to the end user. Proceeds derived from such services are subject to BT and CIT at the WFOE level. In addition, income that is distributed to the listed holding company will be subject to WHT.

Figure 3
Offshore holding structure: Scenario 1



Source: Own creation

Earnings of RMB 1,000,000 at the WFOE level will create RMB 50,000 BT liability and RMB 237,500 CIT liability. The net income will be distributed to the listed company. Since this entity is located offshore another RMB 71,250 will need to be withheld by the WFOE. As a result, the group's overall tax liability amounts to RMB 358,750, which resembles an ETR of 35.88% (Table 5).

Table 5
Scenario 1: *Listed Company & WFOE*

WFOE:		
Earnings before tax		1,000,000
	5% BT	-50,000
Net taxable income		950,000
	25% CIT	-237,500
Net income distributed to ListCo as dividend		712,500
ListCo:		
Earnings before tax		712,500
	10% WHT	-71,250
Net income		641,250
	ETR	**35.88%**

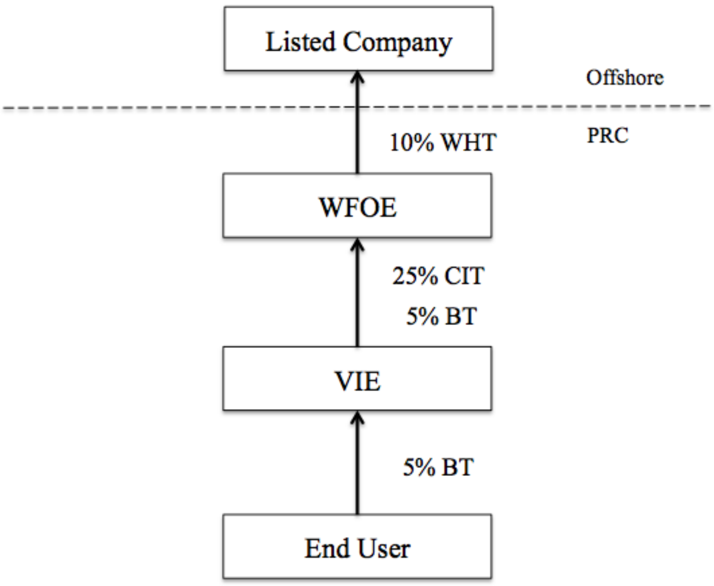
Source: Own creation

Scenario 2

Once a VIE is required to run China operations, the tax structure becomes more complex. First, it will be assumed that the structure functions perfectly. All proceeds from the VIE are paid to the WFOE as technical services fees. The VIE is assumed to receive a full tax deduction on these payments, so that no CIT occurs in the VIE and earnings will only be subject to BT. As soon as these payments are received by the WFOE, CIT is levied on top of another layer of BT. Finally, WHT is imposed on dividends distributed to the listed holding company.

The following diagram (Figure 4) depicts the archetypal VIE structure. It can be observed that a second layer of BT is included in the structure, which makes it slightly less efficient than the offshore structure without the VIE as described in scenario 1.

Figure 4
VIE structure: Scenario 2



Source: Own creation

In this scenario, earnings of RMB 1,000,000 occur at the VIE level creating RMB 50,000 BT liability. The revenue of RMB 950,000 is paid to the WFOE as technical services fees for which the VIE receives a full tax deduction. Consequently the VIE has no income and pays no CIT. At the WFOE level another RMB 47,500 BT plus RMB 225,625 CIT will be subtracted. The last step of distributing the income to the offshore holding company creates a RMB 67,688 WHT liability so that the group's overall tax liability amounts to RMB 390,812, which resembles an ETR of 39.08% (Table 6).

Table 6
Scenario 2: *Listed Company, WFOE & VIE*

VIE:		
Earnings before tax		1,000,000
	5% BT	-50,000
Net taxable income		950,000
paid to WFOE under technical services agreements		
WFOE:		
Earnings before tax		950,000
	5% BT	-47,500
Net taxable income		902,500
	25% CIT	-225,625
Net income		676,875
distributed to ListCo as dividend		
ListCo:		
Earnings before tax		676,875
	10% WHT	-67,688
Net income		609,188
	ETR	**39.08%**

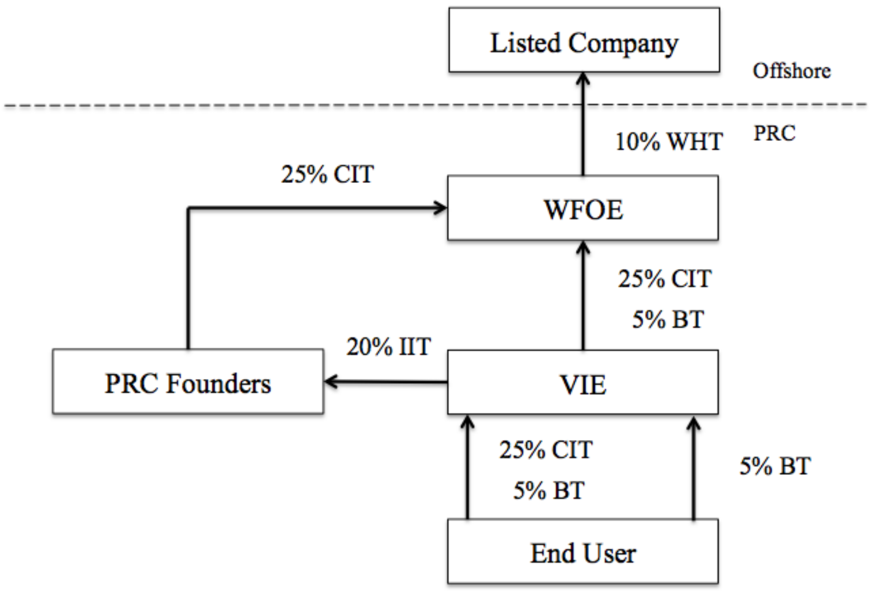
Source: Own creation

Scenario 3

The second scenario including a VIE in the structure assumes that Chinese tax authorities disallow half of the technical services payments under the TP regulations (Figure 5). Therefore the VIE only receives a tax deduction on 50% of the payments to the WFOE. These payments will be taxed the same way as described in scenario 2. On top of the BT at the VIE level, the WFOE pays an additional layer of BT as well as CIT. The other 50% of the payments to the WFOE may be recharacterized as dividends to the VIE shareholders, which in turn contribute the money to the WFOE. However, this procedure has many downsides and creates a lot of tax liabilities. First of all, income that cannot be declared as technical services fees and for which no tax deduction is achieved will be subject to CIT at a rate of 25% in the VIE on top of the 5% BT. In a second step, the income is distributed to the individual shareholders as a dividends. Once they receive the dividend they will be subject to Chinese IIT at a rate of 20%.

At last the shareholders hand the payments over to the WFOE. This payment will likely be classified as interest, since the WFOE has granted the shareholders loans in order to provide the VIE with capital. However, if this contribution is characterized as interest on the loan, the individual shareholders will not get a deduction on the IIT. Taken together, this alternative leads to three different tax payments on the same amount. The last step of distributing dividends to the listed company remains unchanged and creates a 10% WHT.

Figure 5
VIE structure: Scenario 3



Source: Own creation

As with scenario 2, the VIE earns RMB 1,000,000, which creates RMB 50,000 BT liability. The revenue of RMB 950,000 is handed over to the WFOE. However, due to the transfer pricing issue, the VIE only receives a tax deduction for half of the payments. Consequently, RMB 425,000 is paid as technical services fees to the WFOE creating another RMB 23,750 BT liability. The remaining RMB 425,000 generate RMB 118,750 CIT liability at the VIE level. The net income of RMB 356,250 is distributed as dividend to the individual shareholders, for which they pay RMB 71,250 IIT. At the WFOE level further RMB 184,063 CIT will be subtracted. The last step of distributing the income to the offshore holding company creates a RMB 55,219 WHT liability so that the group's overall tax liability amounts to RMB 503,031. This resembles an ETR of 50.30% (Table 7).

Table 7

Scenario 3: *Listed Company, WFOE & VIE*

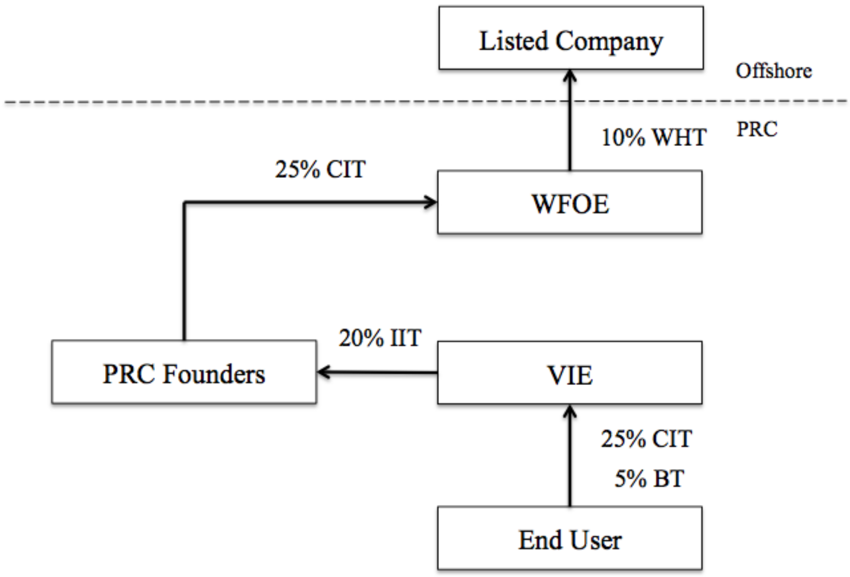
VIE:		
Earnings before tax		1,000,000
	5% BT	-50,000
Net taxable income		950,000
50% of net taxable income paid as technical services fees to WFOE:		475,000
50% of net taxable income subject to CIT		475,000
	25% CIT	-118,750
Net income		356,250
dividended to shareholder at 20% IIT		
	20% IIT	-71,250
Interest on loan		285,000
WFOE:		
Earnings before tax		475,000
	5% BT	-23,750
Interest on loan		285,000
Net taxable income		736,250
	25% CIT	-184,063
Net income		552,188
paid to ListCo as dividend		
ListCo:		
Earnings before tax		552,188
	10% WHT	-55,219
Net income		496,969
	ETR	**50.30%**

Source: Own creation

Scenario 4

The fourth and last scenario (Figure 6) assumes that Chinese tax authorities disallow all of the payments conducted under the technical services agreements due to their non-compliance with the TP regulations. In this case the VIE gains no tax deduction on its income and therefore pays 25% CIT on top of the 5% BT on all of its proceeds. In a second step, the VIE distributes its profits to its shareholders, which will be subject to 20% IIT on the dividend. Once the shareholders have transferred the money to the WFOE, a second layer of CIT at a rate of 25% will be levied before the profits are dividend to the listed company, who is subject to 10% WHT.

Figure 6
VIE structure: Scenario 4



Source: Own creation

Compared to scenario 3, this alternative creates a significant higher tax liability at the VIE level. While BT remains the same at RMB 50,000, the CIT liability increases to RMB 237,500. Additionally, the PRC founders will pay RMB 142,500 IIT on dividends received from the VIE and contribute RMB 570,000 to the WFOE. At the WFOE level, this income will create another RMB 142,500 CIT liability before it finally is subject to RMB 42,750 WHT. In total the group's tax liability amounts to RMB 615,250, which resembles an ETR of 61.53% (Table 8).

Table 8

Scenario 4: *Listed Company, WFOE & VIE*

VIE:		
Earnings before tax		1,000,000
	5% BT	-50,000
Net taxable income		950,000
	25% CIT	-237,500
Net income dividended to shareholder		712,500
	20% IIT	-142,500
Interest on loan		570,000
WFOE:		
Net taxable income		570,000
	25% CIT	-142,500
Net income paid to ListCo as dividend		427,500
ListCo:		
Earnings before tax		427,500
	10% WHT	-42,750
Net income		384,750
	ETR	**61.53%**

Source: Own creation

Comparison of Findings

This case study illustrates the wide range of outcomes that can occur in the taxation of VIE structures. The four scenarios depict different tax liabilities that accrue within diverging VIE structures. This highlights the tax consequences of transferring residual profits to a listed holding company by means other than the technical services agreements. Compared to the offshore holding structure without a VIE, all other scenarios are inferior and exhibit a significant higher tax liability. While scenario 1 has the lowest ETR of 35.88%, scenario 4 presents the highest ETR of 61.53%. With 39.08%, scenario 2 features a slightly higher ETR compared to scenario 1. As pointed out earlier, this difference in ETR is the price to be paid when companies operate through a VIE. Taking a closer look at scenario 3, one will observe that the group's tax liability increases dramatically once parts of the technical services payments to the WFOE are disallowed under the TP regulations. Scenario 4 resembles the worst-case situation with an ETR of 61.53%, demonstrating the devastating tax risk inherent in the VIE structure.

These findings illustrate the high variability in the VIE structures' tax liabilities. First of all it can be observed that the VIE structure is tax inefficient and inferior to the offshore structure including only a WFOE. However, it is important to keep in mind that there is no single correct solution. Every company has its distinct characteristics resulting in different structural setups and cash flows, affecting its taxation accordingly.

Implications

In early 2012, Gillis and Öqvist (2012) conducted a study in which they analysed the VIE's residual profits of Chinese companies listed on NASDAQ and NYSE. Their analysis shows that the net income of VIEs range from 0% to 221% of consolidated net income, with a mean of 56%. These findings reveal the worrying fact about VIE structure that many companies hold significant assets in the VIE. As previously described, the technical services agreements are in place to ensure that the VIE's operating profits can be passed through the WFOE to the listed holding company. The right to receive those profits is a necessary precondition for the listed holding company in order to consolidate the VIE. These data, however, point to another issue. The contracts grant the WFOE the right to extract the VIE's profits, but it seems as though the majority of WFOEs do not actually obtain them. This means that contracts are drawn up without actually being met and the question arises why the profits are not disbursed to the WFOE.

There are two possible scenarios that explain this behaviour. On the one hand, some companies might not be willing to make the payments under the VIE arrangements because they would be subject to a second layer of BT at the WFOE's level. However, this argument is invalidated by any other alternative because this additional tax payment, after all, represents the most effective method to transfer income to the holding company. On the other hand, companies are concerned about the transfer pricing risk, fearing that tax authorities might disallow parts of the payments to the WFOE under the technical services agreements. Consequently, the VIE would not be able to claim a tax deduction on the full technical services payments because they might not be considered a reasonable expense by tax authorities. As a result the company's ETR could swell to a maximum of 61.53%.

The results of Gillis and Öqvist's (2012) analysis suggest that many companies do not appear to be willing to take the TP risk. Instead, they are ignoring the VIE agreements and refuse to distribute the VIE's income to the WFOE, leaving the money in the VIE. However, this creates another risk: The alternative way to extract the residual profits leads through the VIE shareholders thus creating a substantial tax expense. Therefore, the question arises whether these companies ever intend to distribute those profits. Do investors really have an interest in the residual profits of the VIE if there is no intent to ever distribute them and no effective means to do so? Thus, this undermines the whole argument of a VIE and questions the fact, if the VIE can further be consolidated if the holding company does not receive the residual profits.

Chapter 8: Conclusion

This study deals with an important sub-area of China's financial markets. It shows that China's rapid transition from a centrally planned economy to a market economy led to many opportunities, but also nurtured certain issues. The fundamental economic reforms with China's opening up to foreign investment in the late 1970s initiated the emergence of a private economy, which rapidly out-grew the other sectors. However, private enterprises were confronted with many barriers. While China's stock exchanges were set up to reform and provide state-owned enterprises with capital, institutions to facilitate private enterprises were not initiated in time. In their need for necessary growth funding, entrepreneurs turned to foreign investors. To circumvent foreign investment restrictions, lawyers and accountants created the VIE structure.

Over the past decade, the VIE structure has served its purpose to gain access to foreign capital, resulting in the growth of many innovative companies and technologies as well as employment and consumption all over the world. However, a trinity of regulatory, structural and tax risks accompanies the VIE structure, leading to enormous uncertainties for investors and entrepreneurs.

First, the Chinese government retains discretionary power to restrict or prohibit the VIE structure at any given time. The question surrounding this issue is, whether this investment structure is actually legal. So far it may seem as though the authorities have tacitly approved the use of the VIE structure in certain sectors. There has been no clear indication that the Chinese government will expressly ban the general use of the VIE structure; however, there have been individual cases of local authorities declaring VIE agreements to be illegal. Until the present day it remains unclear on what basis this discretionary power relies upon. In any case, the status quo seems to play into the Chinese government's hands. This structure allows businesses to raise necessary funding abroad, whilst the government retains control over foreign investments. In the case that a specific company is considered to be sensitive to China's national security, regulatory authorities may close down their operation by disregarding their contractual agreements and thereby avoid the prohibition of the entire VIE sector. Therefore, it remains to be seen how the government's attitude towards VIE structures will develop so that enterprises continue to operate in a grey area of PRC law.

Second, the shareholder risk rests upon the fact that the listed holding company does not have equity ownership in the VIE, but rather controls it and is entitled to its residual profits through contractual agreements. These contractual agreements pose a tremendous risk to the VIE structure. The VIE founder and shareholder could be motivated to breach the VIE agreements and walk away with the domestic company, the necessary corporate chops and operating licenses. Notwithstanding the fact that all contractual safety measures were drawn up to guarantee the holding company the rights to the equity interest of the VIE, these contracts will most likely be found unenforceable by a PRC court, since their main purpose is to circumvent PRC regulations on FDI restrictions. The recent case of GigaMedia has demonstrated the investors' inability to claim their rights to the VIE. Hence, as long as China maintains FDI restrictions in certain sensitive industries, foreign investors will need to carefully evaluate the corporate structure of their investment in order to reduce this uncertainty.

Third, the VIE structure turns out to be inefficient from a tax perspective. However, it seems as though this issue has largely been ignored or underestimated by companies and investors. While many enterprises have made changes to their corporate structures to withstand increased anti-tax avoidance scrutiny, a significant tax risk is concealed within the VIE structure. The results of this paper's scenario analysis suggest that a severe tax liability may occur as soon as the residual profits are transferred to the WFOE as technical services payments.

In order to mitigate these risks, investors need carefully evaluate the various factors that can adversely affect their investment and take special precautionary actions. On the one hand, investors should aim at reducing the risk of losing control over the VIE. Possible actions include the alignment of interests between the VIE shareholders and the shareholders of the publicly listed company; the diversification of equity interest in the VIE among shareholders; ensuring that all contractual agreements are in order and enforceable; and last but not least, the investors may tighten the monetary leash on the VIE. Without necessary capital, the VIE shareholders will unlikely be motivated to walk away with the VIE. On the other hand, investors need to consider additional tax liabilities that may incur due to the risk of TP adjustments. These costs may not have been fully appreciated by investors so far, although valuation discounts have taken place over the last year due to the decline of the market. Thus, investors need to pay more attention to the problem of TP and the future developments of China's enterprise tax system.

The current debate about VIE structures in China is just the tip of the iceberg. The real problem lies within the development of China's capital market. Reforms need to take place in order to facilitate private enterprise with capital. A successful step in this regard was the establishment of ChiNext in Shenzhen and its continued success to date. Despite this, further reforms are required. First of all, private enterprises need better ways to raise necessary growth funding. To make this possible, the government needs to reduce the regulatory red tape and make direct listings on overseas stock markets easier without the use of an offshore holding structure. Secondly, companies need more efficient structures in order to be able to operate competitively on an international level. This, however, requires drastic policy solutions, which can only come along with ideological change. The government needs to realize the fact that significant foreign investment already exists in China's sensitive industries. Instead of pretending to forbid FDI in these sectors, it should find ways to encourage FDI, provided the necessary safeguards are implemented to protect the national security. An example of such safeguards would be policy prescriptions that require companies to have a Chinese board of directors and a Chinese Chief Executive Officer. The approval of FDI would in turn reduce the risks and uncertainties surrounding foreign invested firms and make these more attractive to investors.

In summary, the VIE structure as it currently exists, contains too many risks and uncertainty for all stakeholders, and is an inefficient way for Chinese enterprises to raise necessary capital.

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Statement of Candidate

I certify that this bachelor thesis entitled *Tax issues and legal obstacles Chinese companies face when seeking to capitalize overseas using a variable interest entity structure* has not previously been submitted for a degree nor has it been submitted as part of requirements for a degree to any other university or institution other than Zeppelin University.

I also certify that the thesis is an original piece of research and it has been written by me. Any help and assistance that I have received in my research work and the preparation of the thesis itself have been appropriately acknowledged.

In addition, I certify that all information sources and literature used are indicated in the thesis.

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