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Outbound Investment Planning: Be Cautious about Tax Evaluation

By David Yu and Clare Lu

The PRC enterprises have seen their opportunities to go globally during the world financial tsunamis that broke out in 2008. Since 2009, outbound investments in the forms of new establishments or mergers and acquisitions ("M&As") have become prevailing methods for the PRC enterprises to "go abroad". Before making such investment decisions, with reference to the cross-border investment experience of foreign investors and precedents in outbound investments by domestic enterprises, Chinese enterprises shall not only study the investment environments of the invested country (region) (the "Host Country") and the transaction structures, but also make overall tax evaluation and planning for the outbound investment. This article is prepared to discuss briefly on major tax issues in relation to the new establishment or M&A of a foreign company (the "Target Company") by a PRC enterprise through an outbound intermediate shareholding company (or "SPV") based on the PRC tax laws, regulations, and relevant double taxation treaties and arrangements (the "DTTs").

Pre-conditions for Cross-border Tax Planning – Familiarity with PRC Tax Incentives and Preferential Treatments

In terms of income tax, under the current PRC CIT laws and regulations, dual jurisdictions of individual and local administration of Corporate Income Tax (the "CIT") can be seen to obtain the jurisdiction of ownership of investment returns from both the SPV and the Target Company (in certain circumstances). Under the prevailing PRC CIT regime, the following policies regarding tax credit for overseas investment return, special tax treatment for restructuring, interim preferential treatments and local fiscal support are worth our attention:

Basis and Core for Cross-border Tax Planning – Making full use of tax treaties and Controlling Tax Risk

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Risk control is vital to any outbound investment/transaction structure. When discussing an SPV structure, the PRC enterprises shall focus on the following risks:

- Pay close attention to differences between DTTs

  Until now Mainland China has signed DTTs with over 90 countries (regions) including Hongkong and Macao. The DTTs signed by the Mainland China are generally written based on the OECD or United Nations models, but the clauses are not the same. PRC enterprises should pay close attention to the special provisions of the DTTs between Mainland China, the country/region where the SPV is situated and the Host Country, in order to avoid double taxation:

- Offshore registered PRC tax resident rule is a "Double-edged Sword"

  As set out under the CIT Law and its DIRs, an enterprise that is established under the law of a foreign country/region but with effective management place in China will be treated as a PRC tax resident, and should pay CIT on its China together with foreign income. Accordingly, if an SPV is registered offshore but is effectively managed in China, such SPV will be regarded as a tax resident for PRC CIT purposes. In such regard, the PRC enterprise should compare the overall tax burden under the situations that the SPV is identified as a PRC tax resident before making outbound investment decision.

- Avoidance of controlled foreign company

  According to the CIT Law and its DIRs, if a resident enterprise or an enterprise of a country (region) controlled by a resident enterprise or Chinese resident with actual tax burden of less than 12.5% that does not distribute profits or reduces its profits distribution without rational business needs, the portion of the undistributed profit that should be allocated to the PRC tax resident enterprise shall be included in the PRC tax resident's taxable income in the corresponding period. PRC enterprises therefore should properly structure their outbound investments and focus on the reasonable commercial purposes for the set up of SPV to eliminate the potential risks that the SPV be treated as a controlled foreign company.

- Be careful of transfer pricing issues

  Transfer pricing matters have been under close scrutiny in many countries/regions in recent years. The *Implementation Regulations on the Special Tax Adjustments* (Trial Implementation) elaborate on a number of relevant issues, including affiliated transactions, arm's length principle, preparation of documentation of the same period, advanced pricing arrangements, cost sharing, etc. Most of the stipulations are made with reference to the international practice. PRC enterprises are recommended to refer to related legal documents before going abroad and make sure that they are in compliance with laws and regulations of both PRC and the Host Country and related prevailing practices, so as to avoid potential tax risks.

It is reported that the PRC government will issue more tax rules to stimulate outbound investment. PRC enterprises should maintain a close contact with tax professionals, from both PRC and the Host Country, to get to know the business environment and the relevant tax laws and regulations in related countries; and based on which to properly structure their investment/transaction, operation, and existing strategy.

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