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Issues on PRC Company's IPO at A-share Market under Red-chip Structure

By Christophe Han, Wayne Chen and Patrick Chen

The structure, under which an offshore listed company is controlled by a PRC company or PRC resident while its substantial assets are located in PRC, is initially selected by PRC state-owned enterprises as a listing structure, therefore, the said structure is called "red-chip structure". As a common practice, in order to satisfy China Securities Regulatory Commission (CSRC)'s regulatory requirements, before a PRC company under the "red-chip structure" is listed at PRC A-share market, the de facto controller or the major shareholder of the company to be listed shall transfer to himself or a resident company controlled by himself, all or part of the company's equity controlled by the offshore company. The aforesaid equity transfer is called as "return of red-chip".

Based on our experiences of securities market, regarding company's IPO under a "red-chip structure" at the domestic A-share market, the following major legal issues shall be considered:

➢ Registration under Circular 75

Pursuant to the "Circular on Issues Concerning Foreign Exchange Administration of the Domestic Residents Financing or Round-Trip Investment through Special Purpose Overseas Companies" (Circular 75) issued on 21 October 2005 by the State Administration of Foreign Exchange (SAFE), a company to be listed offshore under the "red-chip structure" shall complete corresponding registration with SAFE according to its offshore equity structure and financing plan. If the foreign exchange registration, including the registration for the following equity changes, must be performed according to Circular 75, we advise that the PRC resident holding the offshore equity under the "red-chip structure" shall complete the foreign exchange registration according to Circular 75 prior to the company's domestic IPO application.

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- Tax preference for the company to be listed at A-share market

According to the "Provisions on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors" (Provision 10) issued on 8 August 2006, where a domestic company, enterprise or individual acquires a related domestic company through an offshore company controlled by itself, the foreign-invested enterprise trans-formed from the domestic company in the aforesaid manner shall not enjoy tax preference as a foreign-invested enterprise, therefore, the company trans-formed to a foreign-invested enterprise in the manner as provided under Provision 10 after the effectiveness of Provision 10 shall not enjoy the tax preference as a foreign-invested enterprise, unless the increased capital by an offshore company exceeds 25% shareholdings of the domestic company.

- Equity transfer price concerning "return of red-chip"

On 10 December 2009 the State Administration of Taxation issued the "Notice of the State Administration of Taxation for the Administration of Corporate Income Tax on the Income from Equity Transfer by Non-resident Enterprises" (Notice 698) which was effective 1 January 2008. According to Article 7 of Notice 698, where a non-resident enterprise transfers its equity in a PRC resident enterprise to its related parties and the transfer price does not satisfy the arm's length principle resulting in reducing the amount of taxable income, the tax authority shall be entitled to make adjustments with reasonable methods. Therefore, the taxable income of any equity transfer in the "return of red-chip" shall be determined and calculated based on a fair transfer price according to the arm's length principle, and, in practice, we advise that such company shall collect full and complete evidences for the calculation basis of the equity's fair value and may seek tax authority's advice if necessary.

- Investors' contractual rights under the "red-chip structure"

As a common practice under the offshore listing structure, under the offshore investment contracts or the similar legal documents some special clauses concerning investors' special rights before or even after listing will be stipulated between investors and PRC resident individuals, such as the clauses of call option, put option, dividend preference, liquidation preference, preemptive right, redemption right, and price adjustment arrangement.

As there are few provisions concerning aforesaid arrangement of special preferential rights under PRC law, and any arrangement resulting in future changes of shareholding structure of the company to be listed, such as put option, call option, redemption right and preferential right, will cause uncertainty of the shareholding structure of the company to be listed during the listing application period, for the purpose of share offering and listing at the A-share market, we advise to change the aforesaid arrangement during the "return of red-chip". In addition, as equity changes in the foreign-invested enterprise are subject to approvals of department of commerce and investment policies concerning foreign investment amended from time to time, if any party breaches the closing provision with conditions precedent, such as a closing subject to approvals of or registrations with corresponding authority, the defaulting party will only bear the breach or indemnification liability under the contract, while maybe such provision will not be enforced to fulfill the final closing under PRC law.

- Employee stock incentive plan

  As a common practice, most offshore companies to be listed will make conditional employee stock incentive plan. The options under the aforesaid plan may be executed before or after an offshore company is listed.

  If any company that planned for offshore listing decides to conduct "return of red-chip" for A-share market listing, considering the substantial differences between the regulations concerning stock incentive plans for listed companies and unlisted companies, as the practice of listing at the A-share market, it is not permitted to make an employee stock incentive plan before A-share market listing, under which the employees may have share options that may be executed after listing. Therefore, the offshore employee stock incentive plan under a "red-chip structure" shall not be entirely copied to the PRC domestic company after "return of red-chip", and the offshore employee stock incentive plan shall be amended according to the conditions of domestic company, e.g. employee stock incentive plan may be canceled or be accelerated for execution in order that the company to be listed at the A-share market may have a certain shareholding structure.

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