China and Hong Kong
Tax and Regulatory Update

Newsletter Issue No. 7 (06/2013)

Trusts and China Business: Trusts in IPO Planning

Whilst trusts have been widely acknowledged as a useful tool for wealth planning for high net worth private individuals to gain tax advantages and anonymity, the most commonly adopted trust arrangements in pre-IPO planning typically involve family asset arrangements for major shareholders, incentive benefit plans for employees and divorce and matrimonial related arrangements.

MACRO-ECONOMIC ENVIRONMENT

Since January 2013, the China Securities Regulatory Commission ("CSRC") creates a more friendly regulatory environment for Chinese small and mid-sized companies ("SMEs") to float their business on overseas capital markets[1].

A Regulatory Guidance on Application Documents and Examination Procedures of Issuing Shares Abroad and Overseas Listing by Company Limited by Shares ("Guidance") relaxed various controls previously imposed on overseas IPO attempts by SMEs. The new rule is designed to replace the onerous financial qualifications imposed on overseas IPOs as set out in a CSRC circular issued in July 1999 ("Notice No. 83")[2]. The new rule lowers the threshold for Chinese enterprises to list overseas, reduced CSRC approval procedural steps with simplified documentation requirement[3].

Meanwhile on the China capital markets, the CSRC held a tough stance on insider trading and issuer and intermediaries' fraudulent acts relating to IPO applications on China's capital markets. The more rigorous IPO review procedure together with the new tightening legislative amendments have created a backlog of 800 firms waiting to list on the stock exchanges in China. It is reported that most of these are privately-owned SMEs[4]. As such, there is a huge, yet to be satisfied financing demand from Chinese companies.

The Guidance might be seen as an initiative by the Chinese government to promote and encourage Chinese companies to obtain equity financings from overseas markets.

The Guidance however, does not remove the approval requirement of CSRC and MOFCOM in an overseas IPO case, particularly in relation to the *Regulations Concerning Mergers and Acquisitions of Domestic Enterprises by Foreign Investors, Order [2006]*) No. 10 issued on 8 August 2006 (Circular 10)[5].

Interestingly, the move comes at a time when overseas investors become increasingly concerned about the quality of accounting at Chinese companies listed overseas, particularly in the US. The US Securities and Exchange Commission has charged the Chinese affiliates of five leading accounting firms with violating securities laws for refusing to produce paperwork related to investigations into accounting fraud at nine Chinese companies. The tension between both countries and the auditing firms has been rising as the SEC investigates potential fraud at China-based companies that list shares on US markets[6]. Many of the 400-plus Chinese companies that have listed in the US have been eyeing deals to privatize since a wave of short-selling attacks and broader concerns about the Chinese economy have hit the value of their shares.

According to statistics, since September 2012, 827 Chinese companies listed overseas had been delisted since 1990 from global stock markets outside mainland China. Analysts and investors say that tough listing and delisting criteria, and rigorous enforcement, are crucial to ensuring the quality of listed companies, but that has been difficult in China[7].

In Hong Kong, the Securities and Futures Commission wants to make sponsors of initial public offerings criminally liable for false information presented by companies they help to bring public. Under the plan, liability would depend on whether a sponsor "knowingly or recklessly approved a prospectus containing an untrue statement, which was materially adverse" for investors. The regulator wants to ensure that "Hong Kong's listed market remains a quality market" [8]. These new requirements, along with the proposed new code of conduct for sponsors, will apply to listing applications submitted on or after October 1, 2013[9].

Against a backdrop of tougher global market regulations and strict enforcement, founders of Chinese companies thinking of listing their companies abroad should pay particular attention to regulating their accounting systems, improving their corporate management structures and information disclosure systems.

Provided that said practices are established well before the company plans to list, China entrepreneurs should consider the beneficial use of trusts in the context of an initial public offering (IPO).

FAMILY ASSET ARRANGEMENTS

Traditionally, trust has been an unattractive vehicle to hold long-term assets which require trustees to monitor and intervene in the affairs of underlying companies. There is an important dilemma between the prudence required of trustees and the necessity of quick decision-making required to run a successful business and hence the accompanying potential liabilities which trustees are exposed to.

On the other hand, the settlor, usually the owner of the controlling block of shares in the company, is most concerned about the security and controllability of their assets.

In theory, as soon as the trust is created and constituted, the role of the settlor disappears. He has transferred legal ownership of the trust property to the trustees and surrendered dominion and control over it. The settlor may very well have established a catalogue of terms in the trust deed which bind the trustees and govern how they are to hold, manage and dispose of the trust assets. However, he no longer has a say in the management and disposition of those assets. These have aroused most attention and doubts under the civil law system. People believe that once the trusts are established, legal ownership will be passed to the trustees. The key to ease the settlor's concerns is the selection of an appropriate form of trust and hence, the selection of jurisdictions with relevant trust laws.

Choice of Jurisdictions

Amongst the array of jurisdictions available, the British Virgin Islands and Cayman Islands could be viable options for the wealthy settlor or entrepreneur who needs the added comfort of greater flexibility.

British Virgin Islands (BVI)

A VISTA trust created under the Virgin Islands Special Trusts Act 2003 ("the Act") is a very effective tool for asset protection and succession planning. The Act permits the entire removal of the trustee's monitoring and intervening obligations. It also allows a settlor to specify rules for the composition of the board of the company and, hence to allow detailed succession planning in relation to it. These two features have rendered the VISTA regime significantly attractive by virtue of the considerable reservation of indirect settlor power.

The Act also provides that the trust instrument may include 'Office of Director' rules, specifying the manner in which the trustee must exercise its voting powers in relation to appointment, removal and remuneration of directors. There are provisions in the statute which enable beneficiaries and directors to apply to the court for enforcement of the Act terms.

BVI conflict of law provisions relating to trusts

Robust firewall provisions are in place that allow foreign nationals and domiciliaries to take advantage of the unqualified rule of freedom of testamentary disposition which applies in the BVI. The English Recognition of Trusts Act 1987, giving effect to the Hague Convention on Trusts and their Recognition, has been extended to the

BVI. Legislative rules[10] provide a comprehensive code of conditions of validity of transfers of property into BVI trusts where a foreign element is involved.

Proposed Legislative Amendments

VISTA trusts are a key component of the BVI's trust industry. In a move to further enhance the competitiveness and consolidate BVI's popularity as a jurisdiction of choice, the BVI government has recently, on 18 April 2013 gazetted important amendments to four pieces of trust legislation, one of which includes the Act.

A most notable proposed amendment is an increase in the potential use of Private Trust Companies (PTCs) and the increased flexibility of the VISTA regime. Under the new proposals, a BVI PTC would be able to act the trustee of a VISTA trust. This is to be applauded and will be welcomed by both settlors/families seeking to retain control and service providers without a BVI licensed trust company. Under the existing regime, the trustee of a VISTA trust must be a sole trustee and the holder of a trust licence under the Banks and Trust Companies Act, 1990. Pursuant to the amendment, a 'designated trustee' will include Class 1 trust licence holders and PTCs.

The amendments are not yet in force as they are presently undergoing a consultation process. Thus final enactments may be subject to change.

The Cayman Islands

The Cayman Islands may be another jurisdiction worth considering. Its legislative framework effectively confers considerable reserved powers onto the settlor under the Trusts (Amendment) (Immediate Effect and Reserved Powers) Law, now consolidated into the Trusts Law (2011 Revision) as Part III. Under section 14, the settlor of a trust may, without invalidating the trust or affecting the presumption of immediate effect, reserve to him or herself various powers affecting the trust including power to revoke, vary or amend the trust instrument, power to give binding directions (it may be via a management committee) to the trustee in matters of investment or, the investment function may be reserved and removed from the trustee's responsibilities and functions. Other reserved powers include the power to appoint, add or remove the trustee or beneficiaries.

The question about residual fiduciary duties on the part of the trustee, however, may arise. The trustee still has an obligation to oversee what a settlor or his designee does in managing the trust assets. This issue could be addressed by using a STAR trust pursuant to the Special Trusts (Alternative Regime) Law known as 'STAR'. STAR has now been incorporated into the Trusts Law as Part VIII.

Effect of foreign laws on Cayman trusts.

Any judgment of a foreign court which is inconsistent with provisions of the Trusts Law will not be recognized in the Cayman Islands. For instance, no Cayman trust and no disposition of property into a Cayman trust is void, voidable, liable to be set aside or defective in any fashion, nor is the capacity of the settlor to be questioned on the grounds that the laws of any foreign jurisdiction, do not recognize the concept of a trust or that it offends forced heirship laws which apply in the settlor's home jurisdiction.

The common features of the trust laws of the above jurisdictions lie in the separation of legal ownership of the trust assets from their control and from the economic enjoyment of the trust by the beneficiaries.

Corporate Re-Organization and Relevant Taxation Issues

In the course of designing appropriate corporate structures (typically double offshore corporate structures) and the resultant corporate reorganization in preparation for an IPO, complex taxation issues on PRC individual income tax, enterprise income tax and withholding tax inevitably arise. This article simply highlight a few tax laws, implementation rules and tax circulars that might present a myriad of tax issues relevant to the use of trust structures in IPO planning[11].

PRC Income Tax

Under the Enterprise Income Tax Law and its implementation rules that became effective on 1 January 2008 ('EIT Law'), non-tax resident enterprises without an establishment or place of business in the PRC are subject to withholding tax at the rate of 10.0% on various types of passive income, including rental income and capital gains, derived from the PRC.

Under the EIT Law, the standard income tax rate of 25.0% should be applied to foreign invested enterprises as well as PRC domestic enterprises, while dividends, interest and royalties earned after 1 January 2008 and paid by tax resident enterprises to non-tax resident enterprises will be subject to a 10.0% withholding tax, unless there is a tax treaty between the PRC and the jurisdiction in which the overseas parent is tax resident, which specifically exempts or reduces such withholding tax.

Guoshuifa [2009] No. 601 (Circular 601) deals with the requirement in double tax treaties that the recipient of PRC sourced dividends, interest and royalties should have beneficial ownership over the relevant income to qualify for any preferential double tax treaty treatment.

On 12 April 2013, the Chinese State Administration of Taxation (SAT) issued *Circular Shuizonghan [2013] No.165 (Circular 165)* to clarify how local-level tax bureaus should assess beneficial ownership with respect to dividends under China's tax treaty with Hong Kong. Circular 165 further explains how to apply the 'unfavorable factor' tests provided in Circular 601, as well as interpretations of *Public Notice [2012] No.30* with respect to beneficial ownership assessments. The principles and guidelines presented in Circular 165 provide a useful reference guide for taxpayers in other jurisdictions that have similar tax treaties with China.

EIT Law on Controlled Foreign Corporation (CFC)

Chinese tax authority may tax the profits kept by a CFC incorporated in a jurisdiction with a tax rate of 12.5% or less without genuine reasons as taxable income of the TRE or Chinese Resident Individual[12].

PRC Tax Reporting Obligations and Consequences for Certain Indirect Transfers of Equity Interests

Pursuant to the 'Circular on Strengthening the Administration of Enterprise Income Tax for on Gain Derived from Equity Transfer Made by Non-Resident Enterprises issued by the PRC State Administration of Taxation ('SAT') on 10 December 2009 (Guoshuihan [2009] No. 698) ('Circular 698') and the 'Announcement Regarding Several Issues on the Administration of Non- Resident Enterprise Income Tax issued by SAT on 28 March 2011('Announcement 24'), where a foreign investor or effective controlling party transfers the equity interests in a PRC resident enterprise (excluding the sale of the shares of PRC resident enterprises on the public securities markets which were purchased from the public securities markets) indirectly by way of the sale of equity interests in an overseas holding company, and such overseas holding company is located in a tax jurisdiction which has either: (i) an effective tax rate lower than 12.5%; or (ii) no tax on foreign-source income, the Transferor should report such indirect transfer to the competent tax authority of the PRC resident enterprise within 30 days of the execution of the relevant equity transfer agreement[13].

The PRC tax authority will examine the nature of the indirect transfer, and if the PRC tax authority considers that the Transferor has adopted an abusive arrangement without reasonable commercial purposes to avoid Chinese withholding tax, the PRC tax authority may disregard the existence of the overseas holding company and re-characterize the indirect transfer. The transfer would then be effectively treated as a transfer of the equity of the PRC company and will trigger a 10.0% Chinese withholding tax on capital gains derived from the transfer[14].

EMPLOYEE BENEFIT TRUST (EBT)

Another important limb of trust arrangements in IPO planning is the initiation of a trust for the benefit of employees. Though employee benefit or incentive structures can be designed in a variety of ways, many of them are provided through discretionary trusts[15].

Where the company establishing the structure and settling the assets into the trust becomes the settlor, beneficiaries under the trust will comprise of current, future and ex-employees of the settlor company.

The rationale for establishing an EBT as part of these complex transactions is primarily to hold shares in the newly formed listed entity and for those shares to subsequently be used to provide tax efficient incentives for management.

The importance of the use of a discretionary trust is the fact that the settlor is an excluded person under the trust deed. This provides comfort to the beneficiaries who would otherwise be concerned in the event of liquidation of the settlor or the settlor's assets being subject to the demands of its creditors. Significant value in the settlor can be transferred to employees who have remained loyal and worked hard. It is not uncommon for an EBT to hold a majority and/or controlling stake in operating entities to ensure that a controlled level of influence is placed in the hands of management[16].

DIVORCE AND MATRIMONIAL ISSUES

A total of 2.87 million marriages in China ended in divorce in 2012, a 7.65 percent increase from 2011. Beijing leads the nation with the highest divorce rate at 39%. Shanghai closely follows at 38% and Shenzhen is third with 36%[17].

For couples contemplating marriage, Article 19 of the Marriage Law of the People's Republic of China 2001 recognizes pre-nuptial or pre-marital agreements which deal with the ownership of properties (real or personal) earned or acquired during or prior to the marriage, which can jointly or separately owned in whole or in part. Although prenups serve a certain purpose, if not done correctly, prenuptial agreements are open to challenges and may be held invalid.

In the absence of proper planning, all properties acquired by one spouse during their marriage will automatically turned into community property of the couple[18].

Instead of leaving decisions for the division of matrimonial property to the wide discretion of judges and the court system, trusts can be beneficially used in this regard, particularly for entrepreneurs planning an IPO where it is imperative for couples to clearly delineate their wishes with regard to their business interests, gifts, inheritances, income and other assets.

CONCLUSION

Trust involves long term arrangements and should be implemented early enough for the changes to take root in the organization and first and foremost, in the life of the founder of the business.

1. *International Financial Law Review*, 25 March 2013, 'CSRC's reforming chairman steps down'

2. Notice No. 83, Notice on Issues concerning Application for Overseas Listing by Enterprises promulgated on 14 July 1999

3. *Financial Times*, 21 December 2012, '*China relaxes rules for overseas IPOs*'

4. *Financial Times*, 21 February 2013, '*Hong Kong pinning hopes on IPO surge*'

5. Detailed discussions on the regulatory impact and tax implications of Notice No. 83 and Circular 10 are outside the scope of this article

6. *Financial Times*, 3 December 2012, 'Audit firms face SEC China crackdown'

7. *The Wall Street Journal*, 20 March 2013, ' Delisting in China "Exists in Name Only“'

8. *Reuters*, 12 December 2012, ' HK watchdog proposes tough new rules for IPO sponsors'

9. *Financial Times*, 12 December 2012, ' Hong Kong tightens IPO rules for banks'

10. Section 83A of the Trustee Ordinance (originally enacted in 1961) and now referred to as the Trustee Act

11. Detailed discussions on China tax legislation and accompanying implementation rules as well as all regulatory procedures relevant to an IPO are outside the scope of this article

12. Article 45 of the EIT Law. Definition of a 'Controlled Foreign Corporation' is set out in Articles 117(1) & 117(2) of the Detailed Implementation Rules of the EIT Law

13. Article 5 of Circular 698

14. Article 6 of Circular 698

15. A different trust from the one established by the founder or major shareholder of the company

16. A detailed discussion of the many forms of EBT is outside the scope of this article

17. A 2012 Survey by Tsinghua University. *International Business Times,* 25 June 2013, 'China's Divorce Rate Rises For Seventh Consecutive Year'

18. Article 17 of the Marriage Law of the People's Republic of China 2001

Author: STELLA TONG

This newsletter is contributed by the HKTA/STEP Joint Sub-Committee for China Development.
Members include:
Michael Shue (Chairman)
Thomas Lee
Patrice Marceau
Todd Beutler
Ophelia So
Fanny Wong
Alexandra Or
Cathy Pang
Vienne Cheng
Stella Tong