STEP Hong Kong ADVISING FAMILIES ACROSS GENERATIONS
Trustee 香港信託人公會 Hong Kong Trustees' Association

China and Hong Kong
Tax and Regulatory Update

Newsletter Issue No. 11 (12/2016)

Management and control of offshore entities by PRC residents

In recent years we find more PRC residents coming to Hong Kong to form offshore entities or establish family trusts. Many of these PRC residents want to be shareholders and directors of the offshore entities and be involved in one way or another in the family trusts. There are concerns that such entities might be exposed to Chinese tax law by reason that they are managed and controlled by PRC residents. Richard Grasby and I did a seminar to try to address the issue and concern. The following is a summary of our presentation at the seminar.

1. What is a PRC resident?
It is necessary to refer to the PRC Personal and Corporate Income Tax Laws and their implementation rules for an answer.

Individual
By reason of "household registration, family or economic relationship", an individual who lives abroad and who must return to China due to aforesaid connections, is regarded as being usually resident or domiciled in China (not including Hong Kong, Macao or Taiwan).

Expatriates who have lived in China for more than five full consecutive years are regarded as PRC residents.

An individual expatriate living in China means in a tax year spent 365 days in China without having been absent from China for (i) 30days in a single trip, or (ii) a total of 90 days or more within a tax year.

Enterprise
A resident enterprise is an enterprise established in China, or an enterprise that is formed outside of China but its effective management or control is within Mainland China.

2. What is Management and control?
Effective management means actually and comprehensively manages and controls the production, staff, finance and property of the enterprise. It is a question of facts and degree.

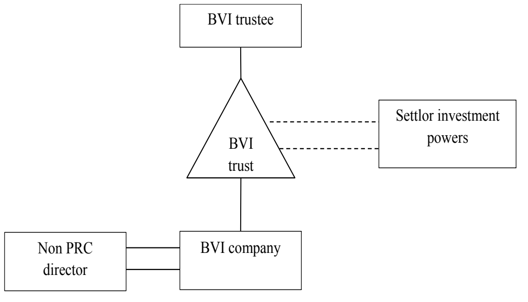
3. Is there PRC corporate income tax exposure if the offshore entity owned by a PRC resident?
The exposure to PRC corporate income tax arises if the effective management of the offshore entity is located in China. It does not matter who owns the entity and whether the effective management is conducted by one or more PRC residents. It is a situs test. The effective management of an offshore entity within China could have been conducted by the staff and senior management of the entity, not by its directors, yet exposing the entity to PRC corporate income tax.

It means that an offshore entity owned directly or indirectly by a foreign trust may have PRC corporate income tax exposure if the effective management of the offshore entity is conducted in China. The fact that it is owned by a trust would not help to eliminate the exposure.

4. Tax treaty protection against PRC Corporate Income Tax exposure
Offshore jurisdictions such as Cayman, Bahamas, BVI and Bermuda do not have a comprehensive tax treaty with China to provide companies incorporated in these jurisdictions treaty protection against PRC corporate income tax, such that these companies would only be subject to PRC corporate income tax if they have permanent establishment in China.

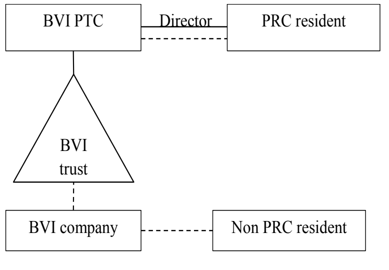
Offshore entities in these jurisdictions would need to establish that they are resident in a jurisdiction such as Hong Kong or Singapore which has concluded comprehensive double tax treaty with China to take benefit of treaty protection.

5. PRC tax exposure for a BVI trust with reserved powers held by a PRC resident



If the PRC settlor only gives investment advice to non-PRC director from time to time, the risk may be limited. However, if the BVI trust sets up an office in China with the help and support of the PRC resident with reserved investment powers to collect market and company data, research and strategize investment policies and manage the portfolio of the BVI company, the BVI trust will have an exposure to PRC corporate income tax.

6. BVI Private Trust Company ("PTC") with effective management of the trust in China



Once the PTC (and as a result the trust) becomes a PRC resident by reason of its effective management being conducted in China, all income the PTC and the trust receive, including dividend from underlying BVI companies managed outside of China, will be exposed to PRC Corporate Income Tax.

Conclusion

To avoid offshore entities set up for PRC residents and their families exposing to PRC corporate income tax, effective management of the entities must not be conducted or carried out in China. It would certainly help to reduce the risk and exposure by not appointing PRC residents as directors and/or senior management of these entities.

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