STEP Society of Trust and Estate Practitioners

香港信託人公會 Hong Kong Trustees' Association

# China and Hong Kong Tax and Regulatory Update

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## Pre-IPO Tax Planning for PRC Residents with US Connections

With the PRC's economic engine continuing to be the driving force behind initial public offerings ("IPOs") that are making entrepreneurs and investors into millionaires overnight, PRC residents with ownership interests in these companies should be considering pre-IPO tax planning to minimize their tax liability and to otherwise plan for the wealth generated from these IPOs. For those PRC residents who are also US citizens (perhaps because they were born in the US or one or both of their parents were US citizens) or US green card holders, there could also be significant US federal tax exposure to minimize or eliminate. For these PRC residents and US taxpayers, there are several special planning opportunities that can be considered. Following is one of those opportunities:

**Freeze Planning**

Because US taxpayers can transfer only a certain amount of their wealth without paying US gift tax and face US estate tax on their deaths, those who are well-advised seek to use types of so-called "freeze" planning to remove the potential appreciation of certain assets from their taxable estates with minimal or no gift tax exposure and no current income tax liability. This freeze planning could be used to transfer a pre-IPO interest in a company that is expected to appreciate significantly. Two planning techniques could be well-suited to pre-IPO planning: a transfer to a grantor retained annuity trust (or "GRAT") and a sale to an intentionally defective grantor trust ("IDGT").

**GRAT**

The GRAT involves a transfer into an irrevocable trust established for the benefit of family members or other third parties by the PRC/US owner of the pre-IPO interest. As part of the transfer, the owner/transferor retains the right to an annuity interest for a fixed term of years. When the annuity period and the payments end, the remaining assets in the GRAT – including all appreciation on such assets – pass to the remainder beneficiaries of the trust, or possibly to another trust for the benefit of those remaindermen.

By retaining the right to an annuity payment, the owner/transferor can reduce the value of the transferred interest for gift tax purposes to zero (or close thereto) such that the owner/transferor has little or no gift tax liability. In order to do so, the annuity needs to be structured to provide for payments equal to the value of the transferred interest and a statutory-assumed rate of growth (the "hurdle rate"). So long as the transferred interest grows faster than the required annuity payments, including the hurdle rate, the use of the GRAT will allow the appreciation on the transferred interest above that hurdle rate to pass free of estate tax. As the hurdle rate is based on current low interest rates, a pre-IPO interest that is anticipated to appreciate significantly is an attractive asset for funding a GRAT because there could be substantial US estate tax savings for the owner and his or her family.

From a US income tax perspective, where the GRAT is properly structured, the transfer between the owner/settlor and the GRAT is disregarded. In other words, there is no income tax consequence to the completed gift to the GRAT. The owner/settlor remains the owner of the transferred asset for US income tax purposes. As a result, when the owner/settlor later pays tax on income or gain from the transferred asset, the owner/settlor would effectively be making another transfer to the GRAT and its beneficiaries without any additional gift tax.

The GRAT must be structured to avoid having the transferred assets pulled back into the owner/settlor's estate. This requires that the GRAT be an irrevocable trust and the settlor/owner retain only limited powers over the trust, but powers that can still be quite attractive to the settlor/owner. As a drawback, should the settlor/owner pass away during the annuity period, the transferred assets will be treated as part of the settlor/owner's estate regardless of the trust structuring. There are other tax and trust issues to address depending on the specifics of the client situation.

**IDGT**

A sale to an IDGT would involve a sale of assets to the IDGT in exchange for an instalment note, often structured with balloon payment terms. The note must bear interest, although this interest rate could be less than the hurdle rate associated with the GRAT. As was the case with the GRAT, the IDGT would need to be structured so its assets are excluded from the settlor's estate, which involves an irrevocable trust in which the settlor retains limited connections. Similarly, the IDGT would be structured so that the settlor remains the owner of the asset sold to the IDGT and the sale is disregarded for income tax purposes with the same benefits noted above.

Special to this type of planning, the settlor makes a "seed gift" to the IDGT in an amount at least equal to 10% of the value of the asset to be sold to the IDGT. Following the 10% seed gift, the settlor sells the asset (or remainder of the asset) to the IDGT at fair market value in exchange for the note. This type of "leverage" allows for a far greater transfer than with a GRAT. Depending on the specifics of the client situation, there may be additional tax benefits available as well as trust options. For example, the GRAT and IDGT techniques can be combined to limit or eliminate the seed gift.

**Conclusion**

With this type of planning, significant wealth can be passed free of US estate tax. For example, a transfer or sale involving a pre-IPO interest valued at US$1,000,000 that is anticipated to appreciate to US$10,000,000 could be transferred through a GRAT or IDGT with the bulk of that appreciation avoiding US estate tax. To ensure the viability of such planning, it is imperative to work with PRC tax and trust counsel so PRC tax issues can be optimized as well.

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# Tax Information Exchange Agreement Between the BVI and the PRC

**Introduction**

The British Virgin Islands ("BVI") has historically been one of the most popular jurisdictions for both foreign investors aiming to set up entities to hold investments in the PRC as well as for PRC-based investors for international transactions (though often with a view to invest in the PRC in what is colloquially referred to as "round tripping"). It is therefore not surprising that, on 7 December 2009, the PRC entered into a Tax Information Exchange Agreement ("TIEA") with the BVI to establish a formal framework for the exchange of tax information between the two jurisdictions. The new TIEA has now been in force since 30 December 2010.

**BVI TIEA**

The BVI TIEA allows the PRC tax authorities to request information from the BVI authorities on matters relating to both PRC individual and enterprise income tax. The information subject to exchange includes such information as is generally required to be kept by banks and financial institutions in the BVI as well as any information relating to interests and ownership of the relevant companies, partnerships, trusts, investments funds etc. against which the request is directed.

However, as a general principle, PRC tax authorities will be subject to strict guidelines and criteria when making a request for information pursuant to the TIEA. For instance, they will have to provide appropriate reasons why the information is requested and how the information is relevant to a tax investigation. In addition, the PRC tax authorities will have to confirm that, before resorting to a TIEA request, they have exhausted all other means available in the PRC to obtain the relevant information. Those safeguards have been inserted in the TIEA to ensure that there will be no fishing expeditions and that only information actually relevant to a tax inquiry will be exchanged.

The TIEA also confirms that neither government will apply restrictive tax measures against residents or nationals of either jurisdiction so long as the TIEA is in force and effective.

**Impact**

With the development of the PRC anti-avoidance regime, particularly as it pertains to international transactions, it is not surprising that the PRC would wish to enhance its ability to gather information from outside its borders. The BVI TIEA (and the others it has concluded in recent years) has become part of the arsenal to enforce what is becoming as complex and difficult a system as any in the world. We note in particular.

**Circular 698**

Pursuant to Circular 698 of 2009, in certain circumstances, an offshore seller of an indirect interest in a PRC enterprise will be required to file various information with the PRC tax authorities. The filing can then lead to the imposition of taxation if it is found that the transfer was completed without proper business purpose. Given the predilection of investors in using BVI companies in their international structures, there has been and will be many instances where Circular 698 will apply on a disposition of a BVI company. The TIEA will now provide a means for the PRC tax authorities to seek information allowing them to identify the seller in transactions for which Circular 698 would not have been respected, thereby giving them a target against whom to apply their enforcement tools.

**Circular 82**

Article 2 of the Enterprise Income Tax Law provides that a non-resident enterprise whose 'place of effective management' is in the PRC will be treated as a resident enterprise. Circular 82 of 2009 explains the concept of 'place of effective management' as well as provides for the taxation rules where effective management is found to be in the PRC. The TIEA will now allow the PRC tax authorities to seek information to identify PRC entities who may be exercising effective management over a BVI entity and thereafter seek to tax the BVI entity as a resident taxpayer.

These are but two examples of circumstances where the PRC tax authorities can benefit from better access to information originating from the BVI or other jurisdictions. The more the PRC tax authorities continue to improve their collection and enforcement systems, the more need there will be for effective exchange of information, particularly with jurisdictions with favourable tax systems such as the BVI.

**Conclusion**

The TIEA is still new so it has yet to reach its full potential. However, with the PRC tax authorities becoming ever more cunning at gathering information (to detect unreported transactions, they are known to surf the internet looking for public announcements relating to PRC enterprises, to monitor significant changes in the organisation of PRC enterprises, etc), the TIEA will in due course allow the authorities to pursue their investigations beyond where they could go before. In our view, there is no doubt that the TIEA makes, and will make, the investigations of tax avoidance cases by the PRC tax authorities more effective and it increases, and will continue to increase, the chance of successful enforcement. Taxpayers beware!

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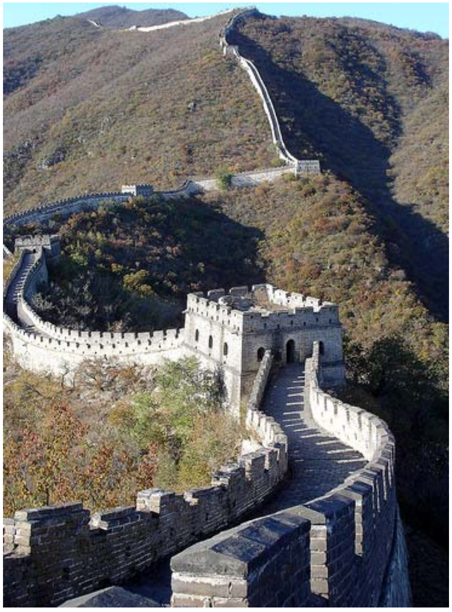

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