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# Plan offshore for China opportunities

**Elizabeth L. Thomson** highlights the advantages of Hong Kong and other offshore centres for foreign companies doing business with Mainland China

In the early days of China's liberalization, when the barriers to entry were still high, foreign investments into China were confined largely to joint ventures with Chinese state-owned enterprises until China authorized the establishment of Wholly Foreign-Owned Enterprises (WFOEs) in the mid-1990s.

Today, WFOEs can be set up significantly easier in China with far fewer restrictions, and changes are continuously being made to lower barriers to entry. Such liberalizations can be seen in China's recently amended Company Law, which came into effect on 1 January 2006 and introduced with it a series of further relaxed capital requirements for domestic companies. The amendments have made setting up in China more accessible to companies of a smaller scale such as Small and Medium Enterprises (SMEs).

One of most the important initial decisions for any business looking to establish operations in China is the most basic question: what type of Chinese legal structure best suits the particular company's plans and resources? Foreign investors have three basic options to start operations in China: a representative office, a joint venture or a wholly foreign-owned enterprise.

Currently, the preferred form of foreign direct investment (FDI) into China is the WFOE, which accounted for over 70% of approved projects in 2004, representing close to 75% of FDI in value terms. Nevertheless investors are advised to discuss their business objectives with corporate structuring professionals to access the most appropriate form of vehicle for doing business in China as some industries are restricted to joint ventures only and representative offices are not permitted to engage in

direct business activities, such as sales.

While many foreign investors may be successful in choosing the right form of vehicle to set up in China, often investors neglect to plan for a comprehensive China strategy, such as a proper entry strategy to help mitigate risk. Even more fail to lay the foundation for exiting in case things go astray or for ending a project when the time comes.

Failure to implement a comprehensive structuring strategy for China exposes investors to a variety of potential risks. These may include getting caught in China's tight monetary controls, entrapment in complicated application and corporate compliance procedures as well as trying to keep up to pace with the forever changing laws, or simply getting money and profits back out of China.

Large and small companies face similar risks, although the situation may be more manageable for large multinational corporations that may have greater financing capabilities and a larger tolerance for risk. This unfortunately is not the case for SMEs. Any wrong move may mean a very expensive and time-consuming fix.

Regardless of whether an investor is a large multinational corporation or an entrepreneurial SME, the question remains, why take the unnecessary burden of risk, when it can be mitigated? Moreover, there may be even greater long-term savings through the use of the right offshore structures in the equation.

## Hong Kong, the strategic gateway

Hong Kong-based individuals and businesses have been pioneers in opening up the Chinese economy over the past 27 years. Yet despite the wealth of China experience and expertise associated



Textile factory on contract manufacturing to Hong Kong-invested firm.

with Hong Kong companies, professionals here often prefer to use offshore jurisdictions when they offer structuring solutions to their clients doing business on the Mainland. In many cases, this is a shortsighted

strategy that offers reduced disclosure requirements at the cost of operational and financial flexibility down the road.

Based on past experience, the sensible advice remains: incorporate a Hong Kong limited liability company to act as the “firewall” between the mother company and the China operation. Have everything set up in Hong Kong, including the banking facilities, and then establish the WFOE, joint venture or representative office in China to comply with Chinese legal requirements.

First, the Hong Kong legal system, guaranteed to be separate from the Chinese system until 2047, is a familiar system based on English common law. The judiciary is impartial, and the sheer volume of commercial case law makes judgements more predictable. Structuring your China business with a Hong Kong parent company can allow you to enter into some contracts under Hong Kong law, and also provides a liability firewall between your operations in China and your head office.

Second, Hong Kong’s tax and banking systems also allow for more efficient operations, with consistent and predictable costs. Large numbers of Chinese companies have been flocking to Hong Kong to access the international financial markets precisely because it is difficult for private companies to finance

their businesses in China. Similarly, Hong Kong companies with solid commercial track records have access to a variety of equity and debt financing options.

Third, the corporate rate of tax in China is 33% (not including other domestic taxes), while profits of a Hong Kong source are taxed in Hong Kong at a rate of 17.5%, offering significant savings. Furthermore, Hong Kong has a territorial source principle of taxation, which means only profits that have a source in Hong Kong are taxable locally, and profits that are deemed to have an offshore source are not taxed in Hong Kong. Put simply, if the decision to buy and sell is made outside of Hong Kong, even though the transactions may flow through a Hong Kong structure, the profits are deemed to be from an offshore source and thus not taxable in Hong Kong. Effective tax planning can help to reduce the tax bill significantly.

Finally, a physical Hong Kong office is not required. Many foreign companies, in particular SMEs, choose to operate out of a “virtual office”. This means, that the Hong Kong company has no physical presence, but takes its registration agent’s address. Company services providers may also provide additional services such as trade facilitation, accounting and treasury so that investors can have a fully operating office in Hong Kong without the costs or concerns of actually running one. This also eases complications when exiting from Asia, or if operations expand, the virtual office can act as a stepping-stone to a full physical office in Hong Kong.

Hong Kong businesses were among the first to take advantage of business opportunities on the Mainland, and remain the single largest investors in every province and region of China, accounting for just over 50% of China’s total foreign investment stock of US\$156 billion. According to the Hong Kong government, Hong Kong companies own well in excess of 60,000 production facilities in the Pearl River Delta alone, employing upwards of 10 million

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workers, creating a strong reputation as the leading commercial centre for business in China.

Subsequent to this close connection, Hong Kong's corporate documentation is familiar to officials in most mainland investment regions, while Hong Kong professionals are equipped with a wealth of experience in handling the requirements and procedures of the Mainland government. As a result, authenticity is more easily verified and application-processing times are substantially lower than if invested through a company incorporated in another jurisdiction.

## The offshore gateway to China

Traditionally, British Virgin Islands (BVI) companies were commonly used as part of China entry strategies, making it the second largest investor in China. However, in recent years, concerns about "round-tripping" (use of offshore companies by mainland residents to avoid Chinese taxes and capital controls) have led to greater scrutiny of foreign investment applications where the applicant is domiciled in a traditional "tax haven" jurisdiction. Anecdotal evidence has circulated of cases where the Chinese authorities have required that all copies of corporate documents from a BVI company be duly notarized at the Chinese Embassy in the United Kingdom, an expensive and time-consuming endeavour for most applicants.

Offshore jurisdictions nevertheless still have their role to play in comprehensive structuring solutions for international businesses entering the China marketplace. Barbados, for example, is well positioned to capture the growing popularity of WFOEs in China. Of course, there are other jurisdictions that offer similar advantages, but Barbados is being taken as a concrete example in this instance.

A unique advantage of Barbados is in the country's extensive tax treaty network. One of the more interesting developments in the Barbados

network of treaties is perhaps the Barbados-China double taxation treaty, which was concluded in 2000, making the island a strategic, low-tax entry point for companies looking to invest in China. In 2005, only five years after the tax treaty was introduced, Barbados had emerged as the leading jurisdiction for offshore Wholly Foreign-Owned Enterprise (WFOE) holding companies in China.



Raising finances in Hong Kong is efficient.

According to Chinese law, dividend payments made to a non-resident by a Chinese resident of China are subject to a withholding tax of 10%. Under the Barbados-China tax treaty, that withholding rate is reduced to 5%. In many cases, new foreign investments in China receive a variety of tax incentives, often including an exemption from withholding tax for all dividend distributions to the foreign parent. However, domestic private companies have been pressuring the government for several years to end preferential tax treatment for foreign companies and create a truly level playing field with similar tax rates. Beijing has stated its intention to harmonize the tax regimes. It is just a question of when the change takes place and how existing concessions will be treated when that occurs. If the investment goes through a Barbados company, it will either continue to receive an exemption from withholding tax if such concessions are grandfathered; if not, it will be eligible for the lower rate applicable under the treaty.

Either way, such dividends paid to a Barbados IBC would be taxed at the normal rates of 2.5% down to 1% upon receipt. However, the company could claim a tax credit against the Barbados tax otherwise payable for the 5% withholding tax paid on the dividends, and for the underlying taxes in China on profits out of which the dividends are paid. To qualify for such a credit, the Barbados recipient needs to own only 10% of the capital of the paying Chinese company. As in the cases stated above, these credits can only be applied in so far as they reduce the tax payable in Barbados to a minimum of 1%.

The Barbados-China treaty also includes a favourable article on capital gains. Under the treaty, capital gains arising from the sale of property, other than immovable property situated in China (which would include shares), are taxable only in the state in which the taxpayer is resident. As a result, a Barbados IBC that owns shares in a Chinese company would not be subject to the normal Chinese 10% withholding tax on capital gains from the sale of those shares. The right to tax such capital gains would rest solely with the Barbados government, and Barbados IBCs are not subject to capital gains tax. So, by structuring China investments through a Barbados IBC holding vehicle, the company can establish a potentially tax-free exit strategy for its venture.

One of the key competitive points related to working in China through a tax treaty country is that Mainland laws often differ significantly from those in investing countries, and can sometimes seem vague in terms of implementation and interpretation.

In the tax sphere, this means that many companies investing in China have difficulty projecting their specific tax liability, and this uncertainty raises another source of risk for investors in a developing market. However, Chinese law specifies that the provisions of an international treaty to which China is a party will always prevail over the domestic law in case of inconsistency or discrepancy. As a result, using a jurisdiction such as Barbados to

channel investment into the Mainland allows a company to transact its business with a greater degree of certainty regarding its tax obligations.

## The China Opportunity

China offers business opportunities that are too great for most companies to let pass. In many cases, the price of missing these opportunities may be a persistent threat to the business from Chinese competitors or domestic rivals who have moved to China.

However, the cost of high rewards is often additional risk. Many overseas businesses are unfamiliar with the kinds of challenges they will face in China, and need to pay close attention to these details when they develop their China strategies. With proper planning and a solid business model, the upside can be almost unlimited.

In many cases it makes sense to consider using Hong Kong as a gateway, especially for mid-market companies, which tend to have more limited resources to invest in the initial stages and can less easily afford to fail. Hong Kong offers a familiar business environment and a variety of risk-mitigation options.

Investors are also encouraged to look at offshore jurisdictions and the different types of vehicles that are available to help them achieve the results they want for their China projects as part of a more comprehensive China business structuring strategy.



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