Cross-border Estate Planning: China Round-Trip Investment Rules

Description

To many, estate planning is just a part of family law practice having little involvement of corporate and investment laws. It is no longer true in today's world when clients often have their major assets in the form of ongoing businesses, i.e., companies or corporations.

I. Why Round-Trip Investment Is Relevant

There has been growing demand among Chinese high net worth individuals for estate and succession planning set up offshore (outside China) where such Chinese HNWIs can keep operating their businesses within China. The typical structure that is designed for that purpose looks like the following:

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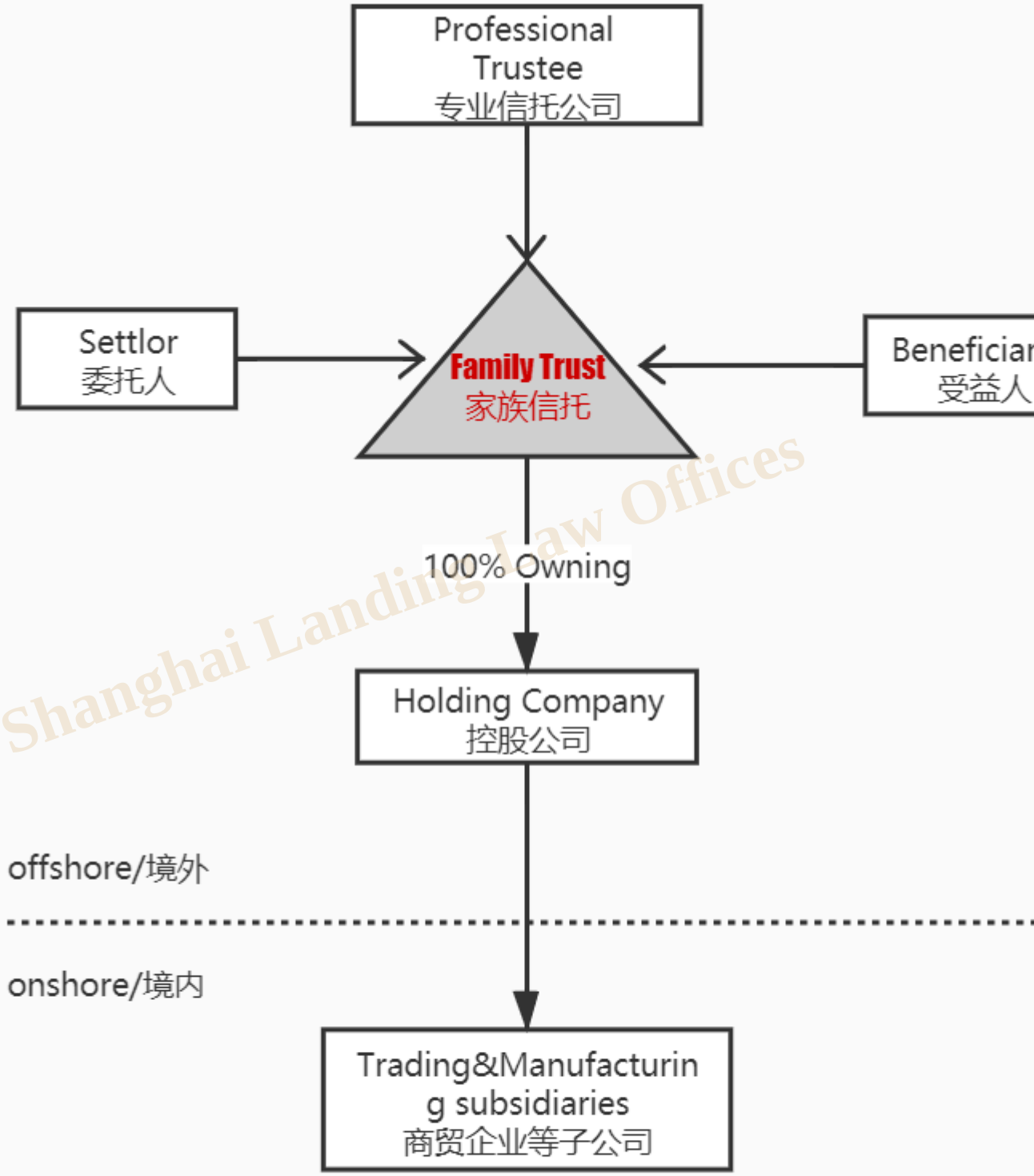

Structure for Chinese HNWIs Offshore Estate Planning
中国高净值人群之海外财富传承的结构

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In the structure, at the core is a family trust set up is popular offshore common law jurisdictions such as BVI, Cayman Island, Guernsey, Hong Kong or Singapore. The trust can also be replaced by a civil law foundation such as the STAK foundation popular in Netherlands.

The most difficult part of executing the plan embodied in the above figure is how to turn the onshore trading or manufacturing business entities into the subsidiaries of the offshore immediate holding company.

II. China Law Implications for Achieving the Holding Structure

Assuming Douglas, a rich China entrepreneur, has an ongoing successful business in China, a domestic company fully owned by Douglas and his family members who are all Chinese citizens, and he wishes to put in place an estate and business succession plan as depicted in the above figure.

So, the inevitable question is how Douglas can legally turn his domestic Company A into a company invested and owned by a foreign entity, and in the meantime, Douglas and his family can still control own or control the foreign entity. An easy and ready option is for Douglas to incorporate a company first, say in BVI, which is generally considered as a foreign company, and then use this BVI company to acquire the shares or equity interests in Company A. Once the acquisition is completed, Company A will become a foreign invested entity, attaining the goal set in the above figure.

Is that a viable option? What are the barriers if any?

(1) Concept of Round-Trip Investments by Chinese Residents

Round-trip investments in China refer to investments made by foreign entities (incorporated outside China) that are actually set up and controlled by Chinese citizens, also dubbed as “fake foreign investments”. Such phenomena were initially sparked by China governments offering favorable tax and policy treatments to foreign investments. Smart Chinese businessmen quickly learned to set up their own offshore company (in offshore jurisdictions like BVI, Bermuda and Cayman Island) that will come back to China as foreign investors so as to enjoy those favorable treatments available.

This trick has been widely adopted and China governments are no fools and started to scrutinize and regulate such fake foreign investments, mainly by virtue of foreign exchange control.

To appreciate the matter, one shall know that China has not allowed its citizens (for purpose of this article, Chinese citizens refer to those citizens who are also tax residents within China, excluding overseas Chinese citizens who have obtained permanent residences in foreign countries) to engaged in foreign direct investment in other countries. In other words, it is illegal for Chinese citizens to invest outside China, a prohibition aimed at preventing capital flight out of the country. I know you have known many Chinese citizens investing all over the world, but if they have not taken their domestic funds out of China or vice versa, then it is not a real concern of China governments.

On the other hand, even if Chinese citizens have already managed to set up their business entities in foreign countries and use such foreign entities to invest in China, they may have trouble when caught by China State Administration of Foreign Exchange (SAFE). They are often caught when the companies they invest in China pay big amount of dividend to the foreign parent holding company.

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There have been quite a few cases published by China SAFE in this regard. Typically, such cases involve Chinese citizens using their offshore entities to invest in mainland China without disclosing the controlling persons of such offshore entities, and there has even been a case in which a Chinese couple was penalized for not updating their offshore entity information after they migrated to Singapore and became real foreigners.

(2) Circular NO. 37 Issued by SAFE

A major piece of regulation of round-trip investments by Chinese citizens is the so called “Circular No. 37” issued by China SAFE on July 4, 2014. There are other related regulations I will briefly touch on later.

A few takeaways of Circular NO. 37.

(i) *Definition of Special Purpose Vehicle*

Circular No. 37 defined the term “Special Purpose Vehicle” (SPV) which is a foreign entity directly or indirectly established or controlled by Chinese residents (domestic resident entities and domestic resident individuals) for purpose of investments or financings, contributing their assets and interests legally owned onshore or offshore.

While it is always difficult for any Chinese individuals to use their domestic assets (those located in China) to make offshore investments (except as permitted in limited circumstances such as offshore IPO or employee stock plan in foreign companies), the regulation does for the first time acknowledge SPV set up by Chinese individuals using their offshore assets so long as such assets are legal (as a result of your work, borrowing etc.).

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(ii) *Foreign Exchange Registration for Outbound Investments*

China SAFE’s primary concern is China’s financial security that is often affected by enormous inflow or outflow of money across border. Thus, SAFE monitors closely the activities of foreign exchange capital accounts, in particular, cross-border investments by asking banks to record any and all such activities.

According to Section 3 of the Circular, before Chinese residents (bear in mind, including Chinese entities and individuals) contribute capital to the SPV, they shall effect the foreign exchange registration for outbound investments with relevant banks. Without forex registration, funds cannot be sent out for capital contribution and future profits obtained outside the country cannot be taken into China.

(iii) Forms of Round-trip Investments

Before Circular No. 37, round-trip investments often mean the acquisition by the SPV of their own existing businesses in China owned by Chinese residents. Under this Circular, round-trip investments include greenfield investment of setting up new foreign invested company.

This new development may offer a way to circumvent the acquisition hurdle in the way when SPV comes back to China to acquire the businesses owned by Chinese residents, since acquisition of domestic enterprises by existing foreign-invested companies (real ones) is mainly regulated by other regulations other than Circular No. 10 as described below.

(iv) *Disclosure of Controlling Persons for Investments in China*

In practice, many Chinese businessmen have set up their offshore entities long time ago, and when they come back to China for investments, they intentionally hide the fact that foreign investing entities are controlled by them. This is where they get caught when their China companies send money out to the foreign investing entities.

Disclosure of controlling persons (something similar to the concept of ultimate beneficial owners) is now a key requirement in the course of foreign investors investing in China, a requirement by both foreign investment department and China SAFE.

(3) *Regulation on Acquisition of China Businesses by Foreign Investors*

Circular No. 37 is very inspirational towards achieving the desired succession planning structure shown in above figure. But the road doesn't look that rosy.

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Assuming Chinese residents have set up their SPVs, to achieve the goal of the offshore holding structure, SPV (the holding company in the Figure above) needs to come back to acquire the shares or equity interests of the domestic companies in China owned or controlled by the same Chinese residents. Here is where the insurmountable barrier lies.

Acquisition by such foreign entities of such domestic companies is explicitly addressed in the regulation regarding merger and acquisition by foreign investors of domestic enterprises, the well-known Circular No. 10 jointly issued by several ministries back in 2006, as amended in 2009. This Circular No. 10 explicitly provides in its Article 11 that such connected acquisition transactions shall be submitted to China Ministry of Commerce for approval. Ever since the inception of Circular No. 10, there has no successful precedent of such deals. This means the SPV will not be able to acquire the domestic businesses owned or controlled by those Chinese residents.

Unfortunately, the round-trip investment strategy doesn't really work here for cross-border estate and succession planning.

III. Possible Solutions

These legal obstacles have made it virtually impossible to set up the desired structure to help Chinese HNWI businessmen with their offshore estate and succession plan.

Any possible way out of the impasse?

Identity and Residence Planning

To break the impasse, a plausible option is to get a foreign passport by way of those countries' Citizenship by Investment programs. Indeed, these passports sale in China has been promoted

relentlessly by all kinds of market players in that industry.

That would sound too good to be true.

First off, if the client or his or her family members (those intended beneficiaries) obtain foreign passports but they continue to live within China as usual, this will render them subject to Circular No. 37. This is because domestic resident individuals under Circular No. 37 include those foreign individuals who habitually reside in China due to economic relationships. In other words, even the Chinese HNWIs or their family members have foreign passports, they will still be considered domestic resident individuals under Circular No. 37 if they continue their life as usual, residing in China most of time for work and businesses.

Second, to conduct greenfield investments or acquisitions, foreign passport holders need money. But they cannot easily take their China domestic funds out of China.

So, clients don't just need a foreign passport, they need serious identity and residence planning.

Once choosing the proper and desirable foreign passport, clients need to ensure they actually reside in the foreign passport issuing country to establish their tax resident status there. In the meantime, before purchasing foreign passports, they should retitle some China assets (for example, real estates) into their own names, so when they become foreign passport holders and tax residents, they can apply to foreign exchange authority and tax authority to legally move the sale proceeds of those assets out of China. Then they can make their way back to acquire their China family businesses legally.

All such efforts shall be carefully planned in advance and executed with caution. Apparently, the road to set up an offshore estate and succession plan is bumpy but it may well prove to be worthy in the end.

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