

The Study on the Best Structure of Negotiation · Investment into China

- Focused on the Joint Venture in terms of Tax Efficiency -

중국 투자협상의 합리적 구조에 관한 연구
- 절세 측면의 합작투자(JV) 방식을 중심으로 -

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Abstract

본 논문은 국내세법, 한·중 조세협약, 중국세법을 근거하여 특수목적회사(SPC), 사모펀드(PEF) 등의 간접투자 방식과 직접투자 방식에 대한 투자시뮬레이션을 활용하여 최상의 투자형태·협상전략을 제시하였다.

분석결과 중국내 고정사업장이 없는 경우 홍콩과 같은 조세회피지역에 특수목적회사를 설립하여 중국에 투자하는 형태가 직접투자 혹은 국내에 PEF 설립을 통한 투자보다 더 합리적이었다. 더욱이 특수목적회사는 국내의 여러 가지 규제에서 벗어나 자유로운 펀드운용과 새로운 투자추진시 국내과실 송금 처리절차를 거치지 않고 재투자가 가능하다는 점을 포함하여 다양한 장점을 가지고 있었다.

중국 등의 해외투자 고려시 조세회피지역에 특수목적회사를 설립하고 이를 통해 투자를 실행하는 것이 가장 효율적인 방안을 고려하여 투자방식과 JV협상을 진행하여야 할 것이다.

Key words: International Investment, Joint-Venture, Tax Treaty, China NPL

I. Introduction

China's economic growth reached record highs in the second quarter. China's economy expanded by almost 10 percent in the first half of 2008, with growth in the second quarter the highest in over a decade. Industry continues to outpace services on the supply side, and investment remained the main driver of demand. Export growth continued to outpace import growth, contributing to a record current account surplus.

To cool down the economy in reaction to recent economic statistics, the authorities have implemented a series of measures. They include monetary tightening by absorbing liquidity in the inter-bank market, administrative measures to limit investment in real estate, reinforcement of controls and regulations on investment projects, including a re-evaluation of all large investment projects and loosening controls on capital outflows.

Nevertheless, outlook for China's economy remains favorable. With production capacity continuing to expand in line with demand, inflation low, and the current account in surplus, the main policy concern is not general overheating. Rather, policymakers are worried that high investment could cause overcapacity in specific sectors, and may affect the banks because loans may turn bad in the future. The authorities can take some comfort from the fact that most investment is financed from profits rather than credit, and that the highest investment growth is taking place in largely commercialized sectors. But the continued investment boom warrants concerns about efficiency, making more moderate growth desirable. On the external side, key risks are a sharper than expected slowdown in the U.S. economy and a disorderly resolution of global imbalances.

China also faces ongoing and emerging challenges related to its continued rapid growth - growing income inequality, economically lagging western and northeast regions, unsustainable resource exploitation, and issues related to growing regional and global economic integration. Many of these challenges require action on complex systemic issues - like the financial sector and the state-owned enterprises(SOEs) - in order to spur greater efficiency and innovation while maintaining macroeconomic balances. Especially, Chinese authorities have considered the Non-Performing Loans(NPLs) problems as a biggest issues in China in order to make an stead growth of economy to maintain a certain level of potential growth rate, and also have a deep interest to resolve the NPLs through the multiple methods ranging from loans sales to debt-for-equity swaps.

China, like every other Asian economy, is dealing with a mountain of bad loans. It has begun the long process of resolving its NPL problem by establishing four Asset Management Corporations(AMCs) to resolve some \$169 billion of non-performing loans made to the four major state-owned policy banks. Resolution of the NPLs and recapitalization of its banks are of fundamental importance to China as it enters the World

Trade Organization, and prepares its banks to compete head-on with Western banks. Toward this end, China is attempting to attract foreign investors to purchase the NPL portfolios.

The purpose of this article is to review China's progress in resolving NPL matter, and to evaluate a long list of factors that affect investor perceptions of uncertainty and investment risks. These factors must be addressed before investors are likely to enter the Chinese market in force. Further, I will suggest what's best methodology of investment structure in China with a form of Joint-Venture.

This paper has three main parts. It begins with a discussion of the China's experience and status in resolving the NPL problem and sale process in China. It proceeds with a discussion of the classification and magnitude of China's NPLs, and ends with the government's approach to loan resolution by establishing the four AMCs. The second part presents the best structure of investment in terms of Korean investors' viewpoint. The third part concludes by highlighting the best way of investing in china market in terms of tax issue rather than other factors

II. China's NPL and Resolution

1. NPL status

China has invested heavily in recapitalizing its state banks in preparation for 2007, when foreign investors will be allowed unrestricted access into China's banking industry. After a slow start, China's NPL disposition process has accelerated in response to the plans of some banks to go public and the entrance of foreign investors into the banking sector. But China's banks still have a substantial backlog of legacy NPLs on their books. In addition, there is the question of whether another wave of NPLs may hit China's banks, the result of aggressive lending in a superheated property market.

1) Cause of NPL

The underlying causes of China's NPL situation have to do with the way China has traditionally financed its multitude of state-owned enterprises (SOEs). The trials and errors resulting from the country's efforts to return to a market economy have complicated NPL resolution. The current NPL dilemma is the product of a legacy of central planning, and the main players in the drama are Chinese government officials, particularly members of local governments; in most decisions, third parties are conspicuously absent. The banks involved

have acted primarily as government agents, disbursing funds to a variety of pre-determined projects without any preliminary credit analyses. Such analyses were never performed, nor was there thought to be any need for them, since all credit terms—the amount of the loans, loan maturity, interest rates, and so forth—were pre-determined by the government. Such a system could not help but generate irrational investment decisions, and these decisions frequently resulted in non-performing loans.

Moreover, in China's transition to a market economy, there remain institutions that inhibit the maintenance of capital and traditions that have long since outlived their usefulness. Of these, the most serious is the lack of attention given to the maintenance of capital. This, more than anything else, can be blamed for the current NPL problem. In essence, State-owned enterprises(SOEs) have treated their share of credit allocations as government grants and used them to finance working capital and fixed investment. In too many cases, these disbursements have not been thought of as debt obligations that had to be repaid. Though state enterprises have been able to shift the consequences of their lack of foresight to Chinese banks, the banks have had no way to pass the burden on.

2) NPL size

Conservatively, we estimate China's NPL liability from all sources including the banks, AMCs, investment companies, and credit co-operatives at more than U.S. \$900 billion, an amount that exceeds its massive foreign exchange reserves. This is a large amount of distressed assets considering 2002 China's NPLs at U.S. \$480 billion. There are several reasons for the increase. First, better information about the dimension of China's NPL problem is now available. Second, the problem is not limited to the largest banks and AMCs but also extends to other banks, state investment companies, credit cooperatives, and other entities. Third, as noted, the banks are believed to have made more bad loans in recent years that have or will turn into future NPLs.

<Table - 1> Amount of NPL in China

(U.S.Billions)

Financial Entities	NPLs
Big 4 banks	358
AMCs	230
Others	323
total	911

source : Ernst & Young, "Global Non-performing Loan Report", 2006, p. 14.

In retrospect, in 1998, China's four state-owned banks had an estimated U.S. \$620 billion of legacy loans on their books, including some loans dating back to the early 1980s. Recognizing the need to reform and strengthen China's banking system, the government in 1998 reportedly transferred U.S. \$70 billion of these legacy NPLs to four newly created state-owned AMC's. From 2000 to 2005, in order to try and clean up their balance sheets in preparation for future IPO listings, the banks transferred an additional \$ 60 billion of NPLs to the AMC's and aggressively wrote off U.S. \$ 57 billion of NPLs against current earnings.¹⁾

<Tabel – 2> NPL Overview of big four major banks and AMC's

Year	Event	Bank		AMC's	
		+/(–) (\$billion)	Balance (\$billion)	+/(–) (\$billion)	Balance (\$billion)
before '98	Build-up prior to 98	-	620	-	-
'99	Initial transfer to AMC's	(170)	450	170	170
'00 ~ '05	Additional transfer to AMC's	(160)		160	
	write-off/resolution of NPLs	(157)*		(100)	
	potential future NPLs	225	358	-	230

source: Ernst & Young, "Global Non-performing Loan Report", 2006, p. 14.

Because of the lack of transparency and other problems, these figures may not provide a complete picture of NPL disposition activity since 1998. Regardless, the official NPLs of the big four banks, after these transfers and write-offs, as of December, 2005 were reported to be U.S. \$ billion.²⁾ Second, of the U.S. \$340 billion transferred to the AMC's as of the end of 2005, the AMC's have disposed of only about U.S. \$100 billion, and about U.S. \$230 billion still remains on their books. Apart from the banks and the four AMC's, there are still significant NPLs elsewhere in the financial system³⁾, totaling U.S. \$323 billion.

3) Resolution of NPL

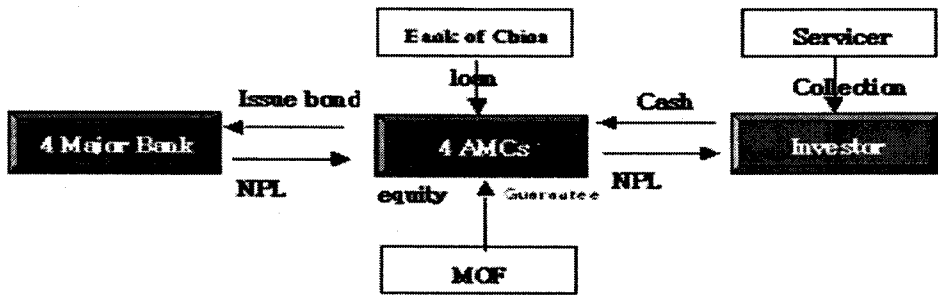
Government involvement in NPL resolutions in China has taken various forms. From the mid 1990s, the government began to separate commercial lending from policy lending. It established three policy banks to

1) Ernst & Young, "Global Non-performing Loan Report", 2006, p. 14.

2) However, according to a research report by UBS, the banks' aggressive lending from 2002 to 2004 has resulted in a potential new wave of NPLs, which eventually could be as high as U.S. \$225 billion. These undisclosed loans may include an estimated U.S. \$65 billion in real estate loans that we, in an earlier analysis, suggested may be buried in the "special mention" loan category that is not included in computing a bank's NPL ratios. All told, the big four banks may have created an estimated U.S. \$845 billion in bad loans over the past 5 years. Of this amount, about U.S. \$225 billion is still in the big four banks and not presently classified as NPLs.

3) State-owned investment holding companies; city commercial banks; and rural credit co-operatives

handle all policy-related lending, in the hopes that wasteful lending to failing companies from the four commercial banks would decline and that internal and external competition would intensify within them. Since Prime Minister Zhu Rongji took control of the financial reform, a number of reform measures⁴⁾ have been put forward to deal with NPLs and to guard against risks in the banking system.



source : KAMCO, "China's NPL report", 2005.

[Figure - 1] Process of NPL resolution in China

The AMCs in China are largely based on the RTC model successfully used in the U.S. They are government-sponsored agencies with limited life(10 year). China's four AMCs are responsible for the disposal of approximately 1.3 trillion-RMB in NPLs injected into them from the four State commercial banks.

<Table - 3> Disposal of non-performing assets by the four AMCs in 2006

(RMB100 Mil, %)

2006	Q1
Accumulated Disposal	8,663.4
(Cash Recovered)	1,805.6
Disposal Ratio	68.61%
Asset Recovery Ratio	24.20%
Cash Recovery Ratio	20.84%

source : http://www.cbrc.gov.cn/mod_en00/jsp/en004002.jsp?infoID=2464&type=1

4) These included (1) injecting equity to recapitalize state-owned banks; (2) compelling banks to adopt international standards when classifying NPLs; (3) requiring banks to make loans on a commercial basis; (4) forbidding local governments to interfere with the lending decision of banks; (5) creation of four Asset Management Corporations(AMCs) to take over and liquidate the NPLs from the "Big Four" state owned banks; and (6) debt to equity swaps.

NPLs in the four AMC's consist largely of corporate loans to SOEs. Among these, it is estimated that around 25% to 30% are real estate loans. Under applicable law, the four AMC's are authorized to deal with all three types of assets: debt, equity and real property. By far the largest proportion of the AMC assets are comprised of unconverted debt in the form of NPLs. Most of these NPLs are unsecured. A comparatively small proportion of the debt now held by the AMC's is secured by physical collateral or pledges.

<Table - 4> China NPL transaction (Sep 2005 - Feb 2006)

seller AMC	buyer	location	OPB (100M RMB)	OPB (USB 1Million)	Date
Cinda	Avenue Capital	Tianjin	50	624	Sep-05
	Cargill	Changsha	20	249	Jan-05
Huarong	Bank of America	Xiamen	9	116	Jan-06
	Cargill	Xiamen	8	95	Jan-06
	Citigroup/SilverGrant	Various	364	4,544	Nov-05
	Deutsche/AIG	Various	16	1,995	Nov-05
	Mellon	Wenzhou	10	125	Jan-06
Orient	PPF	Qingdao	64	801	Jan-06
	Mellon	Shaanxi	42	524	Jan-06
	Cargill	Harbin	35	439	Nov-05
	ADM	Tianjin	6	72	Dec-05
	DAC	Dalian	47	586	Dec-05
	DAC	Changsha	12	150	Dec-05
Great Wall	Corstone	Jiangxi	44	549	Feb-06
	Citigroup	Tianjin	45	561	Feb-06
합계			916	11,429	

Source : PricewaterhouseCoopers, 'China NPL Investor Survey', 2006.

By March 2006, China's four asset-management companies had disposed of 866.3 billion RMB in nonperforming loans and recovered 180.5 billion RMB in cash. The recovered cash accounted for 20.8 percent of the face value of the NPLs that were disposed. Attracting foreign capital to help resolve China's NPLs and raise the recovery rates has become a principle objective of the government. Following the successful experience of the RTC in auctioning off NPL assets in the United States, China Huarong AMC

carried out the first auction to foreign investors in Nov-2001.

2. Challenges and Opportunity

1) Challenges

While AMCs have made strong progress in disposing of NPLs, they face new challenges going forward. They are under a mandate to complete liquidation of assets estimated to be more than U.S. \$230 billion and transform themselves into commercial enterprises after 2006. And they may face competition from the banks, which are seeking more powers from the government, including the power to resolve NPLs on their own. The relationships of AMCs and banks that have gone public could change. As a result, government infusions of capital into China Construction Bank and other listed banks and transfers of NPLs from listed banks to AMCs may be more difficult in the future.

First of all, foreign investors are struggling to get not only an delayed approval from the government authorities but also internal process of four AMCs to purchase NPL by setting up new company in China. Second, it is very difficult for investors to reject or cope with request for price adjustment, terms and condition of sale and purchase agreement from the Chinese entities, which are already done and signed by both parties.

Third, most NPL investors now demand loans to be backed by physical assets, such as property, land, building and so forth. In terms of property valuation, land use right valuation is not an easy job to do in China where there was not well developed real estate market or well traded in market, so hard to measure or relevant information about market value.

Fourth, even though the People's Republic of China passed a new Chinese bankruptcy law recently to reform the old practice of putting right of labor in first place when it comes to file the bankruptcy law, there still remained, foreign investors are reluctant to inject their fund with a concern that Chinese law enforcement is willing to do all issues on its own sole discretion without having international standard.

Finally, short of transparence in financial information related to loan, corporate and real estate, credibility of financial statements would be another obstacle to invest.

2) Opportunity

China's banks are at a crossroads in addressing their NPL problems. The opening of the banking system to foreign competition in 2007, the investments by strategic investors, and the banks' IPOs will expose them to the challenges of global competition and the opportunities in partnership with global banks. After a slow

start, China's banks have made significant progress in disposing of their bad loans through transfers to the AMCs and, increasingly portfolio sales and auctions. The quality of the banks' NPL portfolios is improving.

One of the improving environment is China's legal system, while far from perfect, that it is capable of supporting NPL recoveries. On Aug. 27, 2006, the People's Republic of China passed a new Chinese bankruptcy law⁵⁾ scheduled to become effective on June 1, 2007. The recent enacted bankruptcy law represents the incorporation of numerous sophisticated concepts and demonstrates change in an order and magnitude never before seen.⁶⁾

But gray areas remain, including defective documentation and inadequate due diligence information. Because of the lack of transparency and the general reluctance of sellers to provide representations and warranties, prospective investors are deeply discounting NPLs that banks and AMCs put up for sale. The AMCs have pushed back, insisting that they should receive close to full value for the NPLs because the quality of the collateral has improved.

As regulators and bank executives are well aware, the banks need to keep pushing forward with resolving bad loans through actual sales at market clearing prices, rather than simply transferring them to the AMCs. Banks need to continue to attract strategic investors in NPL portfolios. Regulators need to keep pushing through bank reform. This is a restructuring process that is designed to strengthen the banks in further preparation for China's opening its market to foreign investors in 2007. Meanwhile, China can continue to move forward with developing a capital structure that includes investment banks, REITs, private equity markets, and a wide array of financial products and services. This process will help China to attract investment capital, create markets, and stimulate economic growth. China is making progress, but much remains to be done.

With keeping pace with current movement in China, given the fact that amount of NPL in China is huge, estimated USD 911 Billion, there will be another market to invest in China, not only the current NPL disposition but also new potential NPL due to the increasing loan by the commercial banks as economic growth continue. It is a great opportunity for Korean investors who are eager to inject their money in China, chasing higher yields to expect the higher than market return under the circumstance of flourish liquidity in Korea.

5) The New Chinese Bankruptcy Law consists of 136 articles organized into 12 chapters, compared to the 43 articles and 6 chapters of the 1986 Bankruptcy Law. While the concept of bankruptcy is not entirely new to China, since China enacted a bankruptcy law at the turn of the century in 1906 and then again in 1935,

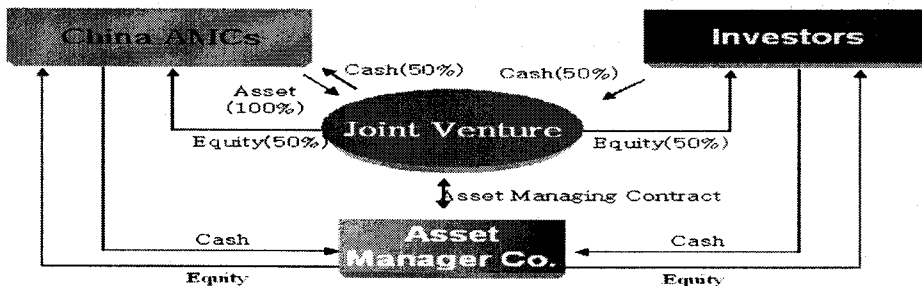
6) In 1949, the Chinese bankruptcy law was abolished and was not reinstated until the passage of the 1986 Law of the People's Republic of China on Enterprise Bankruptcy

III. Best Strategy of Investment

1. Basic Structure of Joint-Venture

Even though China's authorities are trying to reform their legislation to entice foreign capital to help to accelerate NPL resolution process, but there are a lots of loophole in China. Therefore, potential investors have a preference to make a Joint-Venture(JV) with strategic domestic investors in China which have been played for many years before injecting capital. In scrutinizing the structure of JV, AMC will make a contribution to the registered capital by transferring to the equity joint venture 50% of the undivided interest in the Initial assets which is to be managed and disposed of by the AMC upon its establishment will be those transferred to the JV by AMC. The strategic investor will make cash contributions to the registered capital in such amount as determined based on the its equity proportion 50% and the amount of the registered capital of the AMC.

AMC will provide the JV access to the huge potential markets for future business development by transferring to the latter assets that are located in the coastal cities and economically developed regions upon the JV's establishment. In addition, AMC has extensive network of contacts and facilities, and an experienced asset management and servicing team. All these qualities will assist the JV in setting up a business network and identifying business opportunities. On the other hand, strategic investor will use its strong experience in financial services areas to help JV develop its own financial products, core business technologies, service standards, marketing mechanism of new products, management structure, incentive scheme and commercially-oriented operational structure. JV will be a going concern and will not wind up after the completion of the disposition of the Initial Assets. Of course, the terms of JV may be depending on the its contract



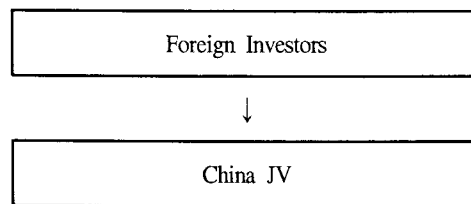
source : KAMCO, "China NPL report", 2005.

[Figure - 2] Basic structure of Joint Venture

2. Tax efficient structures

1) Direct investment

The following diagram illustrates some ideas available for investment into China, whilst mitigating the corporate, capital and withholding tax rates. It has traditionally been usual to see direct investment into a Chinese operating company, so called JV. Direct equity investment into China may present the opportunity to benefit from tax sparing relief and tax holiday, and so forth.



[Figure – 3] structure of direct investment

Usually, the income tax on enterprises with foreign investment and the income tax which shall be paid by foreign enterprises on the income of their establishments or places set up in China to engage in production or business operations shall be computed on taxable income at the rate of 30%, local income tax shall be computed on taxable income at the rate of 3%⁷⁾.

Under the current Chinese domestic law, dividend profits derived by a foreign investor from an enterprise with foreign investment shall be exempted from income tax. Interest arising in China and paid to a resident of the foreign investor may be taxed 10%. According to Agreement for the Avoidance of Double Taxation, such interest may also be taxed in the Contracting State in which it arises and according to the laws of that Contracting State, but if the recipient is the beneficial owner of the interest the tax so charged shall not exceed 10 percent of the gross amount of the interest. Therefore, interest tax will be levied 10% by the China's tax authorities.

After remittance of dividend or interest to Korea, there will be applied by the Korean Corporate Tax Law. Korean Law say that the corporate tax amount on the income for each business year of a domestic corporation shall be the amount calculated by applying the following tax rates of 25% and 2.5% local

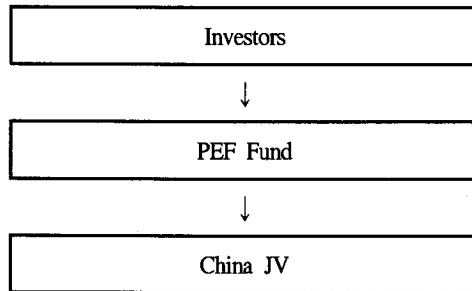
7) Income tax law of the people's republic of China for enterprises with foreign investment and foreign enterprises article 5. "In accordance with the industrial policies, China shall give a tax benefit of the reduced rate of 15% to foreign investment and encourage the establishment of enterprises with foreign investment which adopt advanced technology and equipment and export all or the greater part of their products."

income tax, total at 27.5%.⁸⁾

Related to the corporate tax, Korean government allowed deduction of tax Amount paid in foreign country with a limitation of current taxable rate of 25%.⁹⁾ If an amount of foreign corporate tax on income generated in a foreign country has been paid or will be paid, the investor's company may choose one of the various methods contemplated in Korean Corporate Tax Law.

2) Indirect investment by PEF

Private Equity Fund is a broad term that refers to any type of equity investment in an asset in which the equity is not freely tradable on a public stock market. Passive institutional investors may invest in private equity funds, which are in turn used by private equity firms for investment in target companies. Categories of private equity investment include leveraged buyout, venture capital, growth capital, angel investing, mezzanine capital and others. Private equity funds typically control management of the companies in which they invest, and often bring in new management teams that focus on making the company more valuable.



[Figure - 4] Private Equity Fund invest in China

Regarding to PEF's tax matter, government is going to give income tax deduction to Special Purpose Companies or PEF in pursuit of boosting fund-related sectors. If PEF could meet a certain criteria, pays not less than 90/100 of profits available for dividends, all corporate tax shall be deducted from the calculation of income amount of the relevant business year.¹⁰⁾

Addition to tax benefit of PEF, government allowed deduction of tax Amount paid in foreign country as the same method of direct investment, and also has a willingness to refund paid tax amount to the PEF at a

8) Korean Corporate Tax Law article 55 (tax rates)

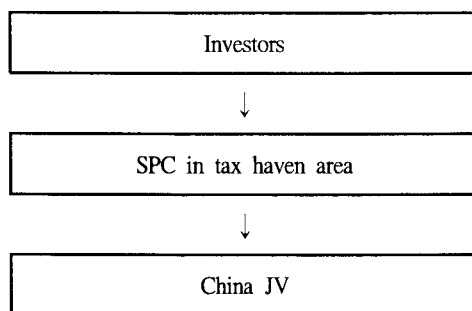
9) Korean Corporate Tax Law article 57 (deduction)

10) Korean Corporate Tax Law article 51-2.(Income Deduction for SPC) A special purpose company under the Asset-Backed Securitization Act; An investment company, private equity fund, and special purpose company pursuant to the Act on Business of Operating Indirect Investment and Assets....

time when PEF is not reaching sufficiently tax deduction amount calculated by the law under the certain amount which has less than 14% of taxable income in foreign country. therefore, we can predict the fact that PEF has more advantage then normal company in investing in China in terms of tax aspect.

3) Indirect investment by SPC

Interposing a other jurisdiction, such as Cayman Islands, Hong Kong, Labuan, between the investors and the JV can achieve many benefits like tax exemption or deduction, and tax holiday.¹¹⁾ Third party country's tax treaty with China also provides favorable provision on capital gains tax. For Chinese tax purposes, any foreign enterprise which has no establishment or place in China but which derives profits, interest, rent, royalties or other income from sources in China, or which, though it has an establishment or place in China, derives such income and the income is not effectively connected with such establishment or place, shall pay an income tax of 10% on such business profits of JV, not 33% as local enterprise's business ones.



[Figure – 5] SPC invest in China

In case of Hong Kong, China and Hong Kong signed a new comprehensive arrangement for the avoidance of double taxation on 21 August 2006 to replace the existing limited scope arrangement signed in 1998. The New Arrangement is broader in scope than old one as it also covers the taxation of passive income which was not covered by the latter.

Related to business tax issues, Permanent Establishment is important in determining whether the business profits derived by an enterprise of the Mainland or Hong Kong from the carrying of a business on the other side will be taxable in the other side. The definition of permanent establishment in the new arrangement is along the lines of that in the United Nation Model Treaty Convention. The term permanent establishment includes a place of management, branch, office, factory, workplace, mine, oil or gas well, quarry, any other

11) PriceWaterHouseCoopers, "Asian Taxation Guide", 2006. p.5.

place of extraction of natural resource, building site, construction, assembly or installation project or connected supervisory activities lasting for more than 6 months, and the furnishing of service, including consultancy services, for the same or a connected project which continue for a period or periods exceeding more than 6 months in any 12-month period. it also includes an agent, other than an independent agent, who has, and habitually exercises, an authority to conclude contracts in the name of the foreign enterprise.¹²⁾

Under the business profits article, the profits of an enterprise of the mainland or hong kong shall be taxable only in the mainland or hong kong respectively unless it carries on business in the other side through a permanent establishment situated therein.¹³⁾

Including the business tax benefit of JV-AMC, It can also provide the shareholder's dividend tax break by using SPC in Hong Kong. From the payment of income tax in accordance with the provisions of the preceding paragraph, the income beneficiary shall be the taxpayer and the payer shall be the withholding agent. The tax shall be withheld from the amount of each payment by the payer. The withholding agent shall, within 5 days withholding income tax to the government and return income tax report to the local tax authorities. An exemption from or reduction of income tax shall apply to the certain income¹⁴⁾

< Table - 5 > Features of Offshore SPC

Off-shore Jurisdiction	Type of company	Minimum annual licence, duty, fee	Taxation on foreign profits	Standard minimum paid up capital
British Virgin Islands	IBC	US\$ 300	Nil	US\$ 1
Cayman Islands	Exempt	US\$ 575	Nil	US\$ 1

12) Double tax agreement china and Hong Kong new arrangement article 5. The business profits article goes on further to explain how the profits of a permanent establishment should be determined. Expenses incurred for the purpose of the business of the permanent establishment are generally allowed as deductions. It is interesting to note that it is the practice of the Mainland tax authorities to generally tax permanent establishments on a deemed profit basis. With the New Arrangement, it remains to be seen the extent to which Hong Kong enterprises having a permanent establishment in the Mainland will be able to be taxed on an actual net income basis if that was more favorable to them.

13) If the enterprise carries on business in the other side through a permanent establishment situated therein, the business profits derived by that enterprise which are attributable to that permanent establishment may be taxed in the other side. in other words, even if an enterprise from one side derived profits from carrying on a business in the other side, it will not be subject to tax on its profits on the other side if it does not have a permanent establishment on the other side.

14) (1) profits derived by a foreign investor from an enterprise with foreign investment shall be exempted from income tax; (2) income from interest on loans made to the Chinese Government or Chinese state banks by international financial organizations shall be exempted from income tax; (3) income from interest on loans made at a preferential interest rate to Chinese state banks by foreign banks shall be exempted from income tax; and (4) income tax on royalties received for the supply of technical know how in scientific research, exploitation of energy resources, development of the communications industries, agricultural, forestry and animal husbandry production, and the development of important technologies may, upon approval by the relevant department for tax affairs under the State Council, be levied at the reduced rate of 10%. Where the technology supplies is advanced or the terms are preferential, exemption from income tax may be allowed.

Hong Kong	Private limited	US\$ 600	Nil on Foreign Profits	HK\$ 2
Labuan	Non Trading	RM 2,600 (US\$714)	Nil	US\$ 1

source : www.offshorebelize.com/other_jurisdictions.html

It will not matter to set up SPC in any place that tax authorities can give tax exemption to foreign investors like Labuan, Cayman Islands and British Virgin Islands. Each jurisdiction have a similar law that an offshore company carrying on an offshore business activity which is an offshore non-trading activity for the basis period for a year of assessment shall not be charged to tax for that year of assessment in tax haven territories. As the above table, there is no difference in terms of tax issue no matter what SPC jurisdiction will be.¹⁵⁾

3. Analysis of alternatives

Summary of all various investment structures will show the clear answer to question what method will be chosen as the best from the last investor's prospective. In terms of final investor's net revenue, SPC has more advantageous than others way of investing into China. Of course, tax treaty with China and Hong Kong can provides no tax at all on capital gains tax at a time when SPC will transfer the equity to the third party instead of collection of NPLs in China.

[Table – 6] Analysis of various investment structures

Content	Direct	PEF	SPC	
			PE*	Non-PE
JV revenue	100.0	100.0	100.0	100.0
JV tax (33%)	(33.0)	(33.0)	(33.0)	(10.0)1)
Withholding tax	-	-	-	-
SPC tax	Nil	Nil	-	-
SPC deduction of tax paid in foreign country	Nil	Nil	-	-
SPC withholding tax of dividend, interest	Nil	Nil	-	-
PEF tax	Nil	Nil	Nil	Nil

15) Labuan offshore business activities tax act 1990. article 9.

PEF deduction of tax paid in foreign country	Nil	14.0 2)	Nil	Nil
Final investor's revenue	67.0	81.0	67.0	90.0
Final investor's tax (27.5%)	(23.0)3)	(22.3)	18.4	(24.7)
Final investor's deduction of tax paid in foreign country	16.5 4)	Nil	Nil	Nil
Final investor's net revenue	60.5	58.7	48.6	65.3

* Permanent Establishment (PE)

1) China Income tax law for enterprises with foreign investment 19 article : tax rate 10%

2) Korean Corporate Tax Law article 57 (deduction) $14 = 100 \times 14\%$

3) $(67.0 + 16.5) \times 27.5\% = 23.0$

4) Korean Corporate Tax Law article 57 (deduction) $16.5 = 33 \times 50\%$

IV. Conclusion

Recently, China has earned the high growth rate of over 10% annually. In order to cool the heated economy, policy authorities and economic research institution have warned that nowadays overheating economy will be a blocking for the china long, stable economic growth needed to keep chinese people to be hired for stable society. Therefore, chinese government has announced many plans and new measures to cool off the real estate investment such as new sanction against foreign acquisition of real estates in case of not one-year of residential period. At the same time, China has begun to resolve the postponed NPL matter to solve to maintain the current pace of growth rate. Due to the result of policy failure to lend the money to the state-owned companies which had lost their comparativeness in the market, but worry shedding labour forces out of company have prevented 4 major banks from withdrawing their lending money from the distressed corporate. This new steps to resolve NPL by selling them in the open market will be new opportunity for us to invest in China. It is needed time to consider which structure of investment in China is more reasonable and beneficial for the potential Korean investors when deciding to put a lot of fund into buying the chinese assets.

In this paper, I would like to present the best structure of investment by simulating three alternative methods with scrutinizing the China's tax laws, tax haven law, Korea-China tax treaty, Korea tax laws and finding out the best among them. Especially, as a result of analysis, I came to conclude that indirect investment of SPC, setting up the SPC in tax haven like Labuan or Hong Kong, is better than others,

setting up the PEF in Korea, or direct investment. In an alternative, Direct investment in Joint-Venture will be second best way to do.

So, bear in mind that before decision-making about the foreign investment in china, indirect method of setting SPC in tax haven jurisdiction is more desirable structure as a best way of investment than direct ones, PEF in Korea. In addition, SPC has many advantages to manage the fund without interrupting by the local government authorities and no need to transfer of money to Korea after sale of stock in China in case of new investment chance in other countries.

It will also be carved out good points when it comes to lower the risk of China investment if you have to search for not only the China's tax laws but also the civil, bankruptcy and foreign investment laws from the first step to involve in China-related matters.

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