2008 Update to Doing Business in China via the Cayman Islands

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Many companies doing business in China are using a structure which includes a company formed under the laws of the Cayman Islands ("CI"). Chinese technology and internet companies listed on U.S stock exchanges such as Actions Semiconductor, Baidu, CTrip, China Medical Technologies, China Sunergy, Focus Media, Longtop Financial Technologies, Noah Education Holdings, Shanda, Suntech Power, Tom Online ,VanceInfo Technologies and Vision China Media are actually CI companies. The primary business reasons for an offshore structure are flexibility in an exit strategy, whether in connection with an initial public offering ("**IPO**") or an acquisition; the possibility of reducing U.S. taxes; and reducing the impact of China's currency exchange restrictions.

In the simplest form, the structure is a CI company with a China subsidiary. Investments are made in the CI company and the subsidiary is the operating company. The next simplest form is when the CI company is the parent company of two subsidiary corporations, one in China and the other in the U.S. A U.S. corporation is needed only if the U.S. is a market for the business. The most complex structure is required when the China business is in a restricted industry such as an Internet business[1]. Other variations include delaying the formation of a U.S. subsidiary until or if U.S. operations are needed and adding a company from a jurisdiction having a tax treaty with China (such as Mauritius) between the CI company and Chinese corporations. Global venture capitalists have become comfortable with these CI structures and many U.S. venture capitalists also understand and use these structures.

Why the Caymans?

The China Entity Selection Chart attached as Exhibit A (the "**Chart**") compares a number of jurisdictions as the possible parent company for a China related business. While alternative jurisdictions have been carefully compared in previous versions of this memorandum, today a CI company is the clear choice for a China related business. An important decision factor is that a CI company is eligible for listing on the Hong Kong Stock Exchange. Only CI, Bermuda, China and Hong Kong companies are currently approved for listing on the Hong Kong Stock Exchange. Neither the British Virgin Islands ("**BVI**") nor U.S. companies are approved.

The Hong Kong exchange has become a major exchange for China related IPOs in part because of the Sarbanes-Oxley requirements for a U.S. public company. Post-IPO liquidity for stockholders, a prior weakness of this market, appears to have improved. While many Hong Kong IPOs to date have been the privatization of Chinese state-owned companies, this exchange appears to be well positioned to attract Internet, IT and other technology companies. The improvements in the liquidity in the Hong Kong market, the cost of complying with Sarbanes-Oxley and the company economic size needed for a Nasdaq offering are factors that are causing Chinese businesses to increasingly consider an IPO in Hong Kong rather than the U.S. The U.S. may have no relationship with the business itself. Hong Kong may be closer to the businesses primary market when, for example, it is an Internet business focusing on China. Chinese business people also can communicate more easily and effectively with investors, regulators and analysts in their own language in Hong Kong.

Other considerations in choosing a jurisdiction of incorporation include the costs of and time necessary for incorporation, the extent of regulation, and the other factors listed in the Chart. A CI company traditionally could be incorporated within a day or two while a Bermuda company could take several weeks to establish. Less time is required to amend the charter documents for a preferred stock financing in the CI, and the startup and recurring annual government fees and legal fees are higher in Bermuda than in the CI.

1. See 2008 Update to Investment and Operating in Restricted Industries in China http://www.fenwick.com/docstore/Publications/Corporate/Invest_Operating_In_China_2008.pdf#xml

Investors will purchase shares and employees will be granted options in the CI company, the tentative IPO entity. A key consideration for investors is that a conventional security such as preferred stock be available for financing. For employees, stock options and other equity incentives need to look and feel the same as those of a U.S. corporation. Both the CI and Bermuda operate under versions of U.K. company and common law, and adequately accommodate these business needs. Neither countries' laws, however, protect shareholders to the same extent as U.S. laws.

The issue for a start-up is to balance the cost of creating too much infrastructure before the business is validated in the market against precluding alternatives that may become too expensive to implement later. Because of the cost of the various CI structures and the uncertainty of business success at the time of start-up, entrepreneurs have considered simpler and lower cost ways of starting a China related business. These include initially using a U.S. corporation, obtaining initial validation for the feasibility of the business, and then later reincorporating in the CI and expanding the structure. This latter scenario is sometimes referred to as a "corporate inversion." The tax cost of an inversion, however, can be extremely high as explained below. While the authors' general approach is to keep things simple until a business is validated in the market, some infrastructure may be needed at the outset to preserve alternatives.

The bottom line in comparing the jurisdiction selection factors in the Chart is the track record of CI companies going public on Nasdaq and the growing importance of Hong Kong for an IPO exit.

U.S. Tax Considerations

Many offshore business formations will not provide immediate U.S. tax minimization. Up to and possibly after an IPO, ownership of the CI company by U.S. shareholders may cause U.S. tax consequences for the CI company to be similar to those for a U.S. corporation. Thus, when commentators refer to a CI structure as being a "tax-free" way to operate, they mean there is no taxation in the CI on income from sources outside the CI.

There are three important U.S. tax planning considerations: the first concerns the transaction of incorporating or reincorporating offshore, the second involves ongoing U.S. income tax liability of the U.S. shareholders of the foreign parent entity, and the third involves making sure the business operations of the foreign parent entity are not subject to taxation in the U.S.

While in the past, entrepreneurs had the flexibility of starting with a California or Delaware corporation, and then reincorporating the parent entity off-shore through an "inversion" transaction once the business plan was validated, this alternative has become very expensive due to changes in the U.S. tax laws. Following the enactment of the 2004 Tax Act, the ability to reincorporate a U.S. parent company structure off-shore via an inversion transaction is severely limited. While not impossible, an inversion transaction today typically is not effective absent a significant capital infusion from new third-party investors or an unrelated foreign acquirer. In most cases, an inversion transaction will be disregarded for U.S. tax purposes, resulting in the new foreign parent company being characterized as a U.S. corporation for U.S. tax purposes. In addition, the new "anti-inversion" rules can impose a substantial tax penalty with respect to the unexercised options of certain "insiders" of the management team. These anti-inversion rules have proven to be very frustrating for a number of our clients seeking to pursue IPOs outside the U.S. As such, entrepreneurs must carefully consider whether an offshore parent structure should be formed at the outset.

Over the years, Congress has devised a number of ways to prevent tax avoidance (or U.S. tax "deferral") by going offshore. The U.S. anti-deferral tax rules are very complicated and what follows is a very simplified summary. The tax rules are tricky and a trap for the unwary. A foreign company may be a controlled foreign corporation ("**CFC**") or a passive foreign investment company ("**PFIC**"). The tax law applicable to CFC's essentially requires the U.S. shareholders of the CFC to report the company's income on their personal tax returns to the extent the foreign corporation has current year "earnings and profits" (a concept that is somewhat similar to retained earnings). The earnings and profits limitation can be an important exception in the case of start-up operations that are not immediately profitable. The tax implications and filings for U.S. taxpayers that hold interests in CFCs can be significant and should not be underestimated.

A CFC is a foreign company in which the total ownership of U.S. shareholders owning at least 10 percent of the voting power of the company ("**Ten Percent Shareholders**") exceeds 50 percent of the total voting power or value of the foreign corporation's outstanding shares. The Ten Percent Shareholders are taxed under the Subpart F rules of the Internal Revenue Code ("**IRC**") as if dividends had been paid to them, even if no cash is actually distributed to them. They are taxed on their share of the foreign company's "Subpart F Income" whether or not this income is distributed – provided the foreign corporation has current year earnings and profits. Subpart F Income can include certain interest, dividends, rents, royalties, and certain business income.

As a CI company closes multiple rounds of financing involving foreign investors, it may eventually avoid CFC status because of the reduction of U.S. ownership. For example, if a foreign person owns 50 percent or more of both the voting power and value of the company, then no combination of U.S. persons can own "more than 50 percent" of the foreign company. If one foreign shareholder owns 30 percent of a foreign company, and ten U.S. persons each own 7 percent, it is not a CFC, since none of the U.S. persons is a Ten Percent Shareholder.

U.S. shareholder, however, is defined very broadly. Various attribution and constructive ownership rules may cause a U.S. shareholder to be treated as owning more stock for tax purposes than he actually owns in his name. "Attribution" means that a taxpayer is deemed to own the shares of certain other related taxpayers such as a spouse, child or parent, because the law presumes that these persons have a common interest. "Constructive ownership" is the same as attribution but it is generally applied with respect to entities in which the taxpayer has some control or beneficial interest.

In other cases, such as with respect to the PFIC rules, the U.S. ownership percentage is not the most important issue. The key factors are the percentage of passive income (interest, dividends, rents, royalties) and the percentage of assets held for the production of passive income.

The third tax issue that must be carefully planned is making certain the business operations of the foreign parent company do not become taxable in the U.S. A foreign corporation is taxed at the full U.S. corporate tax rates with respect to any net income that is "effectively connected income" ("**ECI**") with a U.S. trade or business. An additional deemed U.S. withholding tax can apply with respect to ECI. This issue of ECI is of particular concern where the CI parent company, for example, is managed and controlled by individuals who are U.S. residents who perform certain business operations for the CI parent company within the U.S.'s borders.

Chinese Currency Exchange Considerations

The Chinese government closely regulates the movement of funds both in and out of China. Government approval usually is required before direct investments in Chinese corporations can be made and before cash may be transferred out of China. Investments are made into the CI entity and the CI entity typically funds the Chinese subsidiary on a monthly or quarterly basis so that investment proceeds remain outside of China until needed. In addition, commercial transactions can sometimes be structured so that non-Chinese customers pay the CI parent company directly for products and services. This does not change financial statement reporting but does provide more flexibility for cash availability.

Chinese Tax Considerations

Entrepreneurs should also consider reducing potential Chinese tax liability by taking advantage of tax treaties by forming a new intermediate company in a country having a tax treaty with China. This new company would be a subsidiary of the CI company and the parent of the Chinese company. Among other potential tax benefits, this structure may reduce potential Chinese tax liability in connection with an acquisition of the business by a Chinese acquirer, since a Chinese acquirer would probably acquire the Chinese subsidiary, rather than the CI parent company, in order to reduce unnecessary complexity in its own corporate structure and to avoid some regulatory obstacles. In such a transaction, the intellectual property of the business, the ownership of which may initially be concentrated in the CI company (as further discussed below), would be transferred from the CI company through the intermediate subsidiary to the Chinese subsidiary as a contribution of capital. Payment for the acquisition of the Chinese subsidiary by the Chinese acquirer would be made to the intermediate subsidiary subject to the lower capital gains tax rate established by the tax treaty between China and the relevant jurisdiction. The capital gains tax rate would be zero, for example, if the intermediate subsidiary is established in Mauritius without actual management within China (as discussed below).

The Indian experience with Mauritius provides possible insights on how the Chinese tax authorities may view the use of such an intermediate subsidiary. A Mauritius tax residence certificate would be a necessary but perhaps not sufficient condition for the tax benefit. The issue is the Chinese tax authorities may not accept the certificate without considering other factors, such as observing formalities among the group of companies, and where the subsidiary is being managed. As a practical matter, it can be very difficult to properly include the Mauritius subsidiary in transactions among the group of companies that form the business. The time and additional complexity required to route capital infusions through the Mauritius subsidiary may incompatible with the speed with which business must be done in today's world. According to the *Enterprise Income Tax Law of People's Republic of China and the Implementing Regulations on the Enterprise Income Tax Law of People's Republic of China*, which became effective as of January 1, 2008, if an enterprise incorporated under the law of a foreign country has its actual management, which exercises de facto and overall management and control over the operation, employees, account and properties of the enterprise, within China, such an enterprise will be a China resident enterprise under Chinese law and must pay enterprise income tax for any taxable income derived from or accruing both in and outside China.

Intellectual Property Ownership

Intellectual property ("**IP**") ownership among the group of corporations must be carefully planned. Such ownership should usually be initially concentrated in the CI company that will likely be the IPO vehicle. This concentration is done primarily through research agreements which provide that no matter where the research is actually performed, the IPO vehicle pays for and owns the results. This means that each subsidiary that will use the IP will need an inter-company IP license agreement from the CI company in order to carry out its business. Royalties and/or deemed royalties paid by the U.S. subsidiary to the CI company would be subject to a 30% U.S. withholding tax. This ownership approach is also consistent with planning for tax minimization when a company will license its IP as a revenue source.

The use of "cost sharing" IP ownership structures should also be considered. Under cost-sharing the ownership of the IP, from a tax standpoint, is split between various entities. The division of tax ownership can eliminate the need for intercompany royalty payments, thus reducing withholding taxes. Cost-sharing can also be used as an alternative to the use of a foreign parent company structure, as it can permit the non-U.S. income of a CFC from being characterized as Subpart F income. For example, a U.S. parent company can establish a wholly-owned CFC in a low-tax jurisdiction and cost-share the development of IP with that CFC. If properly structured, the CFC may exploit the co-developed IP outside the U.S. and the earnings from such activities will not be subject to U.S. taxation until distributed from the CFC to the U.S. parent company. The U.S. tax deferral provided by such a structure can provide a significant business advantage if managed correctly.

If a business intends to enter into certain contracts with the Chinese government or wants government grants or subsidies, it may be necessary for all or part of the business's IP to be "located" in China. Since the requirements of different Chinese government entities vary, there is no uniform definition for what it means for IP to be "located" in China. In its most restrictive form, a Chinese governmental entity may require that the IP actually be owned by the Chinese subsidiary. In other situations, however, a license to the Chinese subsidiary to use IP owned by the CI parent company may satisfy "ownership" requirements. As a result, businesses entering into contracts with Chinese governmental entities or seeking subsidies or grants need to carefully review the requirements.

Exit Strategy

Nasdaq as an exit strategy for a CI company is clear but not all China related businesses will have the economic scale to do a Nasdaq offering. As indicated, the increasing strength of the Hong Kong exchange is making it an important alternative for all types of China businesses. The U.K. AIM market is available for smaller offerings and market cap companies of $25M and $100M, respectively, but may be difficult for a China only business to use effectively. As indicated above, the Hong Kong exchange may attract more Internet, IT and other technology companies in the future. Depending on the particular facts, a CI company may be acquired by a U.S. company in a transaction that may qualify for tax-free characterization under the reorganization provisions of the IRC. For example, a share-for-share exchange in which the shareholders of the CI company exchange their shares in the CI company for voting stock of the U.S. acquiring company may be one possible structuring alternative. A number of other alternatives for tax free treatment also exist, such as asset-for-stock exchanges.

In addition, the completion of the reform of the A Share market in China and the market performance of the Chinese domestic stock markets has made the listing of a Chinese company on the Shanghai or Shenzhen Stock Exchange another viable exit alternative for foreign investors in businesses not operating in a restricted industry[2]. This approach is also simpler when most of the equity holders are China residents.

Return Investment

Under current Chinese laws, if the ultimate investor is a Chinese resident, who invests in China though a foreign special purpose venture ("**SPV**"), for example, a CI company, in which he/she has an equity interest ("**return investment**"), the procedures are more complicated. First, a Chinese resident must apply for registration of an overseas investment with the appropriate foreign exchange authorities before he/she carries out the oversea investment in the SPV. Second, if the Chinese resident transfers assets or equity interests of a domestic entity held by himself/herself into the SPV or the SPV seeks an equity financing after the capital injection, he/she must apply for an amended registration with the foreign exchange authorities. Third, if the SPV acquires the domestic affiliate companies of such a Chinese resident, Ministry of Commerce approval must be obtained. In addition, if the SPV has not completed the oversea investment registration mentioned above, or even such registration has been completed but the SPV has been operated for fewer than 3 years, such a SPV may not apply for foreign exchange registration for establishing a subsidiary or acquiring a domestic company in China in accordance with a circular released by the General Affairs Department of State Administration of Foreign Exchange on May 29, 2007. As a matter of practice, the requirement of a three year track record has not been strictly enforced by most foreign exchange authorities so far.

Operational Implications

The operational relationships among the various corporations in the structure must be carefully documented and regularly monitored in order to maintain the separate status of each company in the group. There must be inter-company and other agreements among the companies in order to have the intended effect for tax, liability and other purposes. For example, for a product business, a sales representative or distribution agreement or other commercial channel agreement will be needed between the CI company and each of its subsidiaries. As indicated above, a license agreement should be in place if a subsidiary needs to use technology owned by the CI company. Relationships in the structure must be "arms length" and the Internal Revenue Service may scrutinize transfer pricing among corporations in the structure. Commingling of bank accounts, other assets, operations and other business aspects will reduce the value of the structure if such sloppiness results in the offshore entity being subject to direct taxation in the U.S. If there is a Chinese

2. See the *Catalogues for the Guidance of Foreign Investment Industries* (effective Dec 1, 2007), under this list and its updates, business sectors are divided into four types: allowed, encouraged, restricted and prohibited.

resident shareholder, the structure must be well designed with careful consideration of current Chinese laws and practices.

Conclusion

Although there is more consideration of an exit within China, global investors in China businesses still prefer the exit strategy flexibility provided by a CI company.. Many entrepreneurs form a parent company in the CI for their China business in order to have the possibility of an IPO in either Hong Kong or the U.S., to provide comfort to investors and employees with respect to issuances of preferred stock and stock options, to minimize U.S. tax liability, and to maintain flexibility with Chinese currency restrictions. While it is wise for a start-up to avoid building infrastructure before the business is validated in the market, greater infrastructure may be needed at the outset to preserve important alternatives for a China related business.

If you have any questions about this memorandum, please contact Fred M. Greguras (fgreguras@fenwick.com), Bart Bassett (bbassett@fenwick.com) or Jianwei Zhang (jzhang@fenwick.com) of Fenwick & West LLP.

China Entity Selection Chart

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	Cayman Islands	British Virgin Islands	Delaware	Hong Kong	Bermuda
Local Tax	None	None	Yes	Yes	None
U.S. Tax	Maybe	Maybe	Yes	Maybe	Maybe
IPO in Hong Kong	Yes	No	No	Yes	Yes
IPO in U.S.	Yes	Yes	Yes	Yes	Yes
IPO on AIM (UK)	Yes	Yes	Yes	Yes	Yes
Availability of Taxfree Acquisition Under U.S. Tax Rules	Yes	Yes	Yes	Yes	Yes
Cost of Incorporation (legal fees and costs)	< $5,000	< $5,000	< $5,000	< $5,000	~$10,000
Time to Incorporate	1-3 days*	1-2 days*	1-2 days	7-21 days	14-35 days*
Availability of Government Incentives	No	No	No	No	No
Easy to deal with Government Authorities	Maybe	No	Yes	No	Maybe

* Subject to compliance with local money laundering laws.

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