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An Updated Look at Doing Business in China via Cayman Islands

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Some Silicon Valley entrepreneurs have used or are considering using a structure for doing business in China which includes a company formed under the laws of the Cayman Islands ("CI"). The CI company is the parent company of two subsidiary corporations, one in California or Delaware (if the U.S. subsidiary will operate primarily in the Silicon Valley then a California corporation should be used) and the other in Hong Kong or China. Because of the complexity and cost of such a structure, and the uncertainty of business success at the time of start-up, entrepreneurs have considered simpler and lower cost ways of starting this type of business, such as establishing the CI company and its U.S. subsidiary but delaying formation of the Chinese subsidiary. Others have considered starting the 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."

Other variations to this structure include substituting a Bermuda company for the CI company, delaying the formation of a U.S. subsidiary until U.S. operations are needed, and adding a company from a jurisdiction having a tax treaty with China (such as Mauritius) between the CI and Chinese corporations. In all of this, entrepreneurs must balance the cost of creating unnecessary business infrastructure before the business is validated against inadvertently precluding alternatives that may become too expensive to implement later. While the authors' general approach is to keep things simple until a business is validated, some infrastructure may be needed at the outset to preserve alternatives.

The primary business reasons for an offshore structure are (a) flexibility in an exit strategy, whether in connection with an initial public offering (**"IPO"**) or an acquisition, (b) the possibility of reducing U.S. taxes and (c) reducing the impact of China's currency exchange restrictions. Other factors that should be carefully considered by China-focused entrepreneurs include the possibility of utilizing tax treaties to reduce Chinese taxes, the ownership of the business's intellectual property and operational implications.

Which Jurisdiction?

An initial consideration for entrepreneurs doing business in China is whether a company from the contemplated jurisdiction of incorporation would be eligible for listing on the Hong Kong Stock Exchange, since the Hong Kong stock market may be the appropriate IPO stock market for a China-related business. Only CI, Bermuda, China and Hong Kong companies are currently approved for listing on the Hong Kong Stock Exchange. Neither British Virgin Islands nor U.S. companies are approved.

As between CI and Bermuda, there is also no difference in U.S. tax implications when the exit strategy is an acquisition by a U.S. company. Either a CI or Bermuda company may be acquired in several ways by a U.S. company in a tax-free transaction. (As discussed below, Chinese tax liability in an acquisition of the Chinese subsidiary by another Chinese entity may be reduced by use of an intermediate subsidiary.)

Other considerations in choosing a jurisdiction of incorporation include the costs of and time necessary for incorporation, the costs of on-going governmental and legal services, the extent of regulation and the availability of international financial services. 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. Recent changes in the CI, however, have at least narrowed the CI time advantage.

Investors will purchase and employees will be granted options for the equity in the company at the top of the structure, 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.

Bermuda has been the recent choice of many U.S. public corporations that have reincorporated offshore. Like the CI, there is no corporate income tax in Bermuda on income from sources outside of Bermuda. In addition to tax relief, some of the U.S. public corporations have also chosen Bermuda for its strong anti-fraud and anti-money laundering laws. Some entrepreneurs have expressed an aversion to using Bermuda because Enron was incorporated there, but most of Enron's subsidiaries were CI corporations.

Nevertheless, the lower costs and generally faster time to incorporate and amend charter documents for a financing still give the CI a slight advantage for a startup or early stage company. These factors are particularly important during the early stages of a business, but become less important as the company matures.

Following 9/11 and the Enron debacle, some members of Congress and others have cast reincorporating offshore as unpatriotic. Eliminating eligibility for federal contracts and an outright moratorium on offshore reincorporations have been mentioned as possible actions. On the other hand, legally minimizing taxes to stay globally competitive is a valid business purpose. The global competitor may be the former U.S. corporation that reincorporated offshore before it became more restrictive to do so. Lawmakers have not addressed what actions would be taken against former U.S. public corporations that previously reincorporated offshore or against businesses that incorporate offshore at the outset or reincorporate offshore near startup time long before becoming a public company.

U.S. Tax Considerations

Most 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 two U.S. tax planning considerations: the first concerns the transaction of incorporating or reincorporating offshore and the second involves ongoing U.S. income tax liability. While keeping it simple is always a good way to start a business, if an entrepreneur starts with a California or Delaware corporation and then tries to invert it by reincorporating in the CI, the transaction will be taxable to the shareholders — unlike, for example, a domestic reincorporation in which a California corporation reincorporates in Delaware prior to an IPO. An offshore reincorporation is treated as if the shareholders sold their equity in the original U.S. corporation. The actual impact to the shareholders will depend on the value of the corporation at the time of reincorporation. For example, the much-publicized proposed reincorporation in Bermuda of Connecticut toolmaker Stanley Works — which finally abandoned its reincorporation plans in the face of public protests and threatened congressional action — would have reportedly resulted in $150 million in capital gains taxes to its shareholders. In order to avoid this adverse tax consequence, at least the offshore parent and U.S. subsidiary corporation should be formed at the outset.

Over the years, Congress has devised a number of ways to prevent tax avoidance by going offshore. These 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"), foreign personal holding company ("FPHC") or a passive foreign investment company ("PFIC"). The tax law applicable to CFC's and FPHC's essentially requires the U.S. shareholders to report the company's income on their personal tax returns. The tax implications and filings for U.S. taxpayers 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 company ("Ten Percent Shareholders") exceeds 50 percent. The Ten Percent Shareholders are taxed as if dividends had been paid to them even if no cash is distributed to them. They are taxed on their share of the foreign company's "Subpart F Income" whether or not this income is distributed. Subpart F Income includes certain interest, dividends, rents, royalties and business income unless the business is conducted entirely within the country in which the CFC is incorporated.

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 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.

Chinese Currency Exchange Considerations

One problem faced by foreign investors in China is the repatriation of any return on their investment. The Chinese government closely regulates the movement of funds both in and out of China, and government approval usually is required before investments in Chinese corporations can be made and before cash may be transferred out. The CI entity typically funds the Chinese subsidiary on a monthly basis so that most investment proceeds remain outside of China until needed. In addition, commercial transactions can be structured so that non-Chinese customers pay the CI parent company 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. If the intermediate subsidiary is organized in Mauritius, for example, the capital gains tax rate would be zero.

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 whether the Chinese tax authorities will accept the certificate without considering other factors, such as observing formalities among the group of companies, the sources of funding for the business 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. The subsidiary should be managed from outside China since the Indian experience suggests that a Mauritian tax residence certificate may not be sufficient to protect tax treaty status if the subsidiary is effectively managed from India.

Intellectual Property Ownership

Intellectual property ("IP") ownership among the group of corporations must be carefully planned. Such ownership should typically be initially concentrated in the CI company that likely will be the IPO vehicle rather than among multiple entities. 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 the U.S. subsidiary corporation may need an inter-company IP license agreement from the CI company in order to carry out business in the U.S. This ownership approach is also consistent with planning for tax minimization when a company will license its IP as a revenue source.

If a business intends to enter into certain contracts with the Chinese government, however, 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 often 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 group's Chinese subsidiary. However, in other situations, a license to the Chinese subsidiary to use IP owned by the CI parent company may satisfy government requirements. As a result, businesses entering into contracts with Chinese governmental entities need to carefully review the requirements of the relevant governmental entity. An early-stage business that is unsure of whether it will be relying on Chinese government contracts in the future should initially concentrate its IP in the CI company, since it can later contribute all or part of its IP to its Chinese subsidiary in order to comply with applicable requirements.

Operational Implications

The operational relationships among the various corporations constituting this complex 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. 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 United States.

Conclusion

In order to keep open the possibility of having an IPO in either Hong Kong or the United States, 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 given Chinese currency restrictions, many China-focused entrepreneurs form a parent company in Bermuda or the CI. Bermuda's strengths are its stronger legal infrastructure and momentum as the jurisdiction of choice for offshore reincorporation of U.S. public companies. However, the lower costs and faster time to incorporate and amend charter documents for a financing give the CI an advantage for a startup or early stage business. These factors are particularly important during the early stages of a business but become less important as the company matures. The use of a Mauritius intermediate subsidiary may minimize Chinese tax liability if the exit strategy becomes the acquisition of the China subsidiary by another Chinese entity. Prior to an acquisition event, the IP of the business should be owned by the parent CI company, provided that such ownership is permitted by any contracts between the business and any Chinese governmental entities. Finally, entrepreneurs should be aware of the operational implications of maintaining an international corporate structure. While it is wise to avoid building infrastructure before the business is validated, some infrastructure may be needed at the outset to preserve important alternatives.

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