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Private Equity Law

Will "Foreign-invested Venture Capital Investment Enterprise" (FIVCIE) Fade Away?
- Tax Pass-through Status of FIVCIEs Officially Ended

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On January 4, 2011, the State Administration of Taxation ("SAT") promulgated *Circular on Publishing the Catalogue of Normative Taxation Documents Which Are Totally or Partially Abolished* (SAT Public Notice [2011] No.2, "Bulletin 2"). According to Bulletin 2, Article I, Article II, paragraph 1 and the first sentence of paragraph 2 of Article 3 (collectively, "Abolished Provisions"） of the *Circular of the State Administration of Taxation on Relevant Issues Concerning the Payment of Enterprise Income Taxes by Foreign-Invested Venture Capital Investment Enterprises* (Guoshuifa [2003] No.61, "Circular 61") were abolished effective as of January 4, 2011.

Circular 61, issued on June 4, 2003 under the direction of the *Regulation on the Administration of Foreign-Invested Venture Investment Enterprises*, governs the enterprise income taxation of foreign-invested venture capital investment enterprises ("FIVCIE"). Of critical importance is the provision establishing the tax pass-through principle with regard to the income taxation of non-legal-person FIVCIEs, which was abolished by Bulletin 2. Under Circular 61, a non-legal-person FIVCIE used to be allowed to choose to have its investors pay income tax on their shares of income from the FIVCIE or, alternatively, apply to the local tax authority to pay income tax at the FIVCIE level. If a non-legal-person FIVCIE chose to have its investors pay income tax, its foreign investors generally shall pay income tax as though such foreign companies had a permanent establishment in China, except where the non-legal-person FIVCIE did not directly engage in venture capital management or consulting business through an internal management and operation organ but delegated its daily investment management and operation to another venture capital investment management enterprise or venture capital investment enterprise, in which case foreign investors of such a FIVCIE may pay tax as foreign investors without a permanent establishment in China ("No-PE Tax Treatment"). Many FIVCIEs are structured to fall into this exception. The Non-PE Tax Treatment provision remains intact after the partial abolishment of Circular 61. However, whether foreign investors can enjoy no-PE tax treatment requires a case-by-case analysis, taking into account the definition of "permanent establishment" under the relevant tax treaty between China and the country of residence of the particular investor, whether such investor falls under the purview of PRC tax rules governing the taxation of so-called "PRC-controlled offshore enterprises", among other things.

As a matter of fact, the validity of Circular 61, in particular the pass-through treatment provision, has been in question for some time. Circular 61 was issued under the authority of the PRC Income Tax Law for Foreign-Invested Enterprises and Foreign Enterprises ("Foreign Enterprise Income Tax Law"), which was invalidated on January 1, 2008 with the adoption of the PRC Enterprise Income Tax Law (the "Unified EIT Law"), which clearly provides that all enterprises and other organizations with PRC-sourced income, with the exception of sole proprietorships and partnerships, shall pay enterprise income tax in accordance with the Unified EIT Law. Non-legal-person CJV or FIVCIE is not among the enumerated exceptions.

In parallel with the unfavorable development with respect to rules governing non-legal-person FIVCIEs is the emergence of limited partnerships as a major entity form for private equity and venture capital funds in recent years. Partnerships enjoy tax pass-through status granted by the PRC Partnership Enterprise Law, effective as of June 1, 2007, and subsequent related tax rules. Since March 1, 2010, foreign investors have also been allowed to form foreign-invested partnership enterprises in China. More recently, Shanghai released trial regulations on its QFLP ("Qualified Foreign Limited Partner") pilot program, which allow qualified funds formed in Shanghai with QFLPs to conduct foreign exchange settlement at the fund level rather than portfolio company level and allow such funds whose sole foreign currency capital comes from the general partner or the management company in the amount of no more than 5% of the fund's capital to be generally treated as a domestic RMB fund free from restrictions applicable to foreign investors. With the official end of the tax pass-through status of non-legal-person FIVCIEs, foreign fund sponsors currently operating FIVCIEs or will be raising a fund soon should think carefully about the impact of such developments on their funds.

If you have any questions regarding the foregoing, please feel free to contact us.

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