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1. China Legal Services - Our association with PRC lawyer practicing in China

In order to service the increasing number of our clients and contacts who require advice on investing or establishing manufacturing enterprises in China we have formed an association with a local female Chinese lawyer in Auckland (Ms.June

Liu) who is currently practicing with a Beijing legal firm and has done so for some seven years. She is performing a consulting capacity to our firm. Her firm has associated offices in Shanghai. She has already worked with us on a joint basis with one of our clients making a major investment in Kunming City in China and we have found utilisation of a PRC lawyer who speaks and writes excellent English and who has considerable experience at the domestic legal level in China, an enormous advantage. Many firms aspire to advise on China law but this inevitably means, even with major international firms, utilising local firms in China who are the only ones who can actually sign off with definite legal advice on a particular matter.

The advantage in having access to in-house advice is that when dealing with local firms in China translation of documentation is readily available and this is a huge advantage when many of the staff in China domestic legal firms, particularly in the smaller cities, are not able to speak English and are not familiar with Western legal practice.

We welcome any enquires regarding transactions in China. Although we do not formally practice China law, our association with Ms. June Liu in Auckland means that we have immediate access to a practicing PRC lawyer and a Chinese legal firm. We are prepared to arrange translation and interpretation of any China legal documents.

2. Difficulties of investing in Real Estate in China- a recent transation.

Those clients who have attempted to invest in China will be well aware of the difficulties that can arise These difficulties were highlighted in a recent transaction where clients of ours from Australia and New Zealand purchased a substantial commercial building in Kunming City in China. We were fortunate to be working with our associated China lawyer in Auckland who was able to give advice so as to avoid potential difficulties for our client.

It may be useful to mention some of difficulties that were encountered when attempting to purchase land in China.

In order to assist with the WOFE license and the acquisition of the commercial building, we used a legal firm in Kunming City. Amongst the difficulties we encountered with the firm were:

- a) A complete absence of spoken or written English.
- b) An absence of any of the recognised conveyancing procedures that are common in Hong Kong or other Western countries. For instance, there seems to be no concept of a trust account or holding funds in escrow pending the issue of title.

- c) Title to land in China is akin to having a leasehold interest. There is no possibility of obtaining freehold title as in jurisdictions such as UK, Australia or New Zealand.
- d) The costs quoted for the conveyancing seemed to us and our associate June Liu to be high;
- e) China legal firms do not appear to be required or hold professional indemnity insurance;
- f) We discovered that the firm also acted for the vendor, a local developer. We were assured that this would cause no problems and there was no conflict of interest. However, we elected to instruct another firm;
- g) One of the more alarming features of the transaction was that there appeared to be no procedure to partially release a mortgage or charge against the piece of land being purchased. It did seem that the whole mortgage had to be discharged and this perhaps highlights the infancy of Chinese conveyancing procedures;
- h) Uncertain advice on whether a Hong Company could be used to purchase the property and the need for the WOFE entity to lease the property in order to satisfy the WOFE licensing requirements. At provincial level there seems however to be a degree of flexibility not apparent at the MOFTEC level. We were finally satisfied on perusing the China laws and regulations that a Hong Kong Company could be used to purchase a commercial building.

Our general advice to clients who are making acquisitions such as this is to obtain execution of a non -legally binding heads of agreement subject to Hong Kong law and make that conditional on the obtaining of the necessary license or authority to establish a WOFE and purchase any land.

In summary, we advise clients to proceed with caution in relation to any acquisition of land or a transaction that involves a major up front investment of funds. The procedures including documentation, payment of deposit and retention of funds pending transfer of title appear to be ill-defined and legal practice markedly different from Western procedures.

3. **Investment structures in China – is there any need for change?**

Clients who have previously invested in China will have usually established a structure of an offshore holding company either in Hong Kong or in a offshore tax haven which then owns the interest either in the WOFE or local joint venture company. The advantages of this structure are obvious, as change of ownership

offshore of the venture in China may be possible, and in addition, the offshore company may be able to list on a recognised stock exchange.

However, the new China M & A regulations that came out in August 2006 may force some changes when considering structuring. It now seems that where an offshore company, for instance, wished to acquire control of a PRC business that has a connection with its shareholders, central Mofcom approval is required. This used to be done at provisional level, but Mofcom approvals are difficult to obtain.

It now seems that investors who wish to avoid complications are going back to investing directly into a Chinese domestic company in the same way as years ago when initial investment was in the form of a sino- foreign joint venture governed by the Chinese joint venture laws. The advantages are that approval at provincial level is easier to obtain for this type of structure.

It may be possible at a later date for the local joint venture to be converted into a foreign invested company and possibly the Chinese partner could be brought out by utilisation of offshore cash to purchase its equity interest in the joint venture.

While China has official laws on joint ventures and foreign owned enterprises, they are constantly evolving and there is a need to examine a structure carefully to see if it will be flexible enough if a change is required further down the line.

4. Exemption of trustees for negligent Acts of Directors confirmed

In a recent case in the United Kingdom of *Barnes & Ors v Tomlinson & Ors* 2006 BW8C 3115 (CH) the Queen's bench division in London confirmed that the standard exemption clauses included in trust deeds exempting trustees for management of an underlying company or responsibility for the acts of directors is still the law.

There has always been debate on how far trustees may protect themselves from failing to supervise directors of an underlying company in which they hold shares. There is little doubt that the test is whether the trustees have acted reasonably and prudently and this should still be the guideline for trustees notwithstanding that they have the protective clauses in the trust deed. In the present case it seemed that trustees did not blindly close their eyes to what was going on but nevertheless relied on the advice given by what appeared to be previously trusted and experienced advisors. The fact that these advisors acted imprudently and nearly bankrupted the company did not mean that the trustees were responsible for the negligent actions. The clauses in the Trust Deed exempting them from the responsibility of being involved in management of the Company were held to be effective.

Settlors of Trusts, when trusts are set up, may wish the trustees to act in a way that imposes some controls on the directors of an underlying company. On the

other hand, some Settlers, who may also be the directors of the company, do not wish to have to consult or run all management issues by the trustees with the inevitable delays and the need for the trustees to take independent advice. From the trustees' point of view they have no interest in becoming involved in trading matters on which they have no expertise. Quite commonly now, the trustees wish to appoint an investment advisor to advise them, which at least allows them to make informed decisions, and will also exempt them if they rely on the advisor's opinions, and have an exempting clause in the trust deed.

We recommend that Settlers when establishing trusts should work out an appropriate method of consultation over investment decisions with the Trustees so that a fair balance between the independence of the directors to act, and the need for the trustees to know what is going on is reached.

5. What is the best jurisdiction in which to Establish a Trust?

There have been recent moves by the Hong Kong government to review the trust regime in Hong Kong due to moves by Singapore to move from what is voluntary licensing system to a mandatory licensing system. Big players in the trustee market, such as Citybank, are applauding the move and there is little doubt that with the Singapore extra territorial tax regime, new licensing system and general reputation for stability that it will offer formidable competition to the traditional offshore havens.

However, we believe that the advantages perceived to be present in Singapore are overrated. There will be a mandatory licensing system but there will also be minimum capital requirements which mean that smaller trustee companies may not be able to operate there. Regulation of the trust industry may not always be welcomed and it is not clear whether the Settlers or beneficiaries of the trust will have to be revealed. While no one is suggesting that complete anonymity is required, on the other hand, Settlers do not wish to have unduly restrictive regime.

By contrast, Hong Kong operates a strictly voluntary licensing system. While it is true that it does not have a comprehensive trust regime, in that there are no provisions for asset protection, appointment of protectors, special purpose or vista trusts as in BVI, it nonetheless remains an excellent jurisdiction in which to establish a trust. It has not so far come under FATF control, and there is still provision for corporate directors to be appointed where private companies are involved, which may or may not be important depending on the structure. While it is true that taxation regime for trusts has also been uncertain in Hong Kong, currently with the provision in the IRO that a trustee must only declare income to which he is beneficially entitled, there is effectively no requirement for a trustee to file a return or declare income in respect of the beneficiaries of a trust. However, a factor mitigating against the use of Hong Kong trustees may be the initial and ongoing management costs.

Our preferred jurisdictions remain the British Virgin Islands and New Zealand. The advantages of the British Virgin Islands are well known and it does provide a regime for small family trustee companies without any requirements for licensing or registration. New Zealand operates a foreign Settlor regime which has increasingly been used by Settlers who will never live in New Zealand. It offers the same advantages as the British Virgin Islands, and although recently there was a new legislative requirement to disclose to the NZ IRD the existence of a trust by name, and whether the Settlor was from Australia, there is otherwise no requirement to reveal the names of beneficiaries or indeed the Settlor of a trust. In addition, there remains the possibility that New Zealand's double tax treaty network can, in some circumstances, be utilised by the trustees. The overwhelming advantage that New Zealand offers is that it is regarded as a respectable and stable jurisdiction and again, it has not attracted the attentions of the FATF in Europe. Costs to establish and maintain a trustee company in NZ are minimal compared with other jurisdictions.

We should be glad to discuss the advantages and disadvantages of any trust jurisdiction with anyone who wishes to consider an establishment of a trust. Our firm is engaged extensively in planning, formation and structuring of trusts, together with associated taxation advice and advice on transfer of assets to the Trust.

6. Taxation – accessibility to tax of payments made between a Subsidiary and a Parent company

In a case decided in the Court of Appeal in Hong Kong in November 2006 (Commissioner of Inland Revenue and Tai Hing Cotton Mill (Development) Limited),the Court dealt with a tax issue arising out of a substantial price paid for land by a subsidiary to its parent company. Payments between subsidiaries and parent companies have sometimes attracted the attention of the IRD, the usual issues being whether the payment made by the subsidiary or parent company is deductible, or whether it represents a profit element, meaning that the deduction should be disallowed either because it is not a deduction allowed in law, or because it is an evasion strategy under Section 61 of the Inland Revenue Ordinance.

The essential facts of the case involved a payment of a purchase price made by the subsidiary to the parent in respect of development of a site owned by the parent company. Payments were calculated by reference to the value of the land, but also by reference of a portion of profits generated by the parent company in the development.

The Commissioner claimed that payments exceeded the market value of the site and were not payments but appropriation of profits made to the parent company by the subsidiary tax payer. Accordingly, payments made to the parent company were profits and not deductible by the subsidiary under Section 16 of the IRO.

The Court of Appeal had no difficulty in finding for the taxpayer subsidiary on the basis that the market value of the site was a real and proper one and there was no intention to evade tax. The transaction was in fact one where payment was being made for an income stream. The Court held that there is a distinction between the profits in respect of services rendered or perhaps physical goods and stock in trade, and payments which simply represented a share of profits which had been purchased by some contract whether it be by franchise or otherwise. The quotation by an English judge Roma L J “is the payment that has been made by the trader under the contract which is in question in truth a mere division of profits with another party or is it, in truth the payment to the other party, the amount of which is ascertained by reference to profits?” was held to be the correct approach to determining the nature of the payment made.

In summary, the case does however highlight that payments between parent companies and subsidiaries should always be carefully planned and potential taxation aspects of the transaction examined closely.

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