The Current State of Play of Foreign Investment Vehicles in China: Is Partnership a Rising Star?

In this article, the authors compare and critically evaluate various foreign investment vehicles in China, with a focus on the relatively new concept of foreign-invested partnerships.

1. Introduction

After nearly 40 years of opening up to the world, China has implemented many reforms to improve its business environment for foreign investments. Since China enacted its first modern corporate income tax law for foreign investments in 1980, the income tax system for foreign investment has undergone several reforms in a relatively short period of time. The legal system with respect to investment vehicles for foreign investments has been developed in a similar rapid manner as its taxation counterpart. Commencing with a limited number of choices of investment vehicles in the late 1970s, China has gradually introduced more forms of investment vehicles, including foreign invested partnerships and limited partnerships, in recent years.

The aim of this article is twofold. First, it identifies and analyses the current state of play with respect to the choices of foreign investment vehicles in China, with a focus on the more recently introduced form of partnerships. Second, it critically evaluates some key income tax issues with respect to the foreign investment vehicles, again with a focus on the relatively new concept of foreign-invested partnerships.

This article first reviews the different forms of foreign investment vehicles currently available in China. This is followed by an overview of the general income tax regime applicable to the foreign investment enterprises, setting the stage for a detailed analysis of the income tax issues of partnerships in China, aiming to highlight the key issues and uncertainties in this area of the income tax law in the country.

A caveat is necessary before proceeding. It is not uncommon for sub-national tax authorities in China to offer “local special treatments” in order to attract foreign investment. These treatments may not always be in full compliance with the national tax law and regulations. A detailed discussion of these local variations is beyond the scope of this article. Furthermore, this paper does not aim to analyse in detail the approval requirements and processes of different forms of foreign investment vehicles in China.

2. Investment Vehicles for Foreign Investments

2.1. Introductory remarks

Since the early 1910s, China was in the middle of civil wars and political turmoil, until the Communist Party established the People’s Republic of China in 1949. Due to the political ideology of the government, foreign investment disappeared from China since then. Until the implementation of Deng Xiaoping’s economic open door policy in the late 1970s, all enterprises were owned by the government, which received profit appropriations from these state-owned enterprises.

In 1978, China undertook economic reforms and adopted the open door policy. Due to the lack of experience with foreign investment, the government adopted a cautious attitude, which is nicely encapsulated in a famous quote from a Chinese political leader: China was attempting to “cross the river by feeling the stones on the river bed.” At that time, the concept of companies limited by shares was non-existent. The investments were mostly in the form of joint ventures with Chinese partners. For instance, equity joint ventures (“EJVs”) were allowed to be established since 1980. Wholly foreign-owned enterprises (“WFOEs”) were permitted from the mid-1980s onwards. However, their number was small at that time due to restrictive approval requirements.

4. For an example of such local treatment with respect to the look-through treatment of partnerships in China, see W. Cui, Tax Classification of Foreign Entities in China: The Current State of Play, 64 Bull. Intl. Taxn. 11. p. 562 (2010), Journals IBFD.
8. This was also the general attitude of the Chinese government towards its economic reform and development.
9. Corresponding income tax law for EJVs was enacted in the same year.
10. Cui & Krever, supra n. 6, at p. 342.
Since China’s admission into the World Trade Organisation in 2001, its investment policy was relaxed, allowing foreign investors to establish WFOEs in most industries in China. Nowadays, the majority of foreign investments are in the form of WFOEs, as depicted in the Table. In 2013, they represented nearly 80% of foreign investment in terms of both the number of entities and the amount of investment. The different forms of investment vehicles for foreign investments are reviewed in sections 2.2. – 2.8.

### 2.2. Wholly foreign-owned enterprises

WFOEs have limited liability, and are separate legal entities from their interest holders. The primary advantage of a WFOE is that foreign investors have full control of the business. The involvement of a Chinese partner in a joint venture inevitably increases risks and challenges in terms of economic, legal, social and cultural conflicts among investment partners. For instance, it may be “much easier to recruit, train, and retain employees when [they] are in full control of the employer side of the relationship … [this] also reduces the likelihood of intellectual property erosion.” The advantage of the protection of technology is a critical consideration for many foreign investors. In practice, to establish a WFOE is much easier than to establish other forms of entities. A primary reason is that the establishment of a WFOE does not involve the often difficult negotiation with Chinese partners as in the cases of a joint venture.

### 2.3. Joint ventures

Joint ventures are primarily used by foreign investors in industries in which the Chinese government requires the involvement of a Chinese partner. For example, under the current version of the Foreign Investment Industrial Guidance Catalogue effective from 2012, foreign investors in the mining industry in general are not allowed to form WFOEs; instead, they must form joint ventures with Chinese partners. In practice, the success of a joint venture is often determined to a large extent by the choice of an appropriate Chinese partner.

There are two types of joint ventures for foreign investors in China: EJVs and cooperative joint ventures (”CJVs”). EJVs are separate legal entities from its investors and have limited liability. Their partners share profit and losses strictly according to their proportional capital contributions to the joint ventures. The minimum foreign investment proportion in an EJV is 25%. Similar to WFOEs, EJVs are different from companies in western countries in the sense that they are not limited by shares. Instead, investors hold equity interests in the entities in accordance with the respective capital contributions of the investors. Voting rights are vested in the board of directors, the composition of which often reflects the ratio of capital contributions of the joint venture partners.

CJVs offer more flexibility in terms of capital contributions, as well as allocation of voting rights and rights to profit and losses. These rights of investors in a CJV are determined according to the joint venture agreement, instead of their respective capital contributions to the entity. In practice, most CJVs are separate legal entities with limited liabilities. However, it is possible to establish a CJV that is not a separate legal entity. For instance, before foreign-invested limited partnerships were allowed to be established in China, some non-legal-person CJVs had been set up by venture capital funds.

### 2.4. Joint-stock companies

Joint-stock companies (”JSCs”) have been allowed to be established in China since 1993 when the modern company law was enacted in the country. Under the company law, two types of companies can be established.
22. The major difference between the two types of companies is that only the former can issue shares to the general public. This is the main reason why foreign investors choose to incorporate JSCs in China.

JSCs also offer the advantage of facilitating transfer of interests in the entities. In general, shares in a JSC can be transferred to other parties without the need to obtain consent from other existing shareholders. In contrast, if a foreign investor intends to sell its interest in an EJV or CJV, it will have to obtain consent from other investors in the entities, as well as approval from the relevant government authorities.

Other forms of foreign investment enterprises may be converted into JSCs if they want to be listed on a Chinese stock exchange. The popularity of JSCs is limited by regulatory restrictions, including higher capital requirements than other forms of foreign investment.22

2.5. Foreign-invested partnerships

2.5.1. Initial comments

Partnership is a relatively new concept in China.23 The Partnership Law was enacted in 1997.24 Under the original Partnership Law, only Chinese individuals were allowed to form partnerships in China.25 Furthermore, limited partners were not allowed.26

The restriction with respect to individual partners was relaxed when the Partnership Law was amended in 2006.27 Effective from 1 June 2006, besides individuals, legal entities established in China in general are allowed to be partners of a Chinese partnership.28 However, state-owned enterprises, listed companies and charitable organizations are not allowed to be general partners.29

The rules on partnerships in China were further relaxed in 2010 after the State Council issued the "Measures for the Establishment of Partnerships in China by Foreign Enterprises and Foreign Individuals" on 25 November 2009, effective from 1 March 2010.30 Since then, foreign

23. The Partnership Law stipulates three types of partnerships in China, namely general partnerships, limited partnerships and special general partnerships.

Similar to the concepts in developed countries, a general partnership is not a separate legal entity and its partners have unlimited joint and several liabilities for the debts of the partnership.36

A limited partnership consists of at least one general partner and one or more limited partners, up to 50 partners in total.37 Limited partners are not allowed to participate in the daily operation of the partnership and cannot represent the partnership to third parties.38 They are liable to the debts of the partnership up to the extent of their capital contributions to the partnership. Limited partnerships have proved to be popular for private equity funds.39 This is because the structure is particularly suitable for the business model of such funds, under which the fund sponsor assumes the role of general partner and manages the funds while passive investors assume the role of limited partners.40 China has recently embarked on a pilot scheme for venture capital limited partnerships offering specific tax concessions. This issue is discussed in more detail in section 3.2.5.
The third type of partnership that is allowed under the Partnership Law is known as a “special general partnership”. It is designed specifically for local professional service organizations that utilize professional knowledge and technical know-how to provide services to customers.41 It appears that this type of partnership was designed to promote the growth and development of local professional services firms, including accounting, law and engineering firms.42 For instance, regulations were released by the Ministry of Finance dictating that the top ten local accounting firms had to convert to this form of partnership before 2011, and the top 200 local accounting firms were “encouraged” to adopt this form of partnership before 2012.43

A special feature of special general partnerships is about the liabilities of their partners. In general, all partners bear unlimited liabilities for the debts of the partnership.44 However, if a special general partnership incurs liability due to an “intentional or serious mistake” of a partner, that partner should bear unlimited liability while other partners of the partnership will bear liability limited to their shares of the partnership’s assets.45 In practice, this type of partnership is unlikely to be available to foreign investors, due to the stringent local professional licensing limitations imposed on foreign persons.46

2.5.3. Advantages of partnerships as investment vehicles in China

Partnerships offer a number of advantages over other forms of foreign investment. First, they are more flexible in terms of the requirements on capital contributions by investors. Partnerships are not subject to minimum capitalization requirements that are often applicable to EJVs, CJVs and WFOEs.47 Furthermore, the Partnership Law stipulates that, in general, a partner can contribute capital in the form of “cash, tangible assets, intellectual properties, land use rights and other rights, as well as services” (emphasis added).48 In addition, the value of these capital contributions can be determined by agreement of all partners in the partnership.49 For instance, it is possible for an investor of a property development project to contribute land use rights while another investor contributes services with respect to design and project management.50 The option of contributing services is particularly useful for limited partnerships in which the general partners can contribute their services of managing cash contributions of the limited partners.51 The flexibility with respect to capital contributions has also contributed to the popularity of partnerships among small and medium-sized businesses.52

Second, similar to CJVs, partnerships are flexible with respect to profit allocation among their investors. Partners can share profits of the partnership according to the partnership agreement, which can deviate from the proportion of their respective capital contributions. In contrast, investors in EJVs must share profit and losses of the entities according to their capital contributions. This flexibility offered by a partnership is particularly important for investment funds which often involve a carried-interest arrangement under which, if a fund manager’s performance exceeds a pre-determined benchmark, it is entitled to a performance fee equal to a share of the profits of the funds.53

Third, partnership profits are in general taxed once at the partners’ level as the partnership itself is not a taxpayer. In contrast, a resident individual investor in a WFOE or EJV may be effectively subject to double taxation under the classical system of China’s corporate income tax regime, known as Enterprise Income Tax (“EIT”). In particular, taxable income of resident enterprise is subject to EIT at the entity level and dividends received by its resident individual investor are taxable under the Individual Income Tax (“IIT”) Law without any relief for the EIT paid at the entity level.54

While a partnership may have the tax advantage of avoiding the double taxation issue under the classical system, the look-through treatment does not apply to partnership losses. This issue is analysed in section 3.2.2.

2.6. Foreign-invested holding companies

Another form of foreign investment vehicle is a foreign-invested holding company. It is an option for foreign investors who have multiple projects in China with capital investment of at least RMB 30 million. A holding company can facilitate centralization of various functions of the group, including purchasing, marketing and employee training.55 Besides offering the operational efficiency by having a holding company in China for different investment projects, a holding company also helps raise the profile of the foreign investor. While other forms of foreign investment enterprises are prohibited to use the words “investment holding company” and “China” in their names, holding companies can.56

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41. Art. 55 Partnership Law. Special general partnerships are in some ways similar to limited liability partnerships in the United States. Marsh, supra n. 16, at p. 297.
42. Marsh, supra n. 16, at p. 297. Before the Partnership Law started allowing this kind of partnerships, most Chinese accounting firms were organized in the form of limited liability companies. Cai, supra n. 26, at p. 626.
43. Ministry of Finance, Cai Hui [2010] No. 21 “Provisional Regulations to Promote the Form of Special General Partnership for Big and Medium Size Accounting Services Firms” (announced on and effective from 21 July 2010), arts. 3 and 4.
44. Art. 57 Partnership Law.
45. Id.
47. The minimum capital requirement for these entities varies among industries and locations in China. Partnerships are also not subject to the 70% cap on non-cash capital contributions that are applicable to other forms of foreign investment enterprises (McKenzie, supra n. 34). This is especially important for high-tech start-ups with intangibles constituting a large portion of the capital contributions.
48. Art. 16 Partnership Law. Limited partners are prohibited from contributing services as their capital (art. 64).
49. Art. 16 Partnership Law.
50. Marsh, supra n. 16, at p. 298.
51. McKenzie, supra n. 34.
52. Qiu, supra n. 33, at p. 300-301.
53. McKenzie, supra n. 34.
54. The tax implications of a foreign partner are complex and are discussed in section 3.2.4.
55. Deloitte, supra n. 13, at sec. 2.1.
56. Ross, supra n. 12.
2.7. Representative offices

Representative offices ("ROs") represent "the most traditional type of unincorporated presence in China." They can be set up in China primarily for liaison and marketing activities. They are not separate legal entities, and are in general prohibited from direct profit-making activities. In practice, most ROs in China are taxed on a deemed profit basis in accordance with their operating expenses.

2.8. Branches

China has allowed foreign investors to establish branches in China since 1993. However, the establishment of branches by foreign enterprises is strictly regulated by the government and branches are uncommon in China, except for specific industries such as banks, insurance and oil exploration companies.

3. Taxation of Foreign Investment Enterprises

3.1. Introductory remarks

3.1.1. Overview

Section 3.1. first provides an overview of the income tax regime applicable to foreign investment in China. This review sets the stage for the analysis of the tax issues with respect to partnerships in the country (see section 3.2.).

Before 2008, China had a dual corporate income tax system with two separate enterprise income tax systems for foreign invested enterprises ("FIEs") and domestic enterprises. In broad terms, foreign invested enterprises and foreign enterprises were subject to the Income Tax Law for Enterprises with Foreign Investment and Foreign Enterprises, and often enjoyed generous tax concessions, including reduced tax rates and tax holidays. In contrast, domestic enterprises were subject to the Provisional Regulations on Enterprise Income Tax without similar concessions.

In practice, the effective tax rates of domestic enterprises were substantially higher than that of FIEs due to the various tax concessions available to foreign investors. For instance, most FIEs enjoyed a reduced tax rate of 15% or 24%, while domestic enterprises were subject to a statutory tax rate of 33%. The Chinese government recognized that "the average enterprise income tax burden on foreign-funded enterprises is 15% while that on domestic enterprises is 25% ..." This competitive disadvantage became more acute when China was admitted into the World Trade Organisation in 2001. As more domestic industries were open to foreign investments and thus had to face increasingly fierce competitions with FIEs, domestic enterprises lobbied for "national treatment" from their own government.

In 2008, China replaced the dual enterprise income tax system with the uniform Enterprise Income Tax Law ("EITL"), which applies to both FIEs and domestic enterprises. The standard EIT rate is 25%. The statutory rate was set after a detailed international comparison of prevailing corporate tax rates in other countries, as the Chinese government noted that the level of enterprise income tax rates in the world, especially the neighbouring countries ... has to be taken into account. The average enterprise income tax rate is 28.6% in 159 countries ... while that in China's 18 neighbouring countries ... is 26.7%. The rate of 25% ... is relatively low in the world and will be conducive to enhancing enterprise competitiveness and attracting foreign investment. (Emphasis added)

3.1.2. Definition of taxpayers

Similar to most income tax systems in the world, the EITL adopts the residence and source principles, under which a resident enterprise is subject to EIT on its worldwide income while a non-resident enterprise is subject to EIT on its China-sourced income.

“Resident enterprises” are defined to be enterprises established in China, or enterprises established outside China but with their place of effective management in China. The place of effective management of an enterprise is defined to be the location where the enterprise exercises comprehensive management and control of its business operations, employees, finance and assets.

The decision to adopt the dual-factor definition of corporate residence – namely, the place of establishment and the place of effective management – was partly driven by anti-avoidance concerns. The Chinese government recognized that many enterprises incorporated companies in low-tax jurisdictions for tax avoidance purposes and artificially shifted profits to those locations. The “place of effective management” factor was adopted primarily to address this issue.

A “non-resident enterprise” for EIT purposes is defined to be an enterprise established outside China with its place of effective management also outside China, but either with an establishment in China or deriving income sourced in China.
China. Dividends, profit distributions, interests, rental income, royalties and gains from transfer of property derived by non-resident enterprises are subject to withholding tax. The withholding rate in general is 10%, which is subject to applicable tax treaties.

### 3.1.3. Preferential treatments

China continues to provide preferential EIT treatments under the new EITL to enterprises engaging in industries that the government encourages, but in general to a lesser extent than those allowed under the old EIT laws. The Chinese government appeared to be growing in confidence in its continuing ability to attract foreign investment, despite reducing reliance on concessions in the tax system.

International experience has shown that political stability, sound economic development, big market … constantly improving legal environment and government services are main factors for absorbing foreign investment, and the tax preference is only one factor. Therefore, the new [EITL] will not exert a great impact on foreign investment.

The focus of the EIT preferential treatments also represents a change of economic policy direction of the Chinese government. While the focus was on production enterprises and export-oriented enterprises before 2008, the current EIT Law shifted the focus to the hi-tech industry and removed the original preferential treatments to production and export-oriented enterprises altogether.

### 3.2. Taxation of partnerships

#### 3.2.1. Initial comments

The Partnership Law stipulates that income of a partnership is taxable in the hands of its partners. The EITL follows this general principle, and excludes partnerships established under Chinese laws from its scope. The State Administration of Taxation ("SAT") explained the exclusion of domestic partnerships from EIT in this way:

> Taking into consideration that … partnerships are "natural person enterprises without legal entity status, and the interest holders are subject to unlimited liabilities, the EIT Law does not apply to … partnerships that are established under Chinese laws. (Authors' unofficial translation, emphasis added)

The explanation reflects the fact that, at the time of drafting the current EIT Law, only resident individuals were allowed to form partnerships in China. In other words, partnerships established in China are in general treated as look-through entities and the partners are regarded as the taxpayers instead. However, this look-through treatment is not applied consistently with respect to losses incurred by a partnership. Furthermore, the character of income derived by a partnership may not be preserved in the hands of the partners. More is said about these issues below.

It should be noted that the exclusion of partnerships from the definition of taxpayers under the EITL applies only to partnerships established in China. In contrast, partnerships established outside China would still be within the scope of the EITL. The SAT justified the different tax treatments between domestic and foreign partnerships primarily on the basis of the anti-avoidance policy objective. While the look-through treatment for domestic partnerships was designed primarily to avoid double taxation of the same income at both the entity and partners levels, the SAT believed that this look-through treatment should not be applied to foreign partnerships for the purpose of protection of the tax base. It was concerned that if a foreign partnership could enjoy the look-through treatment, China might not be able to collect tax revenue from its foreign partners. In fact, this "opaque" treatment of foreign partnerships seems to be also applicable to foreign trusts and other non-corporate entities. An important tax implication of this policy is that foreign investors investing in China through a foreign partnership may not be able to claim treaty benefit under the tax treaty between China and the investor’s residence country.

Under the look-through treatment, partners of a domestic partnership are the taxpayers who are responsible for the tax liabilities with respect to their respective shares of the partnership’s taxable income. Pursuant to a tax circular issued by the SAT in 2008, a partner that is a legal entity of foreign entities is possibly beyond the current capacity of the country's tax authorities.

China’s tax rules on partnerships have been described in this way: "esoteric legal rules, as opposed to common sense logic, dominate in this area." The following sections analyse three main issues with respect to partnerships:

1. The denial of the look-through treatment for partnership losses (see section 3.2.2.);
2. The preservation of character of partnership income in the hands of partners (see section 3.2.3.); and

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71. Art. 2 and 3 EITL. "Establishment" is defined in article 5 of the EIT Regulations (which is subject to tax treaties). A detailed discussion of this concept is beyond the scope of this paper.
72. Art. 19 EITL.
73. The general withholding rate is 20% as stipulated in article 4 of the EITL, but in general it is reduced to 10% under article 91 of the EIT Regulations.
74. For instance, enterprises may be eligible to EIT exemptions and reductions for income derived from primary industries, infrastructure projects, environmental protection projects and qualified technology transfers (art. 86-88 EITL). Enterprises engaging in venture capital investments may be eligible for a tax offset of a portion of their capital investment against their taxable income (art. 31 EITL and art. 97 EIT Regulations).
75. Jin, supra n. 63, at sec. IV.
76. Preferential treatments for eligible hi-tech enterprises include reduced tax rate of 15% and tax holidays.
77. Art. 6. Partnership Law.
78. Art. 1 EITL and art. 2 EIT Regulations.
79. SAT, Guo Shui Han (2008) No. 159, supra n. 70, at para. 5.
80. Art. 2 EITL and art. 3 EITL Regulations. See also Li & Huang, supra n. 3, at p. 276.
81. Li & Huang, supra n. 3, at p. 276.
82. Cui, supra n. 23, at p. 64. This tax policy is not unusual among non-OECD countries (Cui, supra n. 4, at p. 539). Another reason for the opaque treatment of foreign entities is that the complexity involved in the classification of foreign entities is possibly beyond the current capacity of the country’s tax authorities (Cui, supra n. 4, at p. 563).
83. For an example of this issue, see Cui, supra n. 4, at p. 560.
84. Ministry of Finance and SAT, Cui Shui [2008] No. 159 "Income tax issues of partners of a partnership", art. 2.
85. Cui, supra n. 4, at p. 539.
(3) the uncertainties of the tax treatment of foreign partners (see section 3.2.4.).

3.2.2. Tax losses of partnerships

For EIT purposes, losses of an enterprise in general can be carried forward for five years to offset its future income. No carry back of losses is allowed.

The EIT regime applies an unusual treatment to tax losses incurred by partnerships established in China. In contrast to the look-through treatment for partnership profits, tax losses of a partnership cannot be attributed to its partners and are trapped at the entity level. It appears that the denial of the look-through treatment with respect to partnership losses is a tradition in China. Ever since partnerships have been allowed to be established in China, losses incurred by a partnership have been trapped at the entity level. In particular, the tax treatment of partnership losses is stipulated in a tax circular issued in 2000 when the Partnership Law allowed only resident individuals to form partnerships:

Losses incurred by a partnership in an income year can be carried forward to the following income year to offset against its income up to five income years. The losses cannot be utilised to offset against income of another partnership established by the same investor(s). (Authors' unofficial translation)

The quarantine of partnership losses at the entity level seems even more perplexing given that the same circular stipulates that:

If an investor establishes two or more partnerships … he should aggregate all his shares of taxable income from the enterprises and use this amount as the basis to determine the applicable tax rates and compute his tax liability.

Bearing in mind that, at the time when this circular was issued, only resident individuals could form partnerships in China, this profit aggregation rule was reasonable, as individual income tax was imposed on a progressive tax rate system. One possible reason for the loss quarantine rule is anti-avoidance purposes. It has also been argued that, if partnership losses were allowed to be attributed immediately to partners, China would have to introduce complex tax rules to address the "overwhelming" problems arising from the passing of losses to partners, which would likely to be beyond the capacity of the tax authority to handle.

After the Partnership Law was relaxed to allow resident legal persons to form partnerships in 2006, the SAT issued a tax circular to confirm that the policy of denying the attribution of partnership losses to partners is also applicable to partners who are "legal entities or other associations". In other words, the losses have to be carried forward at the partnership level and are subject to the normal loss carry forward rules as discussed above. In practice, an enterprise partner has to maintain a separate loss pool for the investment in the partnership. If the share of partnership profits for the next five years is not sufficient to offset fully the amount of losses in the pool, the unused losses will be lost.

3.2.3. Nature of profit distributions from partnerships

Another tax issue for partnerships in China is the inconsistent look-through treatment of the character of income derived by a partnership.

A tax circular issued by the SAT in 2001 – when the Partnership Law allowed only resident individuals to form partnerships – stipulates that interest and dividends derived by a partnership are not included in the taxable income of the partnership. Instead, they are attributed directly to the partners who are subject to IIT at a flat rate of 20% on this kind of income. In other words, this rule preserves the nature of interest and dividend income derived by a partnership in the hands of resident individual partners. In contrast, under a tax circular issued in 2000, other types of income derived by a partnership would be taxed in the hands of the partners as "business income", which is subject to IIT at progressive tax rates up to 35%.

The policy rationale behind these rules is not immediately apparent. Under the IIT Law, interest, dividends, royalties, rents and gains from asset transfers are subject to the same flat tax rate of 20%. It is puzzling why the flow-through treatment applies only to interest and dividends, but not the other types of income.

It is important to note that the 2000 and 2001 tax circulars were issued at the time when the Partnership Law allowed only resident individuals to form partnerships. While this circular appears to be valid at present with respect to resident individual partners, it is unclear if it is applicable to resident legal-person partners, or non-resident partners.

The character of income shared by a partner is critical in determining its tax treatment in the hands of the partner. The EITL stipulates that dividends and profit distributions paid by a resident enterprise are exempt from tax if the recipient is either:

(1) a resident enterprise; or

91. Ministry of Finance and SAT, Cai Shui [2008] No. 159, supra n. 84, para. 5.
92. Cao, supra n. 7, at p. 17.
93. State Administration of Taxation, Guo Shui Han [2001] No. 84 'Individual Income Tax on Investors of Sole Proprietors and Partnerships', art. 2; and art. 3(5) IIT Law.
94. Ministry of Finance and SAT, Cai Shui [2000] No. 91, supra n. 87, art. 4 and art. 3(2) IIT Law.
95. Art. 3(5) IIT Law.
96. The general rule of treating partnership income (except dividends and interest) as "business income" in the hands of partners means that the income, in most cases, would be subject to higher effective tax rates for individual partners under IIT (Cui, supra n. 26, at p. 627-629). This explains partly why partnerships may not be a popular form of business entities for individuals (id., at p. 629).
3.2.4. Taxation of foreign partners

An important issue for a foreign enterprise partner of a partnership established in China is whether the partnership is regarded as an "establishment" of the partner in China. The EITL stipulates that if a non-resident enterprise has an establishment in China, its income derived from the establishment is subject to EIT at 25%. However, if the non-resident enterprise has no establishment in China, its income derived from the enterprise would be subject to withholding tax of 10% (subject to tax treaty).

Alternatively, a foreign enterprise partner may argue that its partnership in China constitutes an establishment in the country for EIT purposes. Then, a literal reading of the dividend-exemption provision mentioned above suggests that the partnership profit shared by the foreign enterprise partner should be exempt from EIT, to the extent that the amount is attributable to dividends derived by the partnership from a resident enterprise.

On the other side of the debate, it is possible for the SAT to argue that, as partnerships are excluded from the scope of EIT and, therefore, not a "resident enterprise" for EIT purposes, profit distributions from partnerships do not qualify for the exemption. However, the SAT has not yet clarified the issues.

In broad terms, "establishment" is defined in the EITL to be a place or organization where business is carried on in China. In particular, a non-resident enterprise which "appoints an agent to carry on business in China, including an agent who executes contracts on behalf of the enterprise on a regular basis, store or deliver goods, etc." would be regarded as having an establishment in China.

The issue may seem to be relatively more straightforward for limited partners, as they are not allowed to carry on the activities of the partnership or to represent the partnership in its relation with third parties. As such, limited partners may have a basis to argue that their partnerships should not be regarded as their establishments.

However, this position does not seem to be supported by a circular issued by the SAT in 2003 with respect to the taxation of foreign investment venture capital enterprises under the old EITL. In particular, the circular stipulated that, for a non-legal person, venture capital enterprise (for example, a non-legal person CJV), its investors could elect to file separate EIT returns. In that case, a foreign investor in the enterprise in general would be regarded as having an establishment in China. However, if the venture capital enterprise did not have its own office in China, did not engage directly in the management of venture capital business, and instead engaged a venture capital management company to perform the daily investment activities, the foreign investor would not be regarded as having an establishment in China. In other words, under this circular, a foreign investor in a venture capital enterprise which managed its business directly in China would be regarded as having an establishment in China. This is so even if the foreign investor itself did not engage directly in the operations of the enterprise.

It is unclear whether the policy stipulated in the circular—which was issued before foreigners were allowed to form partnerships in China—would be applicable to partnerships now in general. The uncertainty is compounded by the fact that this circular was officially made obsolete by the SAT as it was based on the old EIT Law which had been replaced by the current EITL in 2008.

A recent tax circular issued by the SAT in 2013 seems to clarify the position under the current EITL with respect to venture capital limited partnerships. In particular, the circular explicitly states that a legal-person partner of a venture capital limited partnership established in the Suzhou Industrial Park is a "resident enterprise" for the purposes of EIT.

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97. Article 26(2) and (3) EITL. The exemption does not apply to dividends paid by listed resident enterprises if the shares in the enterprises have been held continuously for less than twelve months (art. 83 EIT Regulations).
98. The tax implication also depends on whether the partnership is regarded as an "establishment" of the foreign partner in China. If so, a foreign partner may be treated as a resident enterprise and, thus, subject to the normal EIT rate of 25%. This issue is discussed further in section 3.2.4.
99. Art. 1 EITL.
100. Art. 3 and 4 EITL.
101. Art. 4 and 27(5) EITL and art. 91 EIT Regulations.
102. Art. 5 EIT Regulations. For a detailed discussion of the concept of "establishment", see Cui, supra n. 23.
103. Art. 5 EIT Regulations.
104. Art. 68 Partnership Law.
105. Marsh, supra n. 16, at p. 301.
106. SAT Guo Shui Fa [2003] No. 61 "Enterprise Income Tax of Foreign Investment Venture Capital Enterprises". It should be noted that, at that time, foreigners were not allowed to form partnerships in China yet.
107. Id. at art. 3.
108. In practice, "virtually all [foreign investment venture capital enterprises] formed until … the revised Partnership … Law took effect [in 2010] used the management company structure" to avoid exposing their foreign investors to net-income basis taxation under the EITL. (Cui, supra n. 23, at p. 71).
110. Id. at art. 1. China is not alone in adopting this policy. In fact, many jurisdictions have similar rules of treating a foreign partner in a partnership as being engaged in a business in the country (Cui, supra n. 23, at p. 84).
by this partner are subject to EIT at 25%. It is unclear if this position is applicable to all partnerships in general. It is also not clear whether the deemed residence policy may discourage foreign investors from investing in venture capital partnerships in China.

### 3.2.5. Venture capital limited partnerships

China has been experimenting recently with the concept of venture capital limited partnerships ("VCLPs"). Since 2012, VCLPs have been allowed to be registered in Suzhou Industrial Park under a pilot trial scheme authorized by the State Council. A specific income tax preferential treatment for these limited partnerships is that, in broad terms, they can offset up to 70% of their capital investment amount against their shares of taxable income from their venture capital investments. In particular, a legal-person partner of a venture capital limited partnership established in the Suzhou Industrial Park can enjoy this capital offset regime if the partnership invests in small and medium-sized high-tech enterprises for more than two years. The partner can enjoy this concession after two years of investment by the partnership in this kind of hi-tech enterprises. Any excess of the capital investment amount after offsetting against the current year’s share of partnership income can be carried forward to future income years.

An interesting tax rule for VCLPs is stipulated in a tax circular issued by the SAT in 2013. If a legal-person partner of a VCLP has established other similar partnerships in the Suzhou Industrial Park, the capital investment offset can be applied on an aggregation basis. In other words, the partner can combine its shares of partnership profits to offset against its aggregate capital investment in the different partnerships. This policy seems to be in contrast to the general rule that a partner cannot offset its share of losses from one partnership against its share of profits from another partnership.

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111 Another possible tax implication of this tax rule is that, if a treaty applies, capital gains that might otherwise be exempt under the treaty may become taxable under the business profits article (Cui, supra n. 23, at p. 88).

112 The pilot scheme was approved by the State Council effective from 1 January 2012. This represents the recognition of the Chinese government that, in practice, most venture capital funds are organised in the form of limited partnerships, and its desire to promote the industry in the country.

113 Art. 31 EITL and art. 97 EIT Regulations. These rules are reiterated and elaborated in circulars issued specifically for venture capital limited partnerships established in Suzhou Industrial Park. See Ministry of Finance and SAT, Cai Shui [2012] No. 67 "Enterprise Income Tax issues of enterprise partners of venture capital limited partnerships established in Suzhou Industrial Park"; and SAT, Gong Guo [2013] No. 25, supra n. 109.

114 For the requirements of "small and medium sized high-new technology enterprises" for the purposes of this concession, see SAT, Guo Shui Fa [2009] No. 87 "Enterprise Income Tax Preferential Treatments for Venture Capital Enterprises", art. 2.


116 Id.

117 SAT, Gong Guo [2013] No. 25, supra n. 109, at art. 3.


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### 4. Conclusion

China's business environment for foreign investment has been improving continuously since its open door policy in the late 1970s. Foreign investors now have a wide variety of choices of investment vehicles. They can establish wholly-owned subsidiaries in the form of WFOEs, joint ventures with Chinese partners, incorporate companies limited by shares, and the more recently introduced partnerships. In particular, foreign investors can be general partners as well as limited partners of a partnership established in China. This structure is especially suitable for the venture capital industry which the Chinese government is eager to support.

The income tax law has undergone similar stages of reforms and refinements over the past few decades. The current EIT Law provides a uniform regime for both foreign and domestic investment enterprises. However, the current regime seems to be lagging behind the recent development of the Partnership Law which allows legal entities as well as foreign investors to form partnerships in China. There are two issues that are of particular importance. First, it is unclear whether the character of income derived by a partnership is preserved in the hands of its partners. This issue is critical in determining whether dividends received by a partnership from a resident enterprise would be exempt from EIT in the hands of a resident enterprise partner. The issue may also affect the tax implications of such income in the hands of a foreign partner. Second, it is unclear whether a partnership established in China would be regarded as an establishment of its foreign enterprise partner. This issue is critical in determining whether the foreign partner would be subject to EIT on a net income basis at 25%, or to withholding tax on a gross basis at 10%. It appears that the tax law should keep abreast of the development of the Partnership Law and clarify these issues to further enhance the investment environment in China.