"Check the box" on China and The Netherlands even if you are not a US taxpayer! (The use of hybrid entities in international tax planning structures part V)

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Introduction

In several previous articles (WCR December 2009[1], WCR March 2010[2], WCR June 2010[3], WCR December 2010[4]) I believe I have demonstrated how the use of hybrid entities in international tax planning has changed over time, from somewhat obscure in the past to fully accepted today, as a means to save oneself considerable tax amounts in a fully legal fashion. The times of tax planning via the use of so-called special purpose companies for cross-border investments are almost over if you have kept a close look at the development of tax case law worldwide. Tax authorities have by now found all the weak spots:

1) lack of substance (an old problem);
2) lack of beneficial ownership (especially with the new OECD Model Treaty guidelines , just published);
3) the permanent establishment attack (spc's having a "place of management" in the home country of the multinational to which a large part of their profits can be allocated);
4) transfer pricing tax planning via shifting risks and intangibles to entities which do not have the knowledge to manage them.

However, the use of hybrid entities, if structured properly, will not fly in the face of any tax authority, because both of them, in a two country situation, will be confronted with a structure which to them is fairly "normal" ie. they know from their own tax viewpoint what the tax rules for these structures are and they usually show no interest in how they are treated abroad, because to them that is irrelevant anyway.

The topic for today: China

In this article I should like to focus on an excellent new tax planning opportunity for investments into China, offered by the introduction of the Chinese Partnerships Law per 1/7/2007 which deals with Chinese general and limited Partnerships. Such investments, in a Chinese LP, by multinationals from whatever country, via the Netherlands into China, offer these multinationals, even if they are not US-based, a "check the box" type of tax planning tool whereby they can freely choose to set up a Chinese LP structure which is tax wise treated as a subsidiary of its intermediate holding company in the Netherlands whilst in China it is seen as a tax transparent entity so the partners are subject to Chinese tax and not the LP itself.

This mismatch, in combination with the reverse mismatch that Dutch limited entities which invest abroad may also by characterized as a type of "check the box" tax planning, now under Dutch tax law, so they could be seen as tax transparent ("branches") under the Dutch CIT rules whilst abroad they are treated as foreign legal entities, can lead to a very tax efficient financing of the Chinese operations. This might be achieved either in the way of direct financing of the Chinese operations or via indirect financing: either the operational lease of equipment or the licensing of intangibles. The end result in all three cases being a tax deduction in China without any pick-up of the corresponding income in the Netherlands. This may sometimes even be further combined with a double dip: tax deductible interest in the Netherlands (even after the introduction of a new Bill of Law which was announced in May 2011 to reduce the tax deductibility of interest) and tax deductibility of that same interest (or an economically corresponding lease fee or licensing fee) in China.

This article has been written in close cooperation with several international tax specialists from Beijing University who have excellent access to the SAT, China's state administration for taxes. In fact the University of Beijing, today, is the only institution in China which has been able to enter into a number of "advance tax rulings" (ATR's) with the Chinese government, even though ATR's do not officially exist in China.

What does "check the box" mean?

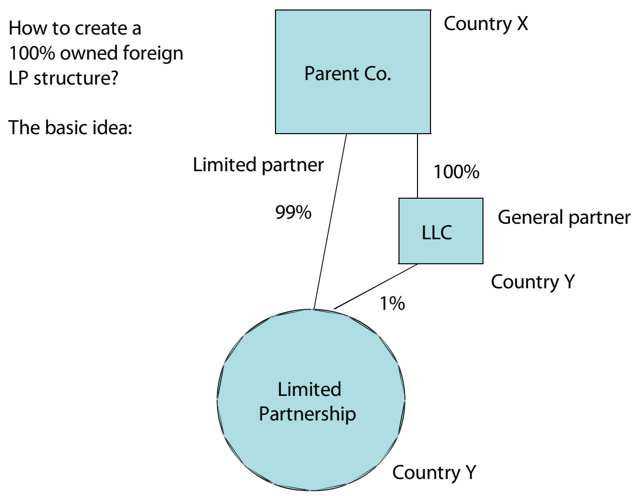
US-based tax payers have the option, for most types of foreign subsidiaries, to freely choose whether they will for US tax purposes be treated as tax entities (subsidiaries) or as tax transparent entities (branches). This can be done in the US tax return by checking a box on each foreign operation. When foreign entities are treated ("checked") as branches, any intercompany agreements with their direct parent companies become invisible for US tax purposes, a feature which has given rise to massive tax planning by US based multinationals since these rules were first introduced in 1994. Tax payers outside the US are not normally offered a choice on how to treat their foreign operations: their home country tax rules will decide whether such foreign operation is to be seen as a shareholding in a foreign entity (subsidiary) or as a foreign branch of the home country enterprise.

This article deals with a dual option right to treat subsidiaries as branches: one in the Netherlands where Dutch subsidiaries of Dutch tax payers may disappear for Dutch tax purposes when entering a tax consolidated group, and the Dutch rules to determine the taxation of a participation by a Dutch tax payer in a Dutch or foreign partnership. The Dutch fiscal unity rules are a real "election" almost like the US check the box procedure; with the partnerships interests the "checking" occurs when determining the details of the partnership agreement. The usual freedom of contract ensures that Dutch tax payers can elect to alter the Dutch tax treatment of a partnership share by merely adjusting a few words in the partnership contract; the insertion or deletion of just one word may be enough to go from tax transparency to full tax liability for a given partnership share. Therefore, as easy as "checking a box."

Why set up a Chinese LP or LLP if there is no joint venture?

Some readers of my previous articles have pointed out to me that they could not easily relate to my advice to set up hybrid LP's abroad because their company's foreign investment plans do not involve any cooperation with a third party: they just want to set up 100% owned foreign operations in case a foreign investment is being planned. To them the only tax question has always been "foreign branch or foreign legal entity?" So apparently it is quite a step already to realize that there is a third way to set up your wholly owned foreign business:

Exhibit 1



In this manner one combines the "foreign branch" tax rules with the "foreign subsidiary" tax rules. The difference is that usually neither a foreign branch nor a foreign subsidiary is capable of constituting a tax mismatch (other than in "check the box" elections made by US investors that are not the subject of this article). A branch is usually a branch in the tax view of the home country and in the tax view of the investment country. And a foreign subsidiary as seen from the home country is usually also a subsidiary in the tax view of the investment country. But an LP may give a tax payer the option to arrive at a tax mismatch at will. Such a mismatch can either be favourable (income elements not taxable in both countries or cost elements tax deductible in both countries) or unfavourable (income elements taxable in both countries or cost elements non-deductible in both countries) which obviously calls for prudence.

In fact, the tax planning around favourable mismatches (double tax deductions or income not taxable in either country) often has its roots in situations of double taxation: two tax authorities not willing (ie. not able) to take foreign tax aspects into account when deciding on the local tax aspects.

So I recommend that both tax payers and tax advisers, when looking at basic foreign investment scenarios, do not only take the usual branch versus subsidiary distinction into consideration but also spend some time on analyzing the tax effects of a fully owned foreign LP.

The Dutch "check the box" rule for foreign limited liability partnerships

The Netherlands is not officially known to have any "check the box" rule for taxation purposes and generally speaking there is no such rule, except for Dutch and foreign limited liability partnerships. Careful reading of the history of the Dutch CIT Act of 1969 reveals that the Dutch tax legislator has been struggling with the question of what forms of partnership should be treated as transparent for tax purposes and what forms should be subject to corporate income tax. This struggle has not been different from the struggle on exactly the same subject in other countries and each country has in the end taken its own decisions on this point, regardless of what other, even neighbouring, countries have done. They never really cared that this created a very high risk of double taxation, even under tax treaties!

The Dutch aim with defining the tax treatment of local partnerships has been to treat partnership forms which showed substantial resemblance with limited liability companies as subject to CIT and other partnership forms as tax transparent. The Netherlands' legal system knows a fairly large number of joint venture formats, so in the end a number of compromises found their way into the Dutch CIT Act. It should be kept in mind that in the days that these decisions were taken, Dutch limited liability companies were always joint ventures: a BV had to be incorporated by at least two incorporators, but each incorporator was free to sell his shares to a third party (albeit under a right of first refusal for the other existing shareholders) even seconds after the incorporation. But the JV aspect prevailed, back then.

"Tax authorities never really cared that their tax treatment proposals for LP's created a high risk of double taxation even under tax treaties"

Therefore the decision was taken to subject so-called "open" limited liability partnerships to Dutch corporate income tax. Whether a Dutch LP is "open" or "closed" has been defined as a situation where upon the entrance of a new partner this decision of the partners meeting would or would not be subject to unanimous approval from all partners. In case such unanimity was part of the document which established a Dutch LP (which used to be and can still be mere contractual arrangements in the Netherlands which can exist without any formal "founding" requirements), the partnership was considered as "closed" and not subject to Dutch CIT.

It follows that a Dutch LP (called a *"Commanditaire Vennootschap"* in Dutch, usually abbreviated to "CV") is in fact a check the box entity for Dutch CIT purposes: the founders may freely choose how to word their internal rules for the admission of new partners so they are free to create a CV which is not subject to CIT, if that suits them best, or to create a CV which is taxable for CIT.

It was not until the late nineties of the previous century that the Dutch tax authorities decided to use the same "open" versus "closed" criteria dating back to 1969 for participations of Dutch tax payers in foreign LP's: this was officially made public via a so-called resolution in which the Dutch Ministry of Finance has laid down the tax criteria for "participations in foreign joint venture formats including LP's".

The main criteria for a foreign LP to determine its Dutch tax status as "open" or "closed" and if "closed", as "comparable to a Dutch CV or not" (the check the box trigger) are:

1) Will the foreign LP own all business assets it uses in its enterprise or can some assets continue to belong to a partner even if used by the LP?
2) Is the capital of the foreign LP divided into shares or does the LP have a similar method to allocate profits to the partners?
3) Are all partners only liable for the debts of the LP for the amounts they have put in or are the partners or some partners liable for the debts of the LP without limitation?
4) Can new partners enter the LP or can partners sell their LP shares to other partners without the unanimous consent of all partners?

From a Dutch CIT viewpoint we will always need a foreign LP interest and not a foreign GP interest

This has to do with fairly old but still prevailing Dutch Supreme Court case law which held that a foreign interest as a GP in a Dutch LP structure must be regarded as directly accruing to the GP even if the Dutch LP is "open". This case law will then also apply to interests held by a Dutch tax payer as a foreign GP interest and this interest can consequently never be regarded as a subsidiary because the GP interest is then always deemed to stem from a "closed CV" from a Dutch CIT perspective. So in fact a Dutch Open CV is a hybrid all by itself: it is only "open" for the limited partners and not for the general partners; slightly confusing perhaps but something not to miss when structuring the set-up.

Country by country tax research is clearly indicated

In general, the question with regard to an investment by a Dutch tax payer into a foreign LP "is this foreign LP comparable to a Dutch CV and if so, is it "open" or "closed"?" cannot be answered without closely studying the LP rules on a per country basis. Each country has different rules as regards the above four "tax attributes" at stake.

It should be carefully noted that the question "is the foreign LP share subject to foreign CIT as a branch office or as a tax entity?" is not part of the criteria! The Netherlands will treat a foreign LP interest of a Dutch tax payer as a foreign branch if the Dutch rules say so, even if the foreign tax system treats that interest as a tax entity and vice versa.

When studying the Law of the People's Republic on Partnerships, it became apparent to me that Chinese LP's seem to have all the characteristics necessary for the Dutch "check the box" election: the partnership can own business assets all by itself, but can also use business assets owned by one of the partners, the managing partners of the LP have unlimited liability and the admission of new partners or the replacement of existing (exiting) partners by other existing (remaining) partners is, according to the Chinese Law, subject to the unanimous voting of the partners meeting "unless arranged otherwise in the LP agreement". So one can found a Chinese LLP where admission and replacement is subject to unanimous voting of all limited partners so the GP has no vote in this and this will turn the Chinese LP into an "open" LP so the interest in it qualifies under the Dutch rules for participations (ie. subsidiaries and the - in many ways different - Dutch tax rules for foreign branches do not apply.

What this might cause is depicted in three different case study scenarios, which show remarkable economical resemblance but are nonetheless treated differently under tax laws and tax treaties: intra-group financing, intra group operational leasing of equipment and intra-group licensing of an intangible. ■

Exhibit 2

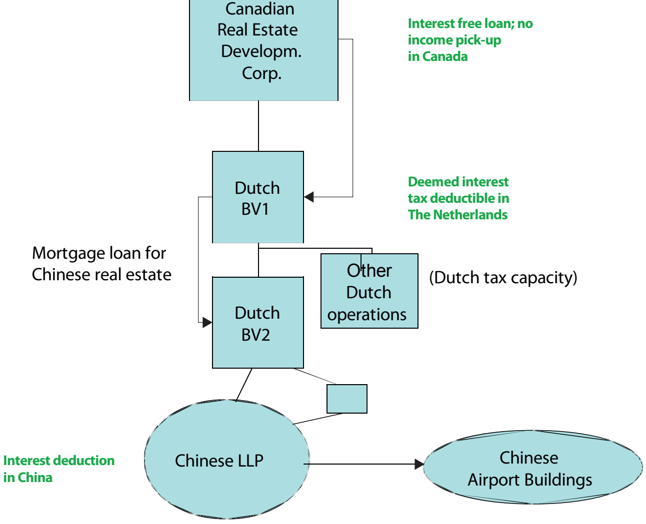


Exhibit 2 explanations

- The Netherlands sees a deemed loan to invest in a subsidiary; deemed interest is tax deductible (obeying thin cap constraints) under the Dutch "informal capital" rule;
- China sees a foreign limited partner in a Chinese LLP who has borrowed to finance the creation of Chinese real estate; interest tax deductible (obeying 1:2 thin cap constraints) in China;
- Equity is being transformed into a loan with interest deductions in two or even three countries

Exhibit 3

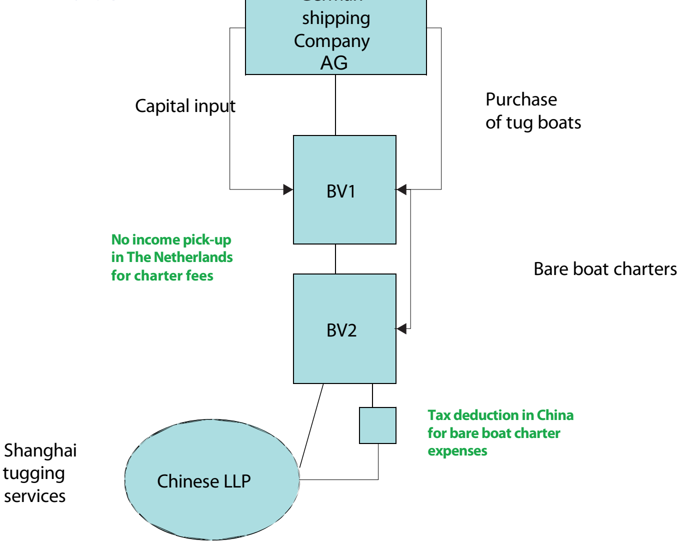


Exhibit 3 explanations

- The Netherlands sees BV2 as a local branch of BV1; the bare boat charter agreement does not exist (one cannot rent out boats to oneself); the income from this agreement is thus invisible and cannot be taxed; the Chinese LP is seen as a 99% subsidiary of BV1; interest to finance a subsidiary is tax deductible in The Netherlands;
- China sees BV2 as a limited partner in a Chinese LP who must rent boats to run the Shanghai business; charter fees tax deductible in China;
- China demands that the charter fees are "at arm's length"; if needed a ship mortgage bank can be put in between (back to back financing analogy)

Exhibit 4

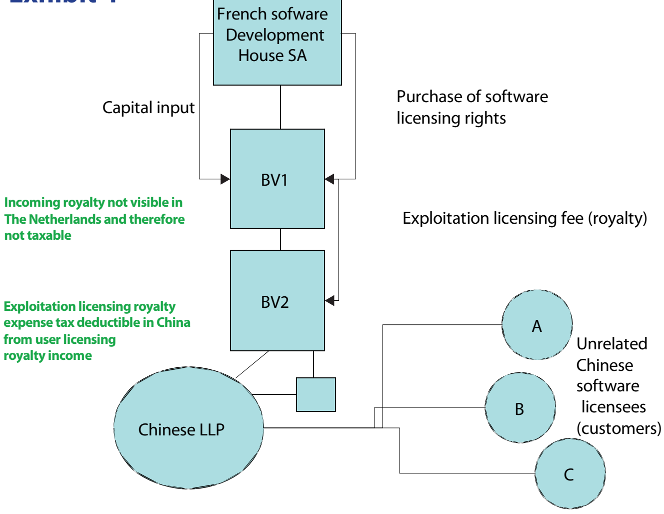


Exhibit 4 explanations

- The Netherlands sees BV2 as a Dutch permanent establishment of BV1; the software licensing agreement is invisible; the royalty income cannot be taxed;
- China sees BV2 as a foreign partner in a Chinese LP who may deduct the royalty it pays from the royalties it receives to compute taxable income in China; the royalty paid by BV2 to BV1 should be "at arm's length"

1. http://www.worldcommercereview.com/publications/article_pdf/202
2. http://www.worldcommercereview.com/publications/article_pdf/243
3. http://www.worldcommercereview.com/publications/article_pdf/273
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