

“Beijing to the Big Apple”

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Investors confront regulatory hurdles as China’s economy continues to grow. Although China’s expansion has been accompanied by some legal relaxation, many new foreign investors still find the environment daunting. At the “Beijing to the Big Apple” forum, sponsored by Columbia Business School and White & Case, four lawyers from White & Case’s Beijing and Hong Kong offices discussed the evolving regulatory environment for foreign investors. Topics included updates to the company and securities laws; structuring of investments and investing in financial institutions; and taxation and repatriation of capital.

The four panelists were

- *Xiaoming Li, White & Case, Beijing, “Impact of New Company Law and Securities Law on Mergers and Acquisitions”*
- *Seung Chong, White & Case, Hong Kong, “Facilitating Market Access in China Using the Right Investment Structure”*
- *Fred Chang, White & Case, Beijing, “Financial Institution Strategic Investment in China”*
- *Tony Fay, White & Case, Beijing, “Taxation of Foreign Direct Investments in the People’s Republic of China”*

William F. Wynne of White & Case’s New York office gave opening remarks on opportunities for investment in China. Charles Calomiris, Charles Calomiris, the Henry Kaufman Professor of Financial Institutions and academic director of the Jerome A. Chazen Institute of International Business at Columbia Business School, moderated the discussion and gave concluding remarks.

Summary of the Discussions

Legal Liberalization. China recently updated its company and securities law, permitting greater flexibility for companies to incorporate and raise money in the capital markets, and greatly expanding shareholder rights. Xiaoming Li explained how these liberalizations are a welcome change for domestic and foreign investors alike because they encourage more private business.

The new company law has improved access for new businesses to incorporate by simplifying and reducing capital requirements by 50–90 percent and by permitting capital

contributions of shares instead of cash. The law further liberalizes corporate life by throwing out a rule that forbade aggregate investments exceeding 50 percent of capital.

The debt market is one of the biggest winners from the upgraded company law. Old restrictions on which companies can issue debt and state oversight of the amount of debt have been fully discarded. This opens the door for all companies to pursue debt financing and for the corporate bond market to flourish.

Shareholders are also among the chief beneficiaries of the new regulations. The new law allows shareholders to sue a company if their rights are infringed and to sue on behalf of the company as well. All foreigners may now own shares, whereas previously only Chinese nationals could do so. In most companies, 10 percent of shareholders can now call a board meeting, and 3 percent can force the dissemination of information. Collectively, these reforms should deepen boards' responsibilities to shareholders and encourage more participation in the Chinese equity markets.

In general, the theme of the new laws is greater flexibility. Restrictions on share transfers, share buybacks and private placements are relaxed. Other major changes include the elimination of a requirement that companies withhold 5–10 percent of their profits for public welfare. Not only will this increase profit margins and investment countrywide, but it is another signal to the world that China is stepping further away from its communist past. The law also ends the segregation of the securities, banking and insurance industries, paving the way for consolidation in the financial services sector.

Financial Sector Investment Structuring. Seung Chong dissected the differences between foreigners making strategic investments versus forming joint ventures in Chinese financial institutions. Pursuance of strategic investments, or foreign ownership of less than a 25 percent stake, is the government's preferred method. Strategic investors have no limits on licensing or expansion and have less onerous requirements, whereas joint ventures require city-by-city licenses and more qualifications. In the insurance sector, foreign or JV firms may only sell either life or nonlife insurance, whereas strategic partners with Chinese firms may do both. Chong continued with a general analysis of JV versus wholly owned structures and gave examples of multiple M&A deals by foreign companies across industries.

Fred Chang continued the discussion by describing four structures into which foreigners can carry out a financial sector investment. The structures include different models and quantities of share purchase or strategic partnership with private and state-owned Chinese banks, each with its separate regulations, benefits and drawbacks. The government is encouraging foreign investment in financial services, although regulations are very strict. Chang emphasized that Chinese banks demand foreign investors who can take a strategic management role and can transfer technology, management and expertise.

Foreign-owned (more than 25 percent) retail banking operations that lack Chinese partners are prohibitively expensive because the law dictates that the foreign bank's offshore "home" capital cannot count toward the minimum capital requirements. In

addition, foreign-owned or JV banks need permission to expand on a city-by-city basis, and currency convertibility is still problematic. The government encourages the banking sector to retain foreign expertise but remain firmly in Chinese hands.

Tax Considerations. China's tax law presents two separate codes for Chinese and foreign enterprises. All businesses are taxed at a rate of 33 percent, though there are extensive additional benefits to foreigners. The 1991 tax law encourages foreign investment through location- and industry-based incentives. Investors receive reductions for businesses in special tax incentive zones and also for investment in the high-tech and manufacturing sectors, while investment in real estate is discouraged. An additional 40 percent refund is given to foreign businesses that reinvest profits in a new or existing enterprise for at least five years. The current U.S.-China Income Tax Treaty mandates a 10 percent tax on dividends, interest, copyrights and withholdings of capital gains.

A discussion of tax shelters ensued after the overview of in-country tax laws. Tony Fay, who led this portion of the presentation, reviewed four potential incorporation structures involving offshore holding companies. Certain islands such as Barbados and Mauritius are exempt from Chinese withholding tax (except in the real estate sector) and are prime locations for holding companies under various circumstances.

Fay continued his presentation by describing after-tax and pretax repatriation methods. Although after-tax dividends are exempt from China's withholding tax, due to legal hurdles they are not the most practiced means of distributing profits. Among pretax repatriation methods, Fay highlighted interest, royalty payments and service fees. While royalty payments incur 15 percent taxes, payment of interest and service fees are tax deductible and therefore the most efficient ways of moving capital out of the country.

Despite a series of comprehensive laws, Chinese authorities do not have the resources to do formal audits, and tax evasion is rampant. Most abuses occur in southern China when investors move goods to Hong Kong or Taiwan. New laws combat tax evasion, and China has sought OECD help in training tax officials on transfer sales and pricing. Gradually, the tax authorities are receiving better information, and they are now sharing information with customs authorities.

Finally, Fay discussed potential changes to the tax law in the near term. Unification of taxes for foreign and domestic investors could occur as early as 2007 or 2008, at a 24–26 percent rate. Incentives will likely continue, but not exclusively for foreign investors. Some incentives could be scaled back, though others could be grandfathered to remain in effect into the future.

Political Considerations. Much is made of the coexistence of China's official communist stance with its capitalistic business culture. While the government holds a sizable percentage of ownership in many companies, new shareholder liberalizations are forcing boards to pay greater heed to their public ownership. Among the major amendments to the company law are allowances for shareholders to be sued for abuse of power or harming the interest of creditors or other shareholders. However, this "piercing of the

corporate veil” will prove a halfhearted gesture unless there is true political reform. While numerous individuals from the private sector have been prosecuted under this clause, so far there has been little comparable action against leaders of state-owned enterprises. At worst, accused SOE executives have been asked to leave their posts. The government sees the rationale in having this law, but it is too early to conclude whether it is a genuine move toward transparency and fairness.

The consensus among the panelists was that foreign companies have much to lose by breaking the law, whereas domestic companies, even private ones, need only obey the party line. This perception is troubling, and China will not gain the full trust of the international investor community until there is a sense that all people, foreign and domestic, private and public, are treated equally under the law.

Columbia Business School's sponsorship of this forum follows other modes of engagement in Chinese business studies, including a new seminar on China at Columbia Business School; the Sir Gordon Wu Distinguished Speaker Series; and a joint executive education program with Fudan University. As Professor Calomiris acknowledged, this forum exemplifies Dean Glenn Hubbard's mission for Columbia Business School to facilitate interaction between professionals and academics.