

Marccus Partners



Tax implications for Chinese investments in Europe

**Presentation
to the Shanghai Bar
Dr. Bernd Sagasser
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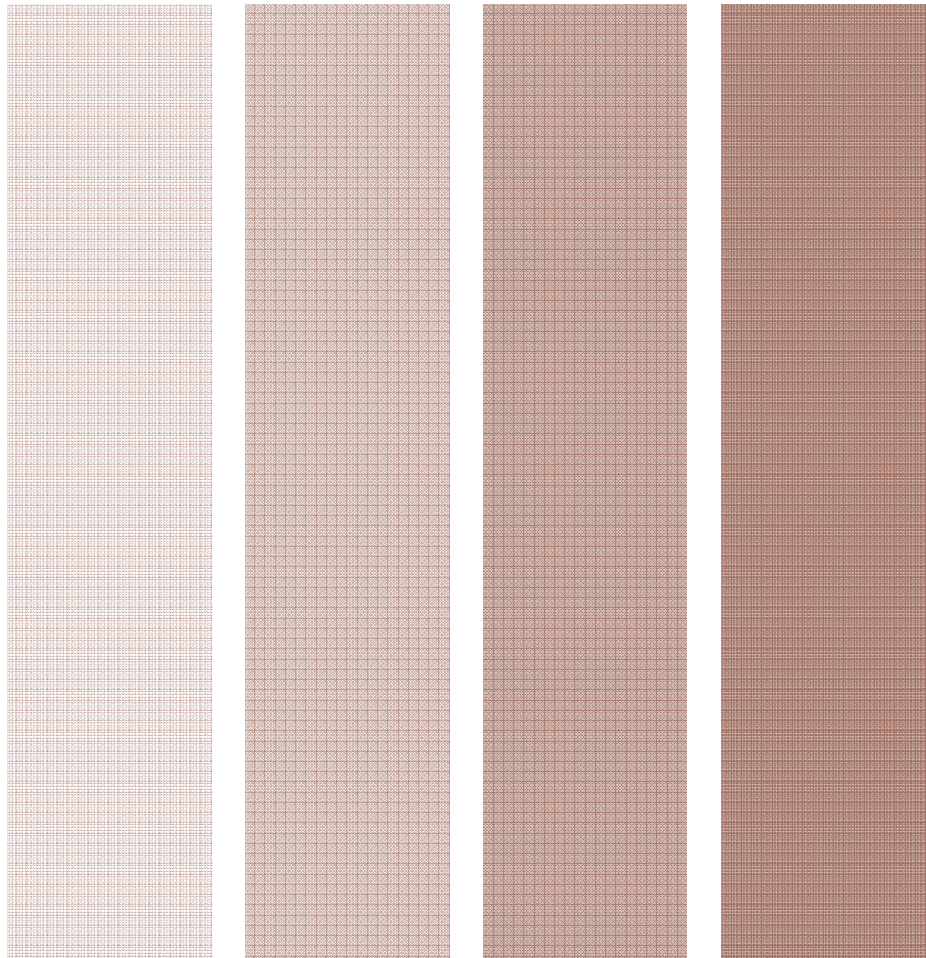
Overview

- China meets Europe
- Outbound Investments from a Chinese point of view
- Europe tax-wise harmonized?
- Type of target
 - Corporate structures
 - Partnership structures
 - Real estate
 - Intangibles
- Investment structures and main tax implications
 - Direct investment
 - Corporate
 - Branch and partnership
 - Using holding companies
 - Share Deal versus Asset Deal

Overview (cont.)

- Dividends
- Interest and Thin Cap Rules
- Royalties
- Anti-Abuse Mechanisms
- Capital Gains

- Examples
 - Investment in Germany
 - Investment in France
 - Holding in
 - Netherlands
 - Luxembourg
 - Belgium via Hongkong
 - Luxembourg via Hongkong



China meets Europe

China meets Europe



- Chinese investments in Europe
- Type of Investments
- Typical structures
- Tax systems



**Outbound Investments from a
Chinese income tax point of view**

Outbound Investments from a Chinese point of view



- Chinese taxation based on worldwide income
 - Business Income
 - Dividends
 - Royalties
 - Capital Gains
- CIT of 25%
- Foreign Tax Credit
 - Direct
 - Indirect
- Consolidation of profits and losses
- CFC Rules
- Network of Double Tax Treaties



Europe tax-wise harmonized?

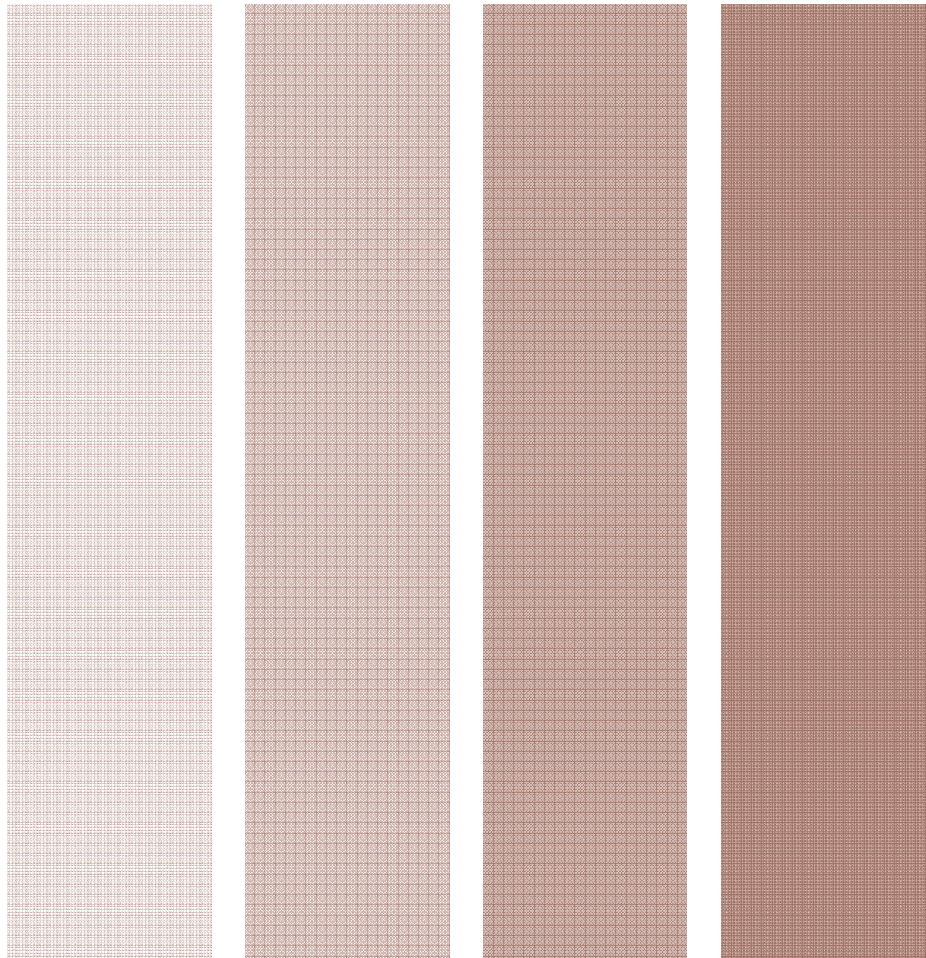
Europe tax-wise harmonized?



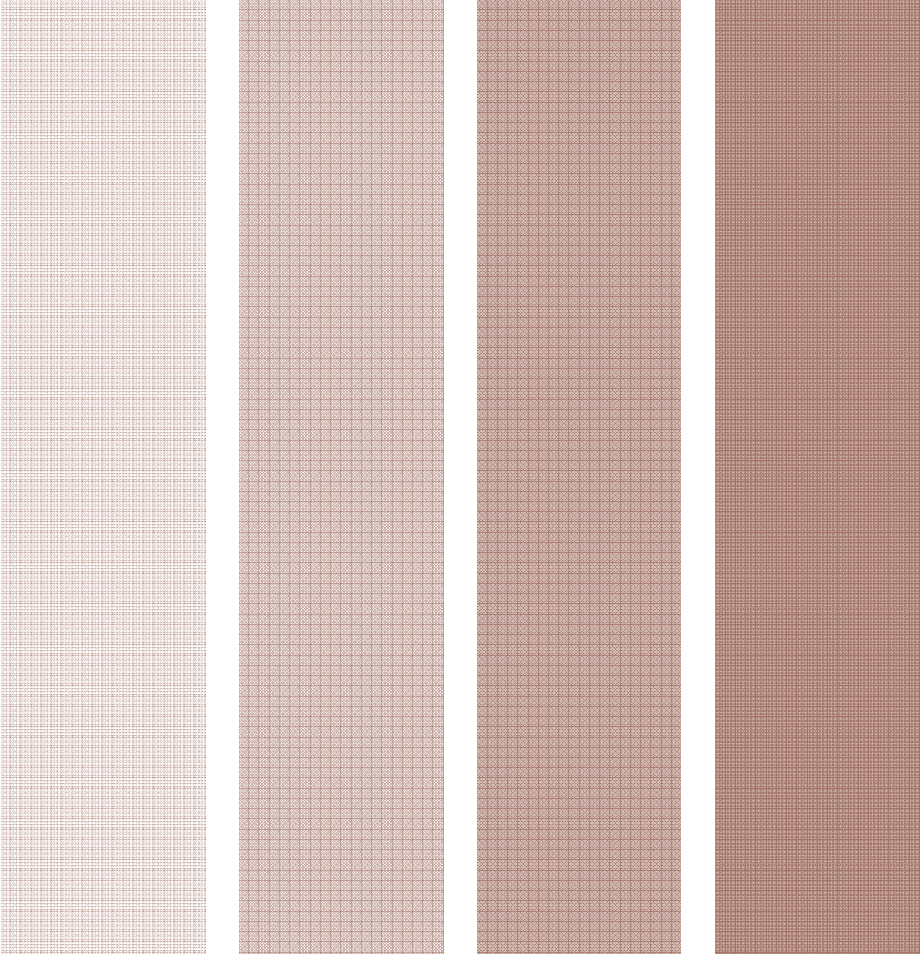
- National tax sovereignty of 51 European states with an equal number of different tax systems

- European Union (covering 27 European states) drives for harmonization of tax systems but for the time being limited to
 - VAT and Indirect taxes
 - Dividends
 - Interests
 - Royalties

- European Court of Justice is on the forefront of creating a « leveled playing field » by forcing the member states to ensure freedom of exchange of goods and services and the non-discrimination of enterprises doing business in the European market (treatment of tax losses, changing the corporate residence)



Type of European Target



Investment structures and main tax implications

Investment structures and main tax implications: corporate

Investment in a corporate structure

- Taxes on income: CIT of 10-35%
- In some countries Trade tax or Business tax
- Overall income tax burden between 10% and 45%

■ Tax base:

- Mainly according to financial accounts for tax purposes
- Certain limitation for interest deduction, amortization, intra-group services

■ Dividend distribution: Withholding tax between 0 and 35%

- But exemptions under various aspects
 - National participation exemption:
 - => depending on share and holding period
 - => depending on type of investor
 - International participation exemption under DTT

■ Capital gains: taxable in case of substantial participation, but under many DTT tax exempt in investee country (except: real estate companies)

Investment structures and main tax implications: branch

Investment in a branch

Qualification as a permanent establishment (PE) for tax purposes

- Tax rates on income: CIT of 10-35%
- In some countries Trade tax or Business tax
- Overall income tax burden between 10% and 45%

Tax base:

- Mainly according to financial accounts for tax purposes
(attribution of profits to PE on arm's length basis)
- Tax transparent => acquisition of assets in the branch
- Certain limitation for interest deduction, amortization, intra-group services

Transfer of profit to main establishment of foreign investor

- No withholding tax !!

Capital gains: taxable in the state in that PE is situated at normal rates !!

Investment structures and main tax implications: partnership

Investment in a partnership

Qualification as a PE for tax purposes if in trade or business

- Tax rates on income: CIT of 10-35%
- In some countries Trade tax or Business tax
- Overall income tax burden between 10% and 45%

Tax base:

- Mainly according to financial accounts for tax purposes
- Tax transparent => PRO RATA acquisition of assets in the partnership
- Certain limitation for interest deduction, amortization, intra-group services

Transfer of profit to foreign investor

- No withholding tax !!

Capital gains: taxable in the resident state of the partnership at normal rates !!

BUT: Some countries don't accept the tax transparency and treat the investment like an investment in a corporate structure (e.g. Spain, France)

Tax effects of holding companies

- Consolidation of profits and losses of various subsidiaries
 - Within a country under many jurisdictions possible
 - Cross- border tax consolidation only possible in Denmark, Austria and exceptionally in France and eventually under ECJ jurisdiction (Marks & Spencer)
- Consolidation of interest for investment financing and operative profits
 - If not possible under a national tax consolidation scheme merger to be envisaged
- Sheltering partnership structures
 - In order to avoid capital gains tax in the country of the investee Holdco is needed to allow a future disinvestment by selling Holdco and not partnership interests

Using holding companies

- Making use of a favorable DTT network and EU directives regarding WHT
 - In the interest of the Chinese investor
 - In the interest of a group of investors from various jurisdictions
 - To arrange a tax optimized debt financing
 - From a Chinese perspective: Luxemburg, Belgium....

- BUT: question of effective place of business
- AND: Treaty Shopping Rules

Share Deal versus Asset Deal

Share Deal

■ Seller

might benefit from participation exemption

■ Disadvantage for the Buyer

- By buying shares tax base may be higher than in case of the acquisition of assets:
 - no step-up of values in the corporate structure
 - the acquired hidden reserves (goodwill !) in the company can not be amortized
 - Under some jurisdictions tax loss carry forward will also perish (e.g. Germany)
- Integration of operative result of the target company in a holding company only solves the problem partially.
- LBO structures are targeting the tax-free step-up of values in the company – but in most European jurisdictions difficult to structure.
- If there is no solution: disadvantage of underlying tax liability is a reason for reducing the purchase price of the shares!

Share Deal versus Asset Deal

Share Deal

- Example: X acquires 100% of a cable operator. Net book value is 10, the purchase price 100. The company generates taxable profits of 15 p.a. but the infrastructure has to be rebuilt all 5 years. The amortization on the basis of 10 does not sufficiently reduce the tax basis. Solutions to be discussed:
 - Use of tax carry-forwards – but might be lost!
 - Tax free step-up of values and depreciation over the remaining life-time of the assets
 - Reduction of purchase price due to deferred tax burden

Share Deal versus Asset Deal

Asset Deal

■ Disadvantage for the Seller

- Sale of assets entails CIT at normal rates for the Seller if the Seller is a corporate
- Seller might be tax exempt or taxed at low rates – in such case he might accept an Asset Deal

■ Buyer

- Step up => amortization
- If Seller(s) sell(s) a partnership interest Buyer is treated as acquiring assets (due to tax transparency of partnership)
- Tax loss carry forward is lost
- Acquisition can be made through a corporate structure



Taxation of dividends

Taxation of dividends

Dividend Taxation in a high tax country	without DTT		with DTT
Profit before tax:	100		100
CIT and Trade tax:	40		40
Profit after tax as distributed	60		60
Withholding tax (25%)	15	(10%)	6
Chinese Shareholder's profit	45		54
Chinese CIT (25%)	15		15
FTC (25%)	- 15		-15 (direct +indirect)
After Tax	45		54

Taxation of dividends

Dividend Taxation in a low tax country	without DTT		with DTT
Profit before tax:	100		100
CIT and Trade tax:	10		10
Profit after tax as distributed	90		90
Withholding tax (25%)	22.5	(5%)	4,5
Chinese Shareholder's profit	67.5		85,5
Chinese CIT (25%)	22.5		22.5
FTC (25%)	- 22,5(direct + indirect)		-14.5
After tax	67.5		77.5

Taxation of shareholder financing

Dividend Taxation in a high tax country

	without DTT	with DTT
Profit before tax:	100	100
Interest on shareholder loan	-50	-50
CIT and Trade tax:	-20	-20
Profit after tax as distributed	30	30
Dividend withholding tax (25%)	-7.5	(10%) -3
Interest withholding tax (25%)	-12.5	(10%) -5
Chinese Shareholder's profit	60	72
Chinese CIT (25%)	-16.875	-18.75
FTC (25%)	+16.875 *	+18.75 (direct +indirect)*
After tax	60	72

*+FCT carry forward for the difference up to 25

Interest and Thin-Cap Rules

- Thin-Cap Rules are largely used by high tax countries to protect the tax base
- Originally discussed as anti-abuse rules targeting
 - Shareholder financing
 - Hybrid financing instruments
 - Back-to back financing
- Thin-Cap Rules are today based on jurisprudence of the ECJ, normally know « Save-Harbour » mechanics
- In General Thin-Cap rules are not applicable if the financing is at arm's length, i.e. if a bank would have given similar financing at the same conditions
- Some countries do not only limit shareholder financing, but the interest deduction in general,
 - German thin-cap rules are targeting also regular bank financing
 - De-minimis rules
- Comparable with the Chinese approach of a reasonable allocation of cost

Anti Abuse Rules

■ Beneficial Ownership concept

- Most of the European countries know the concept of « beneficial ownership »
- DTTs normally make reference to the « beneficial owner » in clauses on dividends and royalties

■ Treaty Shopping Rules

- Most of the European countries have introduced rules on treaty shopping hindering the use of a country through an establishment merely for the purpose of making use of tax advantages (lower WHT rates, weaker conditions for participation exemption etc)
- These rules are mostly combined with the concept of « economic substance » and « place of effective management »

■ Controlled Foreign Companies (« CFC » Rules)

- Making use of foreign holding companies in low tax countries may entail the application of CFC rules largely known in most of the European jurisdictions

Taxation of capital gains

- National tax laws provide that capital gains
 - on real estate may be taxed in the state of situation
 - on shares may be taxable in the resident state of the corporation sold. However, some jurisdictions do grant a capital gains exemption to foreign shareholders under national tax law partly depending on the percentage of shareholding, the holding period or other conditions (eg Germany no taxation but an add-back of 5%, Russia no taxation except property companies, UK no taxation except real property, energy and natural resources).
- Pursuant to DDTs,
 - capital gains from the disposal of shares are generally taxable in the country of residence of the shareholder (except: real estate companies)
 - Chinese DTTs generally maintain right of taxation of the investee country and give a FTC for the foreign capital gains tax, if any, in China.
- Holding structures may be used to shelter capital gains exemption against CIT in China, in order to realize capital gains tax free and to use the retained earnings for further investment,
BUT Chinese CFC rules might be applicable!

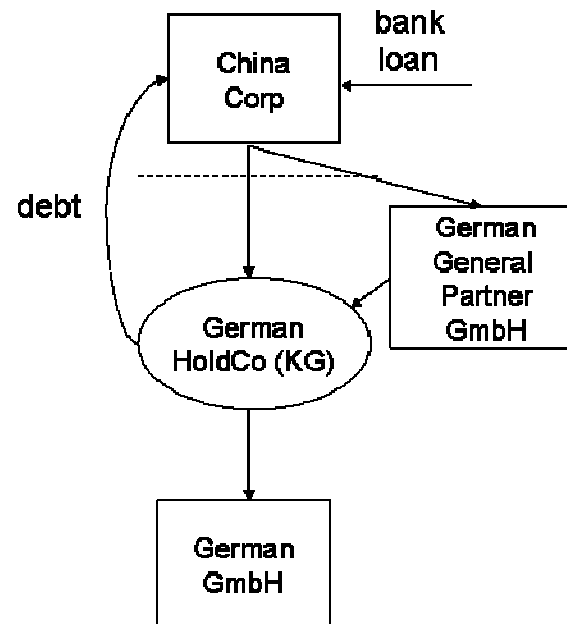


**Frequently used
Investment Structures**

Frequently used Investment Structures

Case 1

- China Corp acquires via a German HoldCo (limited partnership, 'KG') all shares in a German GmbH. The acquisition is financed through a bank loan, and a shareholder loan is pushed down to the local HoldCo.



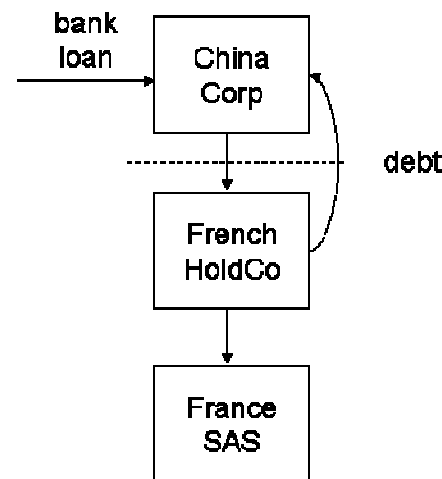
Frequently used Investment Structures

- German HoldCo (Partnership Concept)
 - Germany is entitled to levy income taxes on income derived by German HoldCo and German GmbH.
 - Dividends paid by German GmbH to German HoldCo will be exempt by 95 % (provided no tax group is established).
 - No withholding tax is accrued on repatriation of income derived by German HoldCo to China Corp.
- The structure may allow a ‘double dip’ with regard to interest payable on the bank loan raised by China Corp in order to fund the acquisition : interest may be deductible on the level of China Corp and a second time of the level of German HoldCo.
- Capital gains derived from a disposal of shares in German GmbH by German HoldCo will benefit from a 95 % tax exemption.
- Capital gains derived from a disposal of interests in German HoldCo will be subject to taxation in Germany.
- Germany tax authorities intend to include interest income of China Corp in party to China Corp.

Frequently used Investment Structures

Case 2

- In France, commercial or industrial businesses (others than PME) are conducted in the legal form of SA (société anonyme) or SAS (société par actions simplifiée).
- China Corp acquires through a French HoldCo all shares in a French SAS. The acquisition is financed through a bank loan, and a shareholder loan is pushed down to the local HoldCo.



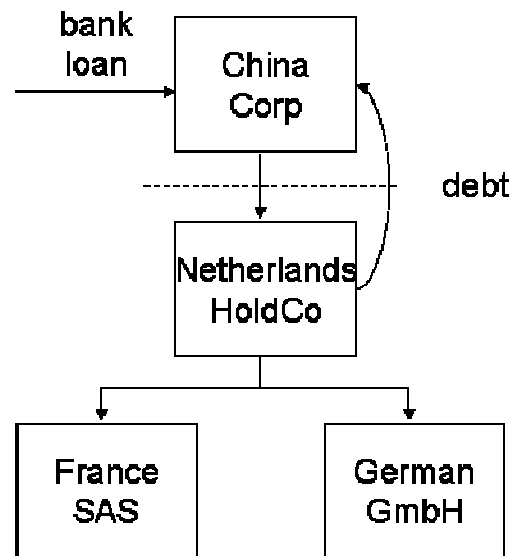
Frequently used Investment Structures

- Under that structure:
 - France is entitled to levy income taxes on income derived by French HoldCo and France SAS.
 - A tax group can be established between French HoldCo and France SAS.
 - Dividends paid by France SAS to French HoldCo will be exempt by 95 % (provided no tax group is established).
 - Under the double tax treaty between France and China, the commonly accrued 25%-withholding tax on dividends paid by French HoldCo to China Corp will be reduced to 10 %.
- Capital gains derived from a disposal of shares in France SAS by French HoldCo will (under certain conditions) benefit from a 95 % tax exemption. Such exemption would, however, not apply if France SAS were a real estate company.
- Capital gains derived from a disposal of shares in French HoldCo by China Corp will be subject to taxation in France provided (i) China Corp has a substantial interest of at least to 25 % or (ii) France SAS qualifies as a real estate company.
- France would not levy any withholding tax on interest paid by French HoldCo, provided interest is not paid to entities (or through entities) in tax havens.

Frequently used Investment Structures

Case 3

- China Corp acquires via a Netherlands (as an alternative: Luxembourg) HoldCo all shares in various European companies. The acquisition is financed through a bank loan, and a shareholder loan is pushed down to the local HoldCo.



Frequently used Investment Structures

■ Dutch Holding

- **Incoming dividends** are excluded from taxable income if the shareholder holds at least 5 % of the shares.
- The same benefit applies to **capital gains**.
- Dividends distributed to Dutch HoldCo from another EU member state should not be subject to any withholding tax, provided no treaty shopping provisions apply.
- **Dividends distributed** from Dutch HoldCo to China Corp are not subject to withholding tax under domestic Dutch law.
- China will tax the dividend income at 25% but will grant a tax credit on taxes paid
 - directly as WHT (there is no)
 - indirectly by the European subsidiaries (German, French etc CIT or trade tax)
 - down the third-tier subsidiaries under the condition of a (indirect) 20% shareholding

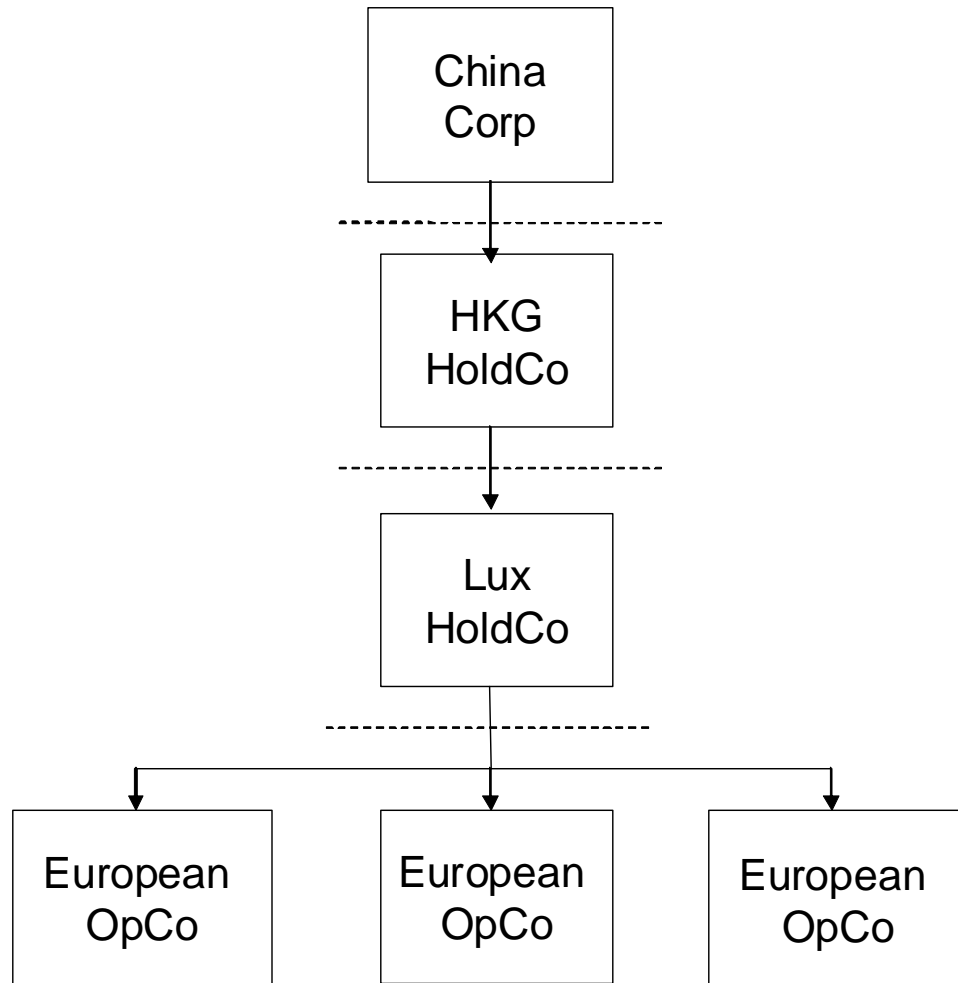
Frequently used Investment Structures

■ Luxembourg Holding

- **Incoming dividends** at Lux HoldCo from another EU member state should not be subject to any withholding tax, provided no treaty shopping provisions apply.
- Furthermore **Incoming dividends** are fully exempt from taxation, provided that
 - Distributing company is subject to comparable tax (min.10.5%)
 - Participation held for >12 months
 - Participation > 10% or €1.2 Mio.
- **Capital gains** are exempt from taxation under the same conditions (Participation > 10% or €6 Mio.).
- **Dividends distributed** from Lux HoldCo to China Corp are subject to 5% withholding tax in case of a minimum participation of 25% and of 10% in all other cases
- China will tax the dividend income at 25% but will grant a tax credit on taxes paid (see above)

Frequently used Investment Structures

■ Double Holding Structure through Hongkong



Frequently used Investment Structures

■ Belgian Holding through Hongkong

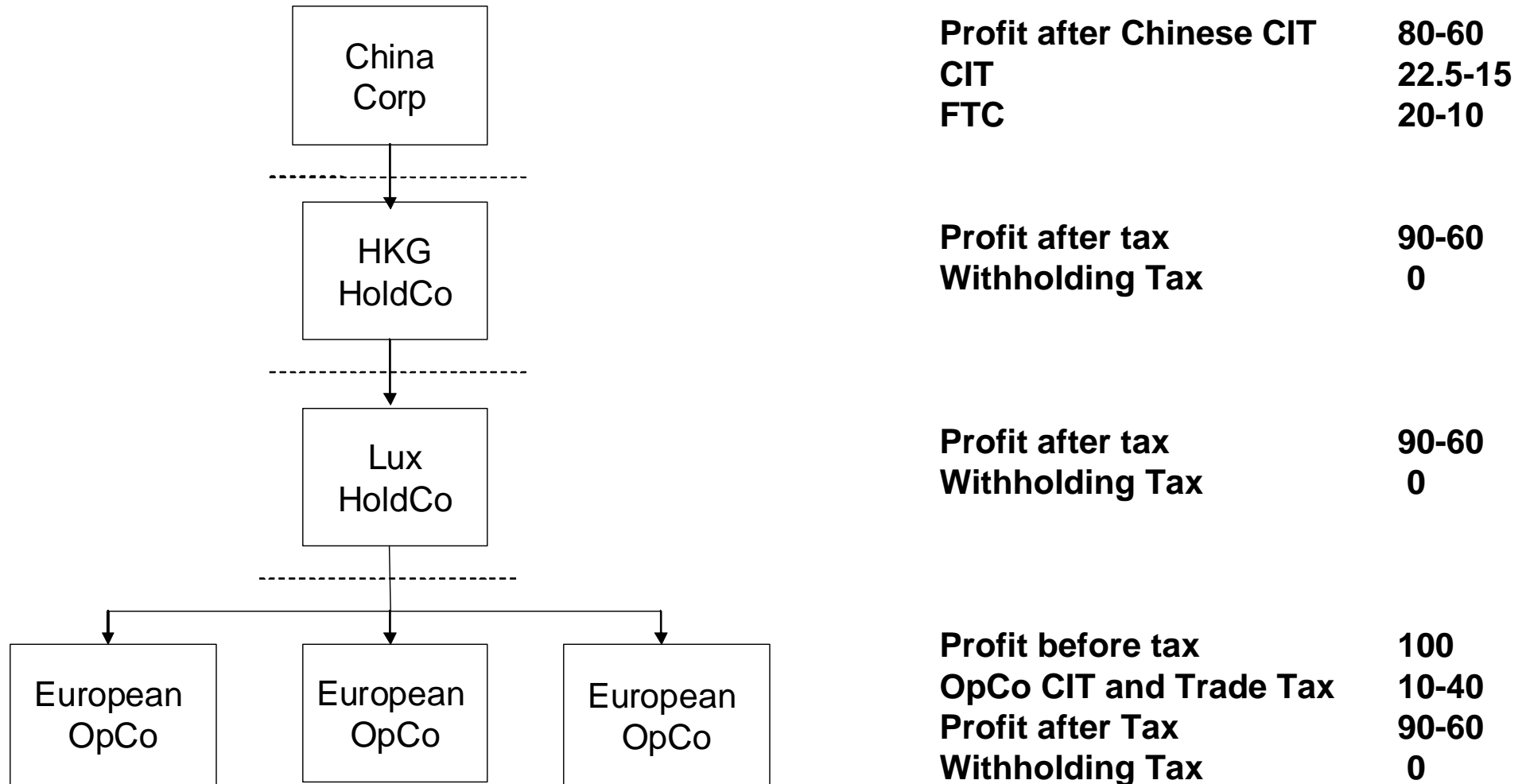
- Hongkong has only a few DTT with Europe; however DTT with Belgium was concluded in 2004
- A HoldCo situated in Belgium is subject to ordinary corporate income tax.
 - Belgium provides, however, for a notional interest deduction (3.8 % of its equity in the years 2011 and 2012 used for investments in Belgium)
 - 95 % of **incoming dividends** are – under certain conditions – exempt from taxation.
 - **Incoming dividends** at Belgian HoldCo from another EU member state should not be subject to any withholding tax, provided no treaty shopping provisions apply.
 - **Capital gains** are exempt from taxation without any minimum shareholding and minimum holding period.
 - The DTT between Belgium and Hongkong provides for a full exemption of dividends from WHT for shareholdings of >25% and in case of a holding period of >12 months, of 5% in case of a shareholding of > 10% and 15% in all other cases
 - China will tax the dividend income at 25% but will grant a tax credit on taxes paid (see above)

Frequently used Investment Structures

- Luxembourg holding through Hongkong
 - Luxembourg combines its favorable tax regime with Hongkong under the DTT and creates further advantages.
 - A HoldCo situated in Luxembourg is subject to ordinary corporate income tax.
 - **Incoming dividends** are – under certain conditions – exempt from taxation.
 - Incoming dividends at Luxembourg HoldCo from another EU member state should not be subject to any withholding tax, provided no treaty shopping provisions apply.
 - **Capital gains** are exempt from taxation without any minimum shareholding and minimum holding period.
 - The DTT between Luxembourg and Hongkong provides for a full exemption of **dividends** from WHT for shareholdings of >10% or a minimum of €1.2 mio and of 10% in all other cases
 - China will tax the dividend income at 25% but will grant a tax credit on taxes paid (see above)

Frequently used Investment Structures

■ Double Holding Structure through Hongkong



Frequently used Investment Structures

■ Summary

- On paper the Hongkong Luxembourg route appears to provide the most tax efficient structure for investments in Europe under the aspect of dividend taxation and capital gains taxation.
- Shareholder loans are generally possible, since Luxembourg thin cap rules are not very stringent.
- More tax problems will arise on the level of the OpCos where typically tax rates are higher and thin cap rules more sophisticated!
- The Hongkong Luxembourg structure has the disadvantage that the FTC in China will not apply on subsidiaries of OpCos since the indirect tax credit only applies on companies down to the third tier of the group



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