Deloitte.
德勤

National Real Estate Industry Practice

Partnerships in China: The New Frontier*

By Nancy Marsh, Jeff Kadet, Bill Ye and Grace Wang **August 2008**

The Partnership Enterprise Law took effect in 2007 and the article analyses the various types of partnership entities and the opportunities offered. The authors also discuss the tax issues affecting such entities.

1. INTRODUCTION

Recent improvements in the laws governing business entities signal a new phase in China's progress toward a more flexible investment environment. These improvements include China's amended Partnership Enterprise Law (PEL), enacted in 2006 and effective from 1 June 2007. Before the PEL entered into effect, a partnership could only have individual partners and was thus of little interest to most domestic and foreign investors. In contrast, under the new law, a partnership may not only have partners that are domestic legal entities, but also foreign partners, whether individual or corporate. The Chinese government has clearly gone to considerable lengths to review partnership laws in other countries with a view to creating a flexible Chinese partnership vehicle and is to be applauded for its efforts.

Although no guidance addressing how a foreign individual or company can become a

---

* © **Nancy Marsh, Jeff Kadet, Bill Ye and Grace Wang**.
Nancy Marsh is a tax partner at the Beijing office of Deloitte Touche Tohmatsu CPA Ltd., China and the leader of the China Real Estate Tax Group. Jeffery Kadet is a senior advisor at the Shanghai office, Bill Ye is a senior manager at the Atlanta office and Grace Wang is a manager at the Shanghai office. They can be reached at nanmarsh@deloitte.com.cn, jkadet@deloitte.com.cn, bye@deloitte.com.cn and gracehwang@deloitte.com.cn respectively.

This article has been published on IBFD Asia-Pacific Tax Bulletin July/August 2008.

partner in a Chinese partnership has yet been published, such guidance has been drafted and is being internally reviewed within the government. This guidance should be published in the near future, and it is anticipated that the new rules will be relatively liberal and will indeed allow both foreign individuals and foreign companies to become partners in Chinese partnerships. The current rules, however, already permit the new partnership form to be used when all partners are either Chinese individuals or Chinese companies, including "foreign invested enterprises" (FIEs), which are Chinese companies having foreign ownership of 25% or more.

Until enactment of the PEL, the only other vehicle comparable to a partnership was the non-corporate cooperative joint venture (CJV), a contractual vehicle that was available only to joint ventures involving both Chinese and foreign interests. In recent years, however, CJVs have seldom been used because of a reluctance on the part of the Chinese authorities to approve the use of such vehicles.

The Chinese authorities have also typically rejected the use of branches by foreign companies (except in the banking and insurance industries) even though the Companies Law provides a broad legal mechanism for branches of foreign companies. Because of these practical obstacles, foreign investment in recent years has almost exclusively taken the form of locally formed legal entities (specifically, wholly foreign owned enterprises (WFOEs), corporate CJVs and equity joint ventures (EJVs), all of which are formed as joint stock companies or limited liability companies (LLCs) under the Chinese Companies Law).

In theory, an LLC provides a reasonable degree of corporate structuring flexibility. However, local attorneys and regulators have still tended to regard a Chinese LLC as essentially a corporation-like vehicle, typically entailing corporate governance and structuring characteristics, with the investors invariably being regarded as shareholders holding *pro rata* rights in a corporation.

The widespread use of these corporate vehicles and the strict business scope requirements that limit the activities of companies have combined to make it difficult to structure certain business relationships that are common outside China. For example, with the exception of convertible corporate bonds, mezzanine financing and hybrid business terms that combine equity and debt characteristics are seldom seen -- either where purely domestic investors are involved or where there is an element of foreign investment.

Whether intentionally or not, the PEL has been drafted in such a way as to allow for this type of flexibility. Although, initially investors may be slow to make use of the PEL, over time it will doubtless become an important tool in structuring cutting-edge transactions. Indeed, partnerships are already beginning to be used for domestic investment funds, and venture capital investors are expected to be among the first to avail themselves of the opportunities offered by the new form.

2. TYPES OF PARTNERSHIPS

The PEL provides for three forms of partnership: the general partnership, the limited partnership and the special general partnership.

2.1. General Partnership

Each partner in a general partnership has the right to conduct the affairs of the partnership in the absence of any limitations imposed by the partnership agreement. A general partnership is not a separate legal entity. Instead, each partner has unlimited joint and several liability for the debts of the partnership. It is important to note in this context that a new partner admitted to an existing general partnership has joint and several liability even for partnership debts incurred before its admittance to the partnership.

2.2. Limited Partnership

A limited partnership may have from 2 to 50 partners, at least one of which must be a general partner. A limited partner may not be involved in the management of the partnership or represent the partnership before third parties. Such actions can cause the limited partner to have unlimited liability in the same way as a general partner. The PEL provides flexibility by making it possible for a limited partner to become a general partner and vice versa.

The interest of a limited partner in the property of the partnership is treated, in some ways, more like an investment in the ownership units of an entity. For example, a limited partner may legally pledge its interest in partnership property as long as the partnership agreement does not provide otherwise. Also, again subject to the terms of the partnership agreement, a limited partner may assign its share of the partnership property to a non-partner, although it must notify all other partners of such assignment at least 30 days in advance. On the other hand, a creditor with respect to a limited partner may ask the People's Court to enforce repayment of the limited partner′s debt with that partner's share in the partnership′s property.

A limited partner may enter into transactions with the partnership and may operate a business that competes with the limited partnership, subject to any restrictions included in the partnership agreement.

2.3. Special General Partnership

A special general partnership is in some ways similar to a "limited liability partnership" within the meaning of the United States Uniform Partnership Act (1997). The special general partnership has been designed specifically for, and may only be used by, professional service providers such as lawyers, accountants, engineers, etc. All partners in a special general partnership have joint and several liability with respect to debts of the partnership. However, any partner that engages in intentional or serious acts has unlimited liability or unlimited joint and several liability for debts incurred by the partnership as a result of those acts. Other partners are liable only to the extent of their share of partnership property. (This particular form of partnership is unlikely to be much used by foreign persons because of the numerous local professional licensing limitations placed on non-Chinese persons.)

3. COMPANIES LAW vs. PARTNERSHIP LAW

A partnership differs from a joint stock company or an LLC formed under the Chinese Companies Law in many respects and these differences are reflected in the different tax treatment afforded to these two kinds of entities.

An entity formed under the Companies Law is a juridical person, able to own property and having a legal existence separate from its owners. The owners hold shares in the entity but have no direct interest in the property owned or obligations owed by the entity. In contrast, the PEL treats a partner as owning a share in the property owned by the partnership. There is no separate legal entity and hence the partners do not hold any separate ownership interest in a legal entity. The existence of a partnership does not entail anything comparable to the share interest of a shareholder in a joint stock company or LLC.

In addition to the differences between partners' interests and those of shareholders, the fact that a partnership is not a "legal entity" is indicated by the following differences between a partnership and a joint stock company or LLC:

- **In the absence of a separately contracted guarantee with respect to the indebtedness of the entity in which it is a shareholder, a shareholder has no liability to cover the losses of the entity to protect the interests of creditors. By contrast, a general partner has unlimited liability for the debts of the partnership.**
- **If a partner privately transfers or disposes of partnership property, the partnership may not challenge the rights of any *bona fide* third party purchaser of that property. By contrast, a shareholder in an LLC would not have the ability to transfer or dispose of the LLC's property unless it held an appropriate management position in the company.**
- **With respect to management, in the absence of any other agreement among the partners, each general partner enjoys equal rights with respect to the execution of the partnership's affairs. There is no equivalent under the PEL to the various management mechanisms (e.g. board of directors) found in the Companies Law.**
- **Because general partners have unlimited liability, the PEL provides for no creditor protection mechanisms such as are found in the Companies Law.**

Subject to some exceptions (e.g. the ability of a partnership to carry on business, make purchases and assume debt obligations in its own name), these factors and the provisions of the PEL in general give a partnership a legal effect similar to that of a contractual CJV.

One significant consequence of this (as is specifically confirmed in the PEL itself) is that a partnership is a transparent vehicle for income tax purposes. Each partner, whether individual or corporate, will report its own share of gain and loss derived from the partnership on its own income tax return. In the case of a partner who is an individual, an individual tax return prepared in accordance with the Individual Income Tax (IIT) Law and in the case of a corporate partner, an enterprise tax return prepared in accordance with the Enterprise Income Tax ("EIT") Law. The possible tax benefits and disadvantages that may arise from transparent treatment are discussed below.

One other general comment needs to be made here. With partnerships becoming vehicles for serious investment in China, legal counsel will need to give some attention to the other

issues arising from the inherent differences between a partnership and a joint stock company or LLC that will have to be dealt with, or at least recognized and accepted, by the parties concerned. Such issues include the effect in China on the partnership if a partner experiences financial difficulties or enters bankruptcy (e.g. the creditor of a partner, whether limited or general, may ask the People's Court to enforce the repayment of its debt with that partner's share in the partnership property); and the ability of a partner to withdraw from a partnership because of an event that makes it difficult for the partner to remain in the partnership.

4. STRUCTURING FLEXIBILITY

A number of features will make partnerships attractive from a structuring point of view.

4.1. General Ability Of Partners To Contribute Property And Services

Many transactions involve a combination of elements contributed by their participants. In the case of real estate transactions, for example, one participant may contribute land use rights while another contributes services that reflect his design and project management skills. Others may contribute only money. In a joint venture context, one party may contribute plant and equipment, while the other contributes money and intellectual property.

The Companies Law does not allow for the contribution of services, and, in the case of contributions of property, it requires the value of property contributed to be assessed and verified. In contrast, the PEL provides that valuations of property and services contributed can reflect the negotiated agreement of the partners, which should make the process of constituting a partnership considerably easier and less bureaucratic than that of forming a joint stock company or LLC.

As the PEL allows for the contribution of services, it should be possible to structure 〝carried interests〞 for some partners. (It should be noted, however, that the draft guidance regarding the admittance of foreign partners provides that foreign partners cannot contribute services; if the guidance is finalized without amendment, only domestic general partners will be able to contribute services.)

4.2. Organizational Basis - Ability To Compensate Varying Partner Roles By Way Of Partnership Profit/Loss Allocations And Distributions

The Companies Law and typical company formation practices follow a standard format with respect to the roles, rights and obligations of the parties. A partnership, on the other hand, is formed based on a written partnership agreement. Subject to any attempts made by local authorities to impose their own organizational approach on the formation of partnerships, partners are relatively free to define their respective roles and fix their income/loss allocations.

For example, in a typical investment situation, one party may organize the partnership, set itself up as the general partner and agree with the passive investors, who will be the limited partners, that the initial cash distributions will flow solely to them and that an incentive return will be paid to the organizing party at a later date. Such terms can easily be written into the gain and loss sharing and distribution provisions of the partnership agreement and are already typical features outside China, for example, where a foreign real estate fund is investing in Chinese real estate. With the entry into effect of the PEL, this flexibility should become available to Chinese domestic investors. (There is a provision in the PEL that may restrict allocations in certain situations. In brief, the PEL prohibits the distribution of all profits to some partners or all losses to some partners. In the case of a limited partnership, as long as the partnership agreement so allows, all profits can be distributed to some partners.)

4.3. Liability Position Of General Partner

While the general partner will have unlimited liability, it is not uncommon in some countries for the organizer of a partnership to set up a limited liability special purpose company to act as the general partner. Interestingly, the draft rules governing how a foreign individual or company can become a partner require all foreign general partners to file a "major assets list" with the local approval and registration authorities. The list should be updated with those authorities whenever there is a significant change in assets and the draft makes it clear that the 〝major assets list〞 is to be available for public inspection, presumably to give prospective creditors of the partnership information on the basis of which they can make their credit decisions.

It is unclear at the time of writing whether the local authorities would be able to refuse to register a general or limited partnership if the general partners were to report that they had no 〝major assets〞 aside from their interest in the partnership (an understandable concern given that the PEL does not provide creditor protections such as those found in the Companies Law).

4.4. Ease Of Increasing Or Decreasing Partner Capital

Increasing the capital of a joint stock company or an LLC is a lengthy and formidable task. Decreasing capital is normally next to impossible, unless the company concerned has significant excess capital, is downsizing in a significant manner or has capital that is otherwise not consistent with its business requirements.

While there is a concern that local officials will make the process complicated or difficult in practice, the PEL makes it easy for partner capital to be increased or decreased. The logical basis for this flexibility is that, with one or more partners having unlimited liability, there is no need for the kind of creditor protection that is necessary in the case of an entity such as a joint stock company or an LLC in which all the owners have limited liability. As noted above, the PEL specifically omits all the creditor protections that are found in the Companies Law.

The particular importance of this issue in China can be illustrated by reference to the real estate industry. For example, in the case of a real estate project undertaken for the purpose of producing rental income, significant non-cash depreciation expense will typically substantially reduce book earnings. In addition, there may be a requirement to set up mandatory non-distributable reserves. The presence of these two factors can cause cash to significantly exceed distributable earnings, so that dividends (which are normally paid once a year) will not be sufficient to ensure that all the cash is regularly distributed.

Given China's exchange controls and the general inability of a company that is not engaged in the banking industry to make direct loans to related companies or otherwise allow such companies to utilize excess funds, considerable amounts of cash can become "trapped" within a company. This has become a particularly acute problem for the real estate industry since mid-2007 when real estate companies were strictly prohibited from obtaining permission for new borrowing from foreign lenders. This has put an end to the making of foreign shareholder loans, which were previously effective in going at least some way towards solving this "trapped cash" problem.

Although the above example concerns an industry in which it is particularly acute, the "trapped cash" problem affects a broad range of industries and companies. Using a partnership would potentially resolve the issue, thus providing a significant operational benefit.

4.5. Potential To Side-Step Restrictions On Foreign Borrowings

As noted above, real estate companies are prohibited from obtaining permission for new borrowing from foreign lenders. A limited partnership vehicle, however, would allow the interests of the limited partners to be structured in such a ways as to be broadly equivalent economically to debt. For example, a limited partner's interest could be structured so as to provide for an income allocation based to a certain extent on a percentage of invested capital and for a preference with respect to the repayment of partner capital as against the general partners. (Such a structure would need to be consistent with the prohibition in Circular 171 (*Jian Zhu Fang* [2006] No.171) against any party receiving a "fixed return".)

Legally speaking, such a structured partner interest would not be debt, and, in a way, it would not be debt in an economic sense because there would be no specific maturity date for repayment. Consequently, it may be possible to "sidestep", albeit partially, the restriction on foreign borrowings by using such structured partner interests.

One uncertainty surrounding such arrangements is the possibility referred to above that local authorities may erect obstacles to discourage or prevent capital reductions, which could make it difficult for the "debt" to be repaid. The inclusion in a partnership agreement of language indicating an intention to make future reductions in partner capital could potentially lessen these concerns.

Although such planning could accomplish an important goal, it will potentially have a significant tax cost. Interest paid to foreign lenders is subject to withholding tax at the rate of 10% (or a lower treaty rate) on the gross amount. The 5% business tax also may apply depending on the locality. If, instead of the payment of interest, a partnership distribution is made, the amount distributed will normally have the character of business income rather than interest income for the recipient. A foreign corporate partner in receipt of such income would likely be taxed at a rate of 25% on the net income. Unless the partner has deductible expenses (see below), the 25% rate will effectively be applied to the gross income, thereby giving rise to a significantly higher tax burden than would have arisen had interest been

paid.

5. TAXATION ISSUES

It is currently possible to form a partnership with all domestic partners, including partners that are FIEs. However, there is only limited provincial or local guidance on the EIT taxation of corporate partners (see below). On a national scale, the only existing guidance, which was issued in 2000, focuses on partnerships owned solely by domestic individual partners (*Caishui* [2000] No. 91). Whether the principles enunciated in Circular 91 will continue to apply to the new broader rules covering both EIT and IIT is unclear.

Domestic companies, which by definition are tax resident in China, can receive dividends from other resident companies free of any taxation. As a partnership is transparent for tax purposes, the partnership itself is non-taxable; instead, the partners pay tax on their respective shares of the partnership′s income. This transparent treatment means that there is only one level of company taxation under the EIT Law. It is unclear whether a corporate partner will be able to offset against its income from other sources its partnership losses. Provincial and local guidance issued to date includes several circulars that are consistent with the transparent treatment of partnerships (see, for example, *Zhedishuihan* [2008] No. 16 issued by the Zhejiang Provincial Local Tax Bureau and *Jindishuisuo* [2007] No. 17 and *Jindishuisuo* [2008] No. 1, both of which were issued by the Tianjin Local Tax Bureau). They provide that corporate partners should include their respective shares of income from a partnership in their own taxable income.

Resident individuals are subject to a 20% tax on the receipt of dividends. On the other hand, individual partners are subject to tax on their shares of partnership income at graduated rates (see the discussion at 5.3. below). As a result, the overall tax on profits distributed by an LLC (25% at the level of the LLC plus a 20% dividend tax at the level of the individual shareholder) will be higher than the single layer of tax paid by an individual partner. It is not clear whether the Circular 91 treatment of partnership losses will continue. In brief, Circular 91 provides that partnership losses may be carried forward for five years to be offset against income from the partnership that generated the losses. The losses, however, may not be offset against income from other partnerships or other income (e.g. employment income).

Although guidance on how foreign individuals and companies can become partners has not yet been issued, it seems likely that the business and structuring advantages of using a partnership will outweigh the tax uncertainties and that the use of partnerships will increase once the guidance is issued.

In the interim, tax advisors and their clients are left to ponder several interesting tax issues and opportunities as explored below. (The following discussion refers to a foreign company as a 〝non-resident company〞 or a 〝non-resident partner〞 because, under the residence rules in the EIT Law, a foreign company that is managed and controlled in China will be treated for all EIT purposes in the same manner as any other company formed in China.)

5.1. Double vs. Single Taxation - Avoiding Dividend Withholding Tax

Using a joint stock company or LLC creates two layers of taxation when the joint stock company or LLC has foreign shareholders. Domestically, one layer of tax, i.e. EIT at the rate of 25%, is imposed at the level of the dividend-paying company and (except where an exemption is available for dividends paid on certain types of listed shares) a second layer of tax is imposed at the level of the foreign shareholders, whether individual or corporate, when the joint stock company or LLC pays a dividend. In the case of non-resident corporate shareholders, withholding tax at the rate of 10% (or a lower tax treaty rate) is imposed on the gross amount of the dividend. The rate is generally 20% (or a lower rate under a tax treaty) when the dividend is paid to foreign individual shareholders. However, if the joint stock company or LLC is an FIE, then dividends paid to such foreign individual shareholders are exempt from withholding tax.

The transparent nature of a partnership means no tax is imposed at the partnership level. Instead, the individual and corporate partners will be taxed on their respective shares of the partnership's business income at the normal IIT rates applicable to sole proprietorships and household businesses (i.e. at graduated rates ranging from 5% to 35%) or normal EIT rates (25%), respectively. Where the partnership earns income other than normal business income, then some other taxation treatment may apply.

Interestingly, the circulars issued in Tianjin referred to above provide that an individual limited partner not active in the business of a limited partnership will not be taxable at the graduated 5% to 35% rates but rather at a flat passive income rate of 20%.

Because of the transparent nature of a partnership, its income or loss is allocated among its partners. Further, because the legal character of a partnership causes each partner to own a share of the assets of the partnership, distributing cash to the partners is merely transferring to them what they already own, i.e. legally, no dividends are paid. Thus where a partnership conducting a business in China distributes cash to its non-resident partners, such distributions, not being dividends, will not be subject to dividend withholding tax. This can represent a significant tax saving for foreign investors.

In view of the benefit of there being no dividend withholding tax on distributions made by a partnership, we can expect that some foreign investors will wish to set up partnerships with their existing WFOEs to allow them to extract some portion of their earnings through partnership interests rather than in the form of dividends from the WFOE. In the case of new investments, foreign investors may choose to set up a partnership owned by two non-Chinese group companies rather than the more typical structure in which a WFOE is owned by just one group member. In such cases, attention will need to be paid to China's new general anti-avoidance rule (GAAR).

Although not yet finalized, a draft of the future rules covering various issues, including the GAAR, has been circulated by the State Administration of Taxation. The draft specifies as a target of the GAAR abuse of the form of organization used. Thus, there should be a strong commercial rationale for any use of a partnership that eliminates the tax on dividends. In addition, in the case of any formation of a new partnership by a related foreign company with an existing WFOE, the "buy-in" price for the partnership percentage interest should be defensible based on arm's length principles.

By way of a final comment on this area, the draft transfer pricing rules (which have not yet been finalized) provide for a 20% threshold level in defining related parties. Enterprise partners in partnerships will presumably need to pay attention to and report in their annual EIT filings any partnership transactions that are executed between the partnership and parties related to the partners. In addition, contemporaneous documentation requirements will apply with respect to related party transactions beginning in 2008.

5.2. Existence Of An "Establishment" - Effect On Taxation

The tax regime applying to a non-resident company differs depending on whether or not the income earned by the company is effectively connected to an "establishment" in China. In brief, the implementation rules issued under the EIT Law define "establishment" very broadly and encompass most operating business activities of a non-resident company in China, whether performed directly from a location in China through employees or through agents.

Income that is effectively connected to an establishment in China is subject to a 25% tax on net income. Where China-source income of a non-resident company is not effectively connected to such an establishment, a 10% tax on gross income generally will apply. Tax treaties typically provide narrower definitions of "establishment" (normally termed a "permanent establishment") and may exempt income or reduce the domestic 10% tax rate.

Once rules are implemented allowing foreign companies to become partners in Chinese partnerships, the transparent nature of a partnership will mean that, from a tax perspective, a non-resident corporate partner will be earning income directly from its share of the partnership property. Thus, it will be necessary to determine whether the partnership property and activities constitute an establishment in China of the non-resident partner (or a permanent establishment where a tax treaty applies). If the property and activities do constitute an establishment, the 25% tax on net income regime will apply to partnership income earned by the non-resident corporate partner; if they do not constitute an establishment, the 10% tax on gross income regime will apply.

The discussion in the preceding paragraph represents our analysis of Chinese law and the transparent nature of partnerships. This analysis is consistent with *Guoshuifa* [2003] No. 61, dated 4 June 2003, a State Tax Administration circular providing guidance for Foreign Invested Venture Capital Investment Enterprises. In brief, Circular 61 deals in part with cooperative joint ventures, formed by contract, which are not treated as separate taxpayers. Foreign corporate owners of such joint ventures will not themselves be treated as having an establishment in China as long as certain conditions are satisfied (e.g. daily management activities are entrusted to another qualified company and no venture capital service activities, such as venture capital management and consultancy, are carried on by the joint venture). If these conditions are not satisfied, an establishment is deemed to exist.

The Chinese tax authorities have not indicated whether they will continue to follow the Circular 61 approach with respect to partnerships. They could, for example, conclude that the mere existence of a partnership enterprise, irrespective of the activities it carries on, means that any non-resident partner will be treated as having an establishment in China. Or the authorities could take the position (which would be consistent with the position apparently being taken in Tianjin with respect to individual limited partners) that a limited partner's share of profits is economically akin to a dividend in which case it should be taxed at a rate of 10% on a gross basis rather than at the rate of 25% on a net basis, irrespective of the nature of the activities carried on by the partnership. It seems likely, however, that, instead of taking either of these approaches, future national guidance will make the determination of the tax status of a non-resident general or limited partner and the resultant taxation of the partner's income dependent on the actual assets of, and the activities carried on by, the partnership concerned. Thus, where the partnership concerned is carrying on a business, as there would be an establishment, a foreign enterprise partner's share of the partnership income would be taxed at a rate of 25% on a net income basis; where there is no establishment, the partner's share would be taxed on the alternative, 10% of gross China-source income basis.

5.3. Employment vs. Business Income - Reducing Personal Tax Rates

Employment income is subject to monthly graduated tax rates that rise to 45%. Certain business income earned by an individual is subject to monthly graduated rates that rise to 35%.

This difference in tax treatment will could have significance in the context of the increased flexibility offered by partnerships. For example, individuals (perhaps in conjunction with one or more companies), could form a partnership to provide services to customers and clients instead of contracting as direct employees of such customers and clients, leading to potential IIT savings.

5.4. Non-Resident Partner Deductible Expenses

As noted above, individual and corporate partners will be taxed on their respective shares of a partnership's business income at normal IIT rates (i.e. at graduated rates ranging from 5% to 35%) or normal EIT rates (i.e. at 25%), respectively. Where a partner incurs expenses that are not reimbursed by the partnership but that are actually related to the business conducted by the partnership, two issues arise with respect to such expenses, i.e. (i) may the partner deduct such expenses in calculating its taxable income base and (ii) if the expense is interest or royalty payable to a non-resident of China, will China impose withholding tax on the interest or royalty? These issues will require consideration in future planning.

5.5. Contributions Of Property And Services To Partnerships/Inside-Outside Basis

It was noted above that valuations of property and services contributed to a partnership can reflect the negotiated agreement of the partners. In the case of a carried interest, where a partner receives an income interest but no amount of capital account, it remains to be seen whether any taxable income will arise to the partner at the time of receipt of the income interest. Also, where valuations of contributed property and services are reflected in the capital accounts of the partners, it is unclear whether the contributing partners should recognize taxable income at the time of the contribution to the extent of any excess of their capital account over their tax basis in the property or service contributed. It is also unclear whether a loss should be recognized if the capital account received is lower than the tax basis of the contributed property.

These issues in turn raise questions regarding differences between the tax bases of assets inside a partnership and the basis of each partner in his share of the assets owned. Again, in the absence of tax rules addressing these issues, any planning for structures involving the contribution of assets or services will need to take these uncertainties into account.

5.6. Flow-Through Of Losses?

While it is clear that a partnership's income will flow through to each partner, it is less clear whether losses from business operations at the partnership level will flow through to the partners. It may, for example, be that the use of such losses by the partners will be limited and that they will only be available for carry-forward and set off against future income from the partnership. As noted above, Circular 91, which is applicable only to individual partners, provides that partnership losses may be carried forward for five years for use against future income from the same partnership.

As some investment transactions, especially those involving real estate, tend to generate losses in early years due to significant interest and depreciation expenses, the ability to use losses at the partner level against other unrelated income could be economically very significant.

5.7. Application Of Tax Treaties In A Partnership Context

In most situations in which a partnership is conducting a business in China, a non-resident partner in that partnership would be treated as having a permanent establishment in China under the definitions of permanent establishment found in most tax treaties. As such, normally, the existence of a tax treaty will not provide any significant protection to a non-resident partner in a Chinese partnership.

Where, however, the partnership has income that is not related to the basic business, a tax treaty might affect the taxation of that income. For example, where a partnership holds funds that are in excess of the needs of the partnership's business and those funds are invested in some manner, depending on the nature of the investment earnings, the provisions of an applicable tax treaty could potentially affect the taxation of those earnings.

Over time, partnerships are sure to become a regular feature of the Chinese business landscape. Additional regulatory and tax guidance with respect to partnerships is still required and the sooner such guidance is forthcoming, the better. In the meantime, though, the business and investment situations that require the kind of flexibility that only a partnership can provide will sometimes make the use of a partnership attractive even in the absence of guidance on taxation.

Contact details for Deloitte's China Practice

Hong Kong SAR
Deloitte Touche Tohmatsu

35/F One Pacific Place
88 Queensway
Hong Kong

Tel: +852 2852 1600
Fax: +852 2541 1911

Beijing
Deloitte Touche Tohmatsu CPA Ltd. Beijing Branch

8/F Office Tower W2,
The Towers, Oriental Plaza
1 East Chang An Avenue
Beijing 100738, PRC

Tel: +86 10 8520 7788
Fax: +86 10 8518 1218

Shanghai
Deloitte Touche Tohmatsu CPA Ltd.

30/F Bund Center
222 Yan An Road East
Shanghai 200002, PRC

Tel: +86 21 6141 8888
Fax: +86 21 6335 0003

Contacts

Richard Ho
National Real Estate Industry Leader

Tel: +852 2852 1071

Fax: +852 2527 3036
Email: richo@deloitte.com.hk

Nancy Sun Marsh
Tax Leader of China
Real Estate Industry Practice

Tel: +86 21 6141 1007

Fax: +86 21 6335 0199
Email: nanmarsh@deloitte.com.cn

Anthony Tam
Regional Deputy Tax Managing Partner, Southern China

Tel: + 86 755 8246 3255 (ext. 8590)
Fax: + 86 755 8246 3222
Email: anttam@deloitte.com.cn