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Private Equity: Structures for Investing in China.

2014/2015 edition

Tax
A publication of Deloitte Tax Research Foundation

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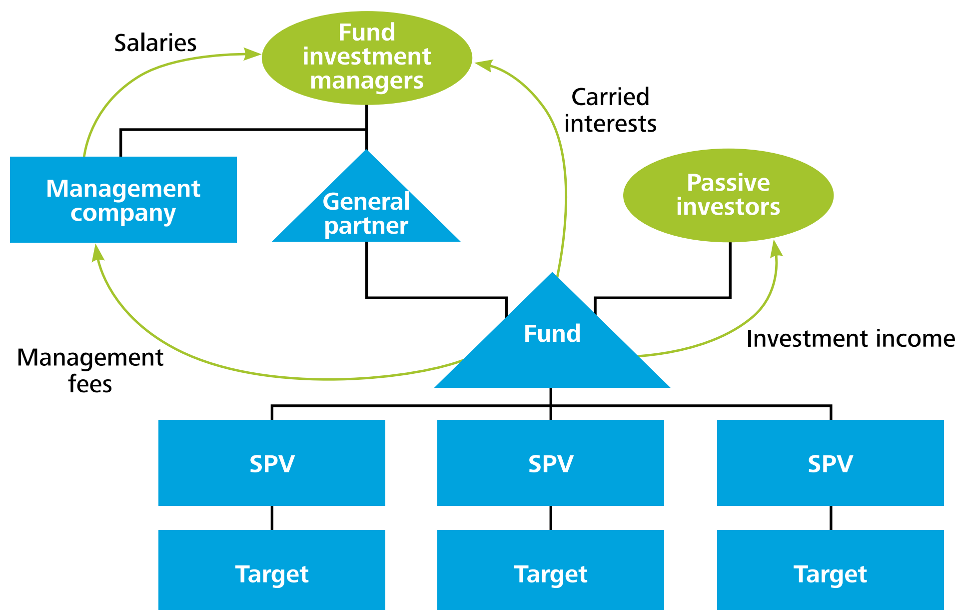
Introduction

The private equity industry in China has grown substantially in recent years. This trend is expected to continue due to the rapid development of the economy in China and the increased recognition of the value that private equity can bring to Chinese companies in terms of, for example, operational performance improvements. However, the regulatory challenge for private equity firms remains. In this context, existing private equity firms and other fund initiators have jointly recognised the acute need for a thorough feasibility study of their proposed fund structure before setting up the fund and making investments. Only by understanding the cumulative effects of the business, legal, regulatory, accounting and tax environment can a fund investment plan ultimately achieve success. When we discuss efficient fund structures, tax implications and risk management emerge as two important and integral links. Proactive tax assessment is necessary not only to help investors manage tax costs and increase investment returns, but also to help manage fund initiators' tax risks. Insufficient attention to tax matters could lead to failure in achieving the desired investment returns.

This publication offers private equity initiators and investors the key to understanding tax implications for fund structures. We hope you find this introduction both helpful and insightful in your future fund structuring.

Overview

Private equity is a combination of passive investors and fund investment managers under a partnership or contractual mechanism. Below is a brief description of a typical fund structure as well as the key roles involved.



Fund

The fund is a vehicle that is set up to receive capital from investors who acquire interests in the fund. It does not have any direct operations other than making actual investments for the benefit of the investors.

Fund investment managers

Fund investment managers usually contribute a very small percentage (e.g., less than 5 percent) of the total committed capital but earn an annual management fee at a certain percentage (e.g., 2 percent) of committed capital through a management company, plus a carried interest (e.g., 20 percent) on the profits after the passive investors' capital is returned and a hurdle profit rate is attained. Normally they have the legal power to act on behalf of the investment fund.

Passive investors

Passive investors could be government guidance funds, financial institutions and high-net-worth individuals.

Management company

The management company is usually set up by the fund investment managers and is responsible for providing investment advisory services to the fund. This is the operating entity that employs investment professionals, evaluates potential investment opportunities and incurs the expenses associated with day-to-day operations and administration of the fund.

Special purpose vehicle ("SPV")

SPVs are holding companies set up by the fund or individual fund investment managers for operational, legal or tax purposes.

Types of funds

Among all the funds with Chinese entities in their investment portfolios, there are generally three types of funds, classified by the location of the fund and investors' profiles, namely:

A. **Pure offshore non-RMB funds**, i.e., non-RMB denominated funds set up outside of China with foreign investors only;

B. **Foreign invested RMB funds**, i.e., funds located in China with one or more foreign investors as well as domestic Chinese investors;

C. **Pure domestic RMB funds**, i.e., funds located in China and without a foreign investor.

For each of the "frequently asked questions" discussed in the next chapter, we consider the above three types of funds in turn.

Frequently asked questions

1. Pure offshore non-RMB funds

The Chinese market has attracted a good number of foreign investors, especially those keen to explore investment opportunities in fast growing business environments. Investors from US, Europe and/or the Asia Pacific region may have vast experience in investing in such funds and have a relatively high expectation of investment returns. Thus, in order to set up an offshore fund that is appealing to investors, careful consideration needs to be given to the fund structure to ensure it is workable from a legal and regulatory perspective, and also the related tax issues are properly addressed.

1.1 Fund vehicle

- **What should I consider first when setting up a fund?**

  The location and legal form of the fund will have a significant impact on all the activities the fund will undertake in the future. As such, time should be taken to consider:

  (i) What is the most appropriate jurisdiction to set up my fund?

  (ii) What legal form (e.g., corporate entity, unincorporated partnership) should I use for my fund?

  In selecting the location of the fund, you should not only consider the business, legal and regulatory environment of a country but also its tax regulations. From a tax perspective, important factors include taxation on the fund, the jurisdictions and tax profiles of fund investment managers and passive investors, and the treaty network of the fund jurisdiction. You may wish to start with jurisdictions that are frequently used by existing private equity funds, which are proven feasible in certain situations.

- **What are the frequently used jurisdictions?**

  As explained above, the jurisdictions and tax profiles of both fund investment managers and passive investors are key considerations in fund jurisdiction selection. We have seen Cayman Islands, Luxembourg and Singapore being typical jurisdictions for US-based, European-based and Asia Pacific-based investors, respectively.

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HK-061ENG-13(Rev1)

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