KIRKLAND & ELLIS

KIRKLANDPEN
Private Equity Newsletter

February 15, 2011

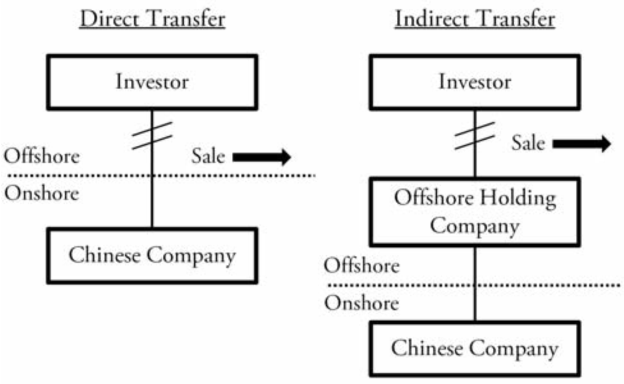
Circular 698: Taxing Offshore Sales of Chinese Companies

PENpoints

Circular 698 is designed to preclude non-Chinese investors from avoiding Chinese capital gain tax by using a non-Chinese holding company structure.

Since January 1, 2008, China's Enterprise Income Tax Law has imposed a 10% tax on capital gain earned by a non-Chinese (offshore) company from selling an equity interest in a domestic Chinese company. In part in order to avoid this Chinese capital gain tax many offshore investors (such as non-Chinese private equity funds) (1) form a non-Chinese (offshore) holding company to hold the Chinese company's equity interest and (2) exit the investment in the Chinese company indirectly by selling the non-Chinese holding company, rather than directly selling the Chinese company.

On December 10, 2009, China's State Administration of Taxation (SAT) issued Circular 698,[1] which covers taxation of a non-Chinese company that transfers the equity of a Chinese company, whether directly or indirectly.[2] Effective retroactively as of January 1, 2008, Circular 698 is designed to preclude non-Chinese investors from avoiding Chinese capital gain tax by using a non-Chinese holding company structure, unless the non-Chinese holding company has a commercial justification, as discussed below. Although it is still uncertain how the SAT will interpret Circular 698, buyers and sellers must consider the circular when negotiating and structuring their deals.[3]



Reporting obligations and tax review

Circular 698 requires a seller to make a filing with Chinese tax authorities within 30 days after signing an agreement to sell the equity of a non-Chinese holding company which owns equity in a Chinese company if the jurisdiction in which the holding company is formed (1) has an actual tax burden lower than 12.5% or (2) does not tax the foreign-sourced income of its tax residents. Given that the 30-day period runs from signing, not from closing, the filing may be due before closing.[4]

Commercial justification or substance

Circular 698 indicates that the Chinese tax authorities will disregard the non-Chinese holding company (i.e., impose the capital gain tax as if the equity of the Chinese company had been transferred directly) if the non-Chinese holding company has no commercial justification other than tax avoidance. Such commercial justification could include, e.g., providing a listing vehicle for an offshore initial public offering, avoiding the necessity to obtain Chinese regulatory approval for a transfer of its interest, or because offshore jurisdictions permit more flexible arrangements among shareholders and the issuance of management equity.

Because it remains uncertain what will satisfy Chinese tax authorities of a non-tax avoidance commercial justification for using an offshore structure, many practitioners recommend building "substance" in the non-Chinese holding company. Although Circular 698 does not address what constitutes substance, practitioners believe that a holding company with the following characteristics has substance: (i) physical offices where meetings can be held; (ii) employees, including management and back-office staff; (iii) management executives and directors who reside in or travel to the jurisdiction in which it is incorporated; (iv) maintenance of books and records; (v) maintenance of bank accounts in its name; (vi) undertaking investment management or other functions; (vii) no obligation to distribute dividends received from the Chinese company within a

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specified period; and (viii) direct incurrence of operational expenses with respect to the group business.

Even if the holding company's substance is not sufficient to avoid Circular 698 taxes, adding substance may nevertheless produce a tax benefit by allowing the selling equity owner to argue that part of the aggregate purchase price should be allocated to the holding company's other assets rather than the holding company's Chinese subsidiary, thus reducing the transfer price for the Chinese company's equity and hence the amount of capital gain tax imposed on the transaction.

Earnings distribution prior to sale

A Chinese company's retained earnings may be taxed twice, once under the capital gain tax imposed upon transfer of the equity and again under a dividend withholding tax if and when such retained earnings are subsequently distributed to the new buyer. Moreover, if a holding company is in a jurisdiction with a favorable Chinese tax treaty (such as Hong Kong or Singapore), an actual dividend is taxed at only a 5% Chinese rate, i.e., a lower rate than the 10% Chinese capital gain tax. The parties to a direct or indirect sale of Chinese equity should therefore consider a pre-sale dividend by the Chinese company to the selling equity owner (prior to the equity transfer), with a commensurate reduction in the equity transfer price.

Purchase agreement terms

The purchaser of a holding company which owns Chinese equity should seek to include in the purchase agreement terms to minimize the risk that the purchaser inherits Circular 698 liability. Once the transaction has closed, the Chinese tax authorities may no longer have recourse against the non-Chinese seller, in which case the tax authorities may seek to collect unpaid taxes from the Chinese company. Accordingly, the indirect purchaser of a Chinese company should consider seeking an indemnity from the seller for losses associated with an attempt by the Chinese tax authorities to collect the seller's Circular 698 taxes from the Chinese company.

A purchaser should also consider seeking a covenant requiring the seller to timely file a Circular 698 return and timely pay any tax, as well as the right to review and approve the information in such filing and to participate in any disputes with the Chinese tax authorities.

If the non-Chinese holding company owns assets other than equity in one or more Chinese companies (e.g., equity in one or more non-Chinese companies), the purchase agreement should allocate the consideration paid by the purchaser for the non-Chinese holding companies' equity between the Chinese companies and the non-Chinese assets (because only gain on sale of the Chinese companies is taxable in China).

Public disclosure risk

Chinese tax authorities have occasionally detected unreported indirect equity transfers,[5] relying, for example, on press releases, internet information, correspondence with the Chinese company or exchange of information under a tax treaty with the relevant offshore jurisdiction. Accordingly, before any press release or other information relating to an indirect transfer is publicly disclosed, a non-Chinese investor should ensure that such information accurately describes the offshore structure and is consistent with the disclosures made to the Chinese tax authorities. The seller and purchaser should agree not to make any disclosures that contravene this goal, whether before or after closing the transaction.

1 Circular 698 is titled "Circular on Strengthening the Administration of Enterprise Income Tax on Income Derived from the Transfer of Equity of Non-Tax-resident Enterprises."

2 Circular 698 does not apply to a transfer of shares in a Chinese company through a public stock exchange, but a transfer of shares in a listed Chinese company other than through a public stock exchange (which would include an indirect transfer) is covered by Circular 698.

3 Because China tax treaty benefits applicable in a direct sale of a Chinese company are unlikely to be available in an indirect transfer of a Chinese company, Circular 698 will likely apply notwithstanding any tax treaty.

4 The filing must contain: (i) a copy of the purchase agreement; (ii) a description of the relationship between each of (a) the offshore seller and the non-Chinese holding company and (b) the non-Chinese holding company and the Chinese company, with respect to, among other things, their respective capital, operations, purchases and sales; (iii) information on the production, operations, employees, accounts, and properties of the offshore holding company; (iv) an explanation of the reasonable business purpose for establishing the non-Chinese holding company; and (v) other relevant information that the tax authorities may require.

5 For example, in June 2010, the Jiangsu tax authority collected RMB 173 million (about USD 26 million) in taxes from a U.S. investor group that had indirectly sold a Chinese company's equity without making the required filing.

If you have any questions about the matters addressed in this *KirklandPEN,* please contact the following Kirkland authors or your regular Kirkland contact.

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Revised Hart-Scott-Rodino Act Thresholds

PENpoints

The Federal Trade Commission recently announced increases to the Hart-Scott-Rodino Act filing thresholds.

The Federal Trade Commission ("FTC") recently announced revisions to the Hart-Scott-Rodino ("HSR") Act filing thresholds. The HSR Act requires annual adjustment of the jurisdictional thresholds based on the change in the U.S. gross national product. The thresholds will increase for 2011, unlike last year, when for the first time the thresholds decreased from the prior year.

Effective February 24, 2011, subject to certain exemptions, an HSR Notification and Report Form must be filed when, as a result of an acquisition, the buyer will hold assets, voting securities, and/or non-corporate interests valued in excess of $66.0 million, and the transaction involves parties with annual net sales of $13.2 million or more or total assets valued at $131.9 million or more. If the value of the assets, voting securities, and/or non-corporate assets exceeds $263.8 million, then—again, subject to certain exemptions—the size of the parties is irrelevant and an HSR Notification and Report Form must be submitted. The revised thresholds will apply to all transactions that close on or after the February 24, 2011 effective date.

The chart below summarizes the original thresholds set forth in the HSR Act and regulations, as well as last year's and the new thresholds.

	Original Thresholds	2010 Thresholds	New Thresholds
Size-of-Transaction	$50 million $200 million	$63.4 million $253.7 million	$66.0 million $263.8 million
Size-of-Person	$10 million $100 million	$12.7 million $126.9 million	$13.2 million $131.9 million

Filing fees have not changed and apply to the new thresholds as follows:

Transaction Value	Filing Fee
Greater than $66.0 million but less than $131.9 million	$45,000
Greater than or equal to $131.9 million but less than $659.5 million	$125,000
$659.5 million or more	$280,000

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PENbriefs

CVRs—A Bridge Too Far?

An earlier *M&A Update* addressed the practical challenges of using an earnout to address valuation gaps in private company M&A negotiations. The public company version of the earnout, known as Contingent Value Rights (or CVRs), presents an equally daunting set of obstacles. In our recent *M&A Update*, Kirkland partner Daniel Wolf discusses why, as a result of these obstacles, the use of CVRs will remain the exception rather than the norm, with their primary utility being the facilitation of a focused dialogue around achieving a mutually acceptable valuation for significant contingencies or binary outcomes.

Crossing State Lines—Cautionary Tender Offer Tales

With the increasing popularity of tender offers, dealmakers have quickly developed a comfort zone around structure and terms for Delaware targets. However, dealmakers are finding that unique, and often quirky, provisions of state and other laws require caution and creativity to implement the tender offer structure for targets incorporated in states other than Delaware. In our recent *M&A Update*, Kirkland partners David Fox and Daniel Wolf discuss quirks of California, Washington and Missouri corporate law seen in recent deals.

PENnotes

Hedge Fund Breakfast Seminar: Market and Regulatory Trends
Minneapolis, Minnesota
February 24, 2011

Kirkland & Ellis and the University of Minnesota Law School will host a networking breakfast and seminar on February 24, 2011, at the University of Minnesota Law School. The seminar will cover current market and regulatory developments affecting hedge funds and other private fund managers. Panelists will include Kirkland partners Scott A. Moehrke, P.C., Nabil Sabki, Charles J. Clark, John F. Hartmann, P.C. and William R. Welke, P.C. For more information, or to register for this event, please visit: http://communications.kirkland.com/vf/7531j9298V7965Izm1.

The 17th Annual Columbia Business School Private Equity and Venture Capital Conference: "Navigating New Opportunities And Challenges"
New York, New York
February 25, 2011

The Columbia Business School Private Equity and Venture Capital Conference, sponsored by Kirkland & Ellis, will bring together alumni, professionals and students for informative discussions on recent opportunities and challenges that have emerged in the private equity and venture capital industries. Kirkland partner Kirk A. Radke will speak on a private equity panel titled "The Leveraged Buyout in 2011" and partner David MacDonald will speak on a panel titled "Private Equity in the Emerging Markets: Charting the Course." Keynote speakers will include Russell L. Carson, co-founder, Welsh, Carson, Anderson & Stowe; Stuart J. Ellman, co-founder and managing partner, RRE Ventures; John D. Howard, chief executive officer, Irving Place Capital, and Stephen P. Murray, president and chief executive officer, CCMP Capital. For more information, or to register, please visit: www.cbspevcconference.com/index.html.

The 17th Annual Harvard Venture Capital & Private Equity Conference
Boston, Massachusetts
February 26, 2011

The 2011 Harvard Venture Capital & Private Equity Conference, sponsored by Kirkland & Ellis, will address issues and trends relevant to venture capitalists, private equity investors, entrepreneurs and those who support the venture capital and private equity communities. This year's keynote speakers include Leon Black, founder and CEO of Apollo Global Management, LLC; William H. Draper III, managing director at Draper Richards L.P. and founder of Sutter Hill Ventures, and Stephen Pagliuca, managing director at Bain Capital and co-owner of the Boston Celtics. Additionally, Kirkland partner Kirk A. Radke will participate in a panel discussing large buyouts and partner Armand A. Della Monica will participate in a panel discussing distressed investments. For more information, please visit: www.hbsvcpeconference.com/index.php.

The 6th Annual NYU Stern Private Equity Conference
New York, New York
March 4, 2011

The 6th Annual NYU Stern Private Equity Conference, sponsored by Kirkland & Ellis, will be held on March 4, 2011, in NYU's Kimmel Center. P. Oliver Sarkozy, managing director and head of the financial services group at The Carlyle Group, will be the keynote speaker. The conference will feature leading panelists discussing, among other topics: emerging markets, leveraged buyouts, distressed investing, growth capital and venture capital. Kirkland partner Markus P. Bolsinger will participate in a panel on "Leveraged Buyouts" and partner Jonathan S. Henes will participate in a panel on "The Distressed Paradox: Where are all the Deals?" For more information, please visit: http://people.stern.nyu.edu/spec/eve_conference_2011.htm.

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Private Equity Practice at Kirkland & Ellis

Kirkland & Ellis LLP's nearly 400 private equity attorneys handle leveraged buyouts, growth equity transactions, recapitalizations, going-private transactions and the formation of private equity, venture capital and hedge funds on behalf of more than 200 private equity firms around the world.

Kirkland has been widely recognized for its preeminent private equity practice. The Firm was named Best M&A Firm in the United States at World Finance's 2011 Legal Awards and was recognized as "Law Firm of the Year" in *Buyouts* magazine's "2010 Deal of the Year Yearbook." Kirkland was also honored with the 2010 "Award for Excellence" in Investment Funds by Chambers & Partners at its annual Chambers USA Awards. Kirkland was ranked in the first tier among law firms for both Private Equity Buyouts and Private Equity Funds by *The Legal 500 U.S. 2010*. Additionally, *Pitchbook* named Kirkland as one of the most active law firms representing private equity firms in its 2010 "Private Equity Breakdown."

The Lawyer magazine recognized Kirkland as one of the "The Transatlantic Elite" in 2008, 2009 and 2010, noting that the firm is "leading the transatlantic market for the provision of top-end transactional services ... on the basis of a stellar client base, regular roles on top deals, market-leading finances and the cream of the legal market talent."

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KIRKLAND & ELLIS LLP

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