

Limited Liability Partnership = Tax Saving?

One of the important motives for private equity funds (for private) in Mainland China to adopt limited liability partnership (“LLP”) is that PE Funds taking LLP form can avoid double taxation. However, due to the lag in LLP taxation legislation in Mainland China, whether the investors can reduce income tax costs through establishing LLP PE Funds is still uncertain. This article will, by taking an example of the equity investment made by investors through establishing LLP PE Funds, analyze the possible income tax impacts to the investors in the operation of the LLP PE Fund and related outstanding issues.

1. Taxation on Individual Partners

According to Guofa [2000] No.16 and Caishui [2000] No.91, partners of a partnership (including an LLP) should be subject to individual income tax (“IIT”) on the income derived from the business operation of the partnership at the tax rate of 5% to 35% as applied for the business operation income of individual business households. Nevertheless, Guoshuihan [2001] No. 84 states that interests and dividends distributed by the invested companies of a partnership shall not be treated as income of the partnership, but shall be deemed as interests and dividends collected by partners of the partnership and therefore partners shall be subject to IIT at the tax rate of 20%. Pursuant to the provisions mentioned above, it is our understanding that partners of LLP PE Funds shall be subject to IIT at the rate of 5% to 35% on the business operation income distributed by the partnership and at the rate of 20% on the interests and dividends distributed by the invested companies to the partnership; and the partnership shall compute business operation income and investment income separately. The tax laws and regulations seems have not clearly stated tax treatments on gains derived by the partnership from transferring of shares of invested projects.

In practice, the individual partners who are not responsible for operation of the LLP generally pay IIT at the rate of 20% (as applied to interests and dividends); and those individual partners who are responsible for operation of the LLP are generally liable for IIT at the rate of 5% to 35% (as applied the business operation income of individual business households). Currently, we noticed that, the incomes collected by LLP PE Funds are mainly gains from transferring of shares of invested projects. Although there are no specific regulations on how to compute IIT on such gains by the individual partners (including general partners and limited partners) who do not

conduct operation of the LLP PE Fund, the gains from share transfer could be deemed as passive incomes received by such individual partners, it is more reasonable to tax such gain as interests and dividends; while for general partners who are responsible for operation of the LLP PE Fund, if the gains on share transfer are taxed as business operation income of individual business households, such calculation might be inconsistent with the purpose of Guoshuihan [2001] No. 84. In fact, the individual partners might be taxed heavier if they pay IIT at the rate applied to the business operation income of individual business households. The tax laws and regulations shall make it clearer on how an individual general partner who is responsible for operation, will be taxed under the circumstance that the LLP is engaged solely in equity investment.

2. Taxation on Legal Person Partners

The tax laws and regulations are silent on the taxability of the income derived by the legal person partner from the LLP. The general practice is that the income (including management fees, income distribution, gains on transfer of shares in invested projects) derived by the legal person partner (regardless whether it is a general partner or a limited partner) from the LLP shall be included into the total taxable income of the legal person partner for enterprise income tax purposes. However, pursuant to PRC Enterprise Income Tax Law, the investment incomes derived by a resident enterprise from another are exempted from enterprise income tax. The question is that if the legal person partner makes capital contribution into the LLP and is entitled to investment income indirectly through LLP from the invested projects (such investment income might be realized in the share transfer price), is the legal person partner qualified for tax-exemption on such investment income? According to our understanding, first, the LLP is usually deemed as a “conduit” entity, the investment made by legal person partners through the LLP could be deemed as direct investment made by such partners to the invested projects; second, according to the purpose of Guoshuihan [2001] No. 84, the investment income generated from the investment made by an LLP shall be deemed as the investment income derived by the partners (including legal person partners). In light of this, it does make sense to give tax-exemption to the legal person partners on the investment income derived through the LLP. On the other hand, if the tax-exemption policy is not applied to the legal person partners, then it is questionable whether the tax burden of the LLP venture capital is less heavy than that of a corporate venture capital.

Due to the lag in tax legislation on LLP, the tax compliance costs and tax burden for

partners of LLP may be higher than it should be. While the tax compliance cost of a corporate venture capitals is lower, and in addition, the government provides various preferential treatments (tax and non-tax) to corporate venture capitals. Therefore, the double taxation issue shall not be the only concern when comparing the tax burdens of LLP venture capitals and those of corporate venture capitals; and the overall tax compliance cost and tax burden of both the entity and the investors shall be taken into consideration, in particular, the tax deduction and tax exemption treatments shall not be ignored. We will pay close attention to the further legislations on LLP taxation legislation.

[This article was published by LexisNexis on China Legal Review in November 2008 (issue [20])]

If you have any questions on the above or need further help, please contact:

Clare Lu (Senior Partner) email: yi.lu@rwlawyers.com

Catherine Chen (Senior Partner) email: catherine.chen@rwlawyers.com