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Investment friendly policies in China and Malaysia

For institutional investors and investors in general, investing abroad can sometimes involve wrestling with difficult foreign investment laws. This article highlights some recent foreign investment policy shifts in two countries, China and Malaysia, to remove barriers to foreign investment inside their countries and to actively encourage inflows of foreign capital.

China

As a reminder, in March last year, new rules were introduced to promote foreign private equity and venture capital investing and to promote increased domestic Mergers and Acquisitions activity.

The Chinese government introduced new regulations (2003 Regulations) that make the establishment of Venture Capital Foreign Investment Enterprises (VCFIEs) in China more attractive to foreign investors. Some of the key changes in the 2003 Regulations include:

- All capital commitments to certain VCFIEs can now be made within five years instead of three years.
- VCFIEs now only require one "essential investor," who can either be a foreign investor or a Chinese investor.
- If the "essential investor" is a foreign fund manager, it is no longer required to have a minimum net asset value of $100 million U.S. dollars but it must have funds under management of at least $100 million;
- A VCFIE can entrust its management responsibility to another VCFIE or an external venture investment management company (which may take the form of a company, either a domestic or foreign invested company, or an overseas VC management company or a partnership).;
- If a VCFIE disposes of its interest in an investee, that part of the sale proceeds representing the original capital invested in the VCFIE may, subject to approval of the relevant authorities, be returned to the investors in the VCFIE.

Coupled with the 2003 Regulations are recent changes to the Chinese tax regime that apply to partnership-type funds organized as VCFIEs under Chinese law. Until recently, the Chinese legal framework was seen as unattractive to fund investors because of, mainly, the unfavorable tax treatment of funds organized under Chinese law. Accordingly, most foreign-based private equity and venture capital funds investing in China have typically been structured using recognised and reputable tax efficient international finance centres.

The new tax regime confirms the creation of a specific tax category for partnership-type funds organized as VCFIEs under Chinese law. The new regime for VCFIEs, together with the existing tax laws, now leads to a position where:

- If a VCFIE is established in a location where preferential tax treatment is available (for example, the Shenzhen Special Economic Zone or the Shanghai Pudong New Area), income tax rates can reduce to 15 percent (from the standard 33 percent).
- Tax treaty benefits between China and other jurisdictions may allow for additional tax exemptions or reductions. Among the better treaty jurisdictions, *Mauritius is by far the most favorable for structuring investments into China. For example, under the treaty the withholding tax rate on dividends is only 5 percent. Also, capital gains by Mauritian investors from the sale of VCFIE portfolio companies (without an establishment in China) are in most cases exempt from tax;*
- Depending on the investment portfolios of VCFIEs, foreign investors may be completely exempt from withholding tax on dividends. Under current Chinese tax laws, dividends paid by Foreign Investment Enterprise (FIE) portfolio companies to foreign investors are free of withholding tax. An FIE is a wholly foreign-owned company or Sino-foreign joint venture. If it is a Sino-foreign joint venture, the foreign investor's share in the company should normally not be less than 25 percent in order to qualify as a true FIE.
- Dividend payments from non-FIE portfolio companies to foreign investors currently attract 10 percent withholding tax, ***although this rate can be reduced to 5 percent under the China-Mauritius tax treaty noted earlier.***

Brief summary of the Mauritius China tax treaty:

1. Under the treaty, dividend withholding tax is reduced from 20 per cent to 5 per cent.
2. There is an interest withholding tax of 10 per cent, save in the case of banks and financial institutions where there is a complete exemption on interest withholding tax.
3. Royalty withholding tax is reduced to 10 per cent.
4. Capital gains arising from the alienation of Chinese shares, except for shares in a company, the property of which consists of immoveable property, are exempt from Chinese tax and are taxable in Mauritius. At present, Mauritius does NOT tax capital gains.
5. The test for a Permanent Establishment in the case of a building site or construction project is if the site or project lasts more than 12 months.

Malaysia

The most recent Malaysian changes on foreign investment have come in the wake of stiff regional competition. The Malaysian government is optimistic that the changes are significant for foreign investors and will increase foreign investment in local corporations.

In Malaysia, manufacturing companies are required to be licensed and are regulated by the Ministry of International Trade and Industry. Prior to the Asian economic crisis in the late 1990s, the level of foreign equity participation in manufacturing companies was determined by the level of exports.

Most recently, the Malaysian government lifted the export and equity conditions on foreign participation in the manufacturing industry. Under the new policy, 100 percent foreign equity is allowed for all new investments, as well as investments for expansion and diversification by existing licensed manufacturers. This liberalization applies to all manufacturing sectors. Unlike the previous liberalization measures, no sectors are excluded from the liberalization policy and there is no time limit imposed.

In addition to liberalizing foreign investment in Malaysia's manufacturing sector, the Malaysian government also introduced a more broadly based economic stimulus package. The stimulus package was considered necessary after the buffeting effects of the Iraq war and the SARs crisis on Malaysia's economy. From a foreign investment perspective, the package includes a general relaxation of Malaysia's foreign investment guidelines. Under the revised guidelines:

- The only equity condition imposed on foreign acquisitions is a minimum of 30 percent Bumiputera (Malays and indigenous people) equity.
- Similarly, for companies seeking a listing on the Kuala Lumpur Stock Exchange, the only equity condition imposed is a minimum 30 percent Bumiputera equity participation on listing.
- Acquisitions of up to RM 10 million (equivalent to approximately $2.6 million U.S.) will be exempted from the committee's approval. The threshold used to be RM 5 million.
- For acquisitions exceeding RM 100 million (equivalent to approximately $26 million U.S.), companies can apply for exemption from the committee's guidelines, subject to the approval of the Minister of Finance, on a case-by-case basis.
- Foreign interests are allowed to acquire landed properties exceeding RM 150,000 per unit (the previous threshold was RM 250,000).

Summary of the Mauritius Malaysian tax treaty:

1. Tax sparing clause.
2. Reduction in Chinese dividend withholding tax to 5 % where shareholding of portfolio investments is at least 10%. However, dividends paid by a company which is resident of Malaysia to a resident of Mauritius who is the beneficial owner are exempt from any tax in Malaysia which is chargeable on dividends. In other cases, dividend withholding tax is 15%.
3. Reduction in Malaysian interest and royalty withholding tax to 15%.
4. Complete exemption from Malaysian capital gains tax upon the alienation of movable property in the absence of a permanent establishment in Malaysia.

Therefore, with proper planning, it is now quite possible for foreign investors to minimize their tax liability on dividend, interest, royalty income and capital gains from investments in China and Malaysia and in some cases even eliminate it.

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Source: American Bar Association website article: Venturing into the Pacific Rim, Changing laws ease U.S. investment in China, Malaysia and Australia By Brian H.G. Chia, Mark McNamara, Stephen M. Nelson,Marc R. Paul, Danian Zhang and Bruce A. Zivian
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