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Entity Characterization Issues in the People's Republic of China

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ENTITY CHARACTERIZATION ISSUES IN THE PEOPLE'S REPUBLIC OF CHINA

Norman N. Nystrom[†]

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I. Introduction

The allure for United States investors of the vast potential markets in developing countries such as the People's Republic

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of China (PRC) has been well documented.¹ The awesome consumer markets and infrastructure needs of the 1.2 billion people of the PRC has commanded a ten-fold annual increase in investment since China opened its doors to foreign investment in 1978.² As of the end of 1993, there were approximately 174,000 foreign investment entities with direct foreign investments in the PRC that now account for over 30% of China's industrial output.³ Despite the apparent optimism shown by foreign investors in the PRC, there are obvious risks involved with investments in developing countries, such as: political instability, a limited middle-class, a volatile economic infrastructure, social unrest, limited currency convertibility, recurring international trade disputes, and inflationary pressures.⁴ Foreign investors often desire to organize ownership structures which minimize potential liability for losses caused by these risks while allowing opportunities to capitalize on the developing market. U.S. investors are faced with the additional challenge of structuring investments in developing countries such as the PRC to ideally obtain tax benefits for losses in this volatile investment climate and minimize tax on potential future income.

Ultimately, the tax efficiency of an organization structure for a U.S. investment in a foreign country depends upon the U.S. tax characterization of the entity utilized in the foreign country. Since U.S. investors (U.S. citizens, residents, or corporations) are taxed on worldwide income,⁵ the U.S. treatment of a foreign entity will dictate when and how the foreign entity's income or loss is taxed in the United States.⁶

1. *How Not to Sell 1.2 Billion Tubes of Toothpaste*, THE ECONOMIST, Dec. 3, 1994, at 75, 76.

2. *Id.* at 75.

3. THE ECONOMIST INTELLIGENCE UNIT, INVESTING, LICENSING & TRADING CONDITIONS ABROAD: CHINA 1994 at 13 (1994).

4. *China's Fading Allure*, THE ECONOMIST, Jan. 6, 1995, at 37; *How Not to Sell 1.2 Billion Tubes of Toothpaste*, *supra* note 1, at 75-76; Joseph Kahn, *China Fails to Curb Its Runaway Growth*, WALL ST. J., Jan. 3, 1995, at A6.

5. Treas. Reg. § 1.1-1(b) (as amended in 1974) (imposing income tax liability on all U.S. citizens or resident individuals on worldwide income); Treas. Reg. § 1.11-1(a) (as amended in 1976) (imposing income tax liability on domestic corporations regardless of source of income).

6. 1 PHILIP F. POSTLEWAITE & TAMARA L. FRANTZEN, INTERNATIONAL TAXATION: CORPORATE & INDIVIDUAL § 1.02 (2d ed. 1994) [hereinafter 1 INTERNATIONAL TAXATION].

Often, U.S. investors face a dilemma in attempting to characterize entities for U.S. tax purposes in developing countries because the legal forms can be radically different from common U.S. entity forms. The PRC offers three basic investment vehicles for foreign direct investors: Equity Joint Ventures, Cooperative (or Contractual) Joint Venture, and the Wholly Foreign-Owned Enterprise.⁷

This article focuses on the entity characterization issues of these three alternative PRC investment forms for U.S. tax purposes. Part II sets forth the general principles and defining factors of entity characterization pursuant to U.S. tax law. Part III discusses the principle forms of business enterprise available to foreign investors in China and provides analysis of each enterprise form using U.S. tax principles. Part IV predicts the likely outcome of the U.S. tax characterization of Chinese equity joint ventures and discusses the flexibility of tax planning related to Chinese cooperative joint ventures.

II. Relevance of Entity Characterization for U.S. Tax Purposes

Whether an entity is characterized for U.S. tax purposes as a corporation or a partnership has numerous U.S. tax ramifications. The most basic tax ramification is that a partnership is merely a conduit or pass-through entity.⁸ In comparison, a corporation is a separate taxable entity.⁹ Therefore, if a U.S. corporation has an interest in a foreign entity which is treated as a partnership for U.S. tax purposes, the domestic corporation is considered to have directly earned its share of partnership income and directly paid its share of partnership expenses, including any foreign taxes paid by the foreign entity.¹⁰ The ability for income and losses to currently flow through can be especially important for the formative years of an entity in a developing country, when tax losses may be expected. A key advantage to partnership characterization is the ability to deduct losses currently against other operating income of the U.S.

7. THE ECONOMIST INTELLIGENCE UNIT, *supra* note 3, at 16.

8. I.R.C. § 701 (1986) (all citations to I.R.C. are to the Internal Revenue Code of 1986, as amended); Treas. Reg. § 1.701-1 (1960); *see also* 1 ARTHUR B. WILLIS ET AL., PARTNERSHIP TAXATION § 2.01 (5th ed. 1994) [hereinafter PARTNERSHIP TAXATION].

9. *See* I.R.C. § 11(a).

10. *See* I.R.C. § 702(a).

parent company to reduce current federal tax liability.¹¹ In contrast, if the foreign entity is characterized for U.S. tax purposes as a corporation, operating losses can only be carried forward and offset against future income of the foreign entity if allowed by the foreign taxing jurisdictions.¹²

Entity characterization is also important for purposes of foreign tax credit utilization. Where a foreign entity pays foreign income taxes at the corporate level, such taxes generally may not be claimed by individuals or less than ten percent corporate owners as deemed paid foreign tax credits.¹³ In contrast, such taxes assessed on a foreign entity characterized as a partnership are imposed at the partner level and are therefore allowed as direct foreign tax credits for individual and less than ten percent corporate partners.¹⁴

The character of a foreign entity impacts the U.S. taxation of U.S. assets contributed for use in the foreign business. This is especially important in the transfer of intangible property to the foreign entity. Assets contributed to a foreign entity that is a partnership for U.S. tax purposes can be subject to an immediate U.S. excise tax.¹⁵ Certain intangible assets contributed to a foreign corporate entity can be subject to U.S. taxation commensurate with the future income earned by the assets.¹⁶

Foreign tax credit issues also arise with respect to a foreign corporation in which a U.S. shareholder owns a fifty percent or less interest. In this case, the income and related foreign taxes must be placed in a separate foreign tax credit limitation basket.¹⁷ In the foreign partnership context, the U.S. shareholder is considered to have earned its share of the partner-

11. See generally I.R.C. § 702(a); 2 PHILIP F. POSTLEWAITE & TAMARA L. FRANTZEN, INTERNATIONAL TAXATION: CORPORATE AND INDIVIDUAL § 17.09 (2d ed. 1994) [hereinafter 2 INTERNATIONAL TAXATION].

12. See I.R.C. § 1503(d); Treas. Reg. 1.1503-2(b).

13. See I.R.C. § 902. See generally D. Kevin Dolan, *Special Issues in Structuring International Joint Ventures - Part One*, 22 TAX MGMT. INT'L J. 51, 52 (1993).

14. See I.R.C. § 901.

15. I.R.C. § 1491. Under I.R.C. section 1491, U.S. assets contributed to a foreign partnership are subject to a 35% excise tax. *Id.* A taxpayer may instead elect to apply the principles of Section 367 or to treat the contribution as a sale taxable in the United States under Section 1057. I.R.C. § 1492(2),(3). Section 367 applies to tax contributions of certain assets, such as intangible assets, to foreign corporations. I.R.C. § 367.

16. I.R.C. § 367(d)(2)(A); I.R.C. § 482.

17. I.R.C. § 904(d)(2).

ship's income directly, and the underlying activity of the foreign partnership will determine its character.¹⁸ A further ramification of foreign partnership versus corporation status is its impact upon the various U.S. anti-deferral rules. While beyond the scope of this article, foreign entity character dramatically affects the determination of whether or not income of a foreign entity is subject to immediate taxation in the United States under the various anti-deferral regimes of subpart F Income,¹⁹ Passive Foreign Investment Company (PFIC) income,²⁰ and income from excess passive assets.²¹

A. General U.S. Entity Characterization Rules

The Internal Revenue Service, with the agreement of the courts, previously considered a foreign entity to be a corporation for U.S. tax purposes if it was treated as such under foreign law.²² Recently, however, the Internal Revenue Service and the courts have recognize that a foreign entity is classified for U.S. tax purposes by applying the rules of Internal Revenue Code Section 7701 and Sections 301.7701-1(c) and 301.7701-2 of the Procedure and Administration Regulations.²³

"Although an entity is classified for U.S. tax purposes under the [Section] 7701 regulations, its classification for foreign tax purposes is governed by the laws of the foreign country."²⁴ The U.S. and foreign classifications often do not coincide, and an entity may be a partnership under U.S. law and a corporation under foreign law, or vice versa (a so-called hybrid entity).²⁵ Inconsistent classifications of entities can provide an opportunity for worldwide tax minimization, as well as potential for double

18. I.R.C. §§ 702(b) and 904(d).

19. I.R.C. § 951.

20. I.R.C. § 1296.

21. I.R.C. § 956A.

22. Bruce N. Davis & Steven R. Lainoff, *U.S. Taxation of Foreign Joint Ventures*, 46 TAX L. REV. 165, 168 (1991) [hereinafter Davis].

23. Regulation § 301.7701-2 is a direct reflection of the six factor entity characterization test found in the Supreme Court decision *Morrissey v. Comm'r*, 296 U.S. 344 (1935). I.R.C. § 7701; Treas. Reg. § 301.7701-1(c) (as amended in 1977) and § 301.7701-2 (as amended in 1993); see also Davis, *supra* note 22, at 168.

24. Rev. Rul. 88-8, 1988-1 C.B. 403 (providing that an entity organized under foreign law is classified for U.S. federal tax purposes based on the standards set forth in section 301.7701-2 of the regulations); Davis, *supra* note 22, at 172-73.

25. See Davis, *supra* note 22, at 173.

taxation or other such traps for the unwary.²⁶ For example, it may be desirable to utilize a hybrid entity which limits legal liability and is taxed as a corporation in the foreign country, while having flow-through character (partnership) for U.S. tax purposes.

Section 7701(a)(3) provides that the term "corporation" includes associations, joint-stock companies, and insurance companies.²⁷ The regulations provide that various organizations fall into certain categories or classes for taxation purposes.²⁸ "These categories, or classes, include associations (which are taxable as corporations), partnerships, and trusts."²⁹ The tests or standards, which are to be applied in determining the classification in which an organization belongs, are set forth in the regulations.³⁰

The basic characteristics of a corporation are: (1) associates; (2) an objective to carry on business and divide the gains therefrom; (3) continuity of life; (4) centralization of management; (5) limited liability; and (6) free transferability of interests.³¹ "Whether a particular organization is to be classified as an association must be determined by taking into account the presence or absence of each of these corporate characteristics."³²

Characteristics that are common to both partnerships and corporations are immaterial in attempting to distinguish between an association and a partnership.³³ "[S]ince associates and an objective to carry on business and divide the gains therefrom are generally common to both corporations and partnerships, the determination of whether an organization which has such characteristics is to be treated for tax purposes as a partnership or as an association depends on whether there exists centralization of management, continuity of life, free transferability of interests, and limited liability."³⁴

26. *Id.*

27. I.R.C. § 7701(a)(3).

28. Treas. Reg. § 301.7701-1(b) (as amended in 1977).

29. *Id.*

30. *Id.*; Rev. Rul. 73-254, 1973-1 C.B. 613.

31. Treas. Reg. § 301.7701-2(a)(1) (as amended in 1993).

32. *Id.*

33. Treas. Reg. § 301.7701-2(a)(2) (as amended in 1993).

34. *Id.* For an in-depth discussion and analysis, see BORIS I. BITTKER & JAMES S. JUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS § 2.02 (6th

The regulations further provide that “[a]n unincorporated organization shall not be classified as an association unless such organization has more corporate characteristics than non-corporate characteristics.”³⁵ To determine if an organization has more corporate characteristics than noncorporate characteristics, do not consider characteristics common to both types of organizations.³⁶ Thus, if an entity possesses fewer than three of the four corporate characteristics, the entity is not considered a corporation for U.S. tax purposes (e.g. the presence of associates and profit objective).³⁷

With respect to foreign entity characterization, U.S. tax law applies for purposes of determining the applicable rules for entity characterization.³⁸ Local law of the foreign jurisdiction must be applied, however, to determine the legal relationships between the members of the entity both among themselves and with respect to third parties.³⁹

B. The Four Key Characteristics of Entity Classification

As previously discussed, the four corporate characteristics of entity classification are continuity of life, centralized management, limited liability, and free transferability of interest. Each characteristic is discussed separately below.

1. Continuity of Life

“An organization has [the corporate characteristic of] continuity of life if the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member will not cause a dissolution of the organization.”⁴⁰ Thus, if the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member of the organization causes a dissolution of the organization, the organization does not have continuity of life.⁴¹ Dissolution is defined as an alteration of the organization’s

ed. 1994) [hereinafter BITTKER].

35. Treas. Reg. § 301.7701-2(a)(3) (as amended in 1993).

36. *Id.*

37. See John S. Karls and C. Mitchell Siegel, *Hybridizing Foreign Entities Can Cause Disaster*, 4 J. INT’L TAX’N 340, 345 (1993).

38. Treas. Reg. § 301.7701-1(c) (as amended in 1977).

39. *Id.*; Rev. Rul. 73-254, 1973-1 C.B. 613; 2 INTERNATIONAL TAXATION, *supra* note 11, § 17.07.

40. Treas. Reg. § 301.7701-2(b)(1) (as amended in 1993).

41. *Id.*

identity as a result of a change in the relationship between its members as determined by local law.⁴² This is consistent with the definition of a dissolution under the Uniform Partnership Act.⁴³ An agreement under which a business is organized may contain provisions for continuation of the business, such as consent of the remaining entity holders after the death or withdrawal of any member. Such an agreement, however, would not be enough to provide continuity of life if, according to local law, death or withdrawal causes dissolution of the organization.⁴⁴ Therefore, even though an organization may be continued by its remaining members after dissolution, it may still lack the corporate characteristic of continuity of life.

Continuity of life is often the focal point of entity characterization of foreign entities, because by local law many foreign entities possess the corporate characteristics of centralized management and limited liability under local law.⁴⁵ The practical application of U.S. tax law for continuity of life characterization is currently unclear in many foreign country statutes. Most notably, the Internal Revenue Service has long been attempting to elaborate when the United Kingdom's company loss procedures for bankruptcy of an equity holder cause a dissolution of the foreign entity "without further action" by the equity holders.⁴⁶ For two years the Internal Revenue Service has apparently attempted to resolve this issue in the context of a United Kingdom limited liability company, as various Internal Revenue Service representatives have offered indications that a public ruling would be issued.⁴⁷

A United Kingdom limited liability company by law has centralized management and limited liability. If the goal is to achieve partnership treatment for U.S. tax purposes the company must lack both continuity of life and free transferabili-

42. Treas. Reg. § 301.7701-2(b)(2) (as amended in 1993).

43. U.P.A. § 37 (1994).

44. See Karls & Siegel, *supra* note 37, at 346-47.

45. *Id.* at 345-46 (citing Rev. Rul. 77-214, 1977-1 C.B. 408, *modified* by Rev. Rul. 93-4, 1993-1 C.B. 225).

46. *Id.* at 346. Bankruptcy does not cause dissolution. *Id.* A meeting of the equity holders is required where they must vote for a dissolution. *Id.*

47. *International Taxes: IRS Official Says Expect Revenue Ruling on Foreign Entity's Continuity of Life*, Daily Tax Rep. (BNA) No. 206, at D-5 (Oct. 27, 1993). A GmbH under German law possesses the same characteristics. Rev. Rul. 93-4, 1993-1 C.B. 225.

ty of interests.⁴⁸ According to United Kingdom law, upon the dissolution, bankruptcy, or insolvency of a shareholder, a shareholder meeting must be called at which the shareholders may vote to liquidate the company.⁴⁹ Because the shareholder vote is not mandatory, nor are the shareholders required to vote for liquidation, continuity of life exists. To destroy continuity of life, however, the organizing papers of the company, its memorandum and articles of association, should provide that the company will be wound up upon the dissolution, bankruptcy, or insolvency of any shareholder.

Another frequent issue with respect to continuity of life is whether a foreign entity that is owned by two or more subsidiaries of the same United States parent can lack continuity of life.⁵⁰ This is the so-called "single interest theory."⁵¹ In Revenue Ruling 77-214, a German GmbH was formed by two subsidiaries of the same United States parent.⁵² In the Memorandum of Association which created the entity, the parties included a provision that the GmbH would be dissolved by the death, insanity, or bankruptcy of any of the shareholders.⁵³ The Service stated that such dissolution provisions are significant only if a separate interest exists that "could compel dissolution of the organization upon the occurrence of one of the listed events of dissolution."⁵⁴ Thus, the Service disregarded the provisions in the Memorandum of Association which called for dissolution upon the occurrence of specific events, considered them to be without substantive effect, and found that continuity of life existed.⁵⁵

Since this ruling was issued, however, the Service has issued a subsequent ruling on the same point, which modified Revenue Ruling 77-214 and appears more in line with entity classification

48. See Rev. Rul. 77-214, 1977-1 C.B. 408, *modified* by Rev. Rul. 93-4, 1993-1 C.B. 225.

49. See *supra* text accompanying note 38.

50. Rev. Rul. 77-214, 1977-1 C.B. 408-09, *modified* by Rev. Rul. 93-4, 1993-1 C.B. 225.

51. *Id.*

52. *Id.*

53. *Id.*

54. *Id.*

55. *Id.*

concepts under U.S. law.⁵⁶ In Revenue Ruling 93-4, the Service again considered a German GmbH owned by two domestic subsidiaries of the same United States parent.⁵⁷ The Memorandum of Association contained the same provision found in Revenue Ruling 77-214, which is that the GmbH would be dissolved upon the death, insanity, or bankruptcy of any shareholder.⁵⁸ The Service indicated that “[i]t subsequently has been determined that the presence or absence of separate interests is not relevant to the determination of whether an entity possesses continuity of life.”⁵⁹ The ruling then states that because the Memorandum of Association “requires dissolution upon the bankruptcy of either [shareholder], without further action, the GmbH lacks continuity of life.”⁶⁰ The ruling seems to focus on the fact that dissolution would occur “without further action.” This is analogous to U.S. partnership law, in which dissolution is defined as “the change in the relation of the partners caused by any partner ceasing to be associated in the carrying on as distinguished from the winding up of the business.”⁶¹ Thus, when an event of dissolution occurs, the partnership is in a state of being dissolved, and no further action is required of the remaining partners.

Revenue Ruling 93-4 seems to indicate that the single entity theory applied in Revenue Ruling 77-214 does not apply to the corporate characteristic of continuity of life.⁶² Practitioners should be aware of the difficulty in applying the rules of Revenue Ruling 93-4 because many foreign entity organization laws do not distinguish between dissolution and winding up (i.e. termination). To avoid having a determination turn on issues of semantics, where possible under local law, one should provide for an event or series of events that will lead to dissolution with at least one of those events being beyond the control of the association’s members.

56. Rev. Rul. 93-4, 1993-1 C.B. 225 (stating that this ruling reconsiders and supercedes Rev. Rul. 77-214, 1977-1 C.B. 408).

57. *Id.*

58. *Id.*

59. *Id.* at 226.

60. *Id.*

61. U.P.A. § 29 (1994).

62. *Id.*

Continuity of life is also at the heart of an on-going Internal Revenue Service debate over the distinction between “dissolved” and “power to dissolve.” In private letter ruling 9002056, a United Kingdom limited liability company’s organizational papers provided that it was to be “dissolved” upon the occurrence of a specific event.⁶³ It further provided that a shareholders’ meeting would be held at which all shareholders were required to vote in favor of winding up the company.⁶⁴ The Service held that the entity lacked continuity of life, based on the mandatory shareholder vote for dissolution.⁶⁵ This resulted in the company being classified as a partnership for U.S. tax purposes.⁶⁶

In private letter ruling 91-52-009, a People’s Republic of China (PRC) limited liability company was classified as a corporation, in part because the Service found that it had continuity of life.⁶⁷ Specifically, the articles of association for the entity provided that bankruptcy of either of two joint venturers constituted grounds for termination “without any further action by the board of directors.”⁶⁸ According to the joint venturers, “upon the demand of the appropriate party . . . the board of directors will unanimously pass a resolution to submit an application for dissolution of [the entity] to the appropriate authorities.”⁶⁹ In finding that this entity possessed the corporate characteristic of continuity of life, the Service focused on the distinction between bankruptcy causing the dissolution, in which case continuity of life would be destroyed, and bankruptcy merely *empowering* a member to cause dissolution, in which case continuity of life was present.⁷⁰ The Service reached this finding despite the fact that the PRC limited liability company statutes are based upon United Kingdom laws.

63. Priv. Ltr. Rul. 90-02-056 (Oct. 18, 1989).

64. *Id.*

65. *Id.*

66. *Id.*

67. Priv. Ltr. Rul. 91-52-009 (Sept. 27, 1991).

68. *Id.*

69. *Id.*

70. *Id.*

2. *Centralization of Management*

An organization has the corporate characteristic of centralized management if any person, or group of persons that does not include all the members, has continuing exclusive authority to make management decisions necessary for conducting the business for which the organization was created.⁷¹ The key concept here is representative management. Thus, where a group of individuals is vested with management authority similar to the power and purpose of a corporate board of directors, centralized management will be found.⁷² The regulations emphasize the power of a member of the organization to bind the entire entity as suggesting the presence of centralized management.⁷³

For centralized management to exist, the managers must have exclusive decision-making power, without requiring ratification by other members of the organization.⁷⁴ It may be difficult to avoid centralized management in a country where by law an entity is required to have at least one director who is appointed by the members, having powers and responsibilities defined by both statute and the company's articles.⁷⁵ This director, by definition, may provide centralized management as defined by the regulations.⁷⁶ It would appear, however, that centralized management would not exist where the applicable articles of organization provide for shareholder veto power and member approval requirements for significant director decisions. Alternatively, the organization could provide that owning members and directors of the company must be identical. In other words, the articles, or shareholder agreement, could provide that shareholders are automatically appointed directors, and directors are required to be shareholders. This arrangement would seem to fail the centralized management requirement, because management decisions would be made by a group

71. Treas. Reg. § 301.7701-2(c)(1).

72. *Id.*

73. *Id.*

74. Treas. Reg. § 301.7701-2(c)(3).

75. See *Law of the People's Republic of China on Sino-foreign Joint Equity Enterprises*, China L. for Foreign Bus. (CCH Austl. Ltd.) ¶ 6-500 [hereinafter *Joint Equity Enterprises*].

76. *Id.*

which includes all members of the organization, rather than by a representative or centralized group.⁷⁷

3. *Limited Liability*

An organization possesses the corporate characteristic of limited liability if, according to local law, no member of the organization is personally liable for the debts of or claims against the organization.⁷⁸ Personal liability means that a creditor may seek personal satisfaction from members of the organization where the assets of the organization are not sufficient to satisfy the creditor's claim.⁷⁹

The presence or absence of limited liability is a local law issue.⁸⁰ Many foreign jurisdictions offer entities with or without limited liability. For example, a German GmbH by German law can have unlimited or limited liability. Likewise, the United Kingdom provides both limited and unlimited liability companies.

Thus, in terms of tax planning considerations, limited liability is often not an area providing much opportunity beyond selecting the appropriate entity in the foreign country. In addition, if an attempt is made to override a default provision of a local entity formation law, care should be taken to ensure that such overrides are valid and will be respected by local law. Further, it is the relationships of the entity and its members with respect to third parties that must be examined under local law to determine if limited liability exists for U.S. tax purposes.⁸¹

4. *Free Transferability of Interests*

An organization possesses the corporate characteristic of free transferability of interests if each of its members (or those members owning substantially all the interests in the organization) have the power to substitute for themselves in the same organization a person who is not a member of the organization without the consent of other members.⁸² This means a member must be able, without the consent of other members, to

77. Cf. Treas. Reg. § 301.7701-2(c)(1), (2).

78. Treas. Reg. § 301.7701-2(d)(1).

79. *Id.*

80. See Treas. Reg. § 301.7701-2(d)(1), (2).

81. See Rev. Rul. 73-254, 1973-1 C.B. 613.

82. Treas. Reg. § 301.7701-2(e)(1).

confer upon his substitute all attributes of his interest in the organization, including both his right to share in the profits and his right to participate in the management of the organization.⁸³ Free transferability does not exist, however, if according to local law, the transfer of a member's interest results in dissolution of the old organization and formation of a new organization.⁸⁴ Finally, if a member can only transfer his interest after offering it to other members of the organization at fair market value, a form of modified free transferability exists.⁸⁵

As previously discussed with respect to the corporate characteristic of continuity of life,⁸⁶ free transferability of interests is often the focus of foreign entity tax planning, because it is sometimes one of two remaining corporate characteristics (along with continuity of life) that is not present by law in certain foreign entities. For instance, a United Kingdom limited liability company possesses by law centralized management and limited liability. To ensure that free transferability of interests is lacking, the memorandum and articles of incorporation should provide that shares may only be transferred with the written consent of the remaining shareholders.⁸⁷

Alternatively, a measure of flexibility could be retained by giving the other shareholders a right of first refusal to purchase the shares at a formula-determined price. The price for purposes of the right of first refusal must not be fair market value, because that would be considered a modified form of free transferability.⁸⁸

III. Characterization of PRC Joint Ventures for U.S. Tax Purposes

A. *Principal Forms of Business Enterprises*

The principal forms of business enterprise available to foreign investors in China are the representative office, coopera-

83. *Id.*

84. *Id.*

85. Treas. Reg. § 301.7701-2(e)(2).

86. See *supra* notes 38-66 and accompanying text.

87. Priv. Ltr. Rul. 92-16-004 (Jan. 14, 1992).

88. *Id.*; see also Treas. Reg. § 301.7701-2(e)(2).

tive joint venture,⁸⁹ equity joint venture,⁹⁰ and wholly-owned foreign enterprises.⁹¹ Both the cooperative joint venture and the equity joint venture require local Chinese investors.⁹² In most cases, Chinese co-venturers are entities ultimately owned by government agencies.⁹³ Wholly-owned foreign enterprises, on the other hand, are 100% owned by one or more non-Chinese investors.⁹⁴ Except for banks and oil and gas exploration, China has historically not allowed branches of foreign enterprises. As of July 1, 1994, PRC-company law introduced branches and certain limited liability company laws. As a practical matter, the Chinese Ministry of Foreign Trade and Economic Cooperation (MOFTEC) may be reluctant in the near term to approve of ventures in these newly introduced forms.

In the past few years MOFTEC has also been allowing limited numbers of PRC umbrella holding companies for foreign investments in China. The umbrella companies hold investments in equity joint ventures, cooperative joint ventures, and wholly-owned joint ventures in order to centralize management, pool currency transactions, and create an entity for possible future public listing of shares in China.⁹⁵ Specific legislation has not been introduced on PRC umbrella companies and less than 100 such entities have been approved on a case-by-case basis by MOFTEC.⁹⁶ As a result, the principal focus for U.S. investors on U.S. entity character today remains on equity joint ventures, cooperative joint ventures, and wholly-owned joint ventures. This article focuses on U.S. entity characterization issues in connection with equity joint ventures and cooperative joint ventures.

1. Equity Joint Ventures

Equity joint ventures were introduced in 1979 as the first legal vehicle allowing foreign direct investments in China in

89. See discussion *infra* part III.A.1.

90. See discussion *infra* part III.A.2.

91. Davis, *supra* note 22, at 218-23.

92. *Regulations for the Implementation of the Law of the People's Republic of China on Joint Ventures Using Chinese and Foreign Investment*, China Laws for Foreign Bus. (CCH Austl. Ltd.) ¶ 6-500(12) [hereinafter *Regulations for the Implementation of Joint Ventures*].

93. *Id.* ¶ 6-550(6).

94. THE ECONOMIST INTELLIGENCE UNIT, *supra* note 3, at 25.

95. *Id.* at 16, 21.

96. *Id.* at 16.

modern times.⁹⁷ As the oldest and most familiar entity for foreign investment in the PRC, the equity joint venture often provides the most comfortable structuring vehicle for both Chinese government and business concerns. Since 1979 a series of regulations has been issued providing guidance on the operation of equity joint ventures in a wide array of topics such as management, finance, currency exchange, personnel and compensation, and entity capitalization.⁹⁸

Equity joint ventures are separate legal entities for Chinese corporate law and tax law purposes.⁹⁹ They are managed jointly with a structured sharing of management functions by the foreign and Chinese partners.¹⁰⁰ Profit and loss must be allocated according to the registered capital ratio.¹⁰¹ The foreign partner must contribute at least twenty-five percent of the capital.¹⁰² This normally is in the form of hard currency working capital, technology, and industrial equipment.¹⁰³ However, the Chinese increasingly are reluctant to accept technology as capital because such intangibles often turn out to be less valuable than expected.¹⁰⁴ Thus, technology often is licensed in return for performance-based royalties (maximum term is usually no more than ten years).¹⁰⁵ Prescribed percent-

97. The 1979 Law of the PRC on Sino-foreign Joint Equity Enterprises and the 1983 Regulation for the Implementation of the PRC on Joint Ventures Using Chinese and Foreign Investment are the primary governing law on equity joint ventures in the PRC. *Equity Joint Ventures*, China Bus. L. Guide (CCH Int'l) ¶ 25-110 (1993). The equity joint venture law was adopted on July 1, 1979 at the 2nd Session of the 5th National People's Congress. *Joint Equity Enterprises*, *supra* note 75, ¶ 6-500. The law was amended on April 4, 1990 at the 3rd Session of the 7th National People's Congress. *Id.* The primary equity joint venture regulations were promulgated on September 20, 1983 by the State Council. *Regulations for the Implementation of Joint Ventures*, *supra* note 92, ¶ 6-550.

98. *Joint Equity Enterprises*, *supra* note 75, ¶ 6-500.

99. *See Equity Joint Ventures*, *supra* note 97, ¶ 25-110.

100. *See Regulations for the Implementation of Joint Ventures*, *supra* note 92, ¶ 6-550(34) (“[T]he chairman of the board shall be appointed by the Chinese participant and its vice-chairman by the foreign participant.”).

101. *Joint Equity Enterprises*, *supra* note 75, ¶ 6-500(4).

102. *Id.*

103. *Id.* ¶ 6-500(5).

104. *See id.*

105. *See also Equity Joint Ventures*, *supra* note 97, ¶ 25-164 (stating that technology contributed as capital by a foreign party is generally limited to not more than 20 percent of the total registered capital).

ages of the investment must be registered capital.¹⁰⁶ Registered capital cannot be repatriated during the life of an equity joint venture.¹⁰⁷ The Chinese partner typically contributes local currency, labor, and land.¹⁰⁸

An equity joint venture offers foreign investors several business advantages in entering the PRC markets. For example, a Chinese partner can bring many things to the table. One is to provide greater access to the domestic market through business contacts, market knowledge, etc. Another is to contribute expertise and influence in areas such as recruiting labor, acquiring raw materials, cutting through official bureaucratic red tape, and providing distribution networks. There is a well-developed legal and regulatory framework for equity joint ventures.¹⁰⁹ This provides certainty, but it also reduces flexibility. By statute, equity joint ventures are eligible for tax holidays and tax reductions.¹¹⁰

An analysis of the relevant U.S. entity characteristics of an equity joint venture for U.S. tax purposes reveals that an equity joint venture possesses both corporate and partnership characteristics.

a. Limited Liability

By law, an equity joint venture possesses limited liability.¹¹¹ Therefore, an equity joint venture possesses the corporate characteristic for U.S. tax purposes.

b. Free Transferability of Interests

Chinese law provides that transfers of interests by one equity joint venture party are only allowed with the consent of the other parties in the joint venture.¹¹² The implementation

106. See *Joint Equity Enterprises*, *supra* note 97, ¶ 6-500(4); see also *Equity Joint Ventures*, *supra* note 97, ¶ 25-162.

107. See *Equity Joint Ventures*, *supra* note 97, ¶ 25-450 (stating that although the equity joint venture regulations permit the foreign party to repatriate proceeds once there has been liquidation, many foreign investors are afraid they will be prevented from doing so).

108. See *Equity Joint Ventures*, *supra* note 97, ¶ 25-164.

109. See generally *Joint Equity Enterprises*, *supra* note 75, ¶ 6-500.

110. *Id.* ¶ 6-500(7).

111. Under Article 4 of the PRC equity joint venture law, "a joint enterprise shall take the form of a limited liability company." *Id.* ¶ 6-500(4).

112. *Id.*

regulations for this provision further require approval from the “examining and approval authority” for the assignment of all or part of a partner’s interest in the joint venture.¹¹³ The “examination and approval authority” is the state department in charge of foreign economics and trade.¹¹⁴ The regulations also provide that where one party assigns his investment to a third party, the other partner has a preemptive right to the interest.¹¹⁵ In conjunction with the preemptive rights, the regulations require that “the conditions given shall not be more favourable than those given to the other party to the joint venture.”¹¹⁶ Failure to follow these requirements will result in the assignment being legally ineffective.¹¹⁷

As a result, an equity joint venture does not have the corporate characteristic of free transferability of interests for U.S. tax purposes.

c. Centralized Management

The parties to an equity joint venture are required by law to establish a board of directors.¹¹⁸ The number of directors must be agreed upon by the partners and provided for in the joint enterprise contract and articles of association.¹¹⁹ Each partner appoints and replaces its own directors.¹²⁰ The board of directors “shall decide all important matters of a joint enterprise.”¹²¹ This includes “development plans, production and operational projects . . . profit distribution, labour and wage plans and suspension of operations”¹²² The joint venturers also appoint general and deputy general managers who are responsible for carrying out board decisions as well as the day-to-day management of the venture.¹²³

113. *Regulations for the Implementation of Joint Ventures*, *supra* note 92, ¶ 6-550(23).

114. *Joint Equity Enterprises*, *supra* note 75, ¶ 6-500(3).

115. *Regulations for the Implementation of Joint Ventures*, *supra* note 92, ¶ 6-550(23).

116. *Id.*

117. *Id.*

118. *Joint Equity Enterprises*, *supra* note 75, ¶ 6-500(6).

119. *Id.*

120. *Id.*

121. *Id.*

122. *Id.*

123. *Id.* Articles 33, 37, 38 and 39 of the equity joint venture regulations implement the specific provisions of Article 6 of the PRC equity joint venture law. See *Regulations for the Implementation of Joint Ventures*, *supra* note 92, ¶ 6-550.

Since a board of directors has the exclusive authority to make management decisions, an equity joint venture has the corporate characteristic of centralized management for U.S. tax purposes.

d. Continuity of Interest

Equity joint ventures have historically been required to specify a duration of operation in their articles of association. The maximum duration for most industries was thirty years.¹²⁴ The Chinese regulations, however, were amended in 1986 to allow certain joint ventures to operate for fifty years or longer with special approval from the Chinese government.¹²⁵ In 1990, this regulation was further modified so that certain lines of business now have the option to choose whether to fix the term of operation of the venture.¹²⁶ If the joint enterprise is engaged in any of the following industries, it is still required to specify the duration of its term of operation in its incorporating papers:

- (1) service industries, such as hotels, apartments, office buildings, entertainment, food and beverages, taxis, colour film development and enlargement, maintenance and consultancy;
- (2) land development and real estate;
- (3) resource exploration and exploitation;
- (4) investment projects restricted by the State;
- (5) other projects which are required to stipulate the duration of their operations pursuant to other State laws and statutory regulations.¹²⁷

Although Chinese equity joint ventures have a specified duration required to be set forth in a term of years in their formation documents, such provisions do not, for U.S. tax entity characterization purposes, destroy continuity of life. U.S. tax regulations specifically provide that a provision in an organizing document stating that an entity will have a specified term of life does not destroy continuity of life.¹²⁸ Instead, continuity of life

124. *Regulations for the Implementation of Joint Ventures*, *supra* note 92, ¶ 6-550(100).

125. *Id.*

126. *Provisional Regulations on the Duration of Sino-foreign Joint Equity Enterprises*, China L. for Foreign Bus. (CCH Austl. Ltd.) ¶ 6-502(2).

127. *Id.* ¶ 6-502(3).

128. Treas. Reg. § 301.7701-2(b)(3) (as amended in 1993).

relates to the ability of the owners of an organization to end its existence prematurely.¹²⁹ Thus, even if the organization is not established with the intention of operating indefinitely as evidenced by a stated term of years, as long as the owners of the organization cannot by their intentional acts end the life of the organization before that term has expired, continuity of life exists for U.S. tax purposes.¹³⁰

PRC equity joint venture law provides that an equity joint venture may be dissolved upon the occurrence of six specified events:

- (1) Termination of duration;
- (2) Inability to continue operations due to heavy losses;
- (3) Inability to continue operations due to the failure of one of the contracting parties to fulfil [sic] obligations prescribed by the agreement, contract and articles of association;
- (4) Inability to continue operations due to heavy losses caused by force majeure such as natural calamities and wars, etc.;
- (5) Inability to obtain the desired objectives of the operation and at the same time to see a future for development;
- (6) Occurrence of other reasons for dissolution prescribed by the contract and articles of association.¹³¹

In the case of events (2) through (6) above, the board of directors shall make an application for dissolution to the examination and approval authority.¹³² Equity joint venture law also requires that decisions of termination or dissolution of an equity joint venture must be unanimously agreed upon by the board of directors.¹³³

Equity joint venture articles of association provide that the death, bankruptcy, etc. of an equity joint venture member would be a termination and dissolution event consistent with equity joint venture regulations.¹³⁴ The salient question for U.S. tax purposes becomes whether or not the termination and dissolu-

129. *Id.*

130. *See id.*

131. *Regulations for the Implementation of Joint Ventures*, *supra* note 92, ¶ 6-550(102).

132. *Id.*

133. *Id.* ¶ 6-550(36).

134. *Id.* ¶ 6-550(102) (stating that a joint venture may be dissolved by other reasons set forth in the articles of association).

tion occurs "without any further action."¹³⁵ The Internal Revenue Service addressed this issue in private letter ruling 91-52-009.¹³⁶ In that ruling, a PRC equity joint venture was formed by a U.S. corporation and a Chinese government entity.¹³⁷ The equity joint venture's articles of association provided that upon the bankruptcy of one of the members, either equity joint ventures member could demand a dissolution and the board of directors would unanimously approve a resolution to submit an application for dissolution to the appropriate authorities.¹³⁸ The Service summarily concluded that the equity joint venture had continuity of life since the termination and dissolution event did not by itself cause the dissolution of the equity joint venture.¹³⁹ Neither party had the legal authority to terminate the equity joint venture at will.¹⁴⁰ A board of directors meeting and application for termination had to be filed with the PRC government.¹⁴¹

In characterizing an equity joint venture as a corporation, private letter ruling 91-52-009 illustrates the very fine distinction that the Service has made between the "power to dissolve" versus "the dissolution of" an entity.¹⁴² In private letter ruling 90-02-056 concerning a U.K. limited liability company, the Service ruled that the entity lacked continuity of life because the U.K. limited liability company was "to be dissolved" on occurrence of a specified event.¹⁴³

135. Priv. Ltr. Rul. 91-52-009 (Sept. 27, 1991).

136. *See id.*

137. *See id.*

138. *Id.*

139. *Id.*

140. Priv. Ltr. Rul. 91-52-009 (Sept. 27, 1991).

141. Curiously enough, it appears that the U.S. taxpayer involved in the letter ruling desired corporate treatment for U.S. tax purposes. *Id.* In today's environment where PRC holding companies or other low-tax holding country companies could own the equity joint venture interest, it is difficult to envision a scenario where corporate characterization would be more advantageous than partnership from solely a U.S. tax perspective.

142. *See id.*

143. *See* Priv. Ltr. Rul. 90-02-056 (Oct. 18, 1989). *Cf.* Rev. Rul. 93-4 1993-1 C.B. 225 (stating that a GmbH lacked continuity of life since it "shall be dissolved" upon the occurrence of a specified event). As discussed previously, the IRS has suspended issuing rulings in this area and indicated several months ago that further guidance is pending. *See generally International Taxes: IRS Official Says Expect Revenue Ruling on Foreign Entity's Continuity of Life, supra* note 47.

It would appear that in order for an equity joint venture to meet the Service's litmus test of automatic termination or dissolution without further action, certain additional binding provisions incorporated into the articles of association would have to be enforceable under Chinese law.¹⁴⁴ There may be a number of options to improve self-executing provisions with the objective of meeting the Service's automatic dissolution standard. One option would be to enter into a binding contract among the equity joint venture members which requires dissolution vote and application to the Chinese government. Other possibilities include irrevocable proxies, pre-recorded board votes, or automatic meeting provisions which would become enforceable under Chinese law automatically upon the occurrence of a specified dissolution event. If such provisions would be enforceable with specific performance as a remedy under Chinese law, even as to non-members such as creditors, it would appear that the Service test of a triggering event automatically causing a dissolution would be met. Although, such a result would require the consideration of factors and agreements beyond the articles of association.¹⁴⁵ Unless the Service issues clear guidelines in its long-awaited guidance in connection with the U.K. limited liability company's characterization, the existence of continuity of life of an equity joint venture will remain unclear. Unless an equity joint venture is found to have limited life, it will be a corporation for U.S. tax purposes since the equity joint venture would possess the three corporate characteristics of limited liability, centralized management, and continuity of life.

2. *Cooperative (Contractual) Joint Ventures*

Cooperative joint ventures were introduced by the 1988 Cooperative Joint Venture Law.¹⁴⁶ The legal framework

144. For a good discussion regarding self-executing dissolution, see James Fuller, "Foreign Tax Credit and Subpart F Developments," 50TH NYU INSTITUTE 30-53 to 30-60 (1992).

145. Based upon recent IRS guidance in the partnership and LLC area, it appears that the IRS is considering factors beyond articles of association and partnership agreements. See Rev. Proc. 95-10, 1995-3 I.R.B. 20-24.

146. The law of the PRC on Sino-foreign Co-operative Enterprises was adopted on April 13, 1988 at the 1st session of the 7th National People's Congress. *Law of the People's Republic of China on Sino-foreign Co-operative Enterprises*, China Laws for Foreign Bus. (CCH Austl. Ltd.) ¶ 6-100 [hereinafter *Co-operative Enterprises*].

directly applicable to cooperative joint ventures is not as comprehensive or developed as that which governs equity joint ventures. No detailed regulations implementing its general guidelines for the establishment and operation of cooperative joint ventures have been published to date. In the absence of detailed implementing rules, the rules governing equity joint ventures are often applied to cooperative joint ventures, either directly or "by reference" in the cooperative joint venture contract. Given this lack of specifically applicable regulations, cooperative joint ventures are largely defined by contract, which is why they are also known as "contractual" joint ventures.

A cooperative joint venture is formed merely by a contract between a Chinese co-venturer and one or more foreign co-venturers.¹⁴⁷ An entity is not necessarily created. However, as will be discussed later, a cooperative joint venture can conceivably acquire the status of a Chinese legal person if its provisions comply with Chinese law.¹⁴⁸ Even though a cooperative joint venture may not be a separate legal entity for Chinese law, a cooperative joint venture will usually be deemed a partnership or corporation for U.S. tax purposes.¹⁴⁹

Cooperative joint ventures are more flexible vehicles than equity joint ventures in that cooperative joint ventures do not have to distribute profits according to the registered capital ratio.¹⁵⁰ Similar to western-style partnerships, the profit splits can vary throughout the life of the cooperative joint venture with no minimum capital percentages.¹⁵¹ Registered capital

147. *Id.* ¶ 6-100(2).

148. *Id.*

149. Under U.S. tax law the term "partnership" is not limited to its common law meaning but is broader in scope and includes groups not commonly called partnerships. The term "includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not . . . a corporation." I.R.C. § 7701(a)(2); Rev. Rul. 90-80, 1990-2 C.B. 170; *see also* *Madison Gas & Elec. Co. v. Comm'r*, 633 F.2d 512, 514-17 (7th Cir. 1980) (holding that a utilities joint venture with two other utilities constituted a partnership within the meaning of the Code); I.R.C. § 761(a) (providing for elections out of partnership classification in limited circumstances).

150. *See Co-operative Enterprises, supra* note 146, ¶ 6-100(22) (stating that profits shall be distributed in accordance with the provisions of the co-operative enterprise contract); *cf. Joint Equity Enterprises, supra* note 75, ¶ 6-500(7) (stating that profits of a joint enterprise shall be distributed between the partners in proportion to their investment contribution to the enterprise's registered capital).

151. *See Co-operative Enterprises, supra* note 146, ¶ 6-100(2). Note that Article 2 imposes no restrictions on the profit-split ratio of the Chinese and foreign partners.

can be distributed to the cooperative joint venture members during the life of the venture provided that all of the ownership of the fixed assets reverts to the Chinese partner at the end of the cooperative joint venture's terms.¹⁵² This is often the preferred arrangement for U.S. investors in asset-intense PRC projects such as real estate, construction, and other infrastructure development projects. Effectively, free flows from depreciation can be repatriated to the U.S. venture partner during the life of the cooperative joint venture while the project will revert to the Chinese venture partner at the end of the venture's terms.

As is the case with an equity joint venture, a cooperative joint venture can possess both partnership and corporate characteristics for U.S. tax purposes.

a. Limited Liability

A cooperative joint venture may be structured either with limited liability or with unlimited liability.¹⁵³ The cooperative joint venture law is very general and does not specifically address liability concerns. However, the cooperative joint venture law states that "a cooperative enterprise which complies with the provisions of Chinese law for a legal person shall acquire the status of a Chinese legal person."¹⁵⁴

As a result, if the cooperative joint venture's relevant contractual agreements specifically provide that the cooperative joint venture is a limited liability company, Chinese law would view the cooperative joint venture as a separate legal person with limited liability.¹⁵⁵ Thus, the members of the cooperative joint venture can effectively choose whether the venture will have

Id. Distribution of earnings and sharing of risks and losses shall be prescribed in the co-operative enterprise contract. *Id.*

152. *Id.* ¶ 6-100(22).

153. *See, e.g., Co-operative Enterprises, supra* note 146, ¶ 6-100(22) (stating that the provisions in the co-operative enterprise contract determine the responsibility for risks or losses).

154. *Id.* ¶ 6-100(2).

155. If the cooperative joint venture is a separate legal person, the cooperative joint venture would be a separate taxpayer for Chinese tax purposes. *See supra* notes 13-21 and accompanying text. If the CJV is not established as a separate legal entity (with limited liability), then the CJV is itself not subject to Chinese taxation. *See supra* notes 13-21 and accompanying text. Instead, the CJV partners are each subject to Chinese taxation on their respective shares of CJV profits. *See supra* notes 13-21 and accompanying text.

limited liability. Such a choice can be very important for entity characterization for U.S. tax purposes.

b. Free Transferability of Interests

Similar to equity joint venture law, a cooperative joint venture member must obtain both the agreement of the other cooperative joint venture members and the appropriate Chinese government agency prior to transferring an interest in a cooperative joint venture.¹⁵⁶ Cooperative joint ventures are supervised by the relevant state departments responsible for economics and trade.¹⁵⁷ As a result, a cooperative joint venture does not have the corporate characteristic of free transferability of interests for U.S. tax purposes.

c. Centralized Management

The members of a cooperative joint venture are required to set up a board of directors or a joint management body to make decisions on all major issues.¹⁵⁸ At first blush, this would seem to indicate that cooperative joint ventures have centralized management. However, the cooperative joint venture law's inclusion of a joint management body option for venture governance merits further consideration.¹⁵⁹

Where a cooperative joint venture does not choose to avail itself of limited liability and comply with the provisions of PRC law for a legal person, it appears that a cooperative joint venture agreement could provide for a joint management body comprised of the joint venture's owners. This management body could have voting power strictly based upon cooperative joint venture ownership ratios. Query whether centralized management would exist for U.S. tax purposes in such a scenario. This is further complicated by the fact that certain Chinese board or management body decisions require unanimous consent by law.¹⁶⁰

156. *Co-operative Enterprises*, *supra* note 146, ¶ 6-100(10).

157. *Id.* ¶ 6-100(3).

158. *Id.* ¶ 6-100(12).

159. Note that a joint management body is not an option for equity joint ventures under Article 6 of the equity joint venture law. *Joint Equity Enterprises*, *supra* note 75, ¶ 6-500(6).

160. For example, unanimous consent of the board or management body is required to engage a non-cooperative joint venture member to manage the business.

Thus, it is unclear as to whether a cooperative joint venture has centralized management for U.S. tax purposes where the joint venture adopts a joint management board and does not comply with PRC provisions as a separate legal person with limited liability.

d. Continuity of Interest

Cooperative joint venture law provides broad latitude for joint venture members to specify the duration and termination of a cooperative joint venture in the joint venture contract.¹⁶¹ The cooperative joint venture terms need to be approved by the appropriate Chinese governmental agency.¹⁶² Upon the expiration or “premature termination” of the cooperative joint venture’s term, the assets, claims, and debts of the joint venture “shall be liquidated” and cancellation of registration “shall be carried out.”¹⁶³ Thus, if the cooperative joint venture provides that the bankruptcy, liquidation, death, etc. of one of the members dissolves the cooperative joint venture, the cooperative joint venture should lack the corporate characteristic of continuity of interest for U.S. tax purposes.

However, if the cooperative joint venture members desire limited liability in the cooperative joint venture and the status of a Chinese legal person, query whether the cooperative joint venture must, by PRC law, adopt the more rigid termination provisions of the equity joint venture law discussed previously. It is much less likely under the equity joint venture termination provisions that the cooperative joint venture members could avoid the corporate characteristic of continuity of interest for U.S. tax purposes for the reasons discussed previously. Both the Chinese law and U.S. tax law are evolving in this area and are far from clear.

A cooperative joint venture can, therefore, be characterized as either a partnership or corporation depending on the provisions of the cooperative joint venture contract.¹⁶⁴ A cooperative joint venture structured without limited liability could conceivably have no corporate characteristics and be

Co-operative Enterprises, *supra* note 146, ¶ 6-100(12).

161. *See id.* ¶ 6-100(25).

162. *Id.* ¶ 6-100(5).

163. *Id.* ¶ 6-100(24).

164. *See supra* notes 155-56 and accompanying text.

treated as a partnership for U.S. tax purposes. Alternatively, cooperative joint venture members choosing limited liability and providing cooperative joint venture provisions which comply with Chinese law for a legal person could conceivably possess three corporate characteristics. Only free transferability would be lacking pursuant to PRC law. Thus, a cooperative joint venture could be a corporation. It remains unclear under Chinese law whether centralized management and continuity of life provisions similar to equity joint venture laws are effectively required for a cooperative joint venture to have the status of a Chinese legal person and enjoy limited liability. It would appear that this issue is currently being dealt with by the applicable Chinese authorities on a case-by-case basis.

IV. Conclusion

U.S. investors have many choices to select entities for joint venture investments in the PRC. While business considerations will often dictate the type of entity and entity governance provisions, U.S. investors can use creative provisions in the establishment of Chinese joint ventures to obtain more advantageous tax results. The characterization of an equity joint venture for U.S. tax purposes is likely to be corporate depending upon the Internal Revenue Service's view of continuity of interest provisions taken in its long-awaited guidance. Taxpayers have far more flexibility with a cooperative joint venture to effectively choose between corporate and partnership character for the joint venture.

