What are the advantages and disadvantages of offshore companies?

—Taking Evergrande Real Estate Group as an Example to Analyze Related Risks and Preventive Measures

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Abstract:
This article takes the phenomenon of “offshore companies” as the main research direction, supplemented by the analysis of potential risks of Evergrande Real Estate Group as a practical case, and attempts to provide certain suggestions for the compliance construction of similar enterprises in the future.

This article adopts a combination of literature review and case analysis methods for research. Firstly, by consulting relevant materials, explain the concepts, characteristics, and advantages of offshore companies compared to general limited companies. Secondly, using case analysis method, elaborate on the potential risks of offshore companies. Finally, by referring to and drawing on the existing systems of international organizations and the United Kingdom, it is possible to establish and improve corresponding legal regulations in China in the future.

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1. Overview of Offshore Companies

(1) Concept

① According to OECD Direct Investment Benchmark Definition, “A company is established in one country and its place of business is established in another country. The place of business holds all the assets of the company and has no dealings with the place of establishment, except for paying dividends to shareholders on behalf of the company. Such companies also have direct investments in third party countries. The actual dividends and fund transactions of the company exist between the place of business and third countries. Third party country statistics usually record this transaction as a transaction between a third party country and the place of establishment of the company. However, from the perspective of the place of business of the company, this transaction actually exists between the third party country and the place of business of the company.”

② The definition of Offshore Company Law, written by Zhang Shiwei and published by China Law Press in 2004, is that “an offshore company is a company established by non local investors in the offshore legal domain in accordance with the local offshore company law and can only conduct business activities outside the offshore area.” The above paragraph is also the most authoritative and systematic discussion and definition of this concept.

③ The subsequent discussion of concepts and features in this article is based on the second point mentioned above.

(2) Characteristics

① Investors of offshore companies should come from countries or regions outside the offshore jurisdiction, in other words, investors or founders should be non local residents.

② The registered capital of an offshore company should also come from outside the offshore jurisdiction.

③ Offshore companies must be established within specific offshore jurisdictions. The so-called offshore jurisdiction often refers to some island countries, which usually formulate relaxed offshore company laws and implement measures such as exempting or only collecting small taxes or management fees on the business income of enterprises, in order to attract foreign investment and promote the local economy.

④ In terms of legal basis, it is the offshore company law norms specially formulated by the offshore legal domain. The Cayman Islands, which will be mentioned later in this article, do not have specific regulations as mentioned above, so the provisions of Cayman Islands Companies Act shall prevail.

⑤ The operating location of an offshore company should be in other countries or regions outside the offshore jurisdiction, and should be guaranteed by relevant offshore company laws. For example, in Cayman Islands Companies Law, it is explicitly stipulated that “Companies intending to apply for registration in accordance with the provisions of this law, which mainly conduct business outside the islands, can apply for registration as exempt-
ed companies……Exempted companies cannot engage in transactions with any natural person, partnership or company within the islands, except to promote exempted companies to conduct business outside the islands.”

(3) Advantages
As stated in the third article of the above characteristics, more and more enterprises are choosing offshore jurisdictions as their place of registration, precisely because they value their tax and preferential policies, which can enable them to have free access to their funds. According to Chen Tao’s *Secrets of Investment Paradise in Tax havens*, tax preferential policies often reflect:

a. Exemption or underpayment of income tax.

b. No need to pay other taxes such as capital gains tax, foreign investment tax, dividend remittance tax, real estate tax, sales tax and value-added tax.

c. There are generally no tariff barriers and no foreign exchange controls.

In addition to the aforementioned tax incentives, the government in the offshore jurisdiction will strictly keep confidential all types of information about the enterprise, such as shareholder information and equity ratios, and the public has no right to access them. In some cases, leaking relevant information may result in heavier penalties.

2. Case Analysis

(1) Basic Information of Evergrande Real Estate Group

“Xu Jiayin holds absolute control over Evergrande Real Estate Group (registered in the Cayman Islands), a group company listed on the Hong Kong stock market, through BVI (British Virgin Islands) Offshore Company.”

Source: 360 Encyclopedia (a Chinese website)

Based on the above paragraph, we can find reasons why we define Evergrande Real Estate Group as an offshore company:

a. Investors come from countries outside the offshore legal domain, China.

b. The actual registered capital also comes from the place outside the offshore jurisdiction.

c. The registered address of Evergrande Real Estate Group is the Cayman Islands, which is an offshore jurisdiction.

d. The main business location of Evergrande Real Estate Group is within the territory of China.

(2) Advantages of Registering a company overseas

① Convenience of Company’s Listing and Simplification of Legal Procedures

According to the previous content, we have learned that Evergrande Real Estate Group holds absolute control through BVI Company and is listed in Hong Kong. And Hong Kong’s laws belong to the common law system, which also explains why Evergrande can apply for bankruptcy protection in the United States and apply Chapter 15 of the US Bankruptcy Code. Compared to general domestic enterprises, this consequence means the simplification of legal procedures in terms of legal application.

In addition, domestic enterprises are subject to stricter supervision from the China Banking Regulatory Commission and China Securities Regulatory Commission after going public compared to offshore jurisdictions. After listing in offshore jurisdictions, the company also has the right to raise funds in overseas securities markets, such as the “US dollar bonds” previously issued by Evergrande, which is more conducive to financing and expanding the company’s size.

② Enjoy Tax Benefits

a. Enjoy tax-free treatment in offshore land

Based on the relevant laws and regulations of the Cayman Islands, where Evergrande Real Estate Group is registered, it has the right to be exempt from taxation for 20 years, which to some extent reduces its operating costs.

b. Obtaining tax incentives as a foreign-funded enterprise

To encourage reinvestment, China has implemented preferential tax policies for tax refunds for foreign-funded enterprises. According to Chinese tax law, “Foreign investors of foreign-invested enterprises who directly reinvest the profits obtained from the enterprise, increase their registered capital, or invest as capital to establish other foreign-funded enterprises with an operating period of no less than 5 years, can apply for a refund or exchange of their reinvestment portion and pay 40% of their income tax after being approved by the tax authorities.”

In addition, it is also stipulated that foreign-invested enterprises will not be subject to urban maintenance and construction tax and education surcharge temporarily. By comparison, domestic enterprises generally pay corporate income tax at a rate of 25%, and the payment of value-added tax is also subject to a “payment before refund” policy.

③ More convenient investment activities

In practice, Chinese citizens or companies often establish offshore companies, and then enjoy the same preferential policies as foreign companies through this identity, which is more conducive to investment activities.

(3) Potential Risks

① Summary

After a period of “heyday”, the international community today has a more negative evaluation of the concept of “tax haven” represented by offshore jurisdiction. After experiencing two major impacts on the international economic and financial environment, namely the 2008 US financial crisis and the pandemic era, the international community began to pay more attention to and attach importance to the many risks generated by offshore companies.

Sovereign countries are increasingly strict in their control
over offshore companies. Offshore companies are generally considered illegal in the United States. Hong Kong and Taiwan in China have also strengthened the management of such companies, and this kind of companies have also attracted high attention from relevant departments in mainland China. The central bank and other four major financial regulatory agencies are also formulating measures to prevent and solve related crimes against an increasing number of offshore enterprises.

Based on this background, the following text will focus on analyzing the various potential risks of offshore companies using Evergrande Real Estate Group as an example.

② Analysis

a. Strict confidentiality system can easily lead to information asymmetry

Due to the opaque nature of information in offshore companies, the public and relevant institutions usually only know their true asset and liability situation based on the company’s independently published annual reports. This also means that it is difficult to obtain information on asset and personnel relationships within the company and with other companies, as well as information on fund allocation.

Therefore, a group company can fully leverage its identity as an offshore company to keep the book debt level of its subsidiaries with higher disclosure obligations under its control at a lower level, in order to conceal the overall high debt level of the group. When the above information becomes known to the public, the group is often on the verge of long-term insolvency or even bankruptcy.

For Evergrande Real Estate Group’s high debt data, has already confirmed as early as 2019 that its net debt ratio still increased by 7.4% that year. Since 2020, although it has placed debt reduction as its core strategic position, unfortunately, the results have been minimal. In June of that year, some holders of commercial bills were unable to redeem them as scheduled. After contacting them, it was found that they still needed to queue up to redeem the commercial bills after their expiration date, and the waiting time could not be estimated at the moment. In September, there was a report circulating online titled “Report on Requesting Support for Major Asset Restructuring Projects”, which disclosed the cash flow situation of Evergrande.

The report requires repayment of 130 billion yuan in principal and 13.7 billion yuan in dividends to strategic investors before January 31, 2021. The report hopes that the government can return A-shares through shell listing as soon as possible. It claims that failure may cause its cash flow to break, thereby triggering systemic financial risks. The signing date is August 24, 2020 and the shareholder information and financial institution information that provided the loan are attached below. But Evergrande denied the authenticity of the report, and the public lost the possibility of confirming it. Since then, although various parties have disclosed that the financial situation of Evergrande has been deteriorating, official information has never been seen. From this, we can see that the offshore company identity of Evergrande Real Estate Group has to some extent caused a tripartite information gap between the public (creditors), institutions, and Evergrande itself.

In addition, there is also a certain degree of asymmetry in the information regarding the creditworthiness of offshore companies, as even the local government of the registered place finds it difficult to obtain the creditworthiness of the company, let alone in China. Even in some offshore jurisdictions, such as the British Virgin Islands, only a certain amount of fees are required to be paid on time every year, and once paid, it is considered “good credit”. Banks will also issue “good credit certificates”, which to some extent increases the risk of damage to the interests of offshore company creditors.

b. Easy to breed illegal situations

Due to the fact that offshore companies are mostly registered outside the country and are not subject to foreign exchange controls or free transfer of funds, many criminals choose to establish offshore companies and legalize them by investing stolen funds into the company as so-called foreign investment.

According to data, approximately billions to trillions of dollars of funds worldwide are transformed into legal assets through these operations every year. The situation in our country should not be underestimated: since the 1980s, approximately 4000 corrupt criminals have fled abroad, taking away over 50 billion US dollars in funds through offshore companies.

Although Evergrande Group has not yet engaged in similar behavior on the surface, its application for bankruptcy protection in the New York court in the United States indicates that it has potential illegal possibilities, and the fact that the actual controller, Xu Jiayin, has also been taken compulsory measures can be seen as indirectly confirming this. So, what extent may Evergrande Group’s illegality have reached so far?

As mentioned earlier, Evergrande’s debt ratio was too high and commercial bills were unable to be redeemed on time. Subsequently, Evergrande also experienced default on public market debt and inability to redeem wealth management products, which led to a large number of upstream and downstream enterprises and homebuyers forming rights protection. Therefore, local governments in China have also set up special classes (i.e. HD special classes) for this purpose, and proposed a three guarantee strategy of “ensuring delivery of buildings, people’s livelihood,
and stability” (later referred to as “delivery of buildings” policy), which means maintaining the core framework and overall operational capabilities of Evergrande Real Estate Group under central unified management to ensure the continuous promotion of the “delivery of buildings” policy. But by applying for bankruptcy protection overseas, Evergrande Real Estate Group has the suspicion of using its high-quality internal assets for subsequent bankruptcy restructuring to redistribute assets overseas, instead leaving its liabilities and abandoned buildings within China. There is information showing that a company disguised as a Saudi foundation was actually controlled by a Chinese offshore company and acquired a large amount of equity in Evergrande Automobile at an extremely low price. Evergrande Real Estate Group claimed that this was to obtain financing and alleviate the pressure of its parent company’s “guaranteed delivery” policy. Even though it knew its purpose was impure, there was no basis to explicitly prohibit it.

At the same time, according to the share subscription agreement publicly announced by Evergrande Real Estate Group on August 15th, Ding Yumei’s identity has changed from her original legal spouse to an independent third-party person. This change in identity not only indicates the technical divorce of Xu and Ding, but also shows that Evergrande Real Estate Group hopes to achieve this transformation from debtor to creditor, so that Ding Yumei has the right to decide on the disposal of high-quality assets as a major creditor in the final bankruptcy protection stage and enjoys the corresponding right of first refusal, realizing the preservation and even appreciation of their personal assets, but in fact, it sacrifices the interests of a large number of small creditors and the national level. However, this operational approach cannot be questioned by the outside world, as Evergrande does need to maintain its “guaranteed delivery” policy by selling assets. Although Evergrande Real Estate Group’s drive is indeed illegal, it cannot directly apply domestic laws in China to punish it, as its offshore company’s nature also applies the laws of Hong Kong in terms of legal application.

Furthermore, the concepts of “bankruptcy protection” and “bankruptcy” mentioned earlier are not the same, and conceptual confusion should be avoided: the so-called bankruptcy refers to the situation where an enterprise legal person is unable to pay off its due debts and its assets are insufficient to pay off all debts or clearly lacks the ability to pay off debts, after being tried by the court, the court, the debtor must propose a bankruptcy reorganization plan, and make arrangements for the repayment period, method, and possible reduction of the interests of certain creditors and shareholders. The former refers to the company ceasing operations due to debt issues, while the latter is to prevent the company from ceasing operations due to debt issues.

According to the universal bankruptcy liquidation criteria, companies need to prioritize paying labor wages, followed by outstanding taxes, and finally other creditors. The rights and interests of the same ranking creditors do not differ based on the size of the debt. Based on Evergrande’s current situation, the compensation that creditors can receive after paying off the first two items is a drop in the bucket compared to the amount that can be obtained through bankruptcy protection. This is why Evergrande Real Estate Group is willing to risk illegal or even criminal activities and still applies for bankruptcy protection in the United States because only during this period of bankruptcy protection can major shareholders reinvest in the company as new creditors after realizing their equity and propose a restructuring and asset divestment plan that maximizes their interests, even if it sacrifices the stability of people’s livelihoods and the interests of small creditors. At the same time, domestic banks also provide Evergrande Real Estate Group with domestic guarantee and foreign loan, that is, they use domestic assets as collateral, domestic financial institutions as guarantee, and overseas financial institutions borrow US dollars for development. If bankruptcy reorganization is applied for overseas, overseas financial institutions will begin to liquidate secured claims and require domestic financial institutions that provide guarantees to fulfill their guarantee responsibilities. At present, the collateral assets obtained within the bank’s territory need to prioritize the implementation of the “guaranteed delivery of buildings” policy, and cannot be directly compensated. If they face overseas litigation again, they will have to compensate.

At the same time, the investments made by the major shareholders of Evergrande to Evergrande’s personal assets will also be accompanied by bankruptcy applications. With the help of US financial institutions and laws, they have the right to pursue domestic financial institutions and operating entities, which may lead to the original ability to recover funds from overseas becoming unrecoverable assets. From a legal perspective, once bankruptcy proceedings are initiated, the Chinese government will lose all enforcement power over Evergrande during the asset freeze period. When all creditors of Evergrande in China are summoned by the New York court in the United States, they also need to submit a debt declaration, which includes many sensitive materials, including historical
correspondence and information, some of which may be closely related to China’s secrets. But China cannot stop Evergrande’s application behavior through tough administrative measures because the application behavior of Evergrande essentially belongs to creditors freezing global assets through the parent company, waiting for the restructuring result, which is reasonable and legal, and also an important way for creditors to protect their own rights and interests. If an offshore company is taken back through compulsory administrative measures, it may cause a great blow to private enterprises and foreign enterprises.

In summary, although Evergrande Real Estate Group’s current actions are illegal, Chinese domestic laws cannot directly sue or take relevant administrative enforcement measures against them. Therefore, through the case of Evergrande, we should be more rigorous in addressing the particularity of offshore companies to prevent illegal situations from causing China to fall into a dilemma.

c. Difficult to hold accountable due to its overseas nature
This can also be said to be an extension of the previous paragraph.

It is precisely because offshore companies have corresponding overseas characteristics that they often need to cite relevant international treaties or regulations in legal application. Some coercive measures cannot be enforced like domestic enterprises, making it more difficult to hold them accountable.

Meanwhile, for the invested country, offshore companies are investment entities of “foreign investment”; Its assets in the investment country are also limited to those already invested, so the recovery of offshore companies can only be limited to the former and can only obtain limited relief.

3. International legal regulatory system

Compared to domestic measures, international preventive measures against offshore companies are more focused on anti-tax avoidance. The current legal supervision of offshore companies by major developed countries in the West mainly includes the following categories: First, supervision based on domestic and foreign investment laws. Secondly, joint supervision by signing bilateral treaties with offshore jurisdictions. The last is seeking international legislative protection based on international treaties.

(1) International Organization——OECD
The OECD (Organization for Economic Cooperation and Development) issued three reports on harmful tax competition from 1998 to 2001, and harmful tax competition is the biggest risk criticized by the international community for offshore jurisdictions because the tax incentives in offshore jurisdictions often result in a huge loss of normal tax revenue for many countries.

According to conservative estimates from the Tax Justice Network, due to the existence of offshore jurisdictions, the world loses over $250 billion in taxes annually, with the United States alone incurring $100 billion in annual tax evasion losses, and other developing countries potentially losing $120 billion in a year.

Therefore, in 1998, in response to such harmful tax competition, the OECD’s Report on Harmful Tax Competition identified harmful tax competition behavior and divided it into two types, one of which is tax havens. In the third part of that report, 19 suggestions were proposed for countries to adopt, including the following three categories: opinions on domestic legislation, opinions on bilateral treaties, and opinions on how to strengthen international cooperation to combat harmful tax competition behavior. The third point is also to put on the agenda the establishment of a forum on harmful tax competition.

In two reports in 2000 and 2001, the OECD identified 47 potential harmful tax preferential zones in member countries, listed 35 countries that met the tax haven indicator, proposed a program for tax havens to join and eliminate harmful tax competition behavior, proposed suggestions for non-OECD member countries to deal with harmful taxes, and proposed some basic elements for possible cooperative defense systems. Meanwhile, the OECD also emphasizes the emphasis on exaggerating international cooperation through dialogue with non-states.

Although the three reports of the OECD only propose some legal constructions for the joint construction of member countries, they do not have corresponding legal effectiveness and binding force. However, it will still put some pressure on member states to comply, and based on relevant facts and data, the above motion has been relatively widely recognized and implemented internationally, such as the highly voluntary cooperation of tax haven countries on the blacklist. At the same time, the lack of binding force in the OECD motion, from another perspective, also provides a more flexible and negotiable follow-up space for issues such as tax havens and harmful tax competition that have not yet reached consensus.

(2) The European Union
As a supranational organization, the European Union had already established a Code of Conduct in 1997, aimed at eliminating harmful tax competition within its member states. On July 11, 2001, the European Union launched an investigation into state aid, mainly targeting 8 EU member states and 11 corporate tax systems, and investigating whether these specific tax systems that were inconsistent with the EU treaties constituted state aid. If they were to
be implemented, they would have to be stopped. If aid had already been paid, it would have to be recovered. The tax treatment of Luxembourg financial companies and the special fiscal system of the Netherlands were also under investigation.

Compared to the OECD motion, the EU’s unified code and subsequent investigation activities are more legally binding. At the same time, the EU is more unified than the OECD, and the subsequent implementation of the Code of Conduct will be more convenient than the proposed one. But in EU member states, its effectiveness may be compromised.

(3) The United Kingdom

The anti tax avoidance legislation in the UK mainly consists of sections 478 and 482 of the 1970 Tax Act, with the core content of substance over form, that is, judging the substance of a transaction as a whole. Therefore, the UK’s determination of whether a domestic company is based on the location of its management organization. Due to the high income tax rates of local enterprises, many companies registered in the UK with local management agencies often choose to set up management agencies in other countries to reasonably avoid taxes.

To prevent the occurrence of the above situation, the tax law stipulates that if a company wants to relocate to operate abroad, it must obtain the consent of the Ministry of Finance. Subsequently, it is stipulated that all companies registered and established in the UK after March 15, 1988, regardless of whether their management is located in the UK or not, belong to domestic companies in the UK and must pay corresponding income tax on their undistributed income and income in foreign countries and income and income that should be included in foreign trust companies. A company that was registered in the UK but has been considered non domestic due to its management agency not in the UK will be considered a domestic company no later than 5 years later.

The above legislation mainly prohibits transactions and transfers without prior approval from the Ministry of Finance through punitive measures such as fines, and is more inclined towards administrative control in nature.

4. Measures and Construction Suggestions in China

(1) Present Situation

At present, there is no separate legal regulation defining the concept of offshore companies and proposing corresponding control measures or opinions on their tax avoidance behavior and possible illegal and criminal activities. The current relevant documents suggest that offshore trade should be conducted in major trading port cities in China, and a comprehensive evaluation of whether enterprises have offshore trade capabilities should be led by the provincial and municipal commerce departments to form a whitelist of offshore trade enterprises. At the same time, dynamic risk management is implemented for the list, and the business department is responsible for list generation management, while other regulatory departments are responsible for reduction management.

(2) Construction Suggestions

a. Narrowing the treatment gap between domestic and foreign-funded enterprises

The fundamental reason for the emergence of offshore companies is still based on considerations of profitability and advantages of profit-earning, so there is a tendency to choose regions with preferential tax policies to establish companies in order to reduce corresponding operating costs. After the reform and opening up, in order to attract more foreign investment, China began to implement tax reduction and reinvestment tax refund preferential policies, which enabled foreign-funded enterprises to receive super national treatment, which means the lower income tax compared to domestic enterprises.

Therefore, in order to obtain the above-mentioned tax benefits, domestic enterprises often adopt the method of registering in offshore jurisdictions and then regretting investments. It is estimated that nearly half of the actual utilization of foreign investment each year is fake foreign investment formed by the transfer of domestic capital to international tax havens.

Therefore, in the new tax law, China has also lowered the tax burden on domestic enterprises, in order to stimulate their competitiveness, narrow the tax gap between domestic and foreign investment, and achieve the goal of reducing the return of domestic and foreign investment. The tax collection and management work will also be more clear.

b. Strengthening international cooperation

Based on the international nature of offshore companies and the background of economic globalization, international cooperation helps China further strengthen its tax collection and management of foreign-related enterprises, and also facilitates regular supervision and inspection by relevant tax authorities. It is worth mentioning that the OECD (Organization for Economic Cooperation and Development), based on the G20 meeting of finance ministers and central bank governors, has agreed to address BEPS through international cooperation.

This plan is mainly aimed at the artificial disappearance of taxable profits caused by the BEPS phenomenon or the transfer of profits to low tax bearing countries (regions) with no or almost no substantial business activities, in order to achieve the goal of not paying or underpaying corporate income tax. Therefore, cross-border enterprises
can profit from BEPS, giving them a competitive advantage compared to domestic enterprises. This portion of the profits may distort investment decisions, causing resources to flow towards business activities with low pre-tax returns but high post-tax returns, thereby affecting fairness. China also signed the Multilateral Convention on Mutual Assistance in Tax Collection and Management (hereinafter referred to as the Convention) on August 27, 2013, becoming the 56th signatory to the Convention. Moreover, China’s tax authorities have revised the existing policies in conjunction with the new international tax rules, modifying relevant regulations from related declaration, investigation adjustment, appointment pricing, and mutual negotiation, forming a new system of anti-tax avoidance regulations that is in line with international standards, in order to reduce information gaps and improve transparency in capital flows.

c. Strengthen information supervision

The transfer of capital by domestic enterprises to offshore jurisdictions before returning to the domestic market will inevitably lead to increased capital flow, and there is still a lack of relevant administrative departments in identifying whether it should fall within the scope of tax collection and management. Therefore, relevant administrative departments should first establish a sound foreign exchange management information system, increase supervision of capital outflows, and effectively identify the essence of foreign-related investments, such as making tax supervision more effective through information verification networks.

China should also strengthen the review of corporate credit status. If it is difficult to obtain comprehensive or valuable relevant credit information from the place of registration, the company’s situation can be investigated through other means, such as investigating the background materials of its parent company, past business operations, and commercial integrity. Alternatively, relevant conventions can be established with other countries to require offshore investors to provide accurate and legally binding proof materials, in order to have a clearer understanding of the company’s creditworthiness. For example, in the new regulations of the Cayman Islands government, all companies are required to disclose relevant information about their main responsible persons, members, beneficiaries, and authorized persons to the registration agency.

5. Conclusion

This article starts with the basic concepts and characteristics of offshore companies, and through the actual analysis of Evergrande Real Estate Group as a specific case, concludes that offshore companies have certain potential risks. Then collect and summarize the different measures taken by the international community, including international organizations and individual countries, as a reference, and propose feasible reference suggestions for China’s subsequent compliance construction of offshore companies.

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