Published on *The National Law Review* https://natlawreview.com

Private Equity Fund Formation in China: Is this the Future?

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Private equity funds have become a staple of investment in every industry sector from real estate to technology to energy to healthcare and more. The investment success of private equity funds has enabled growth in the overall economy and has been a saving grace to many private and public firms who have had difficulty in obtaining growth capital from traditional financial institutions. Some private equity funds originally based in the US have moved offshore or formed offshore parallel or feeder funds in jurisdictions like the Cayman Islands and British Virgin Islands (BVI) in order to attract foreign capital. Many foreign investors who are not U.S. citizens or U.S. resident aliens generally do not wish to invest directly in the US as doing so could cause them to be directly subject to US federal income tax (and potentially U.S. estate and gift taxes) with respect to certain of their U.S. investments. In addition, a direct (or deemed direct) investment can require compliance with certain U.S. filing obligations including the filing of U.S. federal income tax returns. The dual outcomes of direct US federal taxation and U.S. federal filing obligations can be impossible obstacles for foreign investors who would otherwise want to participate in the dynamic US economy.

As a result, private equity funds frequently form a non-US blocker corporation targeted to foreign investors. Such a non-US blocker generally allows foreign investors to invest directly into that offshore fund, which in turn, invests in US assets. The primary benefit of such a structure is that the offshore fund can then redeploy the capital and invest directly into US assets without the foreign investor directly being subject to US federal taxes. Moreover, it generally can also allow such foreign investor to avoid certain applicable US federal tax filing obligations attributable to such investments. To the extent there are any US federal income taxes or US filing obligations, the non-US blocker corporation, rather than the foreign investors, generally would bear such taxes and comply with the applicable US filing obligations.

As a note, US citizens and US resident aliens (generally those with a US green card) usually prefer to invest directly in US assets or through entities treated as fiscally transparent for US federal tax purposes to try to ensure one level of US federal income tax. Ensuring only one level of US federal income tax is material since such persons are generally already subject to US federal income tax on their worldwide income.

Recently, Chinese investors have begun to look at the benefits of participating in US investments through the mechanism of private equity funds. With the success of the China economic engine and its creation of wealth, outbound investment interest is becoming increasingly desirable. In recent years, China has opened free trade zones, for example in Shanghai, which has liberalized and made more flexible the ability of Chinese companies and individuals to participate in outbound investments. The big question is whether the Chinese government will allow the growth of outbound investment at a time when the China economy, which has been slowing the last few years, is in need of maintaining the capital inside China to encourage its own growth. Add to this the fact that the currency of China, the RMB, has been depreciating, and is expected to continue to depreciate in value, causes concern that the Chinese government will seek to restrict outbound investment. Of course, this same rationale has accelerated the desire of Chinese business and individuals to hedge the depreciating value of their assets by converting RMBs into currencies such as the US Dollar which has proven to be a more stable currency. In light of this, it is still possible to establish a private equity fund in places like the Shanghai Free Trade Zone (SFTZ) and file an application with the Management Commission of that zone to permit outbound investment into funds established in the Cayman Islands or BVI for purposes of then investing into US assets, commercial real estate being a prime target. The US investment will need to be identified upfront as the SFTZ Management Commission is unlikely to allow the aggregation of Chinese investors into a blind pool investment vehicle.

Some funds created in these free trade zones have had good success in getting rapid approval for making outbound investments. Time will tell if these recent trends accelerate in allowing greater outbound investments, but as China struggles with how to grow its economy and grow its own middle class, opening the outbound investment pipeline may simultaneously cause acceleration of inbound investments into China, thus accomplishing the ultimate goal of China of building its own GDP and expanding the wealth of the middle class of China. These are complex structures requiring multi-disciplinary expertise, competent legal advisors, and appropriate fund administration.

Circumstances being what they are, the potential for migration agents who have had great success in raising capital for the EB-5 sector to greatly expand their ability to offer new products to its client base while providing significant benefits to Chinese investors (outside EB-5 investment) has never been better. The formation of funds that would allow outside investment is a great opportunity for migration agents and should be seriously considered.

National Law Review, Volume VI, Number 85