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Variable Interest Entities in China

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Investors in Chinese companies soon encounter an obscure accounting term – the variable interest entity or VIE. A VIE is a company that is included in consolidated financial statements because it is controlled through contracts, rather than the more conventional control that is obtained through ownership. The contracts attempt, often imperfectly, to mimic the control and economic interest of direct ownership.

VIEs are widely used in China. Of the 182 Chinese companies surveyed on the NYSE and NASDAQ, 125 (69%) use the VIE structure. Chinese companies traded on other exchanges, including the OTCBB in the US, the Hong Kong Stock Exchange, the Toronto Stock Exchange, the London Stock Exchange, and others, also use VIEs. Some multinational companies use VIEs to hold part, or all, of their China operations.

As these structures are getting further enshrined as stalwarts of investing in Chinese companies it is time for companies, boards, and investors to get serious not just about understanding the risks involved, but about actively managing and controlling these risks. It is time to bring VIE management out of the dark ages.

Why are VIEs used?

After the Communists took power in China in 1949, private business disappeared, and all economic activity was conducted by state-owned enterprises. Following the disastrous Cultural Revolution and the death of Mao Zedong, Deng Xiaoping, in December of 1978, set China on a path of reform and opening up that led to China becoming the second largest global economy.

Many Chinese companies decided to list overseas

China's stock markets reopened in 1990 after having been closed in the early 1950s. Initially the stock markets were used to reform state-owned enterprises by providing capital and bringing in outside investors to reform corporate governance. Many Chinese companies have decided to list abroad in the US and Hong Kong (and other markets) which provided easier access to capital and allowed China to import foreign corporate governance processes.

The government has declared that the private sector is still important to China's development

Private enterprise emerged as the opening up process began, and entrepreneurs prospered in the new environment. By 2002, the share of GDP produced by the non-state sector exceeded two-thirds. Private companies, however, had great difficulty accessing capital. As late as 2006, a study found that 98% of Chinese companies could not access bank loans. In 2000, only 1% of companies listed on China's stock exchanges were privately owned. That began to change in 2001 when Jiang Zemin invited businessmen to join the Communist Party, signaling the beginning of reforms that would lead to the establishment of Chinese venture capital and private equity firms, the SME board on the Shenzhen Stock Exchange, and ChiNext, China's answer to NASDAQ. These new institutions would increasingly meet the capital needs of China's entrepreneurial sector. Although there has been a re-emphasis on state-owned enterprises under President Xi Jinping, the government has continued to declare that private enterprise is important to China's development.

Private firms have been starved of capital

These new capital institutions would lag the development of the private sector in China. Starved of capital locally, privately owned firms looked to overseas markets. Foreign investors were keen to participate in China's economic miracle. Yet, as companies prepared for public listings in overseas markets, obstacles loomed in their way. China required its companies that wanted to list overseas to obtain permission from the State Council, China's highest executive organ. The big state-owned enterprises like PetroChina that listed in the US had no difficulty obtaining this permission, but it was viewed unlikely that a privately controlled business would be able to do the same. Instead, the private companies formed offshore companies, typically in the Cayman Islands, to serve as the company that would actually list on the foreign exchange, which resulted in the listing process largely being outside of Chinese regulation.

Many sectors are off-limits to foreigners

Using offshore companies as the listing vehicle created a new problem for these companies. China controls foreign investment through an investment catalog that classifies industries as encouraged, restricted, or prohibited for foreign investment. It has been moving towards a negative list that retains most of the restrictions. Many of the sectors in which entrepreneurs were active are restricted, including the Internet sector. The Internet entrepreneurs faced a problem. By using offshore companies, they had made their company foreign, yet foreign companies could not operate their business because it was in a restricted sector. The entrepreneurs could have gone to Chinese regulators and asked permission to have foreign investors, but they thought it unlikely they would be successful in doing so.

The VIE structure was established to circumvent these restrictions…

…part of the business restricted from foreign ownership were put into the VIE

Necessity being the mother of invention, this is when the VIE concept was created. The VIE structure is commonly called the Sina structure, named after Sina.com which listed on NASDAQ in 2000. Actually, the structure was developed for two Chinese Internet companies, Sina and Sohu, which both listed in 2000 and Price Waterhouse audited both. The solution to the restricted sector problem was to separate the business into two parts – the parts of the business that were open to foreign ownership were put into a wholly foreign owned enterprise (WFOE) that was owned by the Cayman Islands public company. The parts of the business that were restricted to foreign ownership were put into a Chinese company that was owned by Chinese individuals (the VIE). The challenge was to include the restricted part in the consolidated financial statements, which was considered to be an essential requirement for going public. The accounting rules at the time focused on stock ownership; if a company was more than 50% owned it was to be consolidated. Many companies were abusing these rules by creating special purpose vehicles to hold debt. Since these companies did not own more than 50% of the shares of the special purpose vehicle, they did not consolidate it, keeping the debt off their balance sheet. Enron made extensive use of this technique, and its collapse led to the establishment of VIE rules.

A series of contractual arrangement mimicked ownership of the VIE and allowed it to be consolidated

In the Sina and Sohu cases, PW accountants convinced the US Securities and Exchange Commission (SEC) that the Chinese company that held the Internet content provider license and was owned by Chinese individuals should be consolidated into the financial statements of the offshore parent company. They argued that a series of agreements between the public company and the VIE sufficiently mimicked ownership so that the VIE should be consolidated. The accounting rules were formally changed in 2002 after Enron collapsed, and FASB Interpretation No. 46: Consolidation of Variable Interest Entities established rules that require consolidation of entities when the parent company has the risks and rewards normally associated with ownership, but the accountants at Price Waterhouse had convinced the SEC to apply the concepts to the Sina and Sohu offerings at an earlier date.

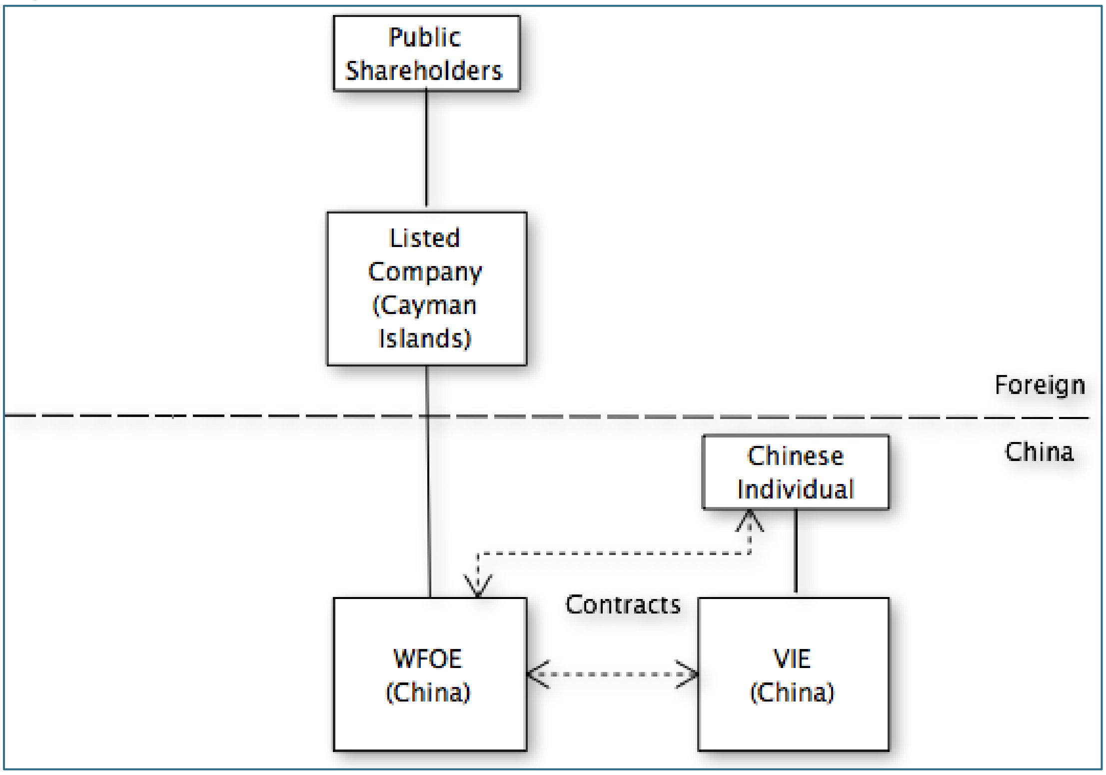
Most companies listed Chinese companies incorporate a VIE-structure

Since its inception the VIE-structure has become the method for listing companies in industries relating to internet platforms, e-commerce, education, P2P lending, O2O businesses, and most of what has been termed the new economy in China. At present most high-profile Chinese IPOs involve a VIE-structure, and some of the highest valued companies in the world use them.

How are VIEs structured?

While there is some variation in VIE structures, an archetypal model has developed which is shown in Figure 1.

Figure 1: VIE Structure



Some structures have Hong Kong companies between the Cayman Islands company and the WFOE. The objective of these intermediary companies is to minimize withholding taxes on dividends paid from China, but China's anti-treaty shopping rules generally make this practice ineffective, and few companies pay dividends anyway.

Starting at the top of the structure, there are shareholders in the public company. The VIE structure is only used on overseas-listed Chinese private companies. It is not used for State-controlled companies like PetroChina or China Life, even when they are listed overseas. It is also not used with private companies listed on Chinese stock exchanges. While the VIE structure is most common on the NYSE and NASDAQ, it can also be found in companies listed on other foreign exchanges, including Hong Kong and Toronto. Because the VIE is an American accounting term, entities controlled through contracts are not called VIEs in those markets, but operate in the same manner, although disclosures of VIE activities are usually severely limited in financial statements prepared under IFRS.

VIE are only used on overseas listed companies, not for State controlled companies like PetroChina

The listed company for non-state-controlled companies listing abroad is always an offshore company. The most popular location for incorporating these companies is the Cayman Islands, although the British Virgin Islands, the United States, and other jurisdictions are sometimes used. The listed company typically has no operations and serves only as a holding company.

Non-state-controlled companies list the offshore company

The WFOE is a Chinese incorporated subsidiary that is wholly owned by the offshore listed company. A WFOE is the conventional entity used by multinational corporations to conduct business in China. Most overseas-listed Chinese companies that do not use the VIE structure will conduct all of their China business in a WFOE. WFOEs are heavily regulated by Chinese authorities and must conduct their business within the scope of a business license that is granted to them. Companies using the VIE structure tend to conduct any part of the business that can be done by foreign invested

The WFOE is owned by the offshore company

enterprises in their WFOE. Often the WFOE obtains a business license that allows it to conduct a consulting business, and its only customer is the VIE.

The VIE is a Chinese company that is owned by an individual who holds Chinese nationality. The Chinese individual is typically the founder and chairman of the public company. In situations where the founder is not a Chinese citizen, another trusted employee is usually selected to own the VIE. This allows the VIE to claim it is domestically owned when it applies for permits to operate a business in a sector that is restricted for foreign investors. However, in order to consolidate the VIE in the financial statements of the public company, the VIE must meet certain accounting requirements.

The VIE is owned by a Chinese individual, normally the public company's founder or a trusted employee

FASB Interpretation No. 46: Consolidation of Variable Interest Entities (FIN 46) contains the accounting rules for VIEs. It has been amended and is now known as FIN 46R and is included in the FASB Codification of Accounting Standards in Section 810. The rules as presently written require an entity to be consolidated where the parent company has the power to direct the activities of the entity which most significantly impact economic performance, has the obligation to absorb the expected losses of the entity, and has the right to receive the expected residual returns of the entity. When the VIE is initially formed, none of those conditions are met. In order to consolidate the VIE, a series of agreements are put in place to meet those requirements. These VIE agreements vary somewhat between companies, but most follow what has become a standard protocol.

In order to consolidate the VIE, a series of agreements are put in place

What are the standard VIE agreements?

The concept that underpins a VIE structure is that control is obtained through legal agreements rather than through share ownership. Taken together, the agreements are intended to provide the WFOE with substantially all of the economic benefits from the VIE and the obligation to absorb all of its losses. The typical VIE will use five agreements to achieve this:

Agreements aim to provide the WFOE with substantially all the economic benefits from the VIE

1. Loan agreement

The first two agreements deal with capitalizing the VIE and attaining some sort of collateral for a loan given to the Chinese individual who owns the VIE to provide funds for the capitalization. To achieve this a loan agreement is set up and the equity in the VIE is pledged as collateral in the event of any failure to comply with the agreement.

VIE is normally capitalized via a loan from the WFOE...

The loan is normally given to the owners of a VIE by the WFOE and is typically in the form of an RMB-denominated, interest free loan running for a number of years with the potential for extension. A loan from the offshore public company would face regulatory problems with the State Administration of Foreign Exchange. Regulatory problems remain, however. The authorized business scope of the WFOE is unlikely to include making loans to Chinese individuals, although no companies appear to have been challenged on this issue.

...although this is most likely outside its business scope

The loan agreement typically transfers most shareholder rights from the Chinese shareholder of the VIE to the WFOE, giving the WFOE the power to vote shares in the VIE, collect dividends, and make other important corporate decisions.

2. Equity pledge agreement

In order to establish security for this loan the owners of the VIE pledge their equity as collateral. Because an equity pledge is a form of security interest, it needs to be registered with the relevant Chinese authorities before it is perfected. If there is no registration, the equity pledge agreement may be unenforceable. In the past, companies have had difficulty getting these equity pledges properly registered. Pressure from the SEC has led to greater compliance by companies in seeking the registration of equity pledge agreements.

Owners of the VIE pledge their equity as collateral

One aspect of the equity pledge for investors to keep in mind is that any time there is a change in the registered capital of the VIE, the equity pledges will have to be updated. This is likely not a problem as long as the pledges get re-registered in a timely manner, but there has previously been some variance in the time it takes for companies to perfect their registrations.

3. Call option agreement

Call option gives WFOE right to purchase the VIE

The call option gives the WFOE the legal right to purchase the VIE at a set price. This price is typically the amount of the loan granted to the founders to capitalize the VIE, or the "lowest permissible price under PRC law". However, because the VIE is usually in an industry that is restricted to foreign investment, the call option cannot be exercised by the WFOE and would instead need to be transferred to another Chinese individual. This agreement is untested. It is unclear how Chinese regulators will respond to an adversarial attempt to exercise the call option agreement. There are issues of price (of concern to tax authorities) and illegal foreign investment (of concern to MOFCOM).

4. Exclusive services agreement

Service agreements give WFOE right to residual profits

The major challenge with VIE arrangements is the requirement that the parent company have a right to the residual profits of the VIE. This is typically accomplished through an agreement or series of agreements that name the WFOE as the exclusive provider of technical services to the VIE. The services provided by the WFOE to the VIE vary by company and industry, but often include website maintenance, programming, sales support, fulfillment services, curriculum development, etc. The agreements give the power to set the pricing for these services to the WFOE, and often explicitly provide that the WFOE can extract all of the profits of the VIE through these service agreements. In practice, however, many companies do not extract all of the profits through service agreements. Some companies also use an asset licensing agreement, under which the WFOE licenses certain assets, typically including intellectual property, to the VIE in exchange for royalty fees.

Recently, the service agreements have tended to all be put under one master services agreement. The naming differs, but in essence they set out all technical and other services the WFOE will provide and take one of two approaches to payments. They either specify that the WFOE can set the price of their services as they see fit, and that these can be adjusted to account for the circumstances of the VIE, or they specify that the VIE shall pay all of its earnings to the WFOE as payment for the services. This creates potential tax issues that are discussed in the section on tax difficulties.

Few VIEs appear to be making payments

Few VIEs appear to actually make payments under the service contracts, likely for two reasons – 1) the VIE often needs the cash, and 2) there is great tax risk associated with making payments in excess of the value received for services rendered.

5. Power of attorney

Founders of VIE give a power or attorney to the WFOE

The founders of the VIE typically give a power of attorney to the WFOE that assigns to it all of the normal shareholder rights, including voting, attending shareholder meetings and executing acts necessary to execute the call option agreement.

Is a danger that one day the VIE refuses to acknowledge the agreements

The VIE structure is dependent on the enforceability of the contracts between the WFOE and the VIE. If those contracts can be breached, not only does the accounting treatment fail, but also the public shareholders lose the business (and operating licenses) that are in the VIE. The nightmare scenario for investors in companies using the VIE structure is that the Chinese shareholder of the VIE will one day take the VIE and refuse to acknowledge the VIE agreements.

Questionably legal

Lawyers have given opinions that VIE structures are legal under Chinese law, often using remarkable legal gymnastics to explain why specific rules such as those of the General Administration of Press and Publication (GAPP) that specifically prohibit the use of VIEs for online games does not apply to their Internet game company. The opinions are consistently caveated with a statement that Chinese law is unclear and that authorities might disagree. The opinions point out that if authorities disagree, the consequences could be disastrous, leading possibly to the business being shuttered. What they do not usually point out is that the shareholder of the VIE might take the position that the contracts are not enforceable, and simply decide to ignore them and take the VIE.

These contracts arguably try to make something legal that is not legal

Like most countries, China has a rule that says that contracts that frustrate public policy are not enforceable, and local regulators and judges might decide that VIE contracts frustrate public policy. The concept that contracts cannot attempt to make something legal that is not legal is a common law concept. While China follows civil law instead of common law, China has a specific statute that covers this.

First case challenging the VIE structure was Sina in 2001

The first case challenging VIE contracts came up with the company that started the VIE trend – Sina. In 2001, not long after Sina's IPO, its board removed a founder who was also the controlling shareholder of its VIE. In the end the founder agreed to sell his shares in the VIE to another insider, and a crisis was averted.

Nina Wang lost control of her Chinese bank because the courts ruled contractual agreements invalid in 2012

A significant case was decided by China's Supreme Court in 2013. Tycooness, Nina Wang of Hong Kong used a VIE-like structure to control a Chinese bank starting in 1995. The VIE and its owner apparently decided to ignore the contracts put in place to give Ms. Wang control, leading her to sue in 1997. Chinese courts can operate slowly, and the case finally led to a ruling by China's Supreme People's Court in October of 2012. The court ruled the contractual arrangements invalid because they had clearly been intended to circumvent China's restrictions on foreign investment and amounted to "concealing illegal intentions with a lawful form". Under China's civil law system, Supreme Court decisions are not precedent that must be followed in future cases in China, and lawyers have argued that modern VIE arrangements are different from the Wang case.

Agria nearly lost its VIE when its COO resigned in 2008

NASDAQ-listed Agria Corporation nearly lost its VIE in 2008 when its COO, who also owned the VIE, resigned in a compensation dispute. The COO had no share interest in the public company. The dispute was settled through a significant payment of cash and shares to the COO and to management of the VIE, and Agria was able to retain control of its VIE.

Gigamedia lost control of its VIE

Gigamedia, a NASDAQ-listed, Taiwan-based online game company, lost its VIE when it tried to replace the VIE owner as head of its China operations. The VIE owner took the company chops, registrations and other key documents for both the VIE and the WFOE. The company eventually lost the case in arbitration and had to start over in China.

Alibaba had difficulties getting Ant Financial licensed via VIE and WFOE

The most serious attack on the VIE structure occurred in late 2010 when Jack Ma of Alibaba Group attempted to obtain a license for Alipay from the People's Bank of China. The PBOC had decided to regulate online payment processors and as a first step required them to obtain a license. Alipay (now known as Ant Financial) is the market leader among online payment processors in China. It operated as a WFOE that was wholly owned by the Alibaba Group, a Cayman Islands company owned in turn by Yahoo!, Softbank and Jack Ma, a Chinese individual and CEO of Alibaba Group. Jack Ma was apparently told by regulators that Alipay could not obtain the required license if it was a WFOE, so the entity was converted to a VIE with Jack Ma as shareholder. Jack Ma was then informed by regulators that the license would not be granted to a VIE, so the VIE was unwound, and Jack Ma ended up owning Alipay entirely by himself. Yahoo! and its shareholders were obviously outraged at the loss of Alipay, and negotiations ultimately gave Yahoo! a continuing, albeit reduced, interest. Alipay was thought to be worth $5 billion. Today the company is known as Ant Financial, and it is the world's largest unicorn (technically a hectocorn) valued at $150 billion based on its most recent fund raising.

Some companies have argued that the risk of the VIE shareholder appropriating the business is mitigated by the fact that the VIE shareholder is also a major shareholder in the public company. The flaw in this argument is that all of the value of the company is usually in the VIE, and the VIE shareholder never owns 100% of the public company. Accordingly, the moral hazard of the VIE shareholder stealing the VIE remains.

Founder might own stakes in both listed co and VIE, but VIE often worth a lot more

VIE structure risks

Despite its widespread use for privately held Chinese companies listing abroad, the VIE structure has come under considerable attack. These risks fall into three broad categories: regulatory risks, shareholder risks, and operational risks.

Regulatory Risks – Will the government shut down my company?

The raison d'être for VIEs is to avoid the effect of regulation. Companies that use the VIE structure tell two inconsistent stories. To Chinese regulators they say that the business is owned by Chinese and not by foreigners. Yet, to foreign investors they claim that foreigners own the business. It is unsurprising that VIEs face regulatory challenges.

A VIE structure says one thing to foreigners and another to regulators

Chinese regulators initially ignored the growing use of VIE structures, even as most of China's Internet sector was developed under this model. If they were aware of VIEs, they must have decided to look the other way because growth of the private sector required capital that Chinese state institutions were unable to deliver.

No PRC regulatory body has officially approved a VIE structure, yet many investors and advisors believe that they have tacit approval to use the structure. A view that has recently been strengthened by the proposed new exchange which will allow VIE structures to list domestically on China's new tech bourse using Chinese Depositary Receipts (CDRs) for the first time.

No PRC body has ever approved a VIE

Nevertheless, there have been significant challenges to VIE structures in the past, and while the new developments offer some encouraging signs, there are still rules in place that implicitly or explicitly ban the use of VIE structures.

The first regulatory attack on VIEs came in 2009 when the GAPP, and two other regulators published Xin Chu Lian [2009] No. 13 (Notice 13). Notice 13 specifically prohibited the use of contractual arrangements to control Chinese Internet game operators. No action, however, has been taken against companies in this sector that use the VIE structure and the rules have essentially been ignored.

Use of contractual arrangements to control internet game operators is prohibited but the rules have been ignored

Buddha Steel pulled its planned IPO in March of 2011 after local regulators in Hebei province told the company that its VIE structure contravened current Chinese regulatory practices related to foreign invested enterprises and, as a result, was against public policy. Steel is a restricted industry for foreign investment.

Buddha Steel was told that its IPO was illegal in 2011

In August 2011, the Ministry of Commerce issued regulations requiring a national security review when foreigners acquire domestic companies. These regulations specifically provide that the required review could not be avoided through use of VIE or similar structures.

In September 2011, a report surfaced in the Chinese press that was purported to come from the China Securities Regulatory Commission (CSRC). The report advocated greater regulation of the VIE structure (particularly in sensitive areas such as the Internet) and suggested that Chinese companies should be encouraged to list at home. The report was widely reported and led to a significant decline in the price of

Chinese companies were to be encouraged to list at home

companies using the VIE structure. Over the next few years, however, no significant changes in the regulation of VIEs transpired.

In 2015, there were moved to try and fix the VIE structure

In 2015, a circular was issued by the State Council outlining proposed new legislation to try to fix the VIE situation. It was a draft proposal that had some notable ideas such as treating foreign entities effectively controlled by PRC citizens as Chinese, allowing VIEs or perhaps even direct ownership of assets for these companies while declaring that any foreign-controlled company would not be allowed this path. The idea was to grandfather the existing VIEs while stopping the practice for new companies. This would have worked for almost every foreign-listed Chinese company, except for Tencent. That is because most US-listed companies use a control structure to keep control in the hands of founders (who are almost always Chinese), while until recently Hong Kong, where Tencent is listed, did not allow control structures. Revised legislation proposed in 2018 omits the VIE solution.

VIE ownership

Who should own the VIE?

Related to the ownership question are risks stemming from differing ownership setups for the VIE. While the contracts that make up the structure have been largely standardized, a standardized solution for who owns the VIE shares hasn't yet emerged.

There are some common themes in the ownership. They tend to be founder heavy, they sometimes add in holdings for key employees or family members, and in some cases, they have ownership from outside interests such as early investors or VCs.

If the founder owns the VIE, are interests really aligned?

The mix between these owners create different risk levels in VIEs. The rule of thumb is that there should be alignment between the interests of the VIE shareholders and the shareholders of the listed company. This is easiest to achieve when there are large shareholdings in both entities by the same people, which is why many promote the founder as shareholder. However, interest is never fully aligned between founders and other shareholders, because the founder owns 100% of the VIE and always less of the public company, so the founder will often be better off taking the VIE and surrendering the public company shares.

If the founder owns the shares, too much risk is given to one person

Further, the founder as shareholder model also amplifies what is known as the "key man" risk issue where too much power at the company is invested in one person. It also raises the question of what would happen if anyone was ever to try to oust the founder from his/her position, or indeed what will happen if the founder retires. Chinese companies tend to be more CEO dependent than enterprises in other countries.

Key employees often own shares in the VIE but careers are not static

Other shareholders all have varying levels of interest alignment issues, or potential issues. It has not been uncommon to see key employees as shareholders in VIEs. As these people are often also smaller shareholders and deeply invested in the company through their work, these appointments can make sense. The problem is that careers are not static, and while in theory the company should be able to take shares away from an employee, the interest alignment of the shareholders slowly gets more and more disjointed from the interests of the listed company as more and more people leave.

This can also put a lot of focus and power in the hands of employees in a way that might not be in the company's best interest. For instance, when Richard Liu, the founder of JD, was accused of sexual improprieties in the US many saw this as a real key man risk event. While this was the case, it also highlighted that the founder himself actually only owned 45% of the company VIEs, with 55% held by two employees.

In a similar way, having VIE shares held by family members exposes the VIE interest alignment to the ins and outs of family politics in a way that is probably not productive. While the founder may be committed to protecting the interest of shareholders, there is no certainty his children or spouse will take the same view.

Not ideas to get relatives involved…

In a nod to this type of risk, there is a semi-standard contract for VIEs called the spousal consent letter, this states that the VIE shares held are separate from any communal assets in the marriage and thus cannot be claimed by the spouse in the event of a divorce. This is sometimes referred to as the Tudou clause because precisely this happened during a divorce between the founder and his wife. The failure to deal with spousal interest in the Tudou VIE likely led to a delay in its IPO that ultimately led to its acquisition by its largest competitor.

…especially if your spouse wants a divorce

The latest addition to the ownership soup comes from Alibaba and is perhaps an attempt to standardize and formalize the ownership of VIEs. Here the VIEs are held by a partnership and not by individuals, and the partners are selected from active members of the Alibaba leadership committee. If used actively this form of ownership might allow for a system where the VIE structure itself remains static while the partners can be rotated to make sure interest alignment is always maintained between the VIE shareholders and the Alibaba management team. Presumably a partnership that owns a VIE must be made up exclusively of Chinese nationals. Companies, like Alibaba, who have foreigners in management positions must consider this. An advantage of using an entity instead of individuals to own the VIE is that governance rules for the entity are better defined.

A new development is that the VIE is owned by a partnership

Operational Risks – Will the VIE actually work?

VIE structures have been in use in China for almost two decades. While the regulatory risks and the risks of VIE shareholder misappropriation have gotten most of the headlines, there is growing concern that the VIE structure is unworkable for some companies. When most of the business in the company is conducted in the VIE, China's tax and business laws make it difficult and expensive to operate a VIE.

It is difficult and expensive to operate a VIE

The problems arise most frequently in asset-heavy VIEs; those where most of the assets and most of the business are conducted in the VIE. Internet companies are often examples of asset-light VIEs. They usually have a small proportion of the assets and business in the VIE, operating most of the business in their WFOE. An Internet company will typically put only the Internet content provider license and the servers necessary to host the site into the VIE, retaining all of the programming, advertising sales, and fulfillment activities in the WFOE. Consequentially, there should be minimal profit in the VIE, and this profit can be easily extracted through the service agreements.

Most problems occur in asset-heavy VIEs…

Education companies are good examples of asset-heavy VIEs. In this industry, it can be necessary to put the entire school into the VIE because of restrictions on foreign ownership. Because the school has to collect the tuition, all of the profit of education companies tends to end up in the VIE. That creates problems.

…such as education companies

Under the typical VIE structure, the profits of a VIE are extracted to the public company through the service contracts. In 2016, China abolished its business tax that applied to VIE revenue and replaced it with a value added tax (VAT) imposed at 6%. The VAT is creditable against the VAT obligation of the VIE (which is effectively bearing the tax), but most VIEs do not have a VAT obligation against which the tax can be credited. Under Chinese law, VAT is payable at the time the service is invoiced.

VIEs should pay a tax on service agreements

There is also concern that Chinese tax authorities might question why a company would pay 100% of its earnings to another company for services. That is especially likely when those services are of dubious value. The authorities might make a transfer pricing adjustment, disallowing a deduction to the VIE for part or all of the entire

Tax authorities might dispute validity of service agreements

service fee. That would significantly increase the tax liability of the VIE (which usually pays tax at 25%). If the tax authorities adjusted the transfer price, they might also allow the WFOE to reduce the income it reports, resulting in a tax refund to the WFOE. But they might not. After all, the cash found its way to the WFOE, so the tax authorities might instead characterize the payment as a dividend to the individual shareholder of the VIE (which is taxed at 20%), followed by a payment from the individual shareholder to the WFOE (which might be characterized as interest on the loan or a taxable gift, and taxed to the WFOE at 25%). The end result would be a disaster – raising the effective tax rate above 60%, as outlined in the previous report from GMT Research, THE OVERSEAS CHINESE: Top 30 US-listed Chinese companies (16 Jan 2019).

Few companies are using service agreements to transfer all profits…

The VIE accounting assumes that the parent company has the ability to benefit from the earnings of the VIE, so agreements contemplate transferring all of the profits of the VIE to the public company (through the WFOE). Few companies transfer all of the VIE profits to the WFOE. It is not possible to determine from filings whether they are in fact accruing these payments (which should give rise to the tax issues).

…because of tax risks

Because of adverse tax risks, many asset-heavy VIEs have not been making the payments on the service contracts. Another reason for not making the payments is that the companies typically need the cash in the VIE, not the WFOE. It is usually not in the authorized business scope of the WFOE to be making loans or capital contributions to the VIE, so if the cash is transferred to the WFOE it is difficult to get it back to the VIE where it is needed for operations or capital improvements.

Should accrue for taxes that are owed on the distribution of profits to the parent but most do not

Under US accounting rules, companies must accrue the taxes that are owed on the distribution of profits to the parent company. Because of the complexity of the rules and likely because they have no intent to ever pay these taxes most Chinese companies do not accrue the taxes. There is a rule under APB 23 that says that deferred taxes do not need to be provided on profits indefinitely invested in a foreign subsidiary. That rule is inapplicable in the case of Chinese VIEs since both the VIE and the WFOE are domestic companies. Two companies have provided deferred taxes on the undistributed earnings of a VIE – Autohome and Fang Holdings. The amount of deferred taxes is the total of individual and corporate taxes likely to be imposed on a transfer from the VIE to the WFOE. Surprisingly, the SEC has not challenged the inconsistent treatment of deferred taxes among Chinese VIEs.

Foreign exchange risks

China has strict exchange controls. Virtually every transaction involving foreign currency is regulated. This causes potential issues for the VIE.

Capital raised overseas can be easily remitted to the WFOE but not the VIE

When a company raises capital overseas, either in an IPO or a private placement, the cash usually is raised in dollars and injected into the Cayman Islands parent company. Although there is regulatory oversight, it is not difficult for the Cayman Islands parent company to contribute the foreign currency to its WFOE and to convert the proceeds into renminbi. Getting the cash into the VIE is another story. Rules prohibit the WFOE from investing in the VIE or from loaning the proceeds to the VIE, either directly or through a bank as an entrusted loan. In most situations, however, the VIE needs the cash raised, since operations are conducted in the VIE. Some companies have argued that they can transfer cash to the VIE as a support payment since the VIE supports the activities of the WFOE. These companies often fail to recognize that the support payment would be taxable upon receipt by the VIE.

It would be very difficult, if not impossible, to move cash from the VIE to the WFOE in order to fund a dividend from the WFOE to the Cayman Islands holding company. The lack of actual ownership means that dividends would go to the individual VIE shareholder. Getting the dividend from the individual VIE shareholder to the WFOE would likely result in very high taxation. Similarly, transferring the funds through service payments to the WFOE likely results in adverse tax consequences.

If VIEs never intend to pay dividends, should not be treated as a VIE

Companies have not typically been accruing the taxes that would result if they made the service payments under the VIE agreements. They argue that they do not intend to ever make these payments. The problem with that argument is that it undermines the basis for treating the company as a VIE in the first place. One of the key requirements for consolidating a company as a VIE is that the parent company has a right to the residual profits of the VIE. If it has no intent to ever distribute the profits of the VIE to the public company, should the public company be considered to have a right to those residual profits?

Where are we now

A new tech board will make it easier for companies to list

The latest development in the long-running saga of the VIE structure is the move to create a new tech board in Shanghai. This new board would have easier listing requirements, and most notably allow for overseas-listed companies that are using VIE structures and shareholder control structures to list CDRs that would be available to trade on Chinese exchanges.

Can be interpreted as tacit approval of the VIE structure

This is probably the biggest move that can be interpreted as tacit approval of the VIE structure. One of the big worries with the structure was that the Chinese government likely would not care if they hurt some foreign shareholders by ruling against the structure, but if there is a significant amount of domestic exposure this should cause them concern.

Governance of VIE arrangements

Do auditors really examine VIE arrangements?

An emerging issue with VIE structures is that as they become more standardized, they are also becoming boiler-plate. They are part of the IPO paperwork to be filed, and once set up, they are not looked after or maintained. There is a serious question as to whether auditors really examine VIE arrangements to make certain they comply with the accounting standards. Management and boards fall into the same trap. VIEs are accepted at face value, while they are based on assumptions and documents that are untested.

The failure to properly examine VIE arrangements has led to some strange cases such as where significant portions of the VIE shares are held by people no longer associated with the company, or VIE contracts have expired and not renewed.

Need a corporate governance framework

What is needed in short is a corporate governance model to force some accountability, oversight, and best practices to be deployed continuously. If VIE structures are necessary for investments in China, it is critical that the VIE arrangements receive appropriate attention. Companies with VIEs should establish a framework to create accountability for monitoring VIE arrangements.

Responsible Executive

Ideally the CFO should be responsible for the VIE

Operationally, the executive responsible for the VIE structure and its maintenance should usually be the CFO. The VIE is presumably in constant use, otherwise it's likely not necessary in the first place, and as such the CFO should be looking at it in order to limit potential tax liabilities and avoiding locking cash in the VIE that might need to be deployed elsewhere.

As part of this job, it is important that the CFO also maintains oversight and actively manages the ownership of the VIE. Allowing this to lapse needlessly creates risks for the shareholders, and if the contracts are drawn up correctly and indeed enforceable maintaining proper interest alignment should be possible.

Secondarily, the company head of legal should be responsible for maintaining the contracts of the VIE, and on a yearly basis conduct a review of them, including analysis of any changes in laws or regulations relating to the contracts.

Head of legal should be responsible for contracts

Board oversight

There needs to be board oversight of the VIE. This could be done either through a committee on its own or as a high-priority job of an existing committee, preferably with heavy independent board member representation to account for minority shareholders having a greater exposure to these risks.

VIE should be overseen by a committee…

The audit committee would be the obvious choice for this, provided they are given enough time and support by external counsel and auditors to properly vet and understand the structure.

…ideally, the audit committee

In general, the responsible executive should report to the committee regarding the current status of the VIEs, and what work has been done on risk and other measures. The committee should have the ability to bring in any outside counsel they see fit to look over the structure as a whole or in parts to inform their view on the subject.

The committee should make recommendations to the board for a decision on any major new tasks to set the responsible executive on further work to mitigate VIE risk.

Annual review

There should be some form of review process put in place to make sure the structure and risk mitigations are up-to-date; legal landscapes change and work on this will likely be ongoing. Initially, the work of an annual review will be more in the nature of mapping out the risk elements.

A review process should be established

Some of the general questions every review should answer are:

Legal:

As China opens up some sectors of its economy to foreign investment, sectors that were previously restricted from foreign investment might no longer be. This has in fact happened in the past, and when it does there is normally no more need for the VIE structure to exist. If this is the case the executives need to start dismantling the structure and fold the previous VIE into the WFOE operations to give shareholders equity control. There are significant tax and legal issues that need to be addressed in these situations.

Look to dismantle the VIE if the opportunity arises

- **Are all of the agreements still in place and still effective?** As the VIE is in essence a contractual structure a review of the relevant contracts should happen to make sure they are up to date. In the past, the main contract discussed for this has been the equity-pledge registration, which may need to be redone in case of capital injections etc. but other situations will also call for a review of the contracts as a whole, and in some cases external second legal opinions might be warranted.

- **Are intercompany arrangements in accordance with law?** Fees and other payables between companies have to be done according to certain laws and regulations. Is this the case for the VIE, and what is being done to limit the potentially huge tax liability if any of the agreements are found to not be in accordance with the law? Are intercompany transactions including accruals properly recorded in the books of the companies?

- **IP ownership:** Has the company made sure to keep all key IP assets away from the VIE, and is it enforcing agreements to make sure that any new IP is filed for outside of the VIE? Further, are the IP assets used as a method to extract payments from the VIE in a way that minimizes transfer pricing risks?

Operational:

- **Does the appropriate person/entity own the VIE?** VIE ownership is a major risk issue and needs monitoring. If employees are holding large parts of the VIE, is there a mechanism for getting the shares back if they leave? What if a major VIE shareholder starts selling off large parts of their stake in the list co?

  Ideally, there should be a mechanism in place to smoothly handle ownership transitions in the VIE shares and monitor when events happen that might trigger the need to use it.

- **VIE minimization:** Have assets and business activities been structured away from the VIE as far as possible? As a rule of thumb, a good VIE is a small VIE; reviewing whether the company can further structure business and cash flows away from the VIE is always in the interest of shareholders.

- **Are tax liabilities being recognized and mitigated?** Even when the business conducted in the VIE has been minimized as far as possible, it's important to review whether the potential tax liabilities are being recognized and what work is being done to minimize them.

- **What issues exist regarding movements of cash?** As moving assets into and out of the VIE isn't straightforward, it's important to review whether other parts of the business have capital needs that will require movements of assets out of the VIE. If this is the case, what steps are being taken to make sure this can be done in a timely manner, and what are the operational and tax implications for doing this?

THE ACCOUNTING PEOPLE

What we do

GMT Research provides independent insight into markets, sectors and companies throughout Asia. Our unique method of mining a comprehensive collection of corporate financial statements for key data allows us to evaluate the financial health of a company, sectors and the market at large. We also investigate the application of accounting standards by companies and sectors, shedding light on the quality of reported profits. Armed with this information, we help investment professionals navigate the financial landscape.

Gillem Tulloch has been a financial analyst since 1994 and has been based in Asia since 1995, with spells in Singapore, Thailand, Korea and most recently Hong Kong. Over his career, Gillem has covered sectors ranging from telecoms to printing to electronics. He has achieved top industry rankings in regional polls like Asiamoney and Institutional Investor, and has appeared on Bloomberg and Business Week. Gillem has worked in research and strategy for several large sell-side institutions, including Cazenove, Nomura and CLSA, and founded the independent research company Forensic Asia before moving on to establish GMT Research.

Nigel Stevenson worked for eight years in investment banking at Dresdner Kleinwort Wasserstein in London, primarily advising on equity offerings and M&A transactions, both in the UK and internationally. He subsequently spent seven years as an equity research analyst at Veritas Asset Management, where he was a member of the global equities team, primarily focusing on the industrials sector. Nigel is a graduate of Cambridge University and a qualified barrister. He has a Masters in Finance from London Business School, awarded with distinction, and is a CFA charterholder.

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