

Holding and Operating Entities in Chinese Overseas Expansion

As an increasing number of Chinese enterprises engage in overseas investment, offshore financing, and international business, their offshore structures are no longer limited to the simple establishment of a single company. Instead, depending on the functions performed by different entities, holding companies and actual operating companies are typically set up separately. For example, upper-tier companies may be responsible for holding group equity, introducing investors, and making capital arrangements, while subsidiaries in different countries and regions handle sales, procurement, employment, and other specific operating activities.

Based on Kaizen's practical experience in assisting Chinese clients with the establishment of offshore corporate structures, enterprises in the early stages of overseas expansion typically focus first on "where to incorporate." However, as business scale expands, what truly affects subsequent management is often "what function each company should perform." If shareholding, financing, personnel, contracts, and actual operations are all concentrated in a single entity, tax, legal, and internal management issues will inevitably increase as the group's business becomes more complex.

Therefore, distinguishing between holding entities and operating entities is not simply a matter of adding more corporate layers. Rather, it involves a reasonable division of functions among different companies within the group based on the enterprise's actual business and investment arrangements.

1. Holding Entities and Operating Entities Perform Different Functions

The primary role of a holding entity is typically to hold equity in group subsidiaries and to handle group-level equity management, financing, investor arrangements, and capital operations. For enterprises with multiple rounds of financing, the shareholding ratios, voting rights, preferential rights, and subsequent exit arrangements of different investors are also typically centralized at the upper-tier holding entity of the group.

Operating entities, on the other hand, are primarily responsible for specific business operations. For example, signing contracts with local customers, procuring goods from suppliers, hiring employees, leasing office premises, applying for local business licenses, opening bank accounts for daily operations, and fulfilling local tax filing obligations should generally be undertaken by the company actually conducting the relevant business.

Therefore, the most important distinction between the two types of entities is not the country or region in which the company is incorporated, but whether the functions, assets, and risks actually

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assumed by the entity match its positioning. Based on Kaizen's actual experience in handling offshore company formation and group structuring projects, clearly defining at the outset whether each entity is responsible for shareholding, financing, or actual operations is often more important than simply choosing a place of incorporation.

2. Appropriate Layer Facilitates the Separation of Operating Risks and Equity Arrangements

C Actual operating activities give rise to customer claims, supplier debts, employee disputes, and other commercial risks. If a group has operating entities in different countries or regions separately undertaking local business, the relevant operating risks can, in principle, be concentrated in the corresponding companies, while upper-tier holding entities primarily assume shareholding and capital-level functions.

This arrangement is also clearer when the enterprise subsequently raises financing, restructures, or sells businesses. For example, if the group intends to sell its business in a particular region in the future, it may consider transferring the equity of the corresponding operating company. If group-level investors need to be introduced, equity arrangements can be made at the upper-tier holding entity without directly adjusting the shareholder structure of each operating company.

It should be noted, however, that the formation of different legal entities does not automatically mean that risks can be completely isolated. If a holding company provides guarantees for an operating company, or if there is long-term commingling of personnel, accounts, contracts, and funds among different entities within the group, the relevant liabilities must still be determined based on local company law, contractual provisions, and actual operating circumstances.

Therefore, the core of establishing holding and operating layers is not simply to "set up more companies," but to ensure that the legal form of each company is consistent with the business functions it actually performs.

3. Distinguishing Entities Also Helps Clarify Tax Relationships

Another common misconception among Chinese enterprises expanding overseas is the belief that as long as a company is incorporated offshore, its income and management activities are necessarily offshore. In reality, a company's place of incorporation is not the sole criterion for determining its tax identity.

Taking China's corporate income tax system as an example, Article 2 of the Enterprise Income Tax Law of the People's Republic of China provides that an enterprise established under the laws of a foreign country or region but whose actual management organ is located within China is also a Chinese resident enterprise. Article 4 of the Implementation Regulations of the Enterprise Income Tax Law of the People's Republic of China further provides that an "actual management organ" refers to an organ that exercises substantive, comprehensive management and control over the enterprise's production and operations, personnel, accounts, and property.

Therefore, if an offshore holding company is incorporated offshore but its major operating decisions, financial management, and personnel management have long been primarily conducted within China, the mere establishment of an offshore registered address cannot automatically eliminate the relevant tax residency risk. The relevant regulations of the State Taxation Administration regarding offshore-registered Chinese-controlled enterprises further identify the

location of senior management, financial and personnel decision-making, and other factors as important considerations in determining the actual management organ.

At the same time, if service fees, loans, intellectual property licensing, or other related-party transactions occur between holding entities and operating entities, attention must also be paid to transaction pricing. Article 41 of the Enterprise Income Tax Law of the People's Republic of China provides that where business transactions between an enterprise and its related parties do not conform to the arm's length principle and thereby reduce the enterprise's taxable revenue or income, the tax authorities have the right to make adjustments using reasonable methods.

Therefore, clearly delineating the functions of different entities also helps to subsequently explain why each company earns the corresponding income, bears the corresponding costs, and obtains the corresponding profits.

4. An Increased Number of Offshore Companies Does Not Automatically Reduce Compliance Obligations

For enterprises within China, after establishing an offshore holding entity and then establishing other offshore companies through that holding entity, China's overseas investment regulatory requirements must also be taken into consideration.

According to Article 13 of the Measures for the Administration of Overseas Investment by Enterprises issued by the National Development and Reform Commission of China, investment entities conducting sensitive projects directly or through their controlled offshore enterprises shall be subject to approval management. Article 14 provides that non-sensitive projects conducted directly by investment entities shall be subject to filing management, and the filing authority shall be determined based on the nature of the investment entity and the investment amount.

Article 25 of the Measures for the Administration of Overseas Investment issued by the Ministry of Commerce of China further provides that where an overseas enterprise invested by an enterprise further conducts overseas reinvestment, after completing the overseas legal procedures, the domestic enterprise shall report to the competent commerce department in accordance with the relevant provisions.

This means that even if a holding company is added to the offshore structure, it does not mean that subsequent investments are completely detached from the domestic investment entity. For each additional layer of company within the group, consideration should be given to the actual commercial purpose of that layer and whether it undertakes shareholding, financing, regional management, or other genuine functions.

In the course of assisting Chinese clients with cross-border investment and offshore corporate structuring, Kaizen has frequently encountered situations where an enterprise has already

completed the establishment of offshore companies but, as new investors, operating regions, or financing arrangements are subsequently added, the original corporate structure needs to be reorganized. Therefore, an offshore structure is not something that remains static after company incorporation is completed; rather, the functions and necessity of each layer of entities should be continuously assessed as the enterprise's actual business develops.

Overall, distinguishing between holding entities and operating entities essentially involves a reasonable division of labor between group-level equity and capital arrangements and actual operating activities in specific countries and regions.

For enterprises with relatively simple businesses, it is not necessarily required to establish a complex multi-layered offshore structure. However, as enterprises enter multiple markets, introduce offshore investors, or conduct group financing, clearly defining the functional positioning of each entity in advance helps to make the group's equity relationships, operating activities, and compliance responsibilities clearer.

Kaizen has long provided clients with company formation, cross-border investment structuring, and ongoing compliance services worldwide, and has assisted numerous clients in establishing and maintaining companies in different countries and regions, accumulating extensive experience in cross-border corporate services. If clients plan to conduct overseas investment, establish a group structure, or need to adjust their existing offshore corporate structure, Kaizen can provide corresponding assistance based on the client's actual business model, shareholding relationships, and financing arrangements.

If you wish to obtain more information or assistance, please visit the official website of Kaizen CPA Limited at www.kaizencpa.com or contact us through the following and talk to our professionals:

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