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Modern Inheritance Develops in China

U.S. investments are affected by changes in requirements on ownership and disposition of property.


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IN THE PAST few years, China, one of the world's oldest civilizations, has begun to enter the field of modern inheritance and estate planning. That step could naturally not be too far behind China's entry into the modern market economy and its attendant set of rights to own property and dispose of property without collective intervention.

As the Chinese economy has begun to mature, China has begun to address the questions of how to transfer property from one generation to the next and how to treat such transfers from a tax perspective. In 1985, China adopted a law on succession of property, and in 2001, it adopted a law of trusts. While China has now adopted a sophisticated system of income, business and related taxes, so far it has not elected to impose a formal gift tax, estate tax or inheritance tax.

Globalization, the rapid ascent of the Chinese economy, and recent changes in Chinese law and policy regarding foreign investment have caused a tremendous influx of U.S. investment in China. The purpose of this article is to describe some basic features of contemporary Chinese law that are relevant to estate planning and to discuss some basic planning considerations primarily for U.S. persons who may acquire or inherit property in China.

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Property Ownership

As a general matter, individuals can acquire and own property in China, profit from the sale of such property and transfer property to their heirs. Individuals are permitted to own personal property such as lawfully earned income, housing and savings in much the same manner that anyone in the United States can. Individuals can also own buildings.

Ownership of land is somewhat more complicated as the transition to a mode of ownership like the common law "fee" is not yet complete.Theoretically, all land continues to belong to the state or collective organizations. The Chinese government has created a market in land by creating a system of usage rights in specified properties that can be acquired by private owners and investors. An individual can acquire "usage rights" in land from the government for various periods, depending upon how the land will be used. For example, a usage right to land dedicated to residential purposes usually has a term of 70 years.

These usage rights can be sold in the private market. At the end of the usage period, the owner will have the right to renew the usage agreement by application to the proper government authority and the payment of a fee. The application is supposed to be routinely approved unless the land is needed to be reclaimed for the public interest. China is now considering proposals to extend the durations of usage rights or even establish a more Western-style system of title and ownership.

China embraces the concept of community property. Unless a husband and wife agree to the contrary, property acquired during a marriage is joint property. A husband and wife enjoy equal rights to possession and management of marital property. On the death of the first spouse, that spouse's half of the marital property will pass by the decedent's will or the Chinese Succession Law, and the surviving spouse will continue to own his or her half of such property.

Principles of Inheritance

China has enacted legislation that provides for testate and intestate succession and procedures for the making of wills. The Chinese system of administering inheritance rights is, in many ways, similar to that of European and other civil law countries. A notary handles most of the administrative aspects related to the transfer of inherited property. There is no probate or surrogate's court, per se; inheritance disputes are supposed to be resolved in the court that has jurisdiction over the disputed property or the court that has jurisdiction over the place where the decedent was domiciled at the time of death.

However, there is a somewhat surprising inconsistency in the law for testate as distinguished from intestate succession: At least theoretically, China now permits "freedom of testation" with virtually as much liberality as most U.S. jurisdictions. However, not unlike many common law jurisdictions outside the United States, China tempers the freedom to dispose of property by will by allowing family members who can demonstrate a special reason to benefit from a decedent's property to obtain a court order varying the terms of the decedent's will to provide for a disposition in their favor.

The intestate Succession Law of China provides that the decedent's spouse, children and parents inherit equal shares of the decedent's property. If none of these individuals survive the decedent, the decedent's brothers, sisters and grandparents will inherit the decedent's property. Successors with the same degree of kinship to the decedent (e.g., siblings, first cousins, etc.) generally enjoy equal shares or sub-shares of the estate. However, Chinese intestate succession rules introduce considerations of need and relative affluence that significantly qualify these rules of inheritance. For example, Chinese courts may adjust an heir's share of a decedent's estate based on the heir's economic situation and how the heir cared for the decedent. In a provision that may bring a wry smile to a U.S. probate litigator—but also reflects China's deep respect for family cohesion—the Chinese Succession Law encourages heirs to adjust and settle their respective shares peaceably.

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Under the Chinese law of inheritance the dispositive provisions of a will take precedence over the Succession Law. Chinese wills can take several forms: written, holographic, notarial, using a sound recording, and in emergencies, oral. Each type of will has its own set of legal formalities. The law of intestate succession will apply and govern the disposition of property in several situations, including when a decedent does not leave a will, if a portion of a will is invalid, or if a will does not dispose of all of a testator's property.

Trusts and Taxes

In 2001, China joined the growing trend of Asian jurisdictions, such as Japan and Korea, that have adopted the institution of the trust into their internal law, notwithstanding the civil law influence on much of their legal systems. The Trust Law of China imposes legal duties on fiduciaries and confers legal rights on beneficiaries, much as we are accustomed to in the United States. Individuals as well as corporations may serve as trustees of Chinese trusts.

However, reservations have been expressed because it is not clear how the distinction between title to property in a fiduciary capacity and title to property in the individual capacity of a trustee can be publicly recorded or recognized. Also, regulations regarding the taxation of trusts have not yet been promulgated. It should be noted that the main catalyst for the 2001 trust legislation was the need to provide a legal vehicle for capital investments. Nonetheless, the Chinese banking authorities are considering regulations that may provide more guidance as to how and when a trust company (regulated as a financial institution in China) can serve as trustee for estate planning purposes as distinguished from capital investment purposes.

As already mentioned, China does not impose an estate tax, an inheritance tax or a gift tax on residents or non-residents of China. The government considered imposing a tax based on the German gift and inheritance tax but elected not to proceed, for fear of causing adverse consequences for China's economic growth.

The Chinese income tax applies to Chinese residents and foreigners. China imposes an individual income tax on the worldwide income of individuals who are domiciled in China and generally on non-domiciliaries who have resided in China for one year or more. Individuals who are not domiciled in China and who have not resided in China for one year or more are subject to tax on their China source income. Actively earned income is taxed at progressive rates ranging from 5 percent to 45 percent, and passive income (including gains on the sale of real and intangible property) is generally taxed at a flat rate of 20 percent.

The United States and the Peoples Republic of China are parties to a bilateral income tax treaty, which entered into force on Nov. 21, 1986. The treaty allows China to tax capital gains on sales of most forms of Chinese property owned by U.S. residents, but U.S. residents may be able to claim a credit against their U.S. income taxes for the tax paid to China.

China also imposes a business tax, which is derived from various business activities. In general, the business tax is imposed on gross receipts and business tax rates range from between 3 percent and 20 percent. Sales of real property and immovable property are generally subject to business tax at the rate of 5 percent.

Foreign Ownership

Individuals who are neither residents nor citizens of China may, in principle, own property in China. However, two important categories of property are subject to important restrictions: shares of Chinese companies and Chinese real estate.

The stock of Chinese corporations are typically divided between "A" shares and "B" shares. The distinction concerns who is entitled to own the shares. "A" shares can only be purchased by Chinese persons and certain non-Chinese large institutional investors. "B" shares, which are shares in Chinese companies traded in certain exchanges, mainly in Shanghai and Shenzhen, may be purchased and sold by Chinese and foreign individuals and institutions. Non-Chinese investors, however, can invest in "A" shares indirectly through funds created by non-Chinese institutional investors and through Chinese companies funded with capital in China.

Non-Chinese individuals who have worked or studied in China for at least one year, Chinese branches or offices of non-Chinese companies and residents of Hong Kong, Macau and Taiwan may acquire homes in China for residential purposes. Non-Chinese institutions and individuals may invest in Chinese real estate for rental or other investment purposes after obtaining approval from, and registering with, the relevant Chinese authorities, as long as these businesses and individuals are adequately capitalized.

Enterprises acquiring Chinese real estate for investment purposes must have at least one million RMB of registered capital ($1 currently equals approximately 7.8 RMB). Local governments often require additional registered capital. For example, a non-Chinese enterprise acquiring real estate for investment purposes in Beijing must have registered capital of at least 10 million RMB.

Planning

Theoretically, under Chinese law, the disposition of intangible assets such as Chinese bank accounts and securities of Chinese companies owned by a decedent domiciled in New York should be governed by New York law and the disposition of real property in China owned by a New York resident should be governed by Chinese law. However, the courts of China do not have extensive experience with conflicts of law rules in the inheritance arena. Even more importantly, there are no guidelines as to how a will executed outside of China or admitted to original probate in a jurisdiction like New York could be recognized or given effect in China. Therefore, even though non-Chinese persons who own property in China, in theory, do not need to worry about planning to minimize Chinese estate duties, there are still good reasons to engage in proper planning to avoid unexpected delays in the transfer of property and proceedings before courts or government agencies for whom complex inheritance issues are relatively novel.

U.S. persons acquiring property in China should consider acquiring their investments through an appropriate vehicle, such as a company or a trust. While there are currently no formal restrictions on the nationality or residence of a trustee of a Chinese trust, trusts established under the China Trust Law as estate planning vehicles or will substitutes are untested. It is also possible that the same restrictions on ownership of Chinese real property and "A" shares of Chinese companies by non-Chinese persons would be attributed to a non-Chinese trustee of a Chinese trust. In addition, the tax status of Chinese trusts remains unclear. Ownership of assets such as Chinese real property through a Chinese company may avoid the complications of transferring ownership of the real property upon the death of the deceased shareholder, but issues could still arise about the transfer of the shares themselves.

In 2003 China and Hong Kong entered into an arrangement which provides tax, trade and investment benefits for Hong Kong companies investing in China. As a result, there may be advantages for U.S. investors to invest in China through Hong Kong trusts and companies. Hong Kong is essentially a common law jurisdiction and has a long tradition of dealing with common law trusts, wills and inheritance concepts.

Hong Kong recently abolished its inheritance tax and maintains a very favorable income tax environment for non-Chinese persons. Dividends paid from a Chinese company to a Hong Kong company and ultimately to a U.S. shareholder should not be subject to withholding tax in either China or Hong Kong. Profits from the sale of stock of a Chinese company owned by a Hong Kong company should not be subject to tax in Hong Kong, but may be subject to tax in China.

In considering a Hong Kong structure to own property in China, a U.S. tax resident should take into account the special U.S. tax regimes designed to discourage U.S. taxpayers from using foreign companies to defer U.S. tax on certain forms of income. In considering the possible application of the anti-deferral regimes under U.S. tax law such as the rules under Subpart F of the Internal Revenue Code regarding "controlled foreign corporations" and the rules regarding "passive foreign investment companies," it is important to keep in mind that Hong Kong is not considered part of China for U.S. income tax purposes. In some cases, use of a Hong Kong entity that could be disregarded or not treated as a corporation for U.S. income tax purposes may be appropriate.

While this article has focused on U.S. persons owning property in China, Chinese individuals with interests in the United States should generally plan for ownership of U.S. assets like other non-U.S. citizens who are not domiciled in the United States. Since there are currently no gift, inheritance or estate taxes in China, it would be unfortunate if a Chinese individual did not properly structure the acquisition of U.S. property and unwittingly became subject to U.S. transfer taxes for which there would be no offsetting credit for Chinese tax purposes.