

China Tax & Investment News

New regulation removes withholding tax concerns related to domestic re-investment made by CHCs

Executive summary

On 8 December 2011, the Ministry of Commerce (MOC) and the State Administration of Foreign Exchange (SAFE) jointly issued a new circular, Shangzihan [2011] No. 1078 (Circular 1078), to further regulate China Holding Companies' (CHCs) reinvestment in China. The capital increase requirement associated with domestic reinvestment by CHCs, which was specified in SAFE internal circular Huizihan [2011] No. 7 (Circular 7), has been eliminated with the announcement of Circular 1078.

Background

Although a CHC requires higher capital commitment and has stricter set-up criteria, many multinational corporations choose a CHC as the intermediate holding vehicle to centralize the management of their China investments. Among all commercial considerations, some frequently mentioned reasons for using a CHC are the higher leverage on financing (i.e., up to 6 times its registered capital in the optimal case) and its efficiency as an investment platform (i.e., effectively centralizing all profits within the group to facilitate cash redeployment within China without triggering Chinese withholding tax).

However, in March 2011, the SAFE issued an internal Circular 7 indicating that if a CHC wants to reinvest in China with its legitimate incomes such as its subsidiaries' dividends, equity transfer income and liquidation income, it has to first increase its registered capital by such income. In other words, the income has to be treated as "dividend distributed" to its foreign investor first and as a result, the Chinese withholding tax liability would be triggered even if the foreign investor has not received or has no intention of receiving such distribution. This requirement has prompted a lot of concern from the business community. Our informal discussions with SAFE officials revealed that they may not have considered the potential tax implications before introducing such capital increase requirement.

This edition of China Tax & Investment News summarizes key features and discusses major changes and implications brought about by Circular 1078.

Circular 7 was issued independently by the SAFE and was meant to be circulated internally only. The MOC, the authority in charge of the administration of foreign investments in China (including CHCs), and the State Administration of Taxation (SAT), the authority in charge of the withholding tax, were not involved in the review process of Circular 7. Thus, questions have been raised as to whether Circular 7 has binding effect on CHCs and if so, whether a CHC is still an effective holding vehicle for China investments, given the tax cost that would arise. The MOC has on the other hand hosted a few public consultation meetings in major cities to solicit input and comments from the business community.

Key features of the new Circular 1078

Circular 1078, which no longer mentions the capital increase requirement, has the following key features:

Qualified income

Circular 1078 reiterates that the following legitimate RMB incomes of CHCs would be permitted for direct reinvestment in China, subject to approval from the local foreign exchange branches of the SAFE:

- ▶ Profit derived in China
- ▶ Income from early investment recovery
- ▶ Income from liquidation
- ▶ Income from equity transfer
- ▶ Income from capital reduction

Documentation requirement

To apply for the aforesaid reinvestment, a CHC shall submit the documents listed below to the local SAFE:

- ▶ Written application letter
- ▶ IC Card for foreign exchange registration of foreign investment enterprises (FIEs)
- ▶ Approval letter from commerce department in charge regarding investment in China by FIEs
- ▶ Evidence for the source of RMB fund
- ▶ The latest capital verification report and annual audit report (with the verification report on the corresponding foreign exchange income and expenditure attached)

After obtaining the approval from foreign exchange authorities, the CHC can directly transfer the RMB funds to the investee companies.

Capital verification

The investee companies shall provide the following information to the foreign exchange authorities in charge for capital verification:

- ▶ Work coordination letter issued by an accounting firm
- ▶ Application letter for capital verification and confirmation
- ▶ Confirmation Letter of Capital Contribution by Foreign Investors
- ▶ Copies of the above reinvestment approval documents issued by the foreign exchange authority in charge of the CHC, etc.

Usage of local loans

Circular 1078 emphasizes that a loan obtained within China by the CHC cannot be used for reinvestment.

Implications and observations

With the enforcement of Circular 1078, there are certain changes and implications from tax and business perspectives.

Tax implications

As mentioned, the earlier Circular 7 stipulates that the legitimate income derived by CHCs should first be converted into new registered capital before reinvestment, which gave rise to potential Chinese withholding tax implications. According to tax Circular, Guoshuihan [2010] No. 79, equity investment income such as dividends, profit distributions, etc., shall be recognized as the taxable income on the day when a board resolution is made to distribute cash dividends or stock dividends and subject to Corporate Income Tax (CIT). In other words, foreign investors would be liable for Chinese withholding tax when their dividends received from Chinese subsidiaries are used as increase of capital.



Circular 1078, which is a public circular jointly issued by SAFE and MOC, does not mention any capital increase requirement. The general public can basically follow this new Circular to handle their reinvestment and should not be concerned about the additional withholding tax cost. In fact, in response to our verbal enquiries with the foreign exchange authorities at the central level and at some local levels, a consistent message was conveyed that the capital increase is no longer a requirement even though Circular 1078 did not overtly supersede Circular 7. To avoid unnecessary payment of withholding tax, investors of CHC can now defer the dividend distribution from the CHC but use the fund directly for domestic investments through the CHC.

Business and foreign exchange concerns

Circular 7 only focused on CHCs; it is arguable that other FIEs (i.e., non-CHCs) are not required to convert profits into new registered capital before making reinvestment. With this joint Circular, the MOC and the SAFE have standardized the requirements for both CHCs and non-CHCs in this regard.

Increasing capital first before reinvestment (i.e., the Circular 7 requirement) would consume much more time going through different authorities before reinvestment could be made. Without this requirement, the entire process of reinvestment would be streamlined.

Simplified documentation requirement

Circular 1078 has simplified the documentation requirements prescribed previously, no longer listing a tax clearance certificate as a requisite document.

The following table lays out the key changes with respect to documentation requirements:

Documentation requirements under Circular 1078	Previous Documentation requirements
<ul style="list-style-type: none"> ▶ Written application letter ▶ IC card for foreign exchange registration of FIEs ▶ Approval letter from commerce department in charge regarding investment in China by FIEs ▶ Evidence for the source of RMB funds ▶ The latest capital verification report and annual audit report (with the verification report on the corresponding foreign exchange income and expenditure attached) 	<ul style="list-style-type: none"> ▶ Written application ▶ IC card for foreign exchange registration of FIEs ▶ Board resolution on profit distribution and the foreign investor's confirmation letter on using the profit to make reinvestment ▶ The latest annual audit report (with the verification report on the corresponding foreign exchange income and expenditure attached) ▶ CIT tax payment or tax exemption certificate related to the profit used to make reinvestment or capital increase ▶ The approval documents of commerce departments in charge of companies to be reinvested ▶ The latest capital verification report

Appendix

Circulars we have referred to in this alert:

Date	Circular no.	Major issues covered
2011-12-08	Shangzihan [2011] No. 1078	Notice for improving the administration of foreign invested China Holding Companies
2011-03-29	Huizihan [2011] No. 7	Notice regarding the procedural guidelines on capital verification of reinvestments made by Chinese Holding Companies
2010-08-27	Huifa [2010] No. 43	The "Administrative Licensing Items of the State Administration of Foreign Exchange (2010)"
2010-02-22	Guoshuihan [2010] No. 79	Implementation issues for Corporate Income Tax Law
2006-05-26	MOC Decree [2006] No. 3	Supplementary notice regarding the establishment of China Holding Companies
2004-11-17	MOC Decree [2004] No. 22	Notice regarding the establishment of China Holding Companies (2004 revision)

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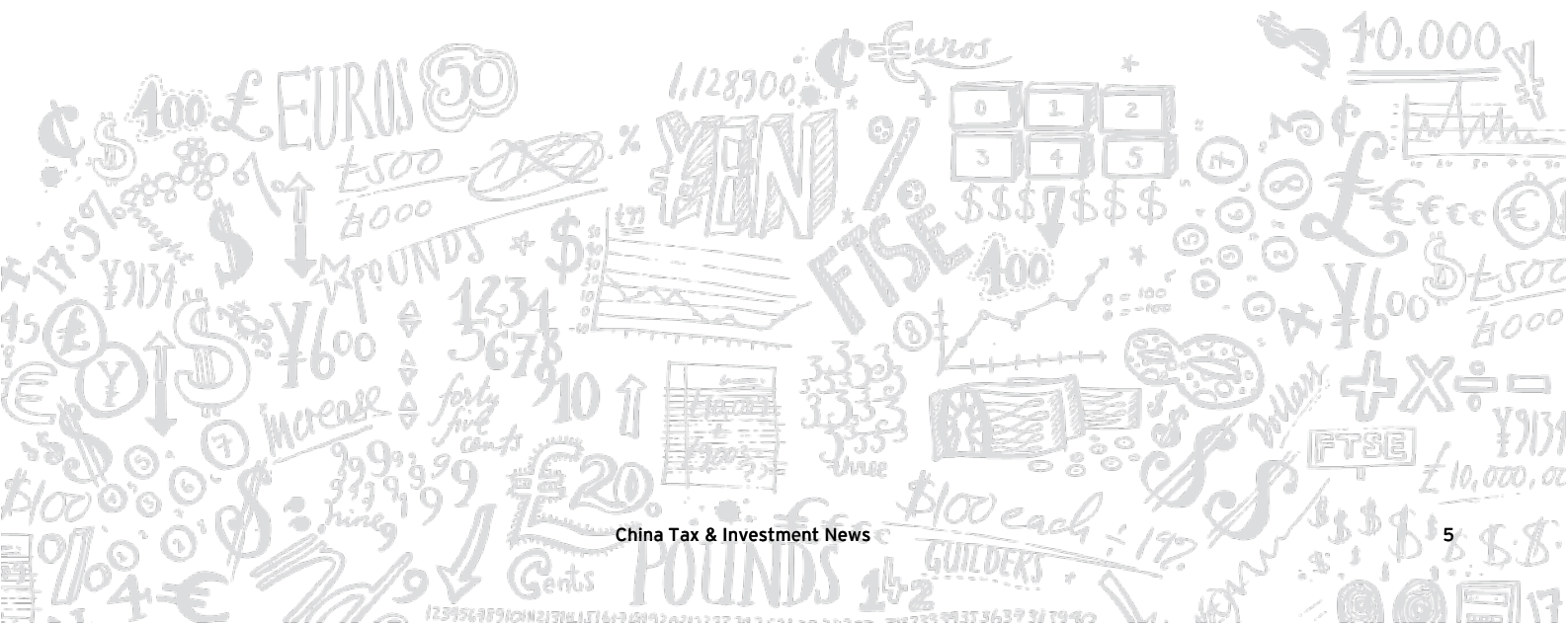
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