

New SAFE Regulation Makes Reinvestment by Foreign Invested HoldCos in China More Difficult

Chinese Holding Companies (so-called *Foreign-invested Companies with Investment Nature*, “HoldCos”) are normally established by foreign investors to act as platforms for their investment in China. HoldCos often want to reinvest the dividends received from their Chinese subsidiaries to establish or acquire new companies or to increase the registered capital of existing subsidiaries. This article aims to help its readership to understand the challenges and changes brought along by a recent Circular issued by the PRC State Administration of Foreign Exchange (“SAFE”) in this respect. As an internal notice which was only distributed by the SAFE to its local branches, this new Circular has not attracted much public attention. However, its implementation has already caused real problems for HoldCos which wanted to reinvest dividends in China.

New Requirement from the SAFE Circular Huizihan [2011] No. 7 (汇资函[2011]7号)

On 29 March 2011, the PRC State Administration of Foreign Exchange (“SAFE”) issued the *Circular on the Operating Guidelines on Issues Relevant to Requests for confirmation Involved in the Re-investment of Foreign-invested Companies with an Investment Nature* (国家外汇管理局外商投资性公司再投资所涉验资询证有关问题操作指引的通知). The Circular took effect on the same day.

According to the above Circular, if a HoldCo wants to reinvest its legitimate income earned in China (including dividends received from its Chinese subsidiaries), it must first use such income to increase its own registered capital by the same amount. That is to say, the HoldCo shall first transform its undistributed RMB profits into its own registered capital before it can reinvest such profits in China (either to establish or acquire a new subsidiary or to increase the registered capital of an existing subsidiary).

Implications of the New SAFE Circular

In the past, it was not necessary to increase a HoldCo’s own registered capital in order to reinvest its legitimate income earned in China.

The new requirement of the SAFE Circular makes the reinvestment procedures more time-consuming, because now increasing a HoldCo’s own registered capital becomes a precondition for reinvestment of its legitimate income earned in China.

In addition, the new requirement also increases the tax burden of the HoldCo's shareholder(s). Under PRC tax law, when a HoldCo's after tax profits are transformed into its registered capital, its shareholder(s) are deemed to receive "dividends" from the HoldCo and then reinvest such dividends in the HoldCo. As such, the HoldCo's foreign shareholder(s) have to pay 10% Chinese withholding tax for such "dividends" (unless a lower tax rate is available under the applicable double taxation treaty).

Before the issuance of the Circular, a Chinese HoldCo structure was viewed as tax efficient for dividend reinvestment. Under the *PRC Corporate Income Tax Law* ("*CIT Law*"), qualified dividends distributed by one tax resident enterprise ("TRE") to another TRE are exempted from CIT. This also applies to the dividends received by a HoldCo from its Chinese subsidiaries. In contrast, if there is no HoldCo structure in China, foreign investors (as non-TREs) shall pay 10% (or a lower tax treaty rate where applicable) withholding tax for the dividends received from their direct Chinese subsidiaries before such dividends are reinvested in China. The new SAFE Circular has eliminated such tax advantage of having a Chinese HoldCo. Since a Chinese HoldCo shall now first transform its undistributed profits into its registered capital, its foreign shareholders can no longer avoid the Chinese withholding tax for dividends.

Reaction from the Authorities of Commerce

The SAFE Circular claims that the new requirement is based on Decree [2006] No. 3 issued by the PRC Ministry of Commerce ("MoC"). However, this earlier MoC Decree only covers the situation where foreign investors use their legitimate income earned in China to invest in a HoldCo as capital contribution to the latter. The MoC Decree does not cover the situation where a HoldCo reinvests its legitimate income earned in China. There is hardly any logical link between the SAFE Circular and the MoC Decree.

Not surprisingly, the Authorities of Commerce take a cautious approach on how to cooperate with the SAFE on this issue. Like every other foreign invested enterprise, a HoldCo shall also obtain an approval from the competent Authority of Commerce before it can increase its registered capital. According to information received from the Shanghai Authority of Commerce, they have been instructed by the MoC to temporarily suspend granting approvals to HoldCos regarding capital increase applications for reinvestment purposes as requested by the SAFE. Without such approval from the competent Authority of Commerce, a HoldCo will not be able to increase its registered capital and, consequently, will not be able to go through the relevant procedures with the SAFE for the reinvestment of its legitimate income earned in China.

For the time being, due to the seemingly different opinions of the SAFE and the MoC, HoldCos are currently not able to make reinvestment in China. The two authorities are reported to be in the process of coordinating with each other to work out a joint guidance in this respect.

CMS Comments

Before the SAFE and the MoC have successfully coordinated with each other, HoldCos may have to wait for reinvestment of their income earned in China. For investment projects where time is essential, HoldCos may need to consider other financing alternatives such as using their registered capital or taking out shareholder or bank loans.

For investors considering establishing a HoldCo structure in China, it is important to follow up with the future development of this issue in order to make a sound business decision.

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