Path made smooth again

A new regulation from the foreign exchange regulator has returned the right of foreign-invested holding companies to re-invest their dividends in China

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On March 29 2011, the State Administration of Foreign Exchange (Safe) issued a Circular which had a significant effect on foreign-invested holding companies seeking to re-invest their income in China (see *Safe, Circular on the Operating Guidelines for Issues Relevant to Requests for Confirmation of Capital Verification Required in the Re-investment of Foreign-invested Companies with an Investment Nature* (国家外汇管理局关于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) and 'Rocky road for foreign-invested holding companies', CLP September 2011).

Under this Circular, before making re-investments of legitimate income earned in China, holding companies (Holdcos) must first increase their own registered capital by the same amount. This meant that overseas shareholders of PRC Holdcos needed to pay 10% withholding income tax for the earnings used to increase the Holdcos' registered capital.

The new Circular brings Holdcos back to where they were before March 2011

Ulrike Glueck, CMS China

Unfortunately, Safe and the Ministry of Commerce (Mofcom) have held different opinions on this matter for quite some time. This has led to local authorities of commerce no longer approving in practice capital increases of Holdcos for the purposes of re-investing in China.

Now, Holdcos have been given a way out of this dilemma. A new Circular was jointly issued by Safe and Mofcom on December 8 2011: *Circular on Further Improving the Administrative Measures for Foreign-invested Companies with an Investment Nature* (商务部、外汇局关于进一步完善外商投资性公司有关管理措施的通知). The new Circular took effect on the date of issuance and has clarified critical issues regarding Holdcos making re-investment in China.

Although not expressly stipulated, the new Circular has the actual effect of abolishing the Safe requirement stipulated in the earlier regulation, thus bringing Holdcos back to where they were before March 2011.

Under the new Circular, Holdcos are allowed to make direct re-investments in China by using their legitimate China-sourced earnings, without first increasing their own registered capital. This is favourable to Holdcos because their overseas shareholders no longer need to pay withholding tax for dividends which would otherwise be triggered by using the Holdcos' earnings to increase their registered capital. Since the discrepancy between Safe and Mofcom has now been solved, Holdcos will no longer be stuck when seeking to make re-investment in China.

Clarifications

Under the new Circular, Safe and Mofcom have also clarified certain issues. The first is that foreign shareholders of Holdcos can use their legitimate China-sourced earnings as contribution or increase to the registered capital of the Holdcos.

Secondly, Holdcos are not allowed to use domestic loans for making re-investments in China. This implies, however, that foreign loans, such as shareholder loans, are still viable options for Holdcos to use for their re-investments. It remains to be seen whether Holdcos can still take domestic M&A loans.

Thirdly, after the re-investment plan has been approved by the competent authority of commerce, Holdcos also need to submit certain documentation to Safe for verification and approval. This documentation includes (i) a written application; (ii) the approval certificate issued by the authority of commerce regarding the reinvestment; and (iii) supporting documents proving the source of the earnings and the latest capital verification report and audited financial statements of the Holdcos.

Finally, after Safe's approval is obtained, the legitimate China-sourced earnings can either be directly transferred to the re-invested company or transferred to the re-invested company through the Holdcos. For example, dividends declared by one Chinese subsidiary of the Holdco can be directly paid to another subsidiary as capital increase/contribution of the Holdco to the latter subsidiary.

Foreign loans are still viable options for Holdcos to use for their re-investments

Charlie Sun, CMS China

The path is smooth again. Holdcos wanting to make re-investments can now go ahead with their plans. It is still advisable, however, to take a look into the document and procedural requirements set by the new Circular.

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