



How can foreign investors invest or reinvest in China using RMB?

Regulations discussed in this issue:

- Notice issued by Peoples' Bank of China Clarifying Issues Relating to Cross Border RMB Business (Yin Fa [2011] No. 145)
- Notice on the Implementation Guideline for Issues Relating to the Capital Verification for the Reinvestment by the Chinese Holding Company issued by the Capital Item Administration Division of State Administration of Foreign Exchange (Hui Zi Han [2011] No. 7)

Background

With the increasing internationalisation of RMB, there will be more opportunities for foreign investors to invest or reinvest in China using RMB rather than foreign currency. However, the approval procedure can be complicated, and there can be tax costs that are not obvious at first glance. Recently, the relevant authorities have issued circulars in relation to RMB investment and reinvestment including Yin Fa [2011] No. 145 (Circular 145), Peoples' Bank of China (PBOC) Announcement [2011] No. 1 (Circular 1) and Hui Zi Han [2011] No. 7 (Circular 7).

We set out below the key points in the abovementioned circulars and our comments on them:

A. Investing from Overseas

1. Where is the source of RMB for foreign investors?

The State Council decided to implement the cross border RMB trade settlement pilot program on 8 April 2009 with four selected pilot cities in China and the pilot foreign countries/territories including ASEAN countries, Hong Kong and Macau. This program allows approved companies in the pilot cities to conduct trades and settle trade payments in RMB which allow foreign companies in pilot foreign countries/territories to receive RMB. Circular Yin Fa [2010] No.186 further expanded the pilot cities in China to four cities and 16 provinces including Beijing, Shanghai, Chongqing, Tianjin, Inner Mongolia, Liaoning, Jilin, Heilongjiang, Jiangsu, Zhejiang, Fujian, Shandong, Hubei, Guangdong, Guangxi, Hainan, Sichuan, Yunnan, Tibet and Xinjiang. On the other hand, the pilot foreign countries/territories have been expanded to the entire world.

Regulations discussed in this issue (Cont'd):

- Administration Measure on the Pilot Program for Cross Border RMB Settlement (PBOC, Ministry of Finance, Ministry of Commerce), General Administration of Customs, State Administration of Taxation, China Banking Regulatory Commission Announcement [2009] No. 10)

2. Which types of investments are permitted under the RMB program?

Foreign investors may utilise their legally obtained RMB to invest in China, including, establishing new companies, acquiring companies in China, transferring equity interests, increasing registered capital of existing investments, providing shareholder loans and investing in non-financial related direct investments.

3. Which types of investments are not permitted?

Foreign companies directly investing in China using RMB is still a pilot program. In order to ensure stable and steady development as well as to avoid the inflow of hot money, applications made by foreign investors to invest in restricted industries and highly regulated projects under the pilot program are currently not accepted.

4. What are the procedures for applying for investment in RMB?

- The domestic settlement bank of the foreign investor or Foreign Investment Enterprise (FIE) must submit a written application for the trial case to the branch of the PBOC at the sub-provincial level city or at level above as well as the approval document or approval certificate issued by the Commerce Bureau in charge
- Upon review and acceptance of the application by the branch of PBOC at the sub-provincial level city or at level above, the application is submitted to PBOC
- PBOC then calls for a meeting to review the trial cases for the cross border RMB financing business and centrally reviews all the trial cases applications
- Upon approving the application of the trial case, PBOC will issue the approval to the branch of PBOC at the sub-provincial city or a level above and the branch would issue the record notice for the cross border financing business to the domestic settlement bank
- The domestic settlement bank may open an RMB settlement account for the foreign investor or an FIE with the record notice to process the cross border RMB settlement.

A foreign investor or FIE shall also go through the relevant procedures with MOFCOM and SAFE or their local offices in accordance with Shang Zi Han [2011] No.72 and Hui Zong Fa [2011] No.38.

B. Reinvesting through Chinese Holding Companies

1. Under what circumstances can CHC reinvest into its Chinese subsidiaries?

According to MOFCOM, Decree [2006] No. 3 (Circular 3) and Circular 7, a Chinese Holding Company (CHC) is allowed to reinvest in its Chinese subsidiaries and increase its own registered capital using RMB profits, proceeds from capital reduction, liquidation and divestment, transfer of equity interests and return on investment as well as income received from other legal means.

2. What documents need to be obtained in support of the abovementioned reinvestment?

- Capital item foreign exchange business verification document issued by the foreign exchange bureau on reinvestment with domestic RMB profit and other legal RMB income
- Tax clearance certificate



As the reinvestment can no longer be made directly with spare cash in a CHC, CHC's will have to revise the financial forecast by taking into account the withholding tax that would be payable on deemed dividends. Foreign companies should rethink their China investment structures and the purposes of the CHC.

Vincent Pang
Tax partner, Beijing
KPMG China

3. *What will be the Chinese tax implications of the abovementioned reinvestment?*

The increase in the registered capital of a CHC suggests that the related profits should be capitalised accordingly. This means that a CHC will deem to have distributed the profits before increasing its registered capital. According to the Corporate Income Tax (CIT) law, a non-resident investor receiving dividends from a resident enterprise in China will be subject to withholding tax at a rate of 10 percent unless the relevant Double Tax Treaty or Arrangement provides a more favourable withholding tax rate.

4. *What will be the requirements, procedure and documentation required for a CHC to reinvest into its subsidiaries in China?*

Circular 3 does not explicitly require a CHC to reinvest its profits in its Chinese subsidiaries by increasing its registered capital. The circular only indicates that a CHC may choose to use all or part of the reinvested registered capital to reinvest in the subsidiaries in China.

However, Circular 7 stipulates an explicit requirement that a CHC may only reinvest in the subsidiaries in China after it has increased its registered capital accordingly. The procedures and documentation requirements are as follows:

- The foreign exchange bureau at the subsidiary location may process the capital verification registration formalities with the capital verification application issued by a CPA firm, "Enquiry Letter on the Capital Contribution Status by the Foreign Investor" and reinvestment approval document and fax the "Enquiry Letter on Reinvestment Using Domestic Legitimate Income by CHC" to the foreign exchange bureau at the CHC location
- The foreign exchange bureau at the CHC location must complete and issue the "Response to the Enquiry Letter on Reinvestment Using Domestic Legitimate Income by CHC" within two working days
- The foreign exchange bureau at the subsidiary location should complete the capital verification registration formalities after receiving the abovementioned response
- A CHC may then contribute the reinvested registered capital into the subsidiary.

5. *What if the reinvestment is made by a holding company in China that does not have CHC status?*

Circular 7 does not specifically refer to non-CHC holding companies. However, in practice, the government authorities may seek to apply the principle underlying Circular 7 to such holding companies.

6. *What if the Chinese subsidiary of a CHC distributes its foreign currency profits to a CHC?*

The Chinese subsidiary may present a foreign exchange certificate, Board resolutions on the distribution of dividends and tax clearance certificate to arrange the payment of dividends to a CHC.

Pursuing to the CIT Law, dividend derived by a resident company from another resident company is exempt from CIT if certain conditions are met.



With the issuance of the new rules, which give rise to both opportunities and drawbacks, foreign companies and CHCs should reassess their trading and investment arrangements and strategies with a view to managing currency risk and improving tax efficiency.

Chris Ho
Tax partner, Shanghai
KPMG China

KPMG observations

By using RMB as a currency for trade settlement, foreign companies may reduce their exposure to currency risk on future investments in and procurement from China. The new rules provide great flexibility to achieve such an objective. However, in reality the complexity involved in getting the necessary approval will create implementation issues. Nevertheless, foreign companies should still consider taking advantage of these rules.

Before the issuance of Circular 7, there was no clear rule prohibiting a CHC from using its investment return (e.g. dividends from its China subsidiaries) to reinvest in its China subsidiaries. As dividend income received from subsidiaries would be exempt from CIT, using a CHC as the vehicle to consolidate investments in China used to be a great tax deferred arrangement. However, with the issuance of Circular 7, a CHC will only be allowed to reinvest in subsidiaries in China by first increasing its registered capital. Hence, the advantage of the tax deferred arrangement using a CHC to retain the profits from Chinese subsidiaries may no longer exist. Further, the increase in CHC's registered capital would result in additional cash trap in China. Many foreign investors that are using a CHC to hold its China subsidiaries or are contemplating to establish such a holding structure are surprised by the potential impact of Circular 7 on their existing or contemplated structure. This is because the potential impact of Circular 7 seems to go against the China authorities' intention to encourage foreign investors to establish and use the CHC structure in China. Having said that, it should be noted that Circular 7 is an internal circular issued by SAFE only, and it is not clear as to whether the SAT and the Ministry of Commerce were consulted prior to its issuance. However, since the rules have been issued, they will have to be observed until they are replaced. Therefore, careful research and planning with painstaking preparation will be required for RMB investment or reinvestment projects.

Contact us

Khoonming Ho

Partner in Charge, Tax
China and Hong Kong SAR
Tel. +86 (10) 8508 7082
khoonming.ho@kpmg.com

Beijing/Shenyang

David Ling

Partner in Charge, Tax
Northern China
Tel. +86 (10) 8508 7083
david.ling@kpmg.com

Qingdao

Vincent Pang

Tel. +86 (532) 8907 1728
vincent.pang@kpmg.com

Shanghai/Nanjing

Lewis Lu

Partner in Charge, Tax
Central China
Tel. +86 (21) 2212 3421
lewis.lu@kpmg.com

Hangzhou

Martin Ng

Tel. +86 (571) 2803 8081
martin.ng@kpmg.com

Chengdu

Anthony Chau

Tel. +86 (28) 8673 3916
anthony.chau@kpmg.com

Guangzhou

Lilly Li

Tel. +86 (20) 3813 8999
lilly.li@kpmg.com

Fuzhou/Xiamen

Jean Jin Li

Tel. +86 (592) 2150 888
jean.j.li@kpmg.com

Shenzhen

Eileen Sun

Partner in Charge, Tax
Southern China
Tel. +86 (755) 2547 1188
eileen.gh.sun@kpmg.com

Hong Kong

Karmen Yeung

Tel. +852 2143 8753
karmen.yeung@kpmg.com

Northern China

David Ling

Partner in Charge, Tax
Northern China
Tel. +86 (10) 8508 7083
david.ling@kpmg.com

Vaughn Barber

Tel. +86 (10) 8508 7071
vaughn.barber@kpmg.com

Roger Di

Tel. +86 (10) 8508 7512
roger.di@kpmg.com

John Gu

Tel. +86 (10) 8508 7095
john.gu@kpmg.com

Jonathan Jia

Tel. +86 (10) 8508 7517
jonathan.jia@kpmg.com

Vincent Pang

Tel. +86 (10) 8508 7516
+86 (532) 8907 1728
vincent.pang@kpmg.com

Michael Wong

Tel. +86 (10) 8508 7085
michael.wong@kpmg.com

Irene Yan

Tel. +86 (10) 8508 7508
irene.yan@kpmg.com

Tracy Zhang

Tel. +86 (10) 8508 7509
tracy.h.zhang@kpmg.com

Catherine Zhao

Tel. +86 (10) 8508 7515
catherine.zhao@kpmg.com

Hiroyuki Takahashi

Tel. +86 (10) 8508 7078
hiroyuki.takahashi@kpmg.com

Abe Zhao

Tel. +86 (10) 8508 7096
abe.zhao@kpmg.com

Central China

Lewis Lu

Partner in Charge, Tax
Central China
Tel. +86 (21) 2212 3421
lewis.lu@kpmg.com

Anthony Chau

Tel. +86 (21) 2212 3206
+86 (28) 8673 3916
anthony.chau@kpmg.com

Cheng Chi

Tel. +86 (21) 2212 3433
cheng.chi@kpmg.com

Bolivia Cheung

Tel. +86 (21) 2212 3268
bolivia.cheung@kpmg.com

Dawn Foo

Tel. +86 (21) 2212 3412
dawn.foo@kpmg.com

Chris Ho

Tel. +86 (21) 2212 3406
chris.ho@kpmg.com

Sunny Leung

Tel. +86 (21) 2212 3488
sunny.leung@kpmg.com

Martin Ng

Tel. +86 (21) 2212 2881
+86 (571) 2803 8081
martin.ng@kpmg.com

Yasuhiko Otani

Tel. +86 (21) 2212 3360
yasuhiko.otani@kpmg.com

Grace Xie

Tel. +86 (21) 2212 3422
grace.xie@kpmg.com

Zichong Xu

Tel. +86 (21) 2212 3404
zichong.xu@kpmg.com

Jennifer Weng

Tel. +86 (21) 2212 3431
jennifer.weng@kpmg.com

William Zhang

Tel. +86 (21) 2212 3415
william.zhang@kpmg.com

David Huang

Tel. +86 (21) 2212 3605
david.huang@kpmg.com

Amy Rao

Tel. +86 (21) 2212 3208
amy.rao@kpmg.com

Leonard Zhang

Tel. +86 (21) 2212 3350
leonard.zhang@kpmg.com

Southern China

Eileen Sun

Partner in Charge, Tax
Southern China
Tel. +86 (755) 2547 1188
eileen.gh.sun@kpmg.com

Jean Jin Li

Tel. +86 (755) 2547 1128
+86 (592) 2150 888
jean.j.li@kpmg.com

Jean Ngan Li

Tel. +86 (755) 2547 1198
jean.li@kpmg.com

Lilly Li

Tel. +86 (20) 3813 8999
lilly.li@kpmg.com

Kelly Liao

Tel. +86 (20) 3813 8668
kelly.liao@kpmg.com

Angie Ho

Tel. +86 (755) 2547 1276
angie.ho@kpmg.com

Hong Kong

Ayesha M. Lau

Partner in Charge, Tax
Hong Kong SAR
Tel. +852 2826 7165
ayesha.lau@kpmg.com

Chris Abbiss

Tel. +852 2826 7226
chris.abbiss@kpmg.com

Darren Bowdern

Tel. +852 2826 7166
darren.bowdern@kpmg.com

Alex Capri

Tel. +852 2826 7223
alex.capri@kpmg.com

Barbara Forrest

Tel. +852 2978 8941
barbara.forrest@kpmg.com

Ken Harvey

Tel. +852 2685 7806
ken.harvey@kpmg.com

Nigel Hobler

Tel. +852 2143 8784
nigel.hobler@kpmg.com

Charles Kinsley

Tel. +852 2826 8070
charles.kinsley@kpmg.com

John Kondos

Tel. +852 2685 7457
john.kondos@kpmg.com

Curtis Ng

Tel. +852 2143 8709
curtis.ng@kpmg.com

Kari Pahlman

Tel. +852 2143 8777
kari.pahlman@kpmg.com

John Timpany

Tel. +852 2143 8790
john.timpany@kpmg.com

Jennifer Wong

Tel. +852 2978 8288
jennifer.wong@kpmg.com

Christopher Xing

Tel. +852 2978 8965
christopher.xing@kpmg.com

Karmen Yeung

Tel. +852 2143 8753
karmen.yeung@kpmg.com