



## Further clarification on reinvestment through Chinese Holding Company

### Regulation discussed in this issue:

- Notice issued by the Ministry of Commerce and State Administration of Foreign Exchange on Further Improving the Administration on CHC (Shang Zi Han [2011] No. 1078)

### Background

The Ministry of Commerce (MOFCOM) and the State Administration of Foreign Exchange (SAFE) issued the notice Shang Zi Han [2011] No. 1078 (Circular 1078) on 8 December 2011 to further clarify several issues in relation to reinvestments through Chinese Holding Companies (CHC).

The salient points of Circular 1078 and our comments are highlighted below:

#### 1. May a CHC only be allowed to reinvest in its Chinese subsidiaries after it has increased its registered capital using its legal RMB income from China?

SAFE issued a circular Hui Zi Han [2011] No. 7 (Circular 7) on 29 March 2011. According to Circular 7, a CHC may only reinvest in its subsidiaries in China after it has increased its registered capital using the RMB income received from legal means in China. For details, please refer to KPMG China's [China alert 2011 Issue No. 21](#).

However, Circular 1078 provides another option for a CHC's reinvestment in China. According to Circular 1078, a CHC could reinvest directly in its Chinese subsidiaries using its RMB profits, return on investment, and proceeds from liquidation, transfer of equity interests and capital reduction as well as income derived from other legal means in China upon approval by the local foreign exchange bureau.

## **2. What if the foreign investor of the CHC reinvest in China using the CHC's legal RMB income from China?**

Circular 1078 re-clarifies that the foreign investor could inject (or increase) the registered capital of the CHC using the abovementioned legal RMB income to reinvest in its Chinese subsidiaries, which is consistent with the rules contained in the MOFCOM Decree [2006] No. 3 and Circular 7. Meanwhile, it is important to note that if a CHC uses its profit after tax to reinvest in its Chinese subsidiaries, it should first increase its registered capital using its profit after tax.

## **3. Is a CHC allowed to reinvest in its Chinese subsidiaries using its domestic borrowing loans?**

Circular 1078 further clarifies that a CHC is not allowed to use its domestic borrowing loans to reinvest in its subsidiaries in China. It is stipulated in the Lending General Provisions by the People's Bank of China that a borrower shall not use the loans to conduct equity investments.

## **4. What will be the approval procedures and the documentation requirements for a CHC to reinvest in its subsidiaries in China?**

Circular 1078 provides that a CHC shall submit the following documents to the foreign exchange bureau for approval for the reinvestment:

- A written application
- Foreign Exchange Registration IC Card
- The approval document issued by the commerce bureau in respect of the CHC's investment in China
- The verification documents on the source of the RMB funds, which shall refer to the required documents for the foreign investor reinvesting (increasing the registered capital) in its Chinese subsidiaries using its profits, return on investment, and proceeds from liquidation, transfer of equity interests and capital reduction (i.e. capital item foreign exchange business verification document issued by the foreign exchange bureau on reinvestment with domestic RMB profit and other legitimate RMB income and Tax Clearance Certificate)
- The latest capital verification report and audited financial statements (with the relevant approved foreign exchange income and expense report).

After the local commerce bureau in charge has reviewed the abovementioned documents and issued the approval document, the CHC could transfer the relevant RMB fund directly into its Chinese subsidiaries or transfer the fund first to the CHC and subsequently to the Chinese subsidiaries.

## **5. Other rules under Circular 1078**

Circular 1078 also requires the commerce bureau at different levels to enhance the administration on the statistics of CHC's approval.

## **KPMG observations**

Generally, the following four sources of funds may be used by a CHC to reinvest in its subsidiaries in China:

- Its registered capital (including the increased registered capital using its profit after tax)
- Its investment return from its Chinese subsidiaries
- Its domestic and overseas borrowing loans
- Its profit after tax (which has not been used for the increase of the registered capital).

Among the abovementioned funds, the legitimate RMB funds from China shall include the 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 in China.

Before the issuance of Circular 7, there had been no clear rules stipulating that a CHC should first increase its registered capital before using its legitimate RMB income to reinvest in its China subsidiaries. However, with the issuance of Circular 7, a CHC only seems to be allowed to reinvest in subsidiaries in China by first increasing its registered capital with its legal RMB income from China. Meanwhile, the withholding tax of the CHC's foreign investor will arise where the CHC uses its profit after tax to increase its registered capital and will consequently increase the foreign investor's investment cost.

Nevertheless, the issuance of Circular 1078 solves the abovementioned problem. Circular 1078 clarifies that in addition to its registered capital, a CHC could use its legal RMB income from China to directly reinvest in its Chinese subsidiaries without increasing its registered capital upon approval by the local foreign exchange bureau. Circular 1078 also simplifies the relevant procedures. In addition, Circular 1078 reiterates that a CHC is not allowed to use its domestic borrowing loan to reinvest in its subsidiaries in China. However, we would like to point out that the CHC's reinvestment without increasing its registered capital is not applicable to its profit after tax. In other words, if a CHC uses its profit after tax to reinvest in its Chinese subsidiaries, it shall first repatriate dividend to its investors and then increase its registered capital.

The issuance of Circular 1078 should be good news for foreign investors that are using a CHC investment structure or are contemplating to adopt such a holding structure.

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