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CHINA TAX ALERT

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State Administration of Foreign Exchange issues policy on centralised foreign currency management for multinational corporations

Regulations discussed in this issue:

- *Notice of provisions on the centralised foreign currency management for multinational corporations issued by the State Administration of Foreign Exchange (For Trial Implementation)*, Huifa [2014] No. 23, issued on 18 April 2014

Background

The State Administration of Foreign Exchange (SAFE) recently issued the Notice of provisions on the centralised foreign currency management for multinational corporations (hereinafter "the Circular"). The Circular further explains the policy for expanding financing and investment activities from the Free Trade Zone (FTZ) to a nationwide level, and sets out the administrative procedures regarding how multinational corporations (MNCs) can centralise their operations to manage the foreign currency ("forex") of their domestic and foreign member companies. These new measures intend to create the same innovative environment for foreign-invested enterprises (FIEs) residing outside of the FTZ as those within the FTZ with respect to cross-border forex flow. The Circular will take effect from 1 June 2014.

Key points of the Circular

According to the Circular, MNCs meeting the following main conditions are entitled to authorise a domestic legal entity to be the host company to manage their cross holding member companies' forex, and benefit from a series of innovative measures:

- The total scale of forex cash flow of domestic participants (branches included) exceeds USD 100 million in the last year.
- There has been no significant illegal and non-compliant conduct in the past three years, and no significant illegal and non-compliant conduct since establishment if established less than three years ago.
- There is a sound forex management framework; internal control and a corresponding electronic internal management system are in place.

A single domestic entity meeting the above conditions is also entitled to the innovative measures in the Circular.

The Circular provides the following innovative measures:

Centralised management of forex	• The host company can centrally manage the foreign debt quota of its domestic member companies. • The host company can centrally handle the forex payment and receipt in relation to current account transactions for its domestic member companies on a net basis. • The host company can handle the conversion of forex derived from current account transactions, direct investment, foreign debt and overseas lending. • There are no restrictions on the transfer of forex from the international master account overseas. In addition, the transfer of forex between international master accounts and domestic master accounts is allowed within the foreign debt quota and lending overseas quota.
Lending overseas	• The upper limit of lending overseas for domestic companies has been adjusted from 30 percent to 50 percent of shareholders' equity.
Discretionary settlement of forex under capital accounts	• Discretionary settlement is allowed for the forex derived from registered capital, as well as the forex in realised asset accounts and domestic reinvestment accounts by the host company and domestic participants. • The converted RMB shall be transferred to the designated RMB deposit account set up by the host company, and should be ready for remittance upon authenticating the legitimacy of its business. • The converted RMB cannot be used for any of the following purposes: - Payments beyond the business scope of enterprises or intended usages of foreign debt funds or payments prohibited by the laws and regulations of the State - Investment in securities and derivatives - RMB entrusted loans - The repayment of inter-company borrowings (including third-party advances) - The repayment of RMB bank loans that have been sub-lent to third parties through banks - The purchase of real estate that is not for personal use.

KPMG's observations

The Circular aims to expand the previous innovative FTZ foreign exchange management measures to the whole nation, allowing qualified MNCs to enjoy the relevant incentives through centralised foreign exchange management. This should provide MNCs in China with more financing flexibility and efficiency in forex remittance.

The current Chinese foreign exchange control policies require that domestic entities separately settle cross-border transactions, while the netting of the payment balance is not allowed even if the foreign payer and payee are the same entity. To some extent, this type of control has increased MNCs' need for working capital, with significant efforts being made to prepare commercial documents as well as a lot of remittance fees being paid to banks. The consent on settlement on a netting basis for current account transactions introduced by the Circular will likely improve the capital turnover rate and reduce the remittance costs for MNCs in China. Although the Circular still requires that the host company report on the participants' cross-border transaction information, it does not require the official submission of the commercial documents with the banks for review. Instead, banks should merely rely on professional prudence and the due care principle, i.e. 'understanding your customers', 'understanding your business' and 'due diligence'. Banks will now only conduct detailed reviews on transactions with uncertain nature, other than remittances in relation to service trades whereby tax registration forms are required. This will save companies a significant amount of time and effort in terms of preparing documents. Compare to policy available to FTZ, the Circular further simplified the administrative procedures of documentation review.

In addition, the current control over the timing of the conversion of forex is very stringent for funds from registered capital accounts, realised asset accounts and domestic reinvestment accounts. Companies can only apply for the conversion of forex with banks when they have actual business substance to substantiate the RMB payment request (e.g. payment for goods and services to the suppliers), and they must present supporting documents for previous conversions before the next one can be processed. To that end, FIEs are often exposed to loss due to foreign exchange fluctuation. The Circular allows companies residing outside the FTZ to carry out the existing discretionary settlement in the FTZ, giving FIEs more flexibility to choose their deposit currency to mitigate the foreign exchange risks. However, it is worth noting that the use of converted RMB is mainly intended for companies' operation instead of for non-operational purposes such as investment, lending, etc. Regarding the existing 100 percent discretionary settlement in the FTZ, the proportion of discretionary settlement has not yet been clarified in the Circular.

Moreover, the Circular adjusts the upper limit of lending overseas for companies residing outside of the pilot FTZ from 30 percent to 50 percent of shareholders' equity. It allows FIEs to directly remit their spare cash to overseas parent companies or affiliates in the group rather than in the form of dividend distribution, thus helping overseas parent companies reduce their funding costs and defer Chinese withholding tax payment. Although FIEs would be subject to Chinese taxes on the interest income, the efficient cash flow arrangement could render opportunities for tax planning to potentially reduce the overall tax burden for the group.

We would like to highlight that the Circular is merely for trial implementation purposes. The relevant authorities are expected to further improve the policy's implementation rules and lower the application criteria of the forex remittance scale in future.

Given that the Circular takes effect from 1 June 2014, qualified FIEs may want to consider their future expansion plans and market situation. They may also want to strategically design their business model, operating procedures, risk control, technical support, etc. with their corresponding banks, as well as lodge their application for centralised forex management with the in-charge SAFE branch.

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