China alert

Issue 21 – November 2012

Foreign investors can now inject equity interest as capital with greater certainty

Regulations discussed in this issue:

- The Provisional Regulation for Capital Contribution with Equity interest of Foreign Investment Enterprises (Ministry of Commerce, Decree No. 8)
- Draft Administrative Measures for Capital Contribution with Equity interest of Foreign Investment Enterprises, issued by the Ministry of Commerce on 4 May 2011

Background

The Ministry of Commerce (MOFCOM) has issued Decree No. 8 to clarify the rules that govern how foreign investors may use equity interest in a company as capital injection in a foreign investment enterprise (FIE). This regulatory breakthrough has given foreign investors greater flexibility in respect of source of capital and reduces the regulatory and foreign exchange constraints for foreign investors.

By way of background, the State Administration for Industry and Commerce issued the Administrative Rules on the Registration of Capital Contribution With Equity Interest in 2009 (Decree No.39), and the local administrations for Industry and Commerce in Beijing, Shanghai, Jiangsu, Zhejiang, Guangdong and Hubei have also released local administrative rules. In practice, these regulations provide meaningful guidance primarily to situations where the equity interest of a Chinese company that is not foreign invested (domestic enterprise) is contributed. There are relatively few cases where equity interest of a FIE is contributed as capital. This is because the formation and the equity transfer of FIEs in China are generally subject to the approval of designated government authorities, and regulations from such approving authorities to accompany Decree No.39 were not previously in place.

To bridge this regulatory gap, the MOFCOM issued the Draft Administration Measures for Capital Contribution with Equity Interest of Foreign Investment Enterprises (Draft Circular) on 4 May 2011, in order to make capital contribution of equity interest in FIEs more feasible in China. KPMG was invited to share our experience and concerns, and we provided extensive comments to the MOFCOM on the Draft Circular. Please refer to KPMG China's 2011 China Alert Issue 15 for an analysis of the Draft Circular.

After reviewing the feedback on the Draft Circular, the MOFCOM approved and issued the Provisional Regulation for Contribution of Equity Interest in Foreign Investment Enterprises (Decree No. 8) on 21 September 2012. Decree No. 8 came into force in 22 October 2012, and seeks to clarify a number of issues in the area.

Main regulations

Scope

Capital contribution of equity interest in FIEs refers to a transaction where domestic and overseas investors (shareholder enterprises) create a FIE or change the capital structure of a pre-existing FIE (invested enterprise) through capital injection of the equity interest they have in another Chinese enterprise (equity enterprise).

In particular, such a transaction may take the following forms:

1. The shareholder enterprises form a new FIE with ownership interest in an existing equity enterprise

2. The shareholder enterprises contribute ownership interest in an existing equity enterprise into a Chinese enterprise as capital injection, and this injection converts the Chinese enterprise from a non-FIE into a FIE

3. The shareholder enterprises contribute ownership interest in an existing equity enterprise into a pre-existing FIE, and this capital injection alters the equity ownership structure of that FIE.

Conditions of capital contribution with equity interest

- **Equity interest that can be used for capital contribution**

Article 5 of Draft Circular sets out what types of equity interest may not be contributed as capital. These provisions have been generally retained in Decree No. 8. Specifically, in the following situations, the respective equity interest cannot be used for capital contribution:

- The registered capital of the equity enterprise has not been fully paid-up
- The equity interest has been pledged
- The equity interest has been frozen by law
- The equity enterprise's ownership interest cannot be transferred per the articles of association
- The equity interest of a FIE that did not participate or failed to pass the previous year's joint annual inspection
- The equity interest of a real estate enterprise, a foreign-invested holding company, or a foreign-invested venture capital company
- The equity interest whose transfer must be pre-approved according to the provisions of laws, regulations and decisions of the State Council but such approval is not obtained
- Any other situations where the equity transfer is prohibited by laws, regulations and decisions of the State Council.

Compared with the Draft Circular, Decree No. 8 adds that the equity interest of a Chinese real estate enterprise should not be used for capital contribution. In addition, Decree No. 8 removed the article in the Draft Circular disallowing a situation where the invested enterprise and equity enterprise own each other's equity interest as a result of the capital contribution.

- **Compliance with foreign investment regulations**

Capital contribution of equity interest in a FIE may give rise to changes in the identities of the equity enterprise and the invested enterprise. For example, when an overseas investor contributes the equity interest in a FIE into a domestic enterprise and receives more than 25 percent equity interest in the invested enterprise, the invested enterprise will be transformed from a domestic enterprise into a FIE.

In light of above, Decree No. 8 stipulates that after the capital contribution, the invested enterprise, the equity enterprise, and other relevant enterprises should comply with foreign investment regulations such as the Guidance for Foreign Investment Directions, and the Foreign Investment Industrial Guidance Catalogue. Foreign investors should not seek to evade foreign investment administration rules in China by contributing equity interest. In the example above, the invested enterprise may now face restrictions in business scope and operations that did not apply before the capital contribution turns it from a domestic enterprise into a FIE.

In the meantime, if the equity enterprise as a former FIE has enjoyed preferential income tax treatment and customs duty exemption on imported equipment as a FIE operating in certain encouraged industries, such tax incentives in previous years may be subject to claw back if it loses its FIE status after being injected to the invested enterprise.

Valuation and pricing of the contributed equity interest

Decree No. 8 stipulates that the equity interest used for capital contribution should be appraised by a qualified valuation firm in China. The transaction value and registered capital contribution value should be agreed upon by the relevant parties based on the appraisal. The transaction value refers to the value that is accepted by all parties to be attached to the capital contribution. The registered capital contribution value refers to the portion of transaction value to be accounted as the registered capital of the invested enterprise. The registered capital contribution value should not exceed the appraised value.

Although Decree No. 8 mandates that the equity interest used for capital contribution should be valued by a qualified valuation firm, it also mentions that the transaction value and the registered capital contribution value could be determined through negotiation among the parties according to the appraised value. In other words, despite the fact that the parties should engage an appraiser to value the equity interest to be contributed, they do not necessarily have to use the appraised value for the transaction, and are allowed to determine the actual transaction value and the registered capital contribution value at their own discretion.

Meanwhile, to prevent the registered capital of the invested enterprise from being inflated, Decree 8 states that the registered capital contribution value should not exceed the appraised value. However, no floor is set for registered capital contribution value. Furthermore, the PRC Company Law specifies that the amount of capital contribution in the form of non-monetary assets should not exceed 70 percent of the total registered capital of a Chinese enterprise. This 70 percent threshold is reiterated in Decree No. 8. As capital contribution to the invested enterprise with equity interest will reduce the percentage of the invested enterprise's register capital that is made up by cash, the parties should make sure that the 70 percent ceiling is not violated.

Approval procedure

Decree No. 8 states that the formation of a FIE or the change of a FIE's capital structure through capital contribution of equity interest should be approved by the provincial-level MOFCOM branch in charge of the invested enterprise, unless the MOFCOM's approval is explicitly required by the regulations. This article is generally consistent with that in the Draft Circular except for the addition of the carve-out language.

When making capital contribution with the equity interest of a FIE, the equity enterprise and invested enterprise often need to obtain approval from their respective in-charge authorities. This sometimes causes an ordering issue between the approval for the equity enterprise's change of shareholder and the approval for the invested enterprise's capital increase. In the 2011 Issue 15 of KPMG's China alertwe referred to this as the 'chicken and egg' problem, i.e., the approval authority of the equity enterprise sometimes will only approve the change of shareholder after seeing the approval document from the approval authority of the invested enterprise endorsing the capital increase; likewise, the approval authority of invested enterprise sometimes insists on seeing the approval document authorising the equity enterprise' change of investor before approving the capital increase for the invested enterprise. This creates an administrative deadlock.

To solve this practical problem, Decree No. 8 re-defines the approval procedures for capital contribution of equity interest as follows:

Step 1: The foreign investor or the invested enterprise should file an application to the approval authority of the invested enterprise.

Step 2: If the equity enterprise is a FIE and its formation was approved by an authority different from that of the invested enterprise, the approval authority of the invested enterprise should consult the provincial authority in charge of the equity enterprise regarding this capital increase.

Step 3: Should the approval authority in-charge of the invested enterprise authorise the capital increase, it should issue or amend the Approval Certificate of FIE accordingly (marked with 'capital contribution with equity unpaid').

Step 4: The equity enterprise then applies to its approval authority for changing its shareholder by presenting the invested enterprise's Approval Certificate of FIE from Step 3.

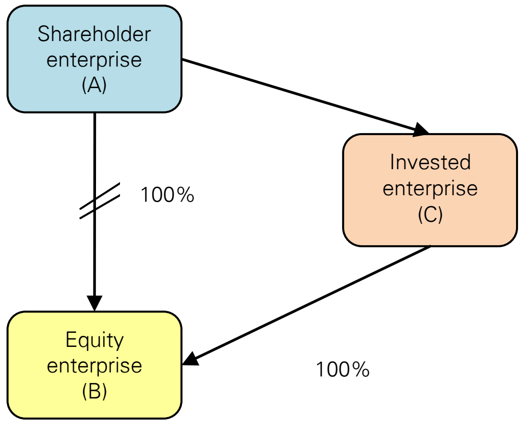
Step 5: The invested enterprise should then apply for the revised Approval Certificate of FIE with its in-charge authority (marked with 'capital contribution with equity paid').

The rules above help resolve a critical problem in practice and significantly improve the feasibility of capital contribution with equity interest of FIEs.

KPMG observations

Many multinationals are facing cash flow problems given today's economy downturn. Decree No. 8 marks a breakthrough transformation from the traditional cash investment to capital contribution with equity interest， which can go a long way in reducing corporate restructuring costs and encouraging cross-border M&A activities.

The Ministry of Finance and the State Administration of Taxation (SAT) issued Caishui [2009] No.59 (Circular 59) in 2009 and prescribed special tax treatment for reorganisations that meet certain conditions. Let us assume that foreign corporate investor (A) transfers its 100 percent shareholding in a Chinese subsidiary (B) to another 100 percent owned subsidiary in China (C). Such atransaction is a typical equity-to-equity swap. If the transaction also meets some other criteria, e.g., reasonable commercial purposes, A can be entitled to the special tax treatment under Circular 59 and the gains derived from transferring B's equity interest by A can potentially be deferred from recognition for PRC corporate income tax purposes.



The above equity-to-equity swap could also be viewed as A making capital contribution into C with B's equity interest. The issuance of Decree No. 8 removes some of the practical obstacles to the transaction. However, there are still some important issues that need to be considered by the relevant parties, as outlined below. We hope that future circulars supplemental to Decree No. 8 will clarify these issues.

A. Registered capital

The transaction value usually exceeds the registered capital contribution value. Since A wholly owns C before and after the capital contribution, does that mean A can select any number within the limit of the transaction value and set it to be the registered capital contribution value and leave the rest to be capital reserve? If the answer is yes, in an extreme case, A can potentially select one dollar as the additional increase in registered capital and thereby easily satisfy the requirement in the PRC company law that non-monetary assets do not constitute more than 70 percent of the total registered capital.

The local practices vary on this issue. Although Decree No. 8 says that the registered capital contribution value may be set by negotiation among the shareholders based on valuation, how much freedom A has as the sole shareholder of C in making this decision is unclear. We recommend that the MOFCOM provide specific guidance and standardise government practices from different locations on this issue.

B. Valuation of equity interest

Although Decree No. 8 required that the equity interest used for capital contribution should be appraised by a qualified valuation firm, the value of equity interest is often not a hard and fast number and different valuation methods may arrive at different results. If the valuation firm uses the income method of valuation and discounts the future income streams of B to the present values for aggregation, the result could be significantly larger than a valuation result computed using the cost method. One may wonder whether this larger valuation number, having incorporated the future profit potential of B under the income method, may put A under the suspicion of exaggerating the amount of its capital contribution, especially if the profit potential of B fails to subsequently materialise.

C. Regulatory uncertainties

While Decree No. 8 is helpful to address certain regulatory ambiguities, if the equity enterprise and the invested enterprise involved are located in different cities, things can still be very complex, even with the issuance of Decree No. 8. As the SAT and State Administration of Foreign Exchange (SAFE) have not issued detailed guidance on how to deal with the related tax and foreign exchange registration issues, different local tax authorities and SAFE branches may have different procedures and documentation requirements. This makes the implementation a very challenging exercise. We anticipate a number of practical uncertainties from our past experience. Taxpayers therefore should carefully plan the transaction with studies of legal and tax issues and consult the relevant authorities before implementation to mitigate regulatory risks.

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

Paul Ma
Tel. +86 (10) 8508 7076
paul.ma@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

Leonard Zhang
Tel. +86 (10) 8508 7511
leonard.zhang@kpmg.com

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

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

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

Kevin Lee
Tel. +86 (10) 8508 7536
kevin.lee@kpmg.com

Jessica Xie
Tel. +86 (10) 8508 7540
jessica.xie@kpmg.com

Eric Zhou
Tel. +86 (10) 8508 7610
ec.zhou@kpmg.com

David Chamberlain
Tel. +86 (10) 8508 7056
david.chamberlain@kpmg.com

Tony Feng
Tel. +86 (10) 8508 7531
tony.feng@kpmg.com

Tiansheng Zhang
Tel. +86 (10) 8508 7526
tiansheng.zhang@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

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

Lily Kang
Tel. +86 (21) 2212 3359
lily.kang@kpmg.com

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

Christopher Mak
Tel. +86 (21) 2212 3409
christopher.mak@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

John Wang
Tel. +86 (21) 2212 3438
john.wang@kpmg.com

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

Lachlan Wolfers
Tel. +86 (21) 2212 3515
lachlan.wolfers@kpmg.com

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

Bruce Xu
Tel. +86 (21) 2212 3396
bruce.xu@kpmg.com

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

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

Michelle Zhou
Tel. +86 (21) 2212 3458
michelle.b.zhou@kpmg.com

Cheng Dong
Tel. +86 (21) 2212 3410
cheng.dong@kpmg.com

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

Dylan Jeng
Tel. +86 (21) 2212 3080
dylan.jeng@kpmg.com

Ho Yin Leung
Tel. +86 (21) 2212 3358
hoyin.leung@kpmg.com

Henry Ngai
Tel. +86 (21) 2212 3411
henry.ngai@kpmg.com

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

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

Sam Fan
Tel. +86 (755) 2547 1071
sam.kh.fan@kpmg.com

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

Jean Jin Li
Tel. +86 (755) 2547 1128
Tel. +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

Maria Mei
Tel. +86 (592) 2150 807
maria.mei@kpmg.com

Michelle Sun
Tel. +86 (20) 3813 8615
michelle.sun@kpmg.com

Bin Yang
Tel. +86 (20) 3813 8605
bin.yang@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

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

Daniel Hui
Tel. +852 2685 7815
daniel.hui@kpmg.com

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

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

Alice Leung
Tel. +852 2143 8711
alice.leung@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

Wade Wagatsuma
Tel. +852 2685 7806
wade.wagatsuma@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

Alex Lau
Tel. +852 2143 8597
alex.lau@kpmg.com

Benjamin Pong
Tel. +852 2143 8525
benjamin.pong@kpmg.com

Rebecca Chin
Tel. +852 2978 8987
rebecca.chin@kpmg.com

Kate Lai
Tel. +852 2978 8942
kate.lai@kpmg.com

kpmg.com/cn