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Reinvestment by China Holding Companies

(Hui Zi Han [2011] 7)

Introduction

State Administration of Foreign Exchange ("SAFE") has recently issued an internal circular Hui Zi Han [2011]7 ("Circular 7") regarding the reinvestment by a China Holding Company ("CHC").

Key Points of the Circular

Circular 7 requires that if a CHC uses it income derived within China to make equity investment, the CHC needs to increase its capital first based on such income. Such income relates to dividend, capital decrease, liquidation, withdrawing of investment, etc.

Possible Impact on Your Group and Our Suggested Approach

According to Circular 7, if a CHC uses its dividend derived from its subsidiaries (or other income) to make reinvestment in China, the CHC needs to use such dividend to increase its own capital first. Thereafter, the CHC can utilize its increased capital to make reinvestment to its subsidiaries. Logically, this will mean that there will be a "deemed" dividend repatriation by the CHC to its overseas parent so that the CHC's capital can be increased, and this may potentially trigger the China Withholding Tax ("WHT") obligation in relation to the above deemed dividend repatriation because:-

- When the CHC derives dividend (or other income), such income belongs to the CHC instead of its overseas parent.

- If the CHC increases its capital, the incremental capital needs to be contributed by the CHC's overseas parent. Thus if the incremental capital will come from the CHC's income, such income should be declared as dividend to the CHC's overseas parent first, so that the overseas parent will "own" such funds and then "contribute" the funds to the CHC for the capital increase. In other words, logically there will be a deemed dividend repatriation by the CHC to its overseas parent.

- According to the Corporate Income Tax regulations, if a foreign investment enterprise ("FIE", e.g. the CHC) pays dividend to its overseas investors from its profits generated in 2008 or subsequent years, such dividend income will be

subject to WHT (generally at 10%).

In view of the above, under Circular 7, potential WHT obligation may be triggered in relation to the CHC's reinvestment in China. Having said that, it needs to be observed whether and how such circular will be enforced, because:-

- Circular 7 was issued by state SAFE to local SAFE offices only and it seems that SAFE has not consulted other relevant authorities (like Ministry of Commerce ("MOFCOM"), State Administration of Taxation ("SAT"), etc.) before issuing such circular.

- The capital increase issue of FIEs (including a CHC) should be governed by MOFCOM instead of SAFE.

- Many large multinational corporation ("MNC") groups have set up CHCs in China and one of their most important considerations when deciding to establish their CHCs was that the CHC can concentrate the funds/income from China for reinvestment purpose without triggering the WHT obligation. The potential WHT obligation under Circular 7 will have significant impact on the above MNC groups, and may greatly hesitate those enterprises/groups that are considering setting up CHCs.

What Texel Consulting Can Help?

Regarding the issues discussed in this China Tax and Business Newsflash, Texel Consulting can help your company on the following aspects:-

- Checking with your in-charge SAFE, MOFCOM and tax authorities regarding the potential WHT exposures as mentioned above.

- Assisting to apply/confirm with your in-charge tax authorities for the exemption of the WHT even if following the required procedures of Circular 7.

The contents in this China Tax and Business Newsflash are for your reference purpose. Readers are suggested to consult professional advisors for detailed analysis before implementation. For more information or further advice on the above subject or analysis of other tax/business issues, please feel free to contact our Partners (see the detailed contact information on the next page).

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