

News Flash

China Tax and Business Advisory

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Our China Investment Business Advisory Team specializes in China regulatory advisory and implementation work, ranging from market entry solutions, structure set-up, foreign exchange solutions, to restructuring solutions, e.g., equity transfer, merger and liquidation, etc. The team maintains close dialogues with various Chinese approval and registration authorities as well as industry bureaus at central and local levels. It also has extensive involvement and experience in advising clients on business cases from both the regulatory and practical perspectives.

Potential tax implications on Chinese Holding Companies by a new requirement of the State Administration of Foreign Exchange

The State Administration of Foreign Exchange (“SAFE”) issued a Circular Huizihan [2011] No.7 (“Circular 7”) on 29 March 2011, stipulating procedural guidelines in relation to the reinvestments of domestic legitimate proceeds* by foreign invested Chinese Holding Companies (generally known as “CHCs”). However, it simultaneously brings along some potential tax implications.

In this issue of News Flash, we will highlight these potential tax implications to CHCs and their foreign investors arising from Circular 7 as well as our observations.

New requirement in Circular 7

It is normal to see the SAFE setting forth detailed procedural guidelines on approval of reinvestments in RMB by CHCs using their own legitimate proceeds generated in China. Some of these domestic legitimate proceeds are profits arising from investments or operations of the CHCs, and accounted for as their retained earnings. For instance, one of the main items of such domestic legitimate proceeds is dividends from investments in Chinese subsidiaries. However, it is generally beyond expectation to see the SAFE stipulating CHCs to convert such domestic legitimate proceeds, among all the domestic and foreign sourced proceeds,

* As per Circular 7, “Domestic legitimate proceeds” shall include profit, reduction or withdrawal of capital, liquidation proceed, share transfer proceed, early repatriation of investment, or other types of incomes.

to registered capital of CHCs before reinvesting in their subsidiaries in China (hereinafter referred as the “New Requirement”). Virtually, the CHC in such situation would be deemed as taking the following two steps:

- (1) Distribution of dividend (out of its retained earnings) by the CHC to its foreign investor(s); and
- (2) Reinvestment of the dividend by the foreign investor as registered capital in the CHC.

Potential tax implications to CHCs and their foreign investors

If this is really the intention of the SAFE and Chinese tax authorities, it could give rise to the following potential tax implications, not only in China but also in the foreign investors’ tax jurisdictions.

- **Potential tax implications to CHCs**
Before the New Requirement was released, CHCs were allowed to reinvest their own profits in China (and other foreign sourced proceeds) in establishing a new subsidiary or making additional capital contribution to their subsidiary without having to first convert such profits to their registered capital. This is one of the benefits of having a CHC, as it allows CHC’s foreign investor(s) to reinvest profits in China without having to firstly repatriate such profits to the foreign investor (parent/holding company) outside China.

However, the New Requirement might change the whole landscape. From a Chinese tax compliance perspective, a CHC would now have the obligation to withhold Chinese Corporate Income Tax (“WHT”) on the deemed dividend income of its foreign investor, as it is derived by the foreign investor from the CHC, even though there is no payment of dividend in cash from the CHC to overseas.

- **Potential tax implications to the foreign investors of CHCs**
As said above, the foreign investors of CHCs would be subject to Chinese WHT on the deemed dividend derived from the CHCs. The foreign investors should also be mindful of the tax implications in their home countries arising from such deemed distribution of dividends. This would also defeat the tax benefit of having a CHC in China for the foreign investors by deferring the recognition of dividend income from the Chinese subsidiaries until and unless the CHC declares and pays out the dividend to the foreign investors.

PwC observations

- Recently, we put forward some key questions as well as our concerns to the SAFE drafters of Circular 7. We are given to understand that Circular 7 was issued for the ease of supervision and administration of CHCs’ reinvestments of domestic legitimate proceeds generated in China by tracking them through their Capital Accounts registered with the SAFE. One major reason is that these domestic RMB proceeds used for reinvestment are treated as foreign capital by special rules issued by the SAFE. The SAFE might not be aware of the complicated and undesirable Chinese tax implications arising from the New Requirement.
- We have not seen any supplementary announcements from the Chinese Ministry of Commerce (“MOFCOM”) or the Ministry of Finance (“MOF”) / the State Administration of Taxation (“SAT”). The MOFCOM is the authority governing the business, investment, utilization of retained earnings, etc, of CHCs, while the MOF/SAT are in charge of tax policies. The SAFE’s New Requirement appears to be trespassed into the jurisdictions of the MOFCOM and the MOF/SAT. It would be of course helpful if the authorities could reach a consensus and make it transparent to the CHCs as soon as possible.
- So far we have not seen any actions taken by local-level tax bureaus to require CHCs to withhold WHT on behalf of their foreign investors upon the reinvestments of the domestic legitimate proceeds by the CHCs. It might be possible that the local-level tax bureaus have not noticed such SAFE New Requirement or are not taking such interpretation arising from the SAFE New Requirement.
- The CHCs and their foreign investors may relate their concerns to the in-charge bureaus of the MOFCOM and MOF/SAT at local levels and hopefully the SAFE could adjust the New Requirement to rectify the potential tax implications.

We will continue to follow up the development on this issue closely and share with you any further details and insights in due course.

In the context of this News Flash, China, Mainland China or the PRC refers to the People's Republic of China but excludes Hong Kong Special Administrative Region, Macao Special Administrative Region and Taiwan Region.

The information contained in this publication is for general guidance on matters of interest only and is not meant to be comprehensive. The application and impact of laws can vary widely based on the specific facts involved. Before taking any action, please ensure that you obtain advice specific to your circumstances from your usual PricewaterhouseCoopers client service team or your other tax advisers. The materials contained in this publication were assembled on August 9 2011 and were based on the law enforceable and information available at that time.

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