Asia Pacific Tax Newsalert

A Washington National Tax Services (WNTS) Publication

China

August 17, 2011

Chinese Holding Companies face new requirements for reinvestment of certain proceeds

The China State Administration of Foreign Exchange ("SAFE") has recently issued new requirements for the reinvestment of domestic legitimate proceeds by a China Holding Company ("CHC") held by foreign investor(s).

Broadly, 'domestic legitimate proceeds' include profits of a CHC, reduction or withdrawal of capital, liquidation proceeds, share transfer proceeds, early repatriation of investment from a Chinese subsidiary, and other types of income.

Under the new requirements, CHCs will be required to convert 'domestic legitimate proceeds', including both domestic and foreign sourced proceeds, to their registered capital before reinvesting the proceeds in their Chinese subsidiaries.

As a result of the new requirements, CHCs will be deemed to have taken the following two steps:

1. Distributed dividends (out of its retained earnings) to its foreign investor(s); and

2. Reinvested the dividend by the foreign investor(s) as registered capital in the CHC.

The new requirements are contained in Circular Huizhihan [2011] No.7 ("Circular 7").

Potential tax implications

- **Potential tax implications for CHCs**

  Prior to the introduction of the new requirements, CHCs were permitted to use/reinvest their profits (both domestic and foreign sourced profits) to establish a new Chinese subsidiary or make additional capital contributions to their existing Chinese subsidiary without having to first convert such profits to their registered capital.

  Under the new requirements, since CHCs will be deemed to pay a dividend to their foreign investor(s), they will now be obligated to withhold Chinese Corporate Income Tax ("Chinese WHT") on the deemed dividend.

- **Potential tax implications to the foreign investors of CHCs**

  As set out above, a CHC's foreign investor(s) will be subject to Chinese WHT on the deemed dividend.

  The foreign investor(s) should consider the potential tax implications arising from the deemed dividends in their home countries.

Observations of the new requirement

- Circular 7 was issued to ease the supervision and administration of a CHC's reinvestment of domestic legitimate proceeds. This new requirement creates additional compliance obligations for CHCs and undesirable Chinese tax implications for foreign investors(s).

- The SAFE's new requirement appears to overlap the obligations imposed by other Chinese authorities such as the Chinese Ministry of Commerce ("MOFCOM") or the Ministry of Finance ("MOF")/the State Administration of Taxation ("SAT"). Perhaps these authorities could reach a consensus and relay that outcome to the CHCs as soon as possible.

- Thus far local-level bureaus have not required CHCs to withhold Chinese WHT on behalf of their foreign investor(s) with respect to the deemed dividend. The local-level tax bureaus might not be aware of the SAFEs new requirement or are not interpreting it as intended.

- The CHCs and their foreign investors may share their concerns to the local in-charge bureaus of the MOFCOM and MOF/SAT which could relay those concerns regarding the potential tax implications of the new requirements to the SAFE.

For more information, please do not hesitate to contact:

Your international tax service team in the U.S.

Rebecca Lei Wang	*(646) 471 7384*	*rebecca.l.wang@us.pwc.com*

Your international tax service team in China

National	*Cassie Wong*	*(8610) 6533 2222*	*cassie.wong@cn.pwc.com*
South	*Charles Lee*	*(86755) 8261 8899*	*charles.lee@cn.pwc.com*
North	*Edward Shum*	*(8610) 6533 2866*	*edward.shum@cn.pwc.com*
Central	*Peter Ng*	*(8621) 2323 8888*	*peter.ng@cn.pwc.com*