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# New SAFE regulation for foreign invested holding companies making reinvestment in China

China

05.07.2011

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As every foreign invested enterprise in China, Chinese foreign invested holding companies ("HoldCos") are allowed to use their legitimate income earned in China (including profits distributed by / received from its Chinese subsidiaries) to reinvest in China, i.e. to establish new companies in China or to increase the registered capital of their existing Chinese subsidiaries.

## 1. New requirement from the State Administration of Foreign Exchange ("SAFE")

On 29 March 2011, the PRC State Administration of Foreign Exchange ("SAFE") issued a Circular titled *Notice regarding Issues related to the Capital Verification Confirmation for Reinvestment Made by HoldCos*, i.e. Circular Huizihan [2011] No.7. The Circular took effect on 29 March 2011.

Under this Circular, before a HoldCo can reinvest its legitimate income earned in China (including profits from invested subsidiaries), the HoldCo must first increase its own registered capital by the same amount. That is to say, capital increase of the HoldCo itself is now a pre-condition for reinvestment of a HoldCo's legitimate income earned in China.

From a tax point of view, this means that foreign investor(s) of a HoldCo may have to pay 10% withholding tax in China because converting earnings into registered capital is regarded as a dividend distribution made by the HoldCo followed by a reinvestment of such dividends from its foreign shareholder(s).

## 2. Reaction from the Authorities of Commerce

The SAFE claims that the new Circular is based on Decree [2006] No. 3 of the Ministry of Commerce ("MoC"). However, Decree [2006] No. 3 only covers the situation where the foreign investor(s) of a HoldCo uses their legitimate income earned in China as capital contribution to the HoldCo. Decree [2006] No. 3 has no relevance for capital contribution made by a HoldCo to its subsidiaries. The SAFE may have misunderstood the earlier MoC Decree.

Like other capital increases of foreign invested enterprises, using earnings to increase the capital of a HoldCo is also subject to the approval from the competent Authority of Commerce. According to information we received from the Shanghai Authority of Commerce, currently, faced with the new regulation from the SAFE, they have been instructed by the Ministry of Commerce to temporarily suspend issuing such approvals until further notice from the latter.

For the time being, the SAFE and the MoC seem to have different opinions on this issue. They are reported to be in the process of coordinating with each other and working out a joint guidance.

## 3. Practical implications

Due to the fact that the Authorities of Commerce have suspended approving HoldCos to increase their registered capital by use of earnings, for the time being, HoldCos that intend to do so may have to wait until the MoC has coordinated this issue with the SAFE.

Alternatively, if time is essential, HoldCos may consider financing their new projects by other funds, such as its registered capital or a shareholder loan.

## KEY CONTACTS

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