



JONES DAY
COMMENTARY

TAX DEFERRAL ON REINVESTMENT BY CHINA HOLDING COMPANY RESTORED

On December 8, 2011, the Ministry of Commerce and the State Administration of Foreign Exchange jointly issued the Notice on Further Improvement of Administration of Foreign Invested Holding Company, Shang Zi Han [2011] No. 1078 (the “Notice”). The Notice clarifies that a foreign invested holding company may directly invest RMB profits derived from China into enterprises within China with the approval of foreign exchange authorities, which restores the tax deferral treatment on reinvestment by foreign invested holding companies.

“Foreign invested holding company” is a special form of Chinese resident company that is wholly or partially owned by one or more foreign companies and whose primary business is to invest in other Chinese companies. Such holding company is often called “China Holdco.” Many multinational companies use China Holdco to hold equity interest in China subsidiaries. On and after January 1, 2008, a nonresident enterprise is subject to a 10 percent withholding tax on dividends received from a China resident

enterprise. The withholding tax is generally exempted for dividends paid between two resident enterprises. As China Holdco is a China resident enterprise, the dividends paid by subsidiaries to China Holdco are exempt from tax. China Holdco can reinvest the dividends into other China subsidiaries without paying the withholding tax.

On March 29, 2011, the State Administration of Foreign Exchange issued the Notice on Operation Guidelines for Capital Verification Inquiry Concerning the Reinvestment by Foreign Invested Holding Companies, Hui Zi Han [2011] No. 7. The notice provides that a foreign invested holding company may reinvest its lawful income from China into enterprises within China after converting the income into the registered capital of the foreign invested holding company. After March 2011 and before the issuance of the Notice, many local foreign exchange authorities took a position that China Holdco can invest its profits in China only after the increase of China Holdco’s registered capital by converting its retained earnings

into registered capital. For tax purpose, such conversion is treated as dividend distribution from China Holdco to its foreign parent and then a capital contribution from the parent to China Holdco. As a result, the withholding tax would be imposed on the amount of reinvestment. As neither the Ministry of Finance nor the State Administration of Taxation is an issuer of the notice, the adverse tax implication of Hui Zi Han [2011] No.7 to China Holdco perhaps was unintended by the foreign exchange authority.

The Notice corrects the “mistake” or misinterpretation of Hui Zi Han [2011] No. 7. Now, China Holdco may either (1) directly invest its lawful RMB profits into enterprises within China or (2) convert the profits into the registered capital of China Holdco and then reinvest. The first option will allow China Holdco to reinvest China profits without paying withholding tax.

LAWYER CONTACT

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