

## China Tax Update – Issue No. 2004.111

### **AS CHINA GRADUALLY EASES ITS FOREIGN EXCHANGE CONTROLS, MULTINATIONAL COMPANIES OUGHT TO REVIEW ALL THE TREASURY OPTIONS AVAILABLE NOW.**



On October the 18<sup>th</sup> 2004, the State Administration for Foreign Exchange (SAFE) issued Circular 104 [Hui Fa (2004)] to offer multinational companies with more flexibility in treasury and financing among their member companies in and outside China.

In short, pursuant to the Circular, effective November 1, 2004, multinational companies may move its foreign exchange surplus among its member firms both within China as well as cross-boarder either through their own group financing company as a loan or through a designated bank in form of entrust loan.

#### **WATCH OUT: THE POTENTIAL TAX COSTS & SAVINGS COULD BE HUGE ...**

##### **□ RISKS**

For certain US corporations, the interest income earned on cross-border lending would be classified as Subpart F income and is subject to 35% US tax.

Worse, when your China venture lends money to its parent (or grandparent) company, in certain cases, the entire loan amount could be classified as deemed dividend under Section 956 loan of the US Tax Code and subject to 35% US tax.

##### **□ OPPORTUNITIES**

If you venture in China pays tax at 15%, you may want to consider lending the foreign exchange surplus to an affiliate in Japan (or other high-tax countries). Under this arrangement, the Japanese entity can claim interest expense (to reduce its tax at 42%) while your Chinese entity only needs to pay tax in China at 15%.

If you venture in China pays tax at 33% and it is invested through a intermediate holding company in a very low tax country (say, 5%), you may want to make a skip level Section 956 loan directly from China to the US (the grandparent company). By doing so, you can claim foreign tax credit at 33% (instead of 5%) to offset against your US tax liability...

## CIRCULAR 104 – CONTINUED: MORE DETAILED INFORMATION ...

### □ DEFINITION OF MULTINATION CORPORATION GROUP

The multinational corporations are defined in the Circular as those which having member companies within and outside China and a specific company in China responsible for regional or even global investment management functions for the group. Therefore, the Circular applies to both China domestic enterprise groups and foreign invested corporation groups.

Specifically, the Circular does not apply to financial institutions.

### □ QUALIFICATIONS & REQUIREMENTS

In respect to the loans between member firms within China, the lender and borrower shall comply with the following requirements:

- Both parties shall be legally registered and their registered capitals have been injected according to relevant schedule;
- All previous loans between the two party have been settled within the agreed terms;

For overseas lending, on top of the above, the following requirements shall also apply:

- For foreign invested corporation group, there shall be no less than 3 member companies within China;
- The ratio of foreign exchange receivable of the lending company of a foreign invested corporation group to its total foreign exchange assets, as well as its balance between the foreign exchange purchasing and settlement shall be lower than the industry's benchmark; In addition, the lending company shall have equity of at least USD 30 million, and its net assets value shall be no less of the total assets.

### □ RESTRICTIONS

The following restriction in implementation of the intra-group loan should be noted:

- The interest rate should be in line with the arm-length rate of peer market;
- The intra-group loan should be funded from the group companies' own foreign currency reserve only;
- Foreign exchange loans lent through entrusting arrangement shall not be settled into RMB or mortgaged for other RMB loans purpose;
- No offsetting between loans, payables, or receivables is allowable.
- Term for each overseas loan is capped at 2 years;
- In case the funds from overseas lending will be subsequently used for purpose of overseas investment, the loaner is required to submit a guarantee from its overseas parent company for a full repayment of the principal.
- In addition, the Circular further requires that the year-end overseas loan entitlement of the loaner company inside China shall not fall below the sum of the corresponding loan principals. Failure to meet this requirement may lead to the suspension on the overseas lending right.

An annual reporting to SAFE on the status of overseas loans is required for multinational corporation group having engaged in overseas lending for the period more than one year.

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