
Foreign-Invested Holding Companies in China Newly Subject to Unpublished SAFE Notice

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China's State Administration of Foreign Exchange ("SAFE") promulgated a notice on March 29 that may complicate the financial planning for foreign-invested holding companies¹ in China.

Document No. 7 (*Huizi Han* [2011] No. 7, entitled Notice of SAFE's Capital Projects Management Section Concerning the Dissemination of Operational Guidance on Relevant Issues Involving the Checking of Funds and Inspection of Certificates for Reinvestment by Foreign-Invested Holding Companies)² requires that all dividends, interest, liquidation proceeds and other income received by the holding company be treated as an increase to its registered capital before it can be reinvested in projects in China.

The requirement to reinvest income as registered capital is seemingly inconsistent with central government policy to encourage the establishment of holding companies. Document No. 7 also raises serious transparency concerns.

Foreign-invested holding companies are holding companies established in China which are at least 25%, and usually 100%, owned by foreign investors to manage their investments and provide services to their subsidiaries in China. Holding companies are barred from engaging in manufacturing or other types of production but may engage in trading (import and export), distribution and R&D. Because holding companies are subject to a \$30 million minimum registered capital investment requirement, and must already have at least one subsidiary in China, only larger multinationals with ambitious expansion plans in China tend to be interested in establishing holding companies.

The Chinese Government has issued several regulations in recent years to incentivize foreign investors to establish holding companies. Such foreign investors are generally larger and have the wherewithal to make substantial investments. Among the biggest incentives is increased leverage. Depending on the amount of registered capital, holding companies can borrow four to six times the amount of their registered capital. By contrast, even the largest foreign-invested companies generally have their borrowing capacity capped at twice the amount of their registered capital.

The requirement to reinvest income as registered capital is unnecessary as well as inconsistent with central government regulations that accord holding companies enlarged borrowing capacity. Indeed, requiring a company to increase its registered capital above minimum requirements is inconsistent with the Company Law, which eliminated mandatory registered capital requirements when it was amended in 2005. Moreover, a wholly foreign-owned holding company is subject to the requirement to allocate 10% of its annual after-tax profits to its company reserve fund before it can declare dividends to its shareholders, provided that the holding company is no longer required to make such allocation when the reserve fund reaches 50% of the amount of registered capital. The requirement to treat the amount to be reinvested as an increase to registered capital will result in a proportionate increase to the reserve fund, which will diminish a company's ability to declare dividends to its shareholder(s). This is inconsistent with the rules governing distribution of profits from all other types of companies under the Company Law and other regulations. While there may be some rationale for barring a holding company from declaring and remitting dividends until subscribed for registered capital has been fully contributed, there is no apparent rationale for maintaining the restriction after registered capital has been fully contributed. Moreover, registered capital of a holding company may not be withdrawn by its shareholders before the liquidation or dissolution of the company. As such, the requirement to reinvest through increases to registered capital makes such restriction more onerous.

Document No. 7 also suffers from a lack of transparency, despite China's transparency obligations under the World Trade Organization and bilateral commitments. It was issued to implement a 2006 Ministry of Commerce revision of its regulations on holding companies.³ No explanation appears to have been published for the multi-year delay. Issued on March 29, it has yet to be published and does not include an effective date, although SAFE officials will provide copies during in-person meetings, at which time they will explain that the effective date is April 1, three days after issuance.

Unless Document No. 7 is withdrawn or substantially revised, many foreign-invested holding companies will be forced to make capital-inefficient reinvestments of their income, delaying or reducing their ability to declare and repatriate dividends to their shareholder(s). They will find the holding company structure to be more costly and cumbersome than they had anticipated, which will reduce its attraction to other investors.

¹外商投资公司。

²汇资函[2011]第7号, 国家外汇管理局资本项目管理司关于外商投资性公司再投资所涉验资询证有关问题操作指引的通知。

³Supplemental Regulations Concerning Investment Companies Established by Foreign Investors [关于外商投资举办投资性公司的补充规定].

Authors



Lester Ross

PARTNER

Partner-in-Charge, Beijing
Office

✉ lester.ross@wilmerhale.com

☎ +86 10 5901 6588



Kenneth Zhou

PARTNER

✉ kenneth.zhou@wilmerhale.com

☎ +86 10 5901 6588