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Pilot Free Trade Zone Series – State Administration of Foreign Exchange issued policy on supporting the development of China (Shanghai) Pilot Free Trade Zone

Regulations discussed in this issue:

- *Circular on Issuing Implementing Rules for Foreign Exchange Control to Support the Construction of the China (Shanghai) Pilot Free Trade Zone*, Shanghai Huifa [2014] No. 26, issued by the Shanghai Branch of the State Administration of Foreign Exchange on 28 February, 2014.

Background

The Shanghai Branch of the State Administration of Foreign Exchange ("SAFE") recently issued the *Circular on Issuing Implementing Rules for Foreign Exchange Control to Support the Construction of the China (Shanghai) Pilot Free Trade Zone* (hereinafter "the Circular"), which sets out the administrative procedures in relation to the simplified formalities for foreign exchange related to direct investment, the relaxation of foreign debt management, the improvement of the centralised management of foreign currency by headquarters of multinationals, as well as foreign currency cash pool and international trade settlement centre etc. These new measures will create a better environment for foreign-invested enterprises ("FIE") to conduct cross-border trading and investments in China.

The Circular provides the following innovative measures on foreign exchange management:

Conversion of registered capital in foreign currency at will	<ul style="list-style-type: none"> • FIEs registered in the pilot Free Trade Zone in Shanghai ("pilot FTZ") can convert its registered capital in foreign currency into RMB according to its operational needs. • RMB converted from registered capital should be placed in a special deposit account, and shall be used on business related expenses, including payment of security deposit, repayment of used-up RMB loans, and payment for current account or approved capital account transactions. FIEs with investment as its main business can transfer such RMB funds to its invested enterprises based on the actual scale of investment. • Banks should review the authenticity of payment with such RMB capital, based on the principle of diligence. • The monthly cumulative amount for FIEs to use such RMB capital as reserve fund shall not exceed RMB 0.6 million. • Such RMB capital cannot be used for the following purposes:
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	<ul style="list-style-type: none"> ✓ Investing in Securities ✓ Issuing RMB entrusted loan ✓ Repaying of inter-company loans (including reimbursement to third parties), and repaying RMB bank loans transferred to third parties ✓ Investing in non-self-use real estate property
Centralised management of foreign currency, foreign cash pool and International trade settlement centre	<ul style="list-style-type: none"> • Qualified companies in the pilot FTZ (host companies) can apply for centralised management of foreign currency of its member companies inside and outside of China, including: <ul style="list-style-type: none"> ✓ Handling centralised payment for current account transactions for domestic member companies and settle payments on net basis ✓ Centralising exchange settlement for domestic member companies ✓ Centralising foreign debt quota for domestic member companies ✓ Opening a main account for international foreign exchange, which allows free overseas transfer of funds, as long as they are within the foreign debt quota and external lending quota, with a main account for domestic foreign exchange
Lending overseas	<ul style="list-style-type: none"> • The upper limit of lending overseas for companies in the pilot FTZ has been adjusted from 30% of shareholder's equity to 50%. • When providing external guarantees, companies in the pilot FTZ do not need administrative approval from SAFE, and are not subject to the requirements on the proportion of net assets between the guarantor and the guarantee, the guarantee's profitability status or correlation conditions on the guarantor's and the guarantee's equities.
Financial leasing service	<ul style="list-style-type: none"> • The administration of financial leasing services provided by financial leasing companies in the pilot FTZ to overseas has changed from approval to registration • Financial leasing companies in the pilot FTZ that provide financial leasing services overseas are not restricted to the current quota on lending overseas • Non-financial financial leasing companies in the pilot FTZ can receive rentals in foreign currency if the leasehold is purchased with over 50% foreign currency loans • Financial leasing project companies in the pilot FTZ can make remittance with the contract and commercial vouchers for the purchased planes, vessels and large equipments from overseas for leasing to the lessees domestic or overseas

KPMG Observations

The Circular offers substantive innovation measures to foreign exchange management, allowing FIEs to convert unlimited percentage of their registered capital in foreign currency into RMB. According to the current policy applied outside of the pilot FTZ regarding the conversion of registered capital in foreign currency, FIEs can only apply to convert registered capital in foreign currency into RMB when necessitated by payments to vendors for goods or services. In addition, FIEs are required to submit documents to prove the use of such RMB funds before the next conversion application. Such policy not only increases

the management cost for foreign currency conversion, but also exposes FIEs to exchange losses when exchange rate volatility is high, thus hampering fund management. The Circular gives FIEs the option to convert foreign currency capital into RMB at will, thus allowing FIEs to choose which currency they want to hold. However, FIEs should keep in mind that the RMB capital should be mainly used for business operation rather than non-operational investment or loan to others.

The other remarkable point of the Circular is the improvement it makes to the pilot policy of foreign currency pool. Prior to this, the policy for pilot foreign currency pool designed for multinationals to centralise their operating cash featured tough access requirements. This Circular relaxes the requirements for pilot FIEs to set up foreign currency pool, allowing those with headquarter-like operational centre or international settlement centre within the FTZ, which fulfil certain requirements and are equipped with complete internal controls and system for foreign currency management, and have no record of serious violation of laws or regulations in the last three years, to apply for centralised operational management of foreign currency of its member companies inside and outside of China, so that they can enjoy centralised receipt and payment for current account transactions as well as settle payments on a net basis. The current Chinese foreign exchange policy for non-FTZ FIEs requires that cross-border receipt and payment be settled separately. Such practice slows down the cash turnover to some extent as it takes time to provide commercial documents or declare income for remittance, and for funds received from overseas to be usable. Therefore, netting settlement is definitely a great change to foreign exchange management, which allows FIEs to improve efficiency in funds utilisation and reduce remittance costs. However, pilot enterprises are still required to provide commercial documents to banks for review, and declare international receipts and payments for all transactions involved in the netting.

In addition, the Circular adjusts the upper limit of lending overseas for companies in the pilot FTZ from 30% of shareholder's equity to 50%. It allows FIEs to directly remit their spare cash to overseas parent company or affiliates in the group rather than in the form of dividend distribution, thus helping the overseas parent company reduce its funding costs and defer Chinese withholding tax payment.

The Circular also supports the development of financial leasing businesses in the pilot FTZ, allowing non-financial financial leasing companies to receive rental in foreign currency in China, and simplifies the advance payment procedures for large finance leasing projects of planes and vessels etc.

In sum, the Circular provides more financing options and efficient foreign currency settlement methods to FIEs in the pilot FTZ. Thus, FIEs can optimise the structure of their various management functions according to the industry they are in, their business development needs and future plans, with a view to increase the competitiveness of their operation in China.

Khoonming Ho Partner in Charge, Tax China and Hong Kong SAR Tel. +86 (10) 8508 7082 khoonming.ho@kpmg.com	Northern China David Ling Partner in Charge, Tax Northern China Tel. +86 (10) 8508 7083 david.ling@kpmg.com	Joseph Tam Tel. +86 (10) 8508 7605 laiyiu.tam@kpmg.com	Zichong Xu Tel. +86 (21) 2212 3404 zichong.xu@kpmg.com	Grace Luo Tel. +86 (20) 3813 8609 grace.luo@kpmg.com	Rebecca Chin Tel. +852 2978 8987 rebecca.chin@kpmg.com
Beijing/Shenyang David Ling Partner in Charge, Tax Northern China Tel. +86 (10) 8508 7083 david.ling@kpmg.com	Vaughn Barber Tel. +86 (10) 8508 7071 vaughn.barber@kpmg.com	Anni Wang Tel. +86 (10) 8508 7518 anni.wang@kpmg.com	William Zhang Tel. +86 (21) 2212 3415 william.zhang@kpmg.com	Maria Mei Tel. +86 (592) 2150 807 maria.mei@kpmg.com	Kate Lai Tel. +852 2978 8942 kate.lai@kpmg.com
Qingdao Vincent Pang Tel. +86 (532) 8907 1728 vincent.pang@kpmg.com	Roger Di Tel. +86 (10) 8508 7512 roger.di@kpmg.com	Sheila Zhang Tel. +86 (10) 8508 7507 sheila.zhang@kpmg.com	Michelle Zhou Tel. +86 (21) 2212 3458 michelle.b.zhou@kpmg.com	Michelle Sun Tel. +86 (20) 3813 8615 michelle.sun@kpmg.com	Alex Lau Tel. +852 2143 8597 alex.lau@kpmg.com
Shanghai/Nanjing Lewis Lu Partner in Charge, Tax Central China Tel. +86 (21) 2212 3421 lewis.lu@kpmg.com	Kevin Lee Tel. +86 (10) 8508 7536 kevin.lee@kpmg.com	Tiansheng Zhang Tel. +86 (10) 8508 7526 tiansheng.zhang@kpmg.com	Cheng Dong Tel. +86 (21) 2212 3410 cheng.dong@kpmg.com	Hong Kong Ayesha M. Lau Partner in Charge, Tax Hong Kong SAR Tel. +852 2826 7165 ayesha.lau@kpmg.com	Benjamin Pong Tel. +852 2143 8525 benjamin.pong@kpmg.com
Chengdu Anthony Chau Tel. +86 (28) 8673 3916 anthony.chau@kpmg.com	Paul Ma Tel. +86 (10) 8508 7076 paul.ma@kpmg.com	Central China Lewis Lu Partner in Charge, Tax Central China Tel. +86 (21) 2212 3421 lewis.lu@kpmg.com	David Huang Tel. +86 (21) 2212 3605 david.huang@kpmg.com	Dylan Jeng Tel. +86 (21) 2212 3080 dylan.jeng@kpmg.com	Adam Zhong Tel. +852 2685 7559 adam.zhong@kpmg.com
Guangzhou Lilly Li Tel. +86 (20) 3813 8999 lilly.li@kpmg.com	Vincent Pang Tel. +86 (10) 8508 7516 +86 (532) 8907 1728 vincent.pang@kpmg.com	Anthony Chau Tel. +86 (21) 2212 3421 lewis.lu@kpmg.com	Amy Rao Tel. +86 (21) 2212 3208 amy.rao@kpmg.com	Chris Abbiss Tel. +852 2826 7226 chris.abbiss@kpmg.com	Darren Bowdern Tel. +852 2826 7166 darren.bowdern@kpmg.com
Fuzhou/Xiamen Maria Mei Tel. +86 (592) 2150 807 maria.mei@kpmg.com	Michael Wong Tel. +86 (10) 8508 7085 michael.wong@kpmg.com	Cheng Chi Tel. +86 (21) 2212 3433 cheng.chi@kpmg.com	Henry Wong Tel. +86 (21) 2212 3380 henry.wong@kpmg.com	Barbara Forrest Tel. +852 2978 8941 barbara.forrest@kpmg.com	Chris Kinsley Tel. +852 2826 8070 charles.kinsley@kpmg.com
Shenzhen Eileen Sun Partner in Charge, Tax Southern China Tel. +86 (755) 2547 1188 eileen.gh.sun@kpmg.com	Jessica Xie Tel. +86 (10) 8508 7540 jessica.xie@kpmg.com	Irene Yan Tel. +86 (10) 8508 7508 irene.yan@kpmg.com	Ho Yin Leung Tel. +86 (21) 2212 3358 ho.yin.leung@kpmg.com	Sam Fan Tel. +86 (755) 2547 1071 sam.kh.fan@kpmg.com	John Kondos Tel. +852 2685 7457 john.kondos@kpmg.com
Hong Kong Karmen Yeung Tel. +852 2143 8753 karmen.yeung@kpmg.com	Tracy Zhang Tel. +86 (10) 8508 7509 tracy.h.zhang@kpmg.com	Leonard Zhang Tel. +86 (10) 8508 7511 leonard.zhang@kpmg.com	Sunny Leung Tel. +86 (21) 2212 3488 sunny.leung@kpmg.com	Angie Ho Tel. +86 (755) 2547 1276 angie.ho@kpmg.com	Alice Leung Tel. +852 2143 8711 alice.leung@kpmg.com
	Abe Zhao Tel. +86 (10) 8508 7096 abe.zhao@kpmg.com		Christopher Mak Tel. +86 (21) 2212 3409 christopher.mak@kpmg.com	Jean Jin Li Tel. +86 (755) 2547 1128 Tel. +86 (592) 2150 888 jean.j.li@kpmg.com	Curtis Ng Tel. +852 2143 8709 curtis.ng@kpmg.com
	Eric Zhou Tel. +86 (10) 8508 7610 ec.zhou@kpmg.com			Jean Ngan Li Tel. +86 (755) 2547 1198 jean.li@kpmg.com	Kari Pahlman Tel. +852 2143 8777 kari.pahlman@kpmg.com
	David Chamberlain Tel. +86 (10) 8508 7056 david.chamberlain@kpmg.co m		Brett Norwood Tel. +86 (21) 2212 3505 brett.norwood@kpmg.com	Lilly Li Tel. +86 (20) 3813 8999 lilly.li@kpmg.com	John Timpany Tel. +852 2143 8790 john.timpany@kpmg.com
	Tony Feng Tel. +86 (10) 8508 7531 tony.feng@kpmg.com		Yasuhiro Otani Tel. +86 (21) 2212 3360 yasuhiro.otani@kpmg.co		Wade Wagatsuma Tel. +852 2685 7806 wade.wagatsuma@kpmg.com
	Li Li Tel. +86 (10) 8508 7537 li.li@kpmg.com		John Wang Tel. +86 (21) 2212 3438 john.wang@kpmg.com	Bin Yang Tel. +86 (20) 3813 8605 bin.yang@kpmg.com	Lachlan Wolfers Tel. +852 2685 7791 lachlan.wolfers@kpmg.com
	Alan O'Connor Tel. +86 (10) 8508 7521 alan.oconnor@kpmg.com		Jennifer Weng Tel. +86 (21) 2212 3431 jennifer.weng@kpmg.com	Penny Chen Tel. +86 (755) 2547 1072 penny.chen@kpmg.com	Jennifer Wong Tel. +852 2978 8288 jennifer.wong@kpmg.com
			Grace Xie Tel. +86 (21) 2212 3422 grace.xie@kpmg.com	Carter Li Tel. +86 (755) 2547 1069 carter.li@kpmg.com	Christopher Xing Tel. +852 2978 8965 christopher.xing@kpmg.com
			Bruce Xu Tel. +86 (21) 2212 3396 bruce.xu@kpmg.com		Karmen Yeung Tel. +852 2143 8753 karmen.yeung@kpmg.com