

CHINA TAX ALERT

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Pilot Free Trade Zone Series — Release of Implementation Rules for Account-based Settlement and Prudent Risk Management in the China (Shanghai) Pilot Free Trade Zone

Regulations discussed in this issue:

- *Circular on Trial Implementation of Rules for Account-based Settlement in China (Shanghai) Pilot Free Trade Zone and Rules for its Prudent Risk Management*, issued by the Shanghai Head Office of the People's Bank of China on 21 May 2014

Background

The Shanghai Head Office of the People's Bank of China (SHPBOC) recently issued the *Circular on Trial Implementation of Rules for Account-based Settlement in China (Shanghai) Pilot Free Trade Zone and Rules for its Prudent Risk Management* (hereinafter "the Circular"). The Circular specifies the requirements for the establishment of a free trade accounting unit, management procedures, free trade accounts (FTA) set-up and the use of capital. The Circular also provides details for the evaluation, verification and risk management of the free trade accounting unit as well as for monitoring any unusual capital transactions and contingent regulatory measures. The Circular took effect on 22 May 2014.

Key points of the Circular

According to the Circular, financial institutions in Shanghai may establish an internal risk control system and an account-based settlement mechanism. By building a special free trade accounts system (FTU), financial institutions can provide innovative financial services for the investment and financing activities of entities in the Shanghai Free Trade Zone (FTZ) and foreign institutions via their free trade accounts (FTAs), i.e. FTA-related financial services.

Financial institutions in the FTZ which carry out FTA-related financial services can open a special RMB clearing account with their corresponding domestic institution, which can be used for RMB clearing purposes via the intra-banking system. The SHPBOC puts in place strict controls on the end-of-day balance, end-of-month accumulative net balance and accumulative daily closing balance of special RMB clearing accounts. When the control systems of these financial institutions have received acknowledgment and approval from the SHPBOC, they can provide FTA-related financial services.

By establishing FTAs, qualified entities in the FTZ can effect cross-border capital transfer, as well as 'Limited Capital Permeation' with non-FTZ areas in China, including:

Entities available to open FTAs	<ul style="list-style-type: none"> • Entities established in the FTZ (including legal persons and non-legal persons) • Legal persons registered and established in foreign countries (including Hong Kong, Macau and Taiwan) and representative offices of other organisations in the FTZ • Chinese citizens working in the FTZ whose individual income tax has been withheld by their employers for more than one year • Foreigners (including Hong Kong, Macau and Taiwan) with foreign IDs, work permits in China and who have been working in the FTZ for more than one year
Usage of FTAs	<ul style="list-style-type: none"> • Capital transfer between FTAs and foreign accounts, and amongst institutional accounts outside the FTZ for non-residents. • Capital transfer (including under the same account name) between the FTAs and non-FTAs of domestic entities (including those established in the FTZ) shall be conducted in RMB, and treated as cross-border transactions. • The transfer of capital in RMB intended for the following can be conducted between FTA and non-FTA settlement accounts set up by the same company: <ul style="list-style-type: none"> ✓ Current account transactions ✓ Repayment of RMB loans with a duration of more than six months issued by Shanghai banking institutions ✓ New investments, mergers and acquisitions, capital increase, and industrial sector-oriented investments ✓ Other cross-border transactions stipulated by the SHPBOC. • The ending balance of FTAs is not subject to foreign debt control.

KPMG's observations

The release of the Circular indicates that the regulatory framework supporting the FTA management system that was introduced in the *Circular Opinions on Supporting the Development of China (Shanghai) Pilot Free Trade Zone* ("the Opinion") has nearly come to fruition, and the detailed implementation phase will commence for certain areas.

Areas currently regulated:

According to the current regulations, enterprises established outside the FTZ shall deposit funds into different accounts based on their source, designated usage and nature, and use such forex accordingly. According to the regulations introduced by the Circular, under the standardised FTA system, financial institutions can arrange for cross-border remittance using the FTAs after receiving collection and payment instructions from enterprises established in the FTZ. This will significantly improve the capital turnover rate and payment efficiency for entities in the FTZ.

In addition, the newly introduced arrangements for capital transfer within certain accounts of the same entity have shown support for the primary and industrial sector of the economy, in keeping with the risk control principle. As stipulated in the current regulations, RMB loans borrowed by foreign invested enterprises (FIEs) from overseas cannot be used to repay domestic RMB loans with domestic financial institutions, which to some extent limits FIEs' use of overseas funding. The Circular, however, allows enterprises established in the FTZ to use the funds in their FTAs to repay RMB loans with durations of over six months issued by Shanghai financial institutions by transferring funds through their accounts opened with the lending bank. Such measures greatly facilitate the utilisation of capital from domestic and foreign markets for FIEs.

To ensure the steady development of account-based settlement in the FTZ, the Circular states that FTA-related financial activities should be carried out in RMB for the first six months, and foreign currency may be introduced in due course after evaluation by the People's Bank of China and State Administration of Foreign Exchange.

It should be noted that financial institutions must establish a sound management framework for their account-based settlement activities, internal risk control system and precautionary measures regime, and file with the SHPBOC for an official evaluation based on their self-assessment. FTA-related financial services can be provided by financial institutions after the SHPBOC has acknowledged and approved their control systems. Meanwhile, financial institutions shall still closely adhere to the three principles (i.e. understand your business, understand your customers and maintain professional due care) when rendering financial services for FTAs.

Areas to be clarified:

Currently, loans borrowed from overseas are only to be used by FIEs for purposes incorporated in the registered business scope, and equity investment is generally prohibited. Such regulation has hindered the ability of those FIEs without investment functions in the business scope to carry out merger and acquisition activities in China. The Circular has now incorporated merger and acquisition and investment activities into the allowed usage of funds under FTA (i.e. within scope of 'Limited Capital Permeation'), however, it remains unclear whether entities in the FTZ need to have investment functions in the business scope to qualify for such treatment.

The Circular has also increased flexibility for the implementation of subsequent reforms, namely entities in the FTZ and financial institutions with an FTU can carry out activities outlined in part III of the Opinion. These include investment in domestic and foreign stocks and securities by residents and non-residents, the issuance of RMB bonds by foreign parent companies of the entities in the FTZ, investment in foreign stocks and financial derivatives by entities in the FTZ, and so on. Such innovative financing and investment activities would involve other relevant government authorities, and the detailed implementation rules are yet to be finalised.

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