

China in focus

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Impact of new regulations controlling forex inflow

The continuous inflow of forex funds into China has become a major concern of the Chinese government because of the potential impact on the stability of China's economy. In a bid to slow down the inflow of hot money, the State Administration of Foreign Exchange ('SAFE') has introduced new measures to tighten the administration of forex inflow through both current and capital account items. As clients encountered increasing difficulty with forex conversions into RMB, we briefly introduce the impact of Circular 142¹ issued on 29 August. Circular 142 basically provides that:

1. A capital verification report is compulsory for any conversion of forex capital into RMB, and the total amount of paid-up capital in forex should not exceed the accumulated paid-up capital which has been verified by a local CPA
2. Usage of the converted RMB should be within the business scope approved by the competent authorities, which does not include purchasing domestic real estate (except for the purchase of self-use property) and equity investment unless except as otherwise provided. A foreign holding company approved by the MOFCOM is the only exception in respect of equity investment. It is however unclear from the text of Circular 142 whether Foreign Invested Venture Capital Companies ('FIVCEs') are permitted to purchase equity interests in China. SAFE has since issued a internal reply to extend the exception to FIVCEs
3. Domestic institutions and individuals involved in M&A transactions should now collect consideration from the disposal of equity interest through a special forex account. Similar to conversion of paid-up capital by FIEs, the domestic institutions and individuals are required to disclose the usage of the converted RMB and provide valid supporting documentation
4. SAFE supervision over bank processing of FIE applications for converting paid-up capital into RMB and on-going inspection over the usage of such converted RMB is strengthened.

¹ the Circular on the Relevant Operating Issues Concerning the Improvement of the Administration of Payment and Settlement of Forex Capital of Foreign-invested Enterprises.

The new policies of Circular 142 will have a far-reaching impact on foreign investors and their FIEs in the following areas:

Conversion of forex capital

Before Circular 142, conversion of paid-up capital was a relatively straight-forward procedure as long as the amount in question is under USD200,000. In the practice, many banks did not require a capital verification report as a pre-condition for conversion. This new circular has, however, introduced tougher requirements which would impact FIEs, namely:

1. Given the stringent documentation requirements for conversion of paid-up capital into RMB, the FIE should make sure that valid documents are available to justify the conversion of paid-up capital into RMB for meeting the working capital needs of the company and achieving efficient cash-flow management
2. FIEs are required to prepare a payment order to the bank specifying the payees of the converted RMB. The FIE, together with its legal representative, has to declare that capital verification has been done and the converted RMB will be used within the approved business scope and according to the usage specified.

Investment by FIEs

Circular 142 specifies that unless the equity investment is within the approved business scope or is provided for elsewhere, an FIE cannot use the paid-up capital to make equity investment. Foreign investors who tend to use FIEs as a holding vehicle for equity investment in China need to be aware of the potential impact of Circular 142:

1. Asset acquisition by FIEs

Circular 142 is silent on the use of RMB converted from forex capital to acquire the assets, rather than the equity, of Chinese domestic enterprises. While the text of Circular 142 is open to interpretation, based on our telephone inquiries on a no-names basis with officials from the SAFE in Shanghai and Shenzhen, Circular 142 is not intended to prohibit asset investment using converted RMB. This will leave much room for FIEs to re-consider and design investment structures, such as the form of registered capital.

2. Equity investment activities through FIVCEs

Since FIVCEs and other investment vehicles are allowed to engage in equity investment activities as specified in their business scope, presumably they should not be subject to the restriction on the use of paid-up capital in forex for equity investment under Circular 142. This was confirmed by an internal reply issued by SAFE on 14 November 2008 which provided each domestic investment by a FIVCEs shall be approved by SAFE and the forex capital can be transferred into the special foreign capital account established by the investee under the supervision of SAFE. However, given the formation of the equity investment FIEs is still at a very initial stage, FIVCEs and foreign investors are advised to evaluate the measures very carefully to ensure compliance.

New incentives finally issued for encouraging multinational corporations to establish regional headquarters in Shanghai

On 15 November 2008, Shanghai Municipal Government issued critical detailed implementing provisions clarifying the incentives available to regional headquarters ('RHQs'). These go some way toward addressing the vagueness of the Regulations on Encouraging Multinational Corporations to Establish Regional Headquarters in Shanghai which were issued by Shanghai Municipal Government more than four months ago in July 2008.

Fiscal incentives

Special funds for encouraging the development of RHQs of multinational corporations in Shanghai will be set up to provide subsidies and fiscal support to RHQs in Shanghai.

- **Start-off cost subsidy**

RHQs in the type of holding companies which are newly registered in Shanghai or relocated to Shanghai will each be granted a subsidy of **RMB 5 million yuan** to support their start-off costs. The subsidy will be granted over the three years following the year of registration or relocation in the proportion of 40%, 30% and 30% over years one, two and three respectively.

- **Lease subsidy for premises**

RHQs newly registered in Shanghai or relocated to Shanghai will be granted subsidies for their lease over premises each year. The subsidy will be granted over three years in an amount equivalent to 30% of the rent. The standard for calculating such subsidy will be RMB 8 yuan per square meter per day.

If a newly-registered or relocated RHQ purchases or builds premises, it will receive a subsidy in one lump sum of an amount equivalent to the amount of the three-year lease subsidy.

- **Fiscal support**

RHQs recognised by the Ministry of Commerce as national-level RHQs will each receive a reward of **RMB 10 million yuan** if such RHQ is a holding company and at the point at which its annual turnover exceeds RMB 1 billion yuan, or **RMB 5 million yuan** if such RHQ is a management company and as soon as its annual turnover exceeds 500 million yuan. Such payment will be given in the proportion of 40%, 30% and 30% respectively over the subsequent three year period.

Simplified entry and exit formalities

- **Temporary entry**

Overseas foreign staff of foreign companies that have RHQs who need to enter China on temporary entrance visas may apply for one-year multiple entry visiting visas.

Foreign senior management personnel and highly skilled technical people may apply for two-to-five-year multiple entry visiting visas which allow stays upon each entry of one year.

- **Long-term residence in China**

Foreign legal representatives, general managers, deputy general managers and finance directors of RHQs may apply for five-year residence permits, their foreign department managers may apply for four-year residence permits and general foreign staff may apply for three-year residence permits.

The same conditions apply to foreign legal representatives, general managers, deputy general managers, finance directors, department managers and general staff of enterprises which are invested in or managed by the RHQs and have registered capital of at least USD 30 million.

Besides, spouses, parents and children younger than 18 years old with foreign nationality may also apply for residence permits with the same term as the above mentioned foreign personnel.

- **Travel to Shanghai under urgent circumstances**

Foreigners arriving Shanghai at the invitation of RHQs may apply for visas upon arrival.

- **Travel to Hongkong, Macao**

Staff of RHQs with Chinese nationality may apply for multiple entry permits to Macao and Hongkong.

- **Travel to Taiwan**

Local Shanghai Staff will be given priority in applying for Exit-Entry Permits to and from Taiwan.

This briefing is intended as general guidance and is not a substitute for detailed advice in specific circumstances.

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