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Revised Holding Structure Regime and New Opportunities

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Governing rules on the foreign-invested holding company (“**Holding Co.**”) have been undergoing relentless adjustment since its inauguration in 1995 pursuant to the original regulation¹. Substantial amendments² were introduced where former thresholds and restrictions were progressively lifted or relieved. On May 17, 2006, the MOFCOM amended the holding company rules once again³, granting more relaxation and wider business opportunities (“**Circular No. 3**”).

This issue of *CHINAjournal* reviews the legal regime for holding structure pertaining to foreign investment in China. Multinationals, while assessing the feasibilities of utilizing the new features under Circular No. 3, shall take account of alternative options, such as wholly foreign-owned consulting and management companies or foreign-invested commercial enterprises etc., for restructure or optimization purpose.

Incorporation Prerequisites

Having been trimmed down for several times, the thresholds for a Holding Co. retain largely three parameters, i.e.

- (i) The total assets of the foreign founder shall be no less than US\$ 400 m, and at least one FIE has been established with the paid-in capital above US\$ 10 m; *or* More than 10 FIEs have been established with the paid-in capital above US\$ 30 m; *and*
- (ii) The minimum registered capital of a Holding Co. shall be no less than US\$ 30 m.

Registered Capital Requirement

Foreign founders cannot simply convert existing paid-in equity capital of investee companies into the registered capital of a Holding Co. At least US\$ 30 m in the registered capital of a Holding Co. must be additional capital injection in the China-domiciled investee companies.

Foreign founders may make their capital contribution in convertible foreign currencies or in RMB. The RMB contribution should derive from foreign founders’ Chinese operation profits or from proceeds obtained through activities such as share transfer or liquidation etc. The RMB contribution must be verified by the SAFE on capital account forex transaction, and be accommodated with proof of tax clearance. When the Holding Co. uses such RMB capital to invest in investee companies, it does not need to once again go through SAFE’s forex verification.

At least US\$ 30 m capital has to be paid within 2 years of incorporation of a Holding Co. The rest must be paid off within 5 years.

Debts Finance

The maximal debts that a Holding Co. is able to incur depend on its registered capital. A Holding Co. with registered capital of no less than US\$ 30 m and less than US\$ 100 m is allowed to take on loans no more than 4 times of the paid-in registered capital, while a Holding Co. with registered capital of no less than US\$ 100 m is allowed to take on loans no more than 6 times of the paid-in registered capital.

¹ *Establishment of Companies of an Investment Nature by Foreign Investors Tentative Provisions*, promulgated by the MOFCOM on April 4, 1995 and effective as of the same date.

² Respectively in 1996, 1999, 2001, 2003, 2004 and 2005.

³ *Supplementing Rules on the Establishment of Companies of an Investment Nature by Foreign Investors*, promulgated by the MOFCOM on May 26 and effective as of July 1, 2006.

Regional Headquarter

In a 2004 revision⁴, the Holding Co. rules for the first time provided prerequisites and privileges for a Holding Co. qualified as a regional headquarter. A Holding Co. may obtain the status of regional headquarter, if

- (i) Its paid-in registered capital is not less than US\$ 100 m; or its paid-in registered capital is not less than US\$ 50 m, the total assets of its investee companies are not less than RMB 3 billion and the consolidated profits are not less than RMB 100 m;
- (ii) At least additional US\$ 30 m have been injected in the China-domiciled investee companies; and
- (iii) It has established R&D facilities in China.

The regional headquarter status entitles a Holding Co. to engage in specific business activities, which will be elaborated in details below.

Notably, local governments (Shanghai, Beijing, Suzhou or Canton etc.) have been striving to attract multinationals to place regional headquarters within their jurisdictions. Consequently, second-tier local regulations proliferate where the criteria for regional headquarter status are often less stringent than those quoted by the central government. Take Shanghai as an example⁵. A Holding Co. incorporated under national rules may obtain regional headquarter status in Shanghai if:

- (i) It has independent legal person status;
- (ii) Its parent company has total assets not less than US\$ 400 m;
- (iii) Its parent company has invested in China an aggregate amount of not less than US\$ 30 m;
- (iv) It invests in or is authorized to manage not less than 3 enterprises in- or outside China and it is charged with

management and service function in respect of such enterprises.

Furthermore, foreign founder may incorporate a so-called *management company* in Shanghai to carry out regional headquarter functions. Such management company does not need to qualify as Holding Co. under national rules and requires a minimum registered capital of US\$ 2 m.

As these local rules were put into force prior to the insertion of the regional headquarter provisions in the national regulation, the issue of confliction is rendered. For those regional headquarters qualified under local rules before the above-mentioned 2004 revision, no request has been ordered so far that such regional headquarters should retroactively comply to the national rules in order to retain their status and thus it is understood that such status recognition is grandfathered. Although it is expected that the local rules would be revised to conform to the national ones, no such action has been taken by the time of writing. Shanghai continues approving regional headquarters in accordance with its own standards. Naturally, the less rigorous Shanghai rules provide forum-shopping opportunities.

Nevertheless, it would become questionable when it comes to the privileges that a regional headquarter could enjoy. Shanghai could only grant benefits and incentives to the regional headquarters within its limit of power. For those privileges that require authority at national level, a regional headquarter status under the national regulation would still be indispensable.

Business Scope

The permitted business scope of Holding Co. has been expanded piecemeal along with the pace of business sophistication and paralleled legal development. An overview of the permitted activities of a Holding Co. is provided in Table 1 for easy reference. The new features introduced by Circular No. 3 are marked in bold.

⁴ Promulgated by the MOFCOM on February 13, 2004 and effective as of March 14, 2004.

⁵ *Encouraging the Establishment of Regional Headquarters by Foreign Multinational Corporations Tentative Provisions*, promulgated by the Shanghai Municipality People's Government on July 20, 2002 and effective as of the same date; *<Encouraging the Establishment of Regional Headquarters by Foreign Multinational Corporations Tentative Provisions> Implementing Rules*, promulgated by the Shanghai Municipality People's Government on March 1, 2003 and effective as of the same date.

	Category 1: All Holding Co.	Category 2: Holding Co. With Fully Paid-in Capital	Category 3: Holding Co. as Regional Headquarter
Permitted Activities	<ul style="list-style-type: none"> • Investing in the areas where foreign investments are permitted; • Establishing R&D centers, engaging in R&D of new products and hi-techs, transferring R&D results and providing corresponding technical services; • Providing consulting services to its parent; • Providing its affiliates with consulting services in the form of market info and investment policies related to its investment; • Promoting to establish foreign-invested joint stock companies or holding unlisted legal person shares; • Undertaking services outsourced by its parent or affiliates, as well as by overseas unrelated parties; • Engaging in im/export after fulfilling foreign trade right registration and handling export rebates; • Selling by commission agency or wholesale in China the imported or domestically acquired commodities; • Providing financial support to investees subject to CBRC approval; • As a foreign investor, making strategic investment in Chinese listed companies. • <i>Being entrusted in writing by its investee (unanimously adopted by the board of directors), to provide the following services:</i> <ol style="list-style-type: none"> (1) Assisting or acting as agent for investees to purchase machinery equipment, office equipment for self-use; (2) Assisting or acting as agent to purchase raw materials, components and parts for production; (3) Selling products manufactured by investees in both domestic and overseas markets, and providing after-sale service; (4) Balancing foreign exchanges among the investees upon the consent and under the supervision of the SAFE; (5) Providing services such as technical supports, personnel training, HR management in the process of production, sale and market development; and (6) Assisting to seek loans, and providing guarantee. 	<p><i>In addition to those under Category 1:</i></p> <ul style="list-style-type: none"> • Exporting Chinese products as agent, distributor or via establishment of procurement facilities and handling export rebates; • Purchasing products (those of the investees have the priority) for system integration and selling the final products in- and outside China (purchased value should not exceed 50% of the final value); • Providing technical training to local distributors or agents of investee's products or to local enterprises which enter into technology licence contract with its parent or affiliates; • Providing operating leasing services for investees in terms of machinery and office equipment or establishing operating leasing company; • Providing after-sale service for products it imports; • Participating in offshore construction projects of Chinese enterprises with requested overseas contracting right; • Selling in China (excluding retailing) its parent's products that it imports; • Before investees start production, importing related products for trial sale in China; • Entrusting domestic unrelated parties to produce or process its products or those of its parent for selling in- and outside China. • <i>Being entrusted in writing by its investee (unanimously adopted by the board of directors), to provide the following services:</i> <ol style="list-style-type: none"> (1) Distributing the products of its investees in- and outside of China; (2) Providing transportation, warehousing and other general services 	<p><i>In addition to those under Category 1 and 2:</i></p> <ul style="list-style-type: none"> • Importing and selling (excluding retailing) in China the products of its parent or affiliates controlled by its parent; • Importing raw auxiliary materials and parts required for providing maintenance services for the products of foreign parents or investees; • Undertaking services outsourced by domestic and overseas enterprises; • Engaging logistic services in accordance with related regulations; • Establishing finance company subject to the approval of CBRC, which may provide related finance service to the Holding Co. and its investees; • Subject to the approval of MOFCOM, engaging in offshore construction contracting business and offshore investment; • Subject to the approval of MOFCOM, engaging in operating and finance leasing business; • Entrusting domestic unrelated parties to produce and process any products for selling in- and outside China; • Engaging in processing trade business with 100% of the processed products to be exported; • Subject to the approval of SAFE, acting as forex cash pooling centre for investees; • Subject to the approval of SAFE, opening offshore account with local banks to manage the forex funds of overseas affiliates or the forex funds of investees which are approved to be loaned overseas.

Table 1

Investment

A Holding Co. used to be the only legal vehicle that is capable of utilizing entire capital in equity investment. Recent revision of the Company Law removes the 50% net assets value cap for investment by all other corporate forms, such as Equity Joint Venture or Wholly-foreign Owned Enterprises etc., enabling them as well to engage their entire capital in equity investment. In this aspect, the crucial advantage retained by a Holding Co. is that it may cover all business areas that are open to foreign investment, while the second-tier investment of a normal FIE is subject to the prescribed business scope of the investor FIE.

Foreign Trade and Distribution

The Foreign Trade Law 2004 revision grants in general the import and export right to all entities and individuals in China. For that account, Holding Co.'s foreign trade right is no longer exceptional.

However, Chinese law treats distribution separate from import/export. Ordinary FIEs are only permitted to import for own use and export for self-made products. Procurement, agent commission, wholesales, retails and franchising activities require special endorsement. As shown in Table 1, a Holding Co. is able to take on certain types of distribution functions, with limitation on the producer identity, exclusion of retailing, purpose of trade (trial sale or parts for maintenance), etc.

In this sense, the legal form of a Foreign-invested Commercial Enterprise ("FICE") provides more comprehensive trading facilities⁶. A FICE is eligible to distribute imported and locally-manufactured products throughout China by way of commission agency, wholesale, retail or franchise and to carry out a host of related ancillary services, such as assembly, sorting and grading of bulk lots, storage and warehousing and garage services, marketing, advertising and after-sale services etc. A FICE, although not without approval complication, is a much

cheaper vehicle with its minimal capital requirement in line with the Company Law, i.e. RMB 30,000, or US\$ 4,000. There is not any asset base test for the foreign founders. Instead, only soft parameters such as good reputation and no illegal records are in place. Therefore, using a stand-alone FICE or a FIE with business scope expanded to include full distribution right would be a quicker and cheaper fit for centralizing trading and distribution activities. For those Holding Cos. that are already existing, it might also be advisable to comply with the FICE rules to benefit from the full range of trade and distribution privileges.

Finance and Treasury Functions

Chinese law forbids direct inter-company lending, while loan business is monopolized by banks or financial institutions. To meet inter-group treasury needs under such a regulatory setting, company groups often leverage the entrustment loan facility, where a bank or trust company is involved as an intermediary between the lender and borrower. Alternatively, a group finance company could be established to provide financial services to group members, although the threshold for such group finance company is so high that very often it is not an affordable solution for many companies. A Holding Co. does not improve the situation a lot. As a group finance company is often not an alternative, entrustment loan arrangements are still the common fit.

Nevertheless, on the forex side, a 2004 regulation⁷ accords to Holding Co. the possibility to temporally lend excess foreign currency fund to related group entities. Domestic borrowing and lending is endorsed in the entrustment loan agreement without the necessity to secure prior SAFE approval. Contrarily, cross-boarder forex loan could be structured as direct lending while SAFE's approval is required case by case.

Furthermore, on a pilot basis, since October 2005 regional headquarters in Pudong New District in Shanghai are able to provide forex currency daily cash concentration among the affiliates. Surplus RMB balance may also be converted into

⁶ *Administrative Measures for Foreign Investment in the Commercial Sector*, promulgated by the MOFCOM on April 16, 2004 and effective as of June 1, 2004.

⁷ Circular Hui Fa [2004] No. 104, promulgated by the SAFE on October 18, 2004 and effective as of November 1, 2004.

foreign currency and loaned to offshore companies. Multinationals could also manage through an offshore account with a local bank the funds of overseas affiliate companies. All these transactions require previous SAFE approval. The pilot program enhances the ability of multinationals to effectively manage their international corporate treasury functions in China.

Shared Services

The services and activities entailed in a Holding Co.'s business scope make it feasible to use such vehicle for a shared service centre. As shown in Table 1, typical shared services that a Holding Co. is eligible to carry out include R&D, HR, technical support and personnel training, after-sale service, market research, operating leases of machinery, transportation, warehousing and other general services etc. Nevertheless, part of the services can only be provided on the condition that the board of investee company unanimously agree to such service provision by the Holding Co., which is not always without complication in the case of Sino-foreign joint ventures. In this sense, with a proper in-advance design of its business scope, a wholly foreign-owned consulting and service company might as well live up to the purpose to centralize back office and administrative functions and thus might be an alternative to a Holding Co. with much less capital and bureaucracy requirement. Service fees charged by a Holding Co. or a service and consulting WFOE to its affiliated in China are subject to a 5% business tax.

Chinese Tax Implication

Although a Holding Co. is an effective tool to collect various business functions under a common ceiling, it is not specially tax efficient. As a non-manufacturing legal entity, it cannot enjoy the income tax holiday or deductions that are accorded to normal FIEs in China, except that the Holding Co. is located in a special economic zone. China tax regime does not allow consolidating the income of all investees companies at the Holding Co. level. As dividends from investees are tax free, expenses or losses related to the investment (such as feasibility study, interest expense, compensation to managerial per-

sonnel and administrative expense etc.) are not deductible or chargeable to the investees. Furthermore, management fees incurred by a Holding Co. may not be allocated or charged to the investees.

Conclusion

A Holding Co. is an attractive legal vehicle for streamlining business operation, consolidating corporate governance, and integrating administrative functions. Recent regulatory manoeuvre have relaxed the limits and expanded the horizon. However, it remains a very expensive tool and sets high threshold to surmount. For shared service centre purpose, a service and consulting WFOE would be a valuable alternative and for distribution business, a FICE might provide a wider permitted business scope. In forging China's Holding Co. Regional Headquarter legal regime, local rules and practices play an instrumental role. Although a Holding Co. might be beneficial on the operational side, it is largely tax inefficient and thus requires a more careful assessment of the trade-off between various impacts and considerations.

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