CRA Insights: Transfer Pricing

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Financing of subsidiary operations in China

By Peter Guang Chen and Perry Urken

The liberalization of China's currency, the renminbi, is much discussed today in the Asian financial world. There is considerable excitement as to how freely trading the historically isolated currency of China can impact the global financial market in general and Asian financial markets in particular.

Over the last two years on an experimental basis, China started allowing the settlement in renminbi of cross-border trade between mainland companies and their foreign trading partners and the trading of renminbi. Since then, the trading of renminbi has skyrocketed in Hong Kong (HK) and other foreign currency markets. According to the Hong Kong Monetary Authority, the value of renminbis on deposit in Hong Kong bank accounts reached US$6.5 billion. According to February 28th edition of *The Wall Street Journal*, economists are projecting the level of renminbi deposits in HK to reach 500 billion and possibly a trillion by the end of the year. It is now also possible for some Chinese banks and companies to issue renminbi bonds, nicknamed "dim sum bonds," outside of China to raise funds.

However, just because there is a large supply of renminbi circulating in Hong Kong does not mean that companies can simply bring the renminbi into China for investment and financing purposes. One needs to obtain permission from the Chinese government to do so. Unless you know how to navigate the rules and have a convincing business case supporting your application to remit renminbi into China, obtaining that permission may not be easy. The Chinese government is wary of allowing too much currency of any kind—renminbi, US dollars, or other currencies—to enter China for fear of increasing speculation in its currency. The government fears that the renminbi will continue to appreciate and overheat the Chinese economy.

It is ironic that while some elements of the Chinese government's currency control system have liberalized, others have not. Indeed, some elements have become even more restrictive in practice due to the government's fear of "hot money" entering its markets. One such element that will continue to pose challenges to multinational companies operating in China is the financing of their subsidiaries' business operations within China. On a regular basis, foreign companies operating in China are faced with how to effectively finance working capital and expansion for their subsidiaries within the country. There are regulatory, tax, and transfer pricing implications that foreign investors must take into account.

Total investment vs. registered capital

As a practical matter, in most cases, a company desiring to do business in China would have to establish a limited liability company as its operating form because the Chinese government permits only a handful of business to operate in the form of a branch of a foreign company. The LLC in China is a corporation for legal purposes. In the process of forming the LLC, the foreign investor will be asked to present a business plan and propose a “total investment” amount that the Chinese Ministry of Commerce will have to approve. Concurrently, the “registered capital” amount of the proposed LLC has to be proposed and approved as well. This is a give-and-take process that includes the government’s review of the reasonableness of the business plan, a projection of the business volume, and the investment and working capital needs of the new company.

Depending on the size of the investment, there is a minimum registered capital requirement. Figure 1 shows the required minimum ratio of registered capital to total investment of the company.

Figure 1

Total Investment	Registered Capital/Total Investment Ratio	Registered Capital as a % of Total Investment
Less than US$3 million	At least 7:10	70%
From US$3 million to less than US$30 million	At least 1:2	Higher of 50% or US$2.1 million
From US$10 million to less than US$30 million	At least 2:5	Higher of 40% or US$5 million
Over US$30 million	At least 1:3	Higher of 33.33% or US$12 million

For example, if the total investment of the company is to be US$10 million, then the requirement is that the foreign investor has to put in at least US$5 million or 40% of the total investment amount, whichever is higher. Of course, a foreign investor may choose to put in the entire total investment amount in the form of registered capital, in which case it would be US$10 million.

Foreign currency loan

When the foreign investor finally gets the business plan approved and is issued a business license the new China LLC may function as its China subsidiary. The total investment and the registered capital amounts are expressly indicated on the business license. If in the future there is a need for the China subsidiary to obtain more funds from the foreign investor then the foreign investor will have to apply to have the business license amended and go through the process of submitting a business plan and documentation in order to again obtain the approval of the Chinese government. Depending on the type of business and the jurisdiction, the process of obtaining a business license can typically take anywhere from two to six months from the point of submission to the Chinese government authority assuming that all the required supporting documents are in order.

What is the benefit of not putting in the entire total investment as registered capital? One of the chief advantages is that it provides the foreign investor the option of financing some of the total investment amount as debt instead of equity. This is a potentially attractive option because the foreign investor is not legally committed to advance a loan to the new China entity. As a loan, the newly formed China subsidiary can pay interest and also make loan principal payments to the foreign investor. This gives the ability to the foreign investor to not have to leave all the funding the form of equity but can repatriate part of the funding and hence part of the subsidiary's profits in the form of loan interest and principal repayments. Otherwise, it is virtually impossible to obtain approval from the Chinese government to reduce the registered capital and repatriate even a portion of it back to the home country.

Another disincentive to having a higher registered capital amount is the capital reserve requirement. Each year, the Chinese subsidiary of a foreign company has to place 10% of its after-tax profits into a legal reserve account, up to a maximum of 50% of its registered capital amount. Therefore, the higher the registered capital amount of the China subsidiary, the higher the legal reserve account balance would be. This account essentially reduces the amount of profits the China subsidiary can pay out as a dividend to its foreign parent.

The difference or gap between the total investment and the registered capital amounts, as defined in the business license, is therefore the amount of foreign currency loan that the foreign investor may lend to the new China subsidiary being formed.

Say, as an example, our foreign investor obtains a business license to form a new China LLC. The business license indicates the total investment as US$10 million and registered capital as US$5 million. Also, the Chinese government authority has given the foreign investor a year to pay in the total registered capital of US$10 million. Therefore, when the new China LLC is formed, the foreign investor paid in half of the registered capital amount, or US$2.5 million.

Does this mean that the foreign investor can now simply inject $5 million as a foreign currency loan to the new China subsidiary since the gap on the business license is $5 million?

The answer is "no." There is a requirement that before the foreign investor can make a loan to the China subsidiary, the registered capital of the China subsidiary has to be paid in full. In practice, however, the responsible officials of the State Administration of Foreign Exchange (SAFE) in some Chinese jurisdictions have not enforced this rule, or they have interpreted it differently, to require only that the first installment of registered capital be "paid in" or by allowing a loan in an amount proportional to the amount of "paid in" registered capital.

Another hurdle is the method of computing how much gap the China subsidiary has. In computing the gap, both the outstanding balance of debt with repayment dates of one year or less and debt with repayment dates of more than one year have to be added together. The sum is what is to be deducted against the gap. The resulting difference is the amount still available. What this essentially means is that short-term debt may be re-borrowed once it is repaid, while mid- and long-term debt cannot.

Foreign currency loan registration and other procedures

Once the above hurdles are behind it, the foreign investor and the China subsidiary can enter into a foreign debt loan agreement. Procedurally, the loan must be registered with SAFE within 15 days after execution in order for the loan to be effective. A copy of the registration will have to be provided to any local bank that services the borrower. The consequences of failing to register a foreign debt loan, or having an invalid registration, can be dire: without a validly registered foreign debt agreement, the China subsidiary will not be able to remit interest and principal payments to the foreign lender.

In addition to registering the loan with SAFE, the China subsidiary must also obtain SAFE approval to set up a foreign currency loan account with the China subsidiary's bank. In all, the process of registration of the loan (getting approval for the setting up of the special account with the bank), can easily take two months or more, even in a city such as Shanghai.

In our example, our China subsidiary is still not home free. Once the China subsidiary has received the foreign currency loan proceeds into its loan account at the bank, it must obtain SAFE approval to settle the funds each time it wishes to draw on the loan proceeds. If the amount of the loan proceeds being drawn exceeds US$20,000, the bank will only remit the funds to the third party payee while amounts under US$20,000 can be deposited into the China subsidiary's renminbi account. The SAFE, in its discretion, may actually deny the request to draw on the loan proceeds if it finds that the use of the loan is not within the China subsidiary's business scope as indicated in its business license or that it is not consistent with the loan contract. This process of obtaining SAFE approval on loan drawdowns can take another 20 days, depending on the jurisdiction.

Renminbi loan from Chinese banks/entrustment loan

As an alternative to getting a foreign currency loan from its parent company, the subsidiary may consider obtaining financing in renminbi from a local Chinese bank. This route has the advantage of avoiding the cumbersome foreign currency restrictions and procedures.

Conceptually, the total investment as defined in the business license of the China subsidiary covers both equity and debt, and therefore encompasses any renminbi loan that the China subsidiary obtains locally. In practice, however, there has not been any effective regulatory enforcement on the renminbi debt that a Chinese subsidiary of a foreign company can obtain.

As a variation on the renminbi loan from a local Chinese bank, there is an arrangement known as an entrustment loan in which the foreign investor parent company deposits to a bank's branch or affiliate outside of China. The bank's branch in China then extends a loan in renminbi to the foreign investor's China subsidiary, drawing on the funds deposited by the foreign investor parent company. The bank will charge a commission on the transaction for the services it provides as a conduit of the loan from the foreign investor parent company to the China subsidiary. The "interest" charged by the bank against the China subsidiary would then be transmitted by the bank to the foreign investor parent company. As this cross-border entrustment loan arrangement can be viewed as a foreign currency debt, then the entrustment loan should be registered with the SAFE and would also be limited to the unused gap of the China subsidiary's foreign debt quota.

As for the tax implications, a cross-border renminbi loan can possibly result in double taxation. For example, while it is expected that a business tax should be incurred by the recipient of the interest income generated from a source in China such that the bank will incur a business tax when interest income is received from the China subsidiary, should a business tax then be again assessed when the bank ultimately transmits that same interest income to the foreign investor parent company overseas? Can the argument that the bank in this case is a mere nominee, with no real substantive stake in the transaction, be sufficient to avoid a double imposition of the business tax?

PRC tax issues of related party financing

With the enactment of the new Enterprise Income Tax Law in 2008, China now has a tax code version of thin capitalization rules. In September 2008, regulations were issued to provide two sets of debt to equity ratios for related party borrowings: one for financial institutions, another for all other enterprises. For financial institutions, the debt to equity ratio cannot exceed 5:1.For all other enterprises, the debt to equity ratio cannot exceed 2:1.If the taxpayer's debt to equity ratio exceeds 2:1, the effect is that a pro-rata portion of the interest accrued on the portion of the loan exceeding the 2:1 ratio will be disallowed, with the disallowed portion carried over to the next year. However, even if a taxpayer's debt to equity ratio exceeds 2:1, the taxpayer may apply for approval of the deduction of the excess portion of the interest if it can be documented that the related party loan is made at arm's length. Since the current Enterprise Income Tax law applies universally to all Chinese companies, the thin capitalization rules will apply to the related party borrowing of foreign-owned entities whether the related party debt is denominated in foreign or Chinese currency.

Under Chinese transfer pricing rules, the terms and conditions of the related party borrowing should be set at arms' length such that they are consistent with those that a commercial bank in China would extend in similar circumstances.

When a Chinese subsidiary makes an interest payment to its foreign investor parent company, the payment is subject to a Chinese income withholding tax. The current withholding tax rate is 10%, which can be reduced if an applicable tax treaty applies. In April 2011, the State Administration of Taxation (SAT) issued Announcement 24, which provided that the income tax withholding obligation will apply at the time the interest expense is accrued on a loan, even if the actual payment of interest to a foreign lender has not yet been made. In addition to the income tax withholding, the interest payment is also subject to a 5% business tax.

Some China advisors have advocated the use of related party transactions as a method of funding by a foreign investor parent. As suggested examples, the Chinese subsidiary can provide goods, services, and intellectual property to the parent at a markup, for which it can receive and settle foreign currency payments from the parent company. The advantage gained is that unlike a foreign currency loan from the foreign investor parent, which is classified as a capital account transaction, the export of goods, services, and intangible property are considered current account transactions. The procedures required to receive and settle foreign currency payments on current account are much simpler and faster.

Still, it is necessary to exercise a high degree of caution in structuring these transactions with an awareness that negative tax consequences can result if the transactions are not conducted with sound tax transfer pricing principles in mind. As with other transfer pricing issues, the regulations of both relevant governments apply. For example, a China subsidiary provides services to its foreign parent company in exchange for a service fee. To the extent that the service fee is higher than what an unrelated party would charge, then the China subsidiary will incur enterprise income tax of 25% and business tax of 5.5% on the service fee income, on both the reasonable portion and amount in excess, while the foreign investor parent is at risk in any transfer pricing audit by its tax authority. The cost of obtaining funding in this case can be high, not to mention the increased tax risk caused by the transactions.

Peter Guang Chen
Vice President
Hong Kong
+852-8127-7500
pchen@crai.com

Perry Urken
Vice President
Washington, DC
+1-202-662-3944
purken@crai.com

www.crai.com/transferpricing