



Crossing international boundaries

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Recent Developments on RMB Internationalization

Internationalization of Renminbi (“RMB”) is the Chinese government’s long term objective. The 12th five-year plan emphasizes continued interest in making RMB a regional or global trade settlement currency. In addition, measures have been introduced to gradually allow using RMB for outbound investment and inbound investment into China. The ultimate goal is for RMB to be recognized as an international reserve currency.

Hong Kong's unique relationship with China has always made it the preferred entry point into and out of China for investment purposes in the last few decades. We will briefly discuss in this newsletter how some recent developments will strengthen Hong Kong’s position as an international financial centre and develop Hong Kong into a major RMB offshore centre.

I. “Step up Co-operation for Development and Prosperity”

During a recent visit to Hong Kong, China’s Vice Premier Li Keqiang delivered his speech titled “Step up Co-operation for Development and Prosperity” at the Forum on the 12th Five-Year Plan” and PRC- Hong Kong Economic, Trade and Financial Cooperation on August 17th 2011. The speech focused on the important role of Hong Kong in overall national development, introducing a platform for a series of new policies aimed at extending the economic co-operation between PRC and Hong Kong. The State Administration of Foreign Exchange (“SAFE”) and the Ministry of Commerce (“MOFCOM”) have also recently released several circulars covering details on the implementation procedures for the use of cross-border RMB funds for foreign direct investment (“FDI”) projects.

"To maintain Hong Kong's long-term prosperity and stability is the starting point and an objective of the Central Government's policy on Hong Kong. These two long-term goals are closely inter-connected. They bear on the fundamental interests of Hong Kong and the country as a whole, and represent the common aspiration of all Chinese people." (Quoted from the original speech).

Mr Li indicated that under the requirements of the 12th Five-Year Plan, the PRC Central Government has, in keeping with the realities and with its long-term perspective, adopted a number of new policies and measures designed to support Hong Kong's development and deepen economic and financial co-operation between the Mainland and Hong Kong. He has further

emphasized the importance on strengthening Hong Kong as an international financial centre and developing Hong Kong into a major RMB offshore centre. Below listed are some of the main points covered in this aspect:

- RMB bond issuing will be made as a regular offering in Hong Kong;
- The issue size of RMB bonds will also be increased gradually with Mr. Li pointing out the size of the upcoming issue has reached RMB20 billion;
- The PRC Central Government will allow mainland enterprises to issue RMB bonds in Hong Kong and expand its issue size;
- To further increase the RMB deposits in Hong Kong in the coming years;
- Allowing Hong Kong stocks exchange-traded funds to be listed in the Mainland;
- Allowing small RMB Qualified Foreign Institutional Investors to utilize RMB capital in Hong Kong for PRC investments.

II. Recent Regulatory Changes

As mentioned above, the Chinese authorities have been releasing new circulars covering details on the implementation procedures for the use of cross-border RMB funds laying the foundation of the RMB internationalization movement.

For trade settlement currency, a number of regulations/circulars have been issued since 2009, including:

1. Measures for the Administration of Pilot RMB Settlement in Cross-border Trade; Customs, Ministry of Commerce, Ministry of Finance, People's Bank of China, State Administration of Taxation, Public Announcement [2009] No. 10, July 1, 2009;
2. Implementation Details on Measures for the Administration of Pilot RMB Settlement in Cross-border Trade, Yinfa [2009] No. 212, July 3, 2009;
3. Notice of the People's Bank of China, the Ministry of Finance, the Ministry of Commerce, the General Administration of Customs, the State Administration of Taxation and the China Banking Regulatory Commission on the Relevant Issues Concerning the Expansion of Pilot RMB Settlement in Cross-border Trade, Yinfa [2010] No. 186, June 17, 2010;
4. Rules On Pilot Scheme For RMB Settlement For Overseas Direct Investment Announced, January 14, 2011;
5. Circular On Clarifying Relevant Issues Regarding Cross-Border RMB Business, June 3, 2011.

The coverage of the RMB Trade Settlement scheme has been expanded from Hong Kong, Macau and ASEAN countries to all overseas countries and regions. In China, the scheme now covers Beijing, Tianjin, Inner Mongolia, Liaoning, Shanghai, Jiangsu, Zhejiang, Fujian, Shandong, Hubei, Guangdong, Guangxi, Hainan, Chongqing, Sichuan, Yunnan, Jilin, Heilongjiang, Tibet and Xinjiang.

Companies in these provinces/cities in China can now settle their product imports, service trades and other current account transactions in RMB, further to an additional list of eligible companies which will be able to settle their merchandise exports in RMB as well.

As for investment currency, RMB fund raising outside of China (especially in Hong Kong) has been one of the hottest topics for foreign investment in China. Below listed are some of the more recent circulars covering the topic:

1. Circular of The Ministry Of Commerce On Issues Concerning Foreign Investment Administration, Shangzihan(2011) No.72, February 25, 2011;
2. Circular On Clarifying Relevant Issues Regarding Cross-Border RMB Business, Yinfa [2011] No. 145, June 3, 2011.

Bringing back of RMB into mainland China by way of FDI first arose in the second half of 2010, subject to approval of People's Bank of China on a case by case basis. Circulars have then been issued step by step covering the application details and procedures for RMB FDI in the non-financial industries by way of setting up a new enterprise, acquiring a domestic enterprise (excluding acquisition by a foreign investor that is controlled by a PRC person or entity), equity transfer, capital injection and shareholder loans. The Circular provides procedures on how to apply for approval. Ongoing circulars are expected to be issued in order to strengthen supervision on RMB internationalization movement.

Huizhongfa [2011] No.38 (“Circular 38”) - SAFE

On April 7th, 2011, SAFE has released Circular 38 covering certain implementation issues in relations to cross-border RMB capital items. This circular is issued to further elaborate on the implementation details after the initial launch of the pilot run of RMB settlement on cross-border trading transactions. Circular 38 covers the implementation details on the following:

1. Outbound investment in RMB;
2. FDI in RMB;
3. RMB loan lending / borrowing by PRC entities to / from overseas subsidiaries; and
4. Cross-border RMB security related items such as dividend payment and capital gain derived from equity investment to overseas shareholders.

In view of the above, the ability for settlement of FDI in RMB, together with the settlement of cross-border trading in RMB will in no doubt enhance the volume of flow of RMB funds in the international market. This is definitely one of the significant steps towards RMB internationalization.

The Draft Circular on Use of RMB for FDI - MOFCOM

On August 22nd, 2011, MOFCOM released a draft circular (for public comments) on issues concerning cross-border RMB for FDI. The draft circular introduces a regulatory framework for foreign investors to follow in using RMB funds that they have “legitimately” obtained outside of the PRC for FDI projects. The public input process ended on August 31, 2011.

The Draft Circular defines “cross-border RMB FDI” as direct investment made by foreign investors according to PRC laws by using offshore RMB funds legitimately obtained by the

foreign investors. Offshore RMB funds that may satisfy the legitimacy requirements include but are not limited to the following:

- RMB payments for cross-border trading transactions;
- RMB bonds or shares issuance overseas; and
- RMB payments received by foreign investors from their PRC subsidiaries, including RMB profits, transfer of equity interest, loans, recoup of investment, liquidation and repayments from reduction in the registered capital.

The Draft Circular explicitly prohibits foreign investors from using offshore RMB funds to purchase onshore financial derivatives, entrusted loan financing or loan repayment both inside and outside China or to purchase securities listed on stock exchanges in the PRC, whether directly or indirectly.

As for PRC real estate projects, while it is allowed for foreign investors to use RMB for direct investment in this industry, certain existing regulations for approval and filing requirements generally applicable to foreign-invested real estate development projects must still be met.

The Draft Circular also lays out the approval procedures and requirement with MOFCOM at both municipal and provincial levels for using offshore RMB funds for FDI projects. It is noted that certain designated FDI projects will still require MOFCOM's approval.

III. Hong Kong – Gateway for China

Hong Kong's unique relationship with China has made it the preferred entry point into and out of China for investment purposes in the last few decades. Statistically speaking, Hong Kong provides almost half of China's inbound and outbound investments. According to statistics released by the Ministry of Commerce, for the period from January 2010 to July 2010, Hong Kong was the largest investor to China's Mainland, with an actual foreign capital up to USD35.95 billion, accounting for 62% percent of all foreign investment (totalling USD58.35 billion) in China during that period. As for outbound investment from China, the overall investments to Hong Kong alone similarly accounted for over 50% of the overall sum (totalling USD26.75 billion) during the same period.

In view of the strong financial and legal infrastructure and the uniqueness in terms of geographic location, Hong Kong has always been the most logical choice to be one of the main offshore RMB centres for Asia and beyond. It is widely expected that Hong Kong's economy will receive a strong push in light of the internationalization of RMB and the continuous economic growth of China in the near future.

Below are some statistics in relations to Hong Kong RMB business (Source Hong Kong Monetary Authority):

1. Hong Kong's RMB business started as early as 2003.

2. Total RMB deposit amounted to RMB150 billion as of Sep 2010, and RMB217 billion as of Oct 2010.
3. 2.2 million RMB demand and savings accounts opened as of Oct 2010.
4. In 2010, China's RMB trade settlement: RMB 506 billion (with 73% handled by banks in Hong Kong: RMB 370 billion).
5. For 1st Quarter 2011, China's RMB trade settlement: RMB 360 billion (with 86% handled by banks in Hong Kong: RMB 310 billion).
6. Hong Kong's RMB estimated trade settlement volume will reach RMB2.2 trillion by 2020. This is the same size as Hong Kong's total trade in all currencies today. (Source: HSBC in-house estimates)

RMB internationalization signifies a new era of rapid growth in China's economic relationships with the rest of the world and Hong Kong is in the best position to be part of this new era.

IV. Our Comment

Banks in Hong Kong have upgraded their systems to cater for using RMB as international trade settlement currency. Non-Chinese companies all over the world are encouraged to open RMB accounts in Hong Kong. The volatility of the USD and Euro would induce more companies to consider using RMB as the international trade settlement currency.

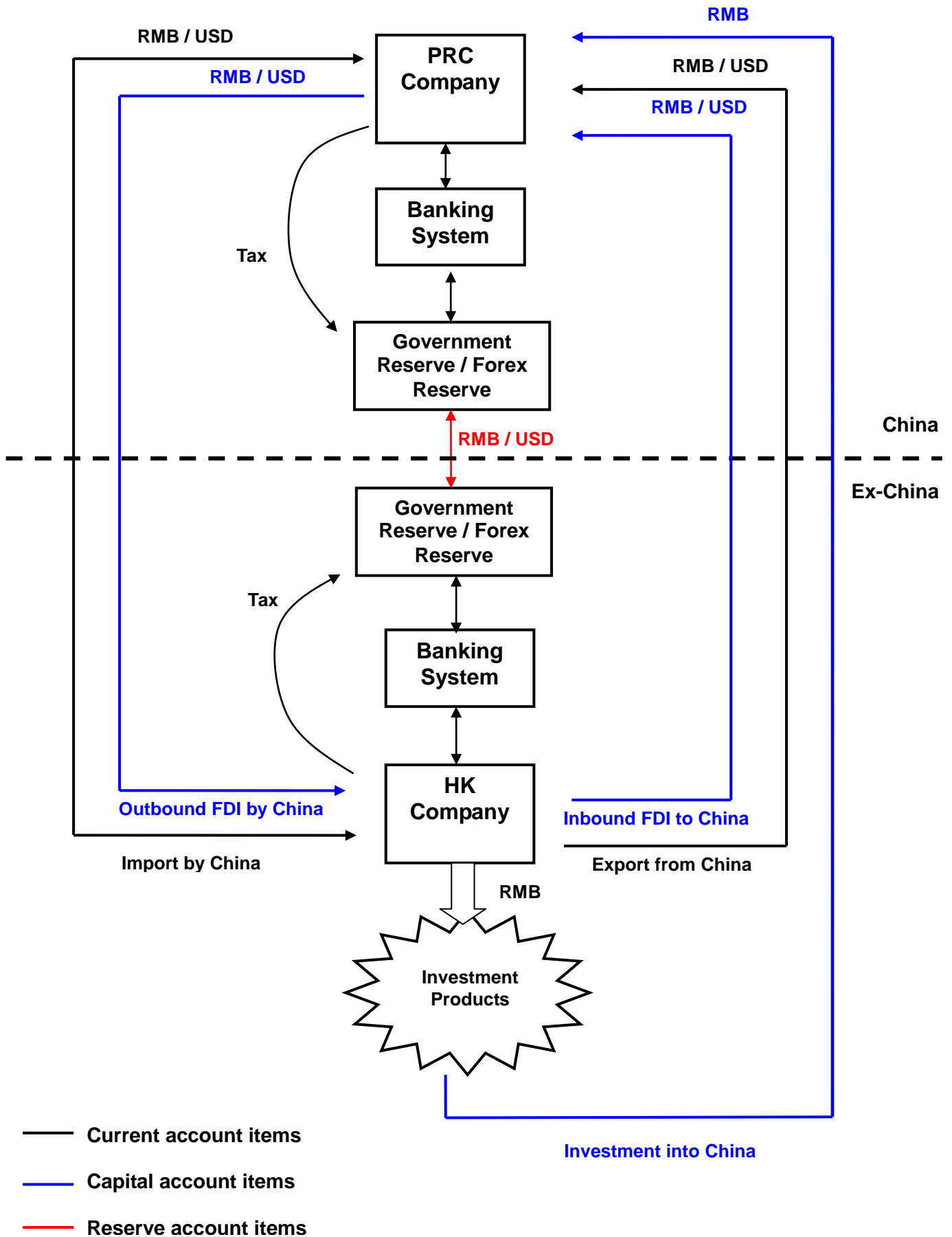
More RMB denominated investment and insurance products will be introduced, including government and corporate bonds, Hong Kong listed stocks, Hong Kong listed derivatives, insurance-linked investment products, private equity funds, etc. All these would enhance investors' interest in receiving RMB through trade settlement and holding RMB for investment purposes.

The prevailing PRC regulations on exchange control will be relaxed to accommodate flowing back of RMB into China economy through current account items, including FDI as well as other investments and loans. Recent SAFE circulars and MOFCOM circulars pave ways for FDI and loans under a stringent approval process. We anticipate foreign investors would gradually be free to choose their investment currency in respect of investing into China. By that time, RMB could be considered as a hard currency (convertibility is not relevant as RMB can be used for both current account items and capital account items).

Financial sectors in Hong Kong including commercial banks, stock exchange, investment banks, private equity firms, insurance companies and supporting professional services will all benefit from new businesses in relation to the offshore RMB centre.

Hong Kong's unique relationship with China, its sophisticated banking system and its position as a global/regional financial centre make it the optimal location to serve as the leading offshore RMB centre. Cash flow cycle of an offshore RMB cycle is depicted as follows:

Cash Flow Cycle – Offshore RMB Centre



V. Implications to Businesses

Companies conducting business with China are recommended to review the current transaction mode and to consider if any change in transaction currency (i.e. using RMB as transaction currency) would be required. Factors to consider include:

- Foreign exchange risk and hedging policy
- Timing of the change
- Using RMB as a company's functional currency
- Using RMB as a company's presentation currency
- Accounting treatment of the change in functional and/or presentation currency
- Tax implications

It becomes a common practice to set the total investment/registered capital of a foreign investment enterprise in terms of RMB instead of USD/HKD in light of the continued depreciation of USD/HKD against RMB. This could establish the tax basis of the investment in terms of RMB at the prevailing exchange rate. Gain on disposal or liquidation in the future could be reduced, compared with setting the total investment/registered capital in terms of USD/HKD.

RSM NELSON WHEELER TAX ADVISORY LIMITED

RSM Nelson Wheeler's dedicated and experienced tax specialists can:

- Advise on tax efficient holding and operational structures for new cross-border investment, including the formation of Hong Kong and Chinese business entities
- Review existing cross-border investment structures, advise on identified deficiencies, quantify any potential exposure from such deficiencies, and further advise on restructuring approach and procedures
- Assist clients to discuss and clarify matters with tax officials, including transfer pricing and advance rulings
- Act as client's representative in tax audits and tax investigations
- Provide transaction support services on mergers and acquisitions, including tax due diligence, deal structure advice, tax health checks, related human resources arrangements and other tax compliance and consultation services
- Advise on human resources and structuring employment arrangements in a tax-efficient manner
- Provide tax compliance services for individual and corporate clients in Hong Kong and China

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