

# Tax Analysis

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## PRC Tax

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### A Break-Through Development in Shanghai for Foreign-Invested RMB Funds

On 11 January 2011, the Shanghai Municipal Financial Services Office, the Municipal Commission of Commerce and the Municipal Administration for Industry and Commerce jointly released long-awaited guidance that will facilitate the formation of partnerships by foreign private equity investors and the conversion of foreign currency into renminbi (RMB) for the purpose of making investments. The Implementation Measures on the Pilot Program for Foreign-Invested Equity Investment Enterprises in Shanghai ("Pilot Measures"), which become effective 30 days from the release date, provide guidance on the formation and operation of foreign-invested equity investment entities (commonly known as foreign-invested RMB funds) and foreign-invested equity investment management entities (commonly known as foreign-invested general partners or GPs).

The Pilot Measures clarify related rules and regulations and mark an important milestone to attract foreign-invested RMB funds to Shanghai. The measures will promote Shanghai as a financial center and is the first city in the nation to create a unified authority that specializes in and handles emerging operational issues for foreign-invested RMB funds.

### Summary

The Pilot Measures introduce the pilot program for foreign-invested RMB funds and foreign-invested GPs and provide guidance on how qualified foreign-invested RMB funds/GPs can participate in the program, the application and set-up procedures, and supervision and management obligations. Qualified foreign investors of foreign-invested RMB funds eligible to participate in the pilot program include sovereign funds, pension funds, endowment funds, charitable foundations, fund of funds, insurance companies, banks, securities companies, and other entities approved by the Joint Committee. An application to participate in the program must be submitted by the GPs of a foreign-invested RMB fund or a foreign-invested RMB fund that is to be formed to the Municipal Financial Services Office, which is the main approval and oversight department for the Pilot Program. Although the Pilot Measures do not require a fund to have a domestic GP, it is generally believed that it will be very difficult to set up a fund with a foreign GP.

According to the Pilot Measures, a qualifying GP is allowed to use foreign currencies to invest in an RMB fund it sets up. However, the amount invested may not exceed 5% of the capital of the RMB fund without changing the nature of the RMB fund. Where all other partners of such an RMB fund are domestic

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investors and the GP's foreign currency investment does not exceed 5% of the capital of the RMB fund, it is our understanding that the RMB fund may be considered a domestic entity in Shanghai. It is unclear, however, whether the "domestic entity" status will be respected by other provinces in the PRC.

The Pilot Measures allow a foreign-invested RMB fund and GP to be established in the form of a partnership. Various provisions set out the qualifications and set-up procedures with respect to the legal form, business scope and capital requirements of the entity. However, the following points should be noted:

- As noted above, the Municipal Financial Services Office will be the responsible bureau, which will approve the set up of foreign-invested RMB funds and GPs.
- An application to set up a GP as a company must be submitted to the Municipal Commission of Commerce and an application to set up the RMB fund and GP as a partnership must be submitted to the Municipal Administration for Industry and Commerce. The Pilot Measures are silent on the procedures to set up an incorporated RMB fund.
- All capital contributions must be in cash. Foreign investors are allowed to invest with the RMB generated within China.
- A GP must have a minimum capital of USD 2 million regardless of its legal form. Further, 20% of the committed capital must be funded within three months of receiving a business license, and the remainder funded within two years.
- There continue to be restrictions on where a foreign-invested RMB fund can invest, i.e. it may not invest in industries where foreign investment is prohibited by the State or in other investment activities identified in the Pilot Measures.
- The foreign-invested RMB fund must use a qualified bank as the custodian to hold its funds.
- The foreign exchange conversion procedures are simplified once a Pilot Program application is approved. The foreign-invested RMB fund only needs to go to the custodian bank to convert foreign currency to RMB before making an investment -- additional approval from the State Administration of Foreign Exchange (or its local branches) is not required.

It is also our understanding that the relevant government departments are developing operating guidelines, implementation rules and procedures that will be published in the near future.

#### Issues to be Further Clarified

- The Pilot Measures do not specify any limit on the extent of foreign investment permitted in a foreign-invested RMB fund. It appears that the government will approve the foreign quota on a case-by-case basis, although it is generally understood that foreign investment should not exceed 50%.
- The Pilot Measures do not comment on tax issues.
- The Pilot Measures do not provide guidance on how capital gains and the original investment amount received by the RMB fund upon disposal of an investment may be distributed to the foreign investors.
- The Pilot Measures do not provide guidance on which banks will qualify as custodian banks.

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