Fight against hot money creates new risks for traders

China once welcomed foreign exchange inflows; now, hot money is threatening its developing economy. To control the flow of trade funds, the regulator has set requirements for compliance with rules on advance payments and deferred receipt of payments. The new rules could lead to tax losses and fines for exporters. By David Wang, Chris Yang and Chris Chen, Broad & Bright Shanghai Office.

The *Circular on Issues Concerning the Implementation of Registration and Administration of Foreign Claims Related to Goods Trade Items of Enterprises* (Document No. 56) was recently issued by the State Administration of Foreign Exchange (Safe) and reflects the Chinese government's further strengthening of control and administration over the flow of funds involved in the trade of goods. It lays out specific formality requirements that business players should be aware of when complying with both the *Operation Guidance for Administration of Trade Credit Registration (Advance Payment Part)* and the *Operation Guidance for Administration of Trade Credit Registration (Deferred Payment Part)*, also issued by Safe.

On July 14 2008, Safe promulgated its *Circular on the Issues Concerning the Implementation of Registration of Foreign Debts under the Goods Trade of Enterprises* (Document No. 30) to clarify the relevant issues involved with the registration of foreign debts. Four months later, Document No. 56 went into effect. It requires foreign-related credit rights under the trade in goods to be registered, too. Document No. 56 and Document No. 30 are like two sides of the same coin, reflecting the Chinese government's intention to regulate not only the inflow, but also the outflow of funds under trade of goods so as to try to balance international payments within China and especially restrain the flow of refugee capital.

TWO WEAPONS AGAINST HOT MONEY

As a developing country which was lacking funds for development, China used to be eager to absorb the inflow of foreign exchange while strictly curbing foreign exchange payments and foreign-related debts. However, more and more hot money has been surging into China to make speculative transactions, primarily in the Chinese stock market and real estate market. Aware that this could cause a bubble in the Chinese economy, governmental authorities began enacting rules to examine the actual usage of the inflow of foreign exchange and severely punish hot money inflow in the name of "foreign investment," "transaction payment," and so on. For example, the amendment to the *Foreign Exchange Administrative Regulation*, which was promulgated on August 5 2008, stipulates that foreign exchange and foreign exchange settlement funds under the capital items shall only be used for the purposes approved by the competent department and Safe, all illegal proceeds will be confiscated, and fines of no more than 30% of the misused amount will be imposed upon the person in violation of the regulation. Under serious circumstances, larger fines may be imposed. Since the incoming channel for capital investment is closed, international speculators have turned to foreign debt under the trade of goods, such as advance payments for exports and deferred payments for imports. Document No. 30 was therefore promulgated in order to prevent the speculative funds from circulating through trade and commercial credits. In addition to Document No. 30, the corresponding rules for penalties have also been enacted, which stipulate that violations against Document No. 30 will be deemed as violations of foreign exchange administration in respect to foreign debt.

However, as the global economic crisis begins to affect China, the financial situation, especially with respect to foreign exchange, is gradually being transformed. According to the statistics of the Foreign Exchange Reserve, the added foreign exchange reserve in August and September 2008 is even less than the sum of the foreign trade surplus and the foreign direct investment into China. Moreover, overseas players are beginning to find new ways to transmit their Chinese foreign exchange back out of China to relieve their own financial pressure. It was reported that China might be facing the threat of hot money totalling over one trillion US dollars escaping in 2008. Apart from the influence of the financial crisis, the escape of hot money may also have contributed to the slump in the A-share market and the inactive real estate market in China over the past few months. The Chinese government issued Document No. 56 in order to monitor the flow of funds and prevent the intensive outflow of speculative funds which may result in a heavy blow to the Chinese economy.

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Document No. 30 can be described as a double-edged sword. Its implementation, which was intended to curb the inflow of hot money, is regarded as a hit to the shrinking exportation business of some small- and medium-scale exporters.

Such exporters used to charge a 30% advance payment for exportation in order to purchase raw materials and other necessary goods. Document No.30 creates a dilemma for such exporters: if they charge a higher percentage of advance payment, only part of the payment can be settled before the exportation is completed; if they charge a lower percentage of advance payment, they may risk experiencing fluctuations in the exchange rate or other contractual risks. In addition, the implementation of Document No. 30 might also tie up a large portion of the exporters' cash flow.

A BLOW FOR EXPORTERS

As China's importation industry scale is much smaller than its exportation one, the regulation on deferred receipt of payment as stipulated in Document No. 56 might be more overwhelming to exporters than importers.

A noticeable consequence of failing to register the deferred receipt of payments is that the relevant foreign exchange received in the account for the authority or the bank's examination may not be settled and exchanged into *renminbi* or otherwise transferred. In other words, the exporter will not be able to go through the receipt verification of the foreign exchange payment and obtain the receipt verification of foreign exchange payment for export, which is necessary for the application for VAT refund of such export. According to the *Circular of the State Administration of Taxation involving Relevant Issues of Tax Refund (Exemption) Administration of Exported Goods*, promulgated on May 31 2004, when applying to the relevant taxation authority for a tax refund (exemption), an exporter shall submit the receipt verification of foreign exchange payment for export, which is used exclusively for export tax refund, within 180 days after the date on which the goods are declared for exportation (that is, the export date listed in the customs declaration for exported goods). Without the receipt verification of foreign exchange, the relevant exported goods shall be deemed domestically sold. The exporters shall pay the VAT and other taxes accordingly or shall return the refunded tax amount. The Circular involving the Period in which the *Receipt Verification of Foreign Exchange Payments for Export Provided by Export Enterprises*, promulgated on May 5 2008, extends the aforementioned 180-day period to 210 days. If the registration of deferred receipt of payment cannot be completed within such period, exporters might face a considerable tax loss, which is generally a significant profit resource for them.

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Safe has not yet clarified how to deal with the paid deferred payment without registration. If such deferred receipt is later defined as not having been received, the exporter will not be able to complete the verification procedure for such foreign exchange payment. Consequently, according to the *Implementation Rules of the Administrative Regulations on Receipt Verification of Foreign Exchange Payment for Export* (Implementation Rules), effective from October 1 2003, the exporter will be subject to fines ranging from Rmb50,000 (US$7,300) to Rmb300,000. If the paid deferred payment is deemed as received, but is incapable of being verified, according to the Implementation Rules, the exporter shall be subject to fines ranging from Rmb10,000 to Rmb30,000. In short, apart from the above-mentioned tax loss, exporters who do not register the deferred receipt of payments will also likely be subject to considerable fines.

On the other hand, if the importer fails to register the advance payment, thereby also failing to complete the verification of foreign exchange payment for import within the prescribed period, fines ranging from Rmb1,000 to Rmb300,000 will be imposed pursuant to the *Interim Measures for Treatment of Failure of Verification of Payment Receipt for Export and Payment for Import Within the Prescribed Period*.

KEY POINTS OF THE NEW AND OLD CIRCULARS

Document No. 30

- *Circular on the Issues Concerning the Implementation of Registration of Foreign Debts under the Trade in Goods of Enterprises*
- Promulgated July 14 2008
- Punishment against non-registration of advance receipt of payment and deferred payment

Document No. 56

- *Circular on Issues Concerning the Implementation of Registration and Administration of Foreign Claims Related to Goods Trade Items of Enterprises*
- Promulgated October 30 2008
- Non-registration of deferred receipt of payment will not result in VAT refund
- Fines between Rmb50,000 and Rmb300,000 for deemed non-received deferred payments; and fines between Rmb10,000 and Rmb30,000 for deemed received but unverified deferred payments
- Without registration of advance payments, possible fines of between Rmb1,000 and Rmb300,000
- Provides guidance for registrations of advance payment and deferred receipt of payment

PRACTICAL GUIDANCE FOR IMPORT AND EXPORT TRADING COMPANIES

To make Document No. 56 more practicable, Safe also issued the *Operation Guidance for Administration of Trade Credit Registration (Advance Payment Part)* (Guidance for Advance Payment) and the *Operation Guidance for Administration of Trade Credit Registration (Deferred Payment Part)* (Guidance for Deferred Receipt of Payment) on November 5 2008 and November 15 2008, respectively. Import and export trading companies in China should pay special attention to the following points in Document No. 56 and the two pieces of Guidance:

(i) Relevant dates

If a contract containing an advance payment provision is entered into on or after November 15 2008, or the advance payment is made on or after that date, both the contract and the advance payment shall be registered in the specific online system. The corresponding triggering date for contracts containing deferred receipt of payment provision is December 1 2008.

(ii) Quota

Both advance payments and deferred receipt of payments shall be limited to their respective maximum quota, which shall be determined by Safe according to the registration and cancellation situations of the previous advance payments and deferred receipt of payments. As most export and import trading companies do not now have history of registering advance payments and deferred receipt of payments, their maximum quota of advance payments shall generally be no more than 10% of the foreign exchange payment for imports during the last 12 months. For companies importing large-scale sets of equipment, such portion shall not exceed 30%. No such portion is stipulated in the Guidance for Deferred Receipt of Payment.

(iii) Consequence of failure of registration

If a company fails to register advance payments, the bank will not allow it to purchase and pay foreign exchange with respect to such advance payment. The purchase and payment of foreign exchange can be made on the proper date if the type of foreign currency, the name of the payee, etc. are identical to those recorded in the registration system.

If a company fails to register deferred receipt of payment, the relevant foreign exchange received in the account for the examination may not be settled and exchanged into *renminbi* or transferred otherwise. According to the *Measures for the Online Examination of the Collection and Settlement of Foreign Exchange in Export* (Measures), promulgated by Safe on July 2 2008, the examination system will generate the amount of foreign currency receivable corresponding to the export of this enterprise on the basis of the data in relevant customs declaration for export and the registered data for advance payments, taking into account the enterprise's trade as well as the features of the industries involved. Where the applied-for amount of foreign exchange settlement or transfer exceeds the aforementioned receivable amount of foreign exchange generated in the examination system, the bank shall not approve or deal with the settlement or transfer procedure. Accordingly, the deferred receipt of payment shall not be collected without prior registration. However, it is not clearly stipulated in Document No. 56, Guidance for Deferred Receipt of Payment, or the Measures how the unregistered amount of deferred payment will be dealt with, i.e. returned or settled through supplementary registration.

(iv) Registration formalities

The advance payment registration includes the following four steps:

(1) Contract registration shall be made within 15 working days after the execution of import contract, in which the advance payment provision is stipulated. Where no such provision is stipulated, contract registration shall be made within 15 working days before the advance payment is actually made;

(2) Foreign exchange payment registration shall be made within 15 working days before the advance payment is to be made. Foreign exchange payment registration shall be completed for advance payment after the contract registration is completed;

(3) The importer shall designate a bank of foreign exchange payment in the registration system before the advance foreign exchange payment, which has been registered and confirmed by the relevant branch of Safe, is made so that the registered information of such advance payment may be available to that bank. Otherwise, it is not allowed for any bank to make relevant foreign exchange payment; and

(4) If the goods under the registered advance payment were declared to be imported, but no goods are imported and the foreign exchange payment is returned, the importer shall apply for advance payment registration cancellation within 15 working days after the relevant customs declaration is issued or the foreign exchange payment is returned. Thereafter, the quota taken up by such advance payment shall be cleared and further advance payment may be registered.

Four similar steps are applicable to the registration of deferred receipt of payment as well. In addition, the circumstances under which the registered deferred receipt of payment may be cancelled are: (a) return of exported goods; (b) foreign exchange proceeds which are approved by Safe to be stayed outside China; and (c) other circumstances under which the foreign exchange payment is not to be received.

Safe will not limit the flow of funds necessary for normal cross-border trades.

(v) Return of advance payment

If the goods are not imported and the relevant advance foreign exchange payment is to be returned, or if the returned amount is larger than the registered amount of advance payment due to the reason of interest or exchange rate fluctuation, the registration system will automatically pick the smaller amount of the two for cancellation.

(vi) Manual confirmation

Temporarily, Safe does not control the deferred receipt of payments and all the registered deferred receipt of payments will be confirmed by Safe in full. However, if the registration is rejected by the registration system due to the insufficient quota of deferred receipt of payment, the unregistered deferred receipt of payment listed in the registration system may still be manually determined by the relevant branch of Safe. Such branch of Safe may make its determination based on the truthfulness of the trade by examining the written application, the foreign exchange income and settlement condition of the last 12 months, main provisions of relevant export contract, the relevant customs declaration, and the registered information in the registration system. Such criteria are also applicable to the registration of advance payment.

(vii) Supervision

Relevant branches of Safe will conduct supervision and offsite examination of the registration, usage and cancellation of the advance payments for importers under any of the following circumstances:

(a) Where the advance payment exceeds 20% of the foreign exchange payment for imports of the last 12 months;

(b) Where the import date is delayed for more than one year and the advance payment balance exceeds US$5 million; or

(c) Where the expected import date regarding the advance payment is frequently changed.

The corresponding circumstances applicable to deferred receipt of payment are read as follows:

(a) Where the basic proportion for deferred receipt of payment exceeds 20%;

(b) Where the expected date of receipt of payment is delayed for more than one year and the deferred receipt of payment balance exceeds US$5 million; or

(c) Where the manual determination of deferred receipt of payment registration is frequent (three times in each month) and the relevant amount is large (exceeding US$1 million each time).

For advance payment registration which has not been cancelled within 30 days after the registered expected date without reasonable cause, or deferred receipt of payment registration which has not been cancelled within 90 days after the registered expected date of foreign exchange receipt, Safe will pay attention thereto and make onsite examination when necessary.

In sum, the registrations of advance payments for import and deferred receipt of payments for export stipulated in Document No. 56 and the two subsequently issued pieces of Guidance do provide a way for Safe to check the truthfulness of foreign-related credit rights and prevent speculative hot money from leaving China in the form of advance payment or deferred receipt of payment. While curbing the abnormal outflow of funds without true trading background, Safe will not limit the flow of funds necessary for normal cross-border trades. However, there are always problems in practice. It is likely that further detailed interpretations of Document No. 56 and the pieces of Guidance will be issued in order to help clarify some uncertain issues.