瀚一律師事務所
HAN YI LAW OFFICES

China Regulatory Updates

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Shanghai Office
Suite 4103, II Grand Gateway
3 Hongqiao Road
Shanghai 200030, China
Tel: (86-21) 6448-5600
Fax: (86-21) 6448-5611

Beijing Office
Suite 311, Tower E1
Oriental Plaza
Beijing 100738, China
Tel: (86-10) 8518-5580
Fax: (86-10) 8515-3818

www.hanyilaw.com

1. MOFCOM Further Delegates Its Approval Authority over Certain Categories of FIEs to Lower Level Offices

On May 4, 2009, the PRC Ministry of Commerce (“MOFCOM”) issued a circular to further delegate its approval authority over foreign invested enterprises (“FIEs”) engaged in several service and natural resource areas to local level MOFCOM offices at the provincial, municipal and various nation-level economic & technological development zones. The circular has become effective upon its issuance. The service areas covered by the circular include: (i) Sino-foreign equity/cooperative medical treatment joint ventures; (ii) auction enterprises; (iii) distributors of books, newspapers and magazines; (iv) wholesalers of audio & visual products in the form of a Sino-foreign cooperative joint venture; (v) foreign invested mineral exploration enterprises (excluding oil and gas); and (vi) various mineral exploitation enterprises (excluding oil and gas).

Prior to the release of this circular, all foreign investments in the aforesaid six areas used to be subject to central MOFCOM’s approval regardless of their total investment amounts.

2. CSRC Revises Two Listing Related Rules

On May 13, 2009, the China Securities Regulatory Commission (“CSRC”) released the revised *Measures on Issuance Examination and Approval Committee of the CSRC* and the revised *Measures on Administration of Sponsorship for Securities Issuance and Listing*, both of which will take effect on June 14, 2009. These two revised regulations further regulate the issuance and examination mechanism and the listing sponsorship in connection with the GEM board. They are substantially the same as the draft released earlier (*please refer to the May 2009 issue of Han Yi’s China Regulatory Updates for more details*).

3. Approval Authority over Certain Forex Capital Account Items Decentralized

On May 6, 2009, the PRC State Administration of Foreign Exchange (“SAFE”) issued the *Circular on Delegation of Approval Authority over Certain Forex Business under Capital Accounts*, which took effect on June 1, 2009. With an aim to facilitate investment process and shorten approval cycles, SAFE has delegated to its branch offices the approval authority with respect to capital account opening by applicants from other locations, provision of security interest to foreign entities, and other eight categories of capital account forex matters.

According to this circular, purchase or redemption by the open-end China funds set up by a QFII in an amount greater than USD50 million per month on a net basis will be examined and approved by the local SAFE office at the place where such QFII's custodian is located.

4. Draft Rules on Forex Matters Related to Offshore Investment Published for Comments

On May 18, 2009, SAFE released the draft *Regulations on Administration of Foreign Exchanges Related to Offshore Direct Investments Made by Domestic Entities* for public comments. The draft is highlighted with the following:

(a) Domestic entities will be able to source forex funds for offshore investments from more channels, including, without limitation, self-owned forex funds, domestic forex loans, forex purchased with RMB, property or profits retained overseas;

(b) The sources of forex funds for offshore investments and remittance of forex funds will no longer need to be examined and approved. Instead, only a registration with SAFE would be required;

(c) Domestic entities will be able to extend loans and provide financial guarantees to their offshore investee companies;

(d) The treatment and administration principles with respect to the overseas retention or repatriation of income derived from offshore investees are further specified; and

(e) The "joint annual inspection" for offshore investments will be established together with MOFCOM in an effort to improve the overall supervision of the forex administration for such activities.

5. More Regulations on EIT Issued

The PRC State Administration of Taxation has recently issued a series of circulars, separately or jointly with the Ministry of Finance, to further clarify issues related to enterprise income tax ("EIT") treatments and various tax incentives provided under the *PRC Enterprise Income Tax Law*. The circulars mainly involve company reorganization and liquidation, EIT holidays and incentives, and enterprises with operations in multiple locations. Among them, the following three circulars are noteworthy for their investment implications:

(a) *Circular on Issues Related to the Recognition of PRC Controlled Foreign Enterprises Based on Their Effective Management Organs ("Circular #1")*

Pursuant to Circular #1, any enterprise incorporated outside of China with a PRC company or group company (*instead of individuals*) as its controlling shareholder (the "Offshore Company") should pay EIT to Chinese government for its global income, if its senior management team and decision makers actually reside and discharge their duties in China, and its material assets and records are also maintained or placed in China. Nonetheless, the Offshore Company's PRC investees will continue to be taxed as foreign invested enterprises.

The Offshore Company will be entitled to EIT exemption for returns on equity investments received from any other resident enterprise within China if they fully satisfy certain conditions. The Offshore Company's PRC investors will not need to pay EIT for dividend income received from it. However, dividends received by its foreign investors should be subject to the relevant PRC withholding tax.

(b) *Circular on Implementation of Enterprise Income Tax Incentives Applicable to Venture Capital Investment Enterprises ("Circular #2")*

Pursuant to Circular #2, if a venture capital investment enterprise ("VCIE") with legal person status makes equity investments in small and medium-sized unlisted hi-tech enterprises, it will be entitled to a deduction of its taxable income in an amount equal to 70% of the amount of investment that has been held for at least 2 years in such investees, <u>provided</u> that, each of such hi-tech enterprises should meet the following requirements: (<u>i</u>) the hi-tech enterprise status has been duly certified and recognized; (<u>ii</u>) its headcount is no more than 500; and (<u>iii</u>) both the annual sales revenue and the total asset value are no more than RMB200 million.

Compared to a policy statement on the similar subject matter issued in February 2007, Circular #2 has nationwide effect and clearly confirms the eligibility of foreign invested VCIEs for the aforesaid incentives. But it is by no means applicable to VCIEs without legal person status.

(c) Circular on Enterprise Income Tax Treatments for Corporate Restructuring ("Circular #3")

Pursuant to Circular #3, the EIT treatments for corporate restructuring are categorized into general treatment and special treatment. For equity M&A deals, the general EIT treatment requires the fair market value to be used as the tax basis while the special tax treatment allows the original tax basis to be carried forward for the restructuring. Under the special EIT treatment, there may be no EIT levied for equity transfers in the M&A deals.

Equity acquisitions will be entitled to the special EIT treatment if (i) at least 75% of the target's equity will be acquired; (ii) at least 85% of the total purchase price will be paid up by the buyer upon closing of the deal; and (iii) other conditions with respect to business purpose, continuity of operation and lockup period are also satisfied. In addition to the foregoing conditions, cross-border equity acquisitions should further satisfy certain other requirements in order to enjoy the special EIT treatment.

6. Supreme People's Court Issues New Judicial Interpretation on the PRC Contract Law

In the wake of the *Judicial Interpretation I on the PRC Contract Law* issued a decade ago, the PRC Supreme People's Court has recently promulgated the *Interpretation II on Several Issues Concerning the Application of the PRC Contract Law* (the "Interpretation II"), which has became effective since May 13, 2009. The Interpretation II highlights the following changes:

(a) "Change of Circumstance Principle" to be prudently applied

"*Change of circumstance*" refers to the situation where after a contract has been executed, the objective situation has changed materially which change is unforeseeable by the parties, not attributable to any force majeure event and does not constitute any commercial risk item. If subsequent performance of the underlying contract will cause obvious unfairness to one party or make it impossible to fulfill the contract purpose, the competent people's court may, as requested by one party and based on the principle of equity, decide whether to modify or terminate the underlying contract. But the decision will have to be made prudently and on a case-by-case basis.

(b) Failure to effectuate requisite approval procedures potentially deemed as culpa in contrahendo

According to the Interpretation II, after the conclusion of a contract, the failure to effectuate approval and registration procedures which is a legally prescribed condition precedent to the effectiveness of such contract will be deemed as *culpa in contrahendo* (fault in contract conclusion) and the relevant people's court may order the responsible party to effectuate relevant formalities and compensate the other party for actual losses incurred therefrom. This interpretation can certainly be employed by foreign investors to protect their legitimate interests in China where their Chinese partners have failed to effectuate the required government approval.

(c) Reminding obligation of the standard contract provider clarified; unfair standard clauses not necessarily revocable

Pursuant to the Interpretation II, the standard contract providers should use conspicuous signs to effectively remind the other party of the relevant standard provisions unfavorable to such party. Otherwise, such other party may seek a court ruling to revoke such standard provisions. On the other hand, provisions exempting or setting limits to the liabilities of the standard contract provider will not necessarily be held null and void by the court as before, so long as reasonable effort has been made to remind and explain such provisions to the counterparty.

(d) Exercise of discretionary power by judges be further regulated

The Interpretation II has further regulated the exercise of discretionary power by judges as provided under the *PRC Contract Law*. The most remarkable change is that, the term "*liquidated damages extraordinarily higher than the actual loss*" as stipulated in Article 114 of the *PRC Contract Law* is clearly interpreted to mean the situation where the pre-agreed liquidated damage in the underlying contract is higher than 130% of the actual loss, in which case the judges may, at their discretions, make a proper reduction from the pre-agreed liquidated damage. Understandably, it will be much less likely that punitive liquidated damages above this cap will be upheld by people's courts from now on.

For further information, please write us at inquiry@hanyilaw.com.