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PRC TAX DEVELOPMENTS

In 2010, the Chinese tax authorities have focused a great deal of attention on the taxation on non-resident enterprises ("**NREs**"), the implementation of the general anti-avoidance principle and the application of tax treaties. We summarize in this paper the most significant developments in the Chinese tax regime during the past year.

1. Enterprise Income Tax ("EIT")

1.1 Administrative Measures for EIT Treatment of Corporate Reorganizations

On July 26, 2010, the State Administration of Taxation ("**SAT**") issued the *Administrative Measures for Enterprise Income Tax Treatment of Corporate Reorganizations*[1] ("**Bulletin 4**"), which is retroactively effective from January 1, 2010.

Bulletin 4 is an interpretation of the existing tax rules on corporate reorganizations, which are set forth in *Cai Shui* [2009] No. 59 ("**Notice 59**"), and provides clarifications and guidance on the procedural and filing requirements for corporate reorganizations.

Bulletin 4 also provides more definition of the reasonable business purpose requirement for tax-free corporate reorganizations in various scenarios, such as debt restructuring, mergers and divisions. Pursuant to Bulletin 4, the parties to a reorganization need to submit documents with the following information in order to prove that the reorganization has a reasonable business purpose:

- The structure of the reorganization, including the specific transaction model, the background and date of the reorganization, the business operations before and after the reorganization and the related commercial practices;
- The form and substance of the reorganization, including the legal and commercial consequences of the reorganization;
- The potential impact of the reorganization on the tax situation of each party to the transaction;
- The changes in the financial situation of each party to the transaction caused by the reorganization;
- Whether the transaction will result in any unusual economic benefits or responsibilities that would not have resulted under normal market situations; and
- Whether any non-resident enterprise is involved in the reorganization.

Bulletin 4 has addressed many procedural and documentation requirements regarding the EIT treatment of corporate reorganizations. However, several significant uncertainties remain, such as the tax treatment of cross-border reorganizations. It is still not clear whether cross-border reorganizations that do not fully meet the strict requirements set forth by Notice 59 can be subject to special tax treatment upon the approval of the Ministry of Finance ("**MOF**") and the SAT.

Another important but unresolved issue is whether parties can apply for an advance ruling from the competent tax authorities that confirms the final tax treatment of the corporate reorganization before the parties start the reorganization. Bulletin 4 provides a ruling procedure for reorganizations, but it is not clear whether the ruling can be obtained in advance of the reorganization, or only after the reorganization but in advance of the related tax filing deadline.

1.2 Income Recognition

The SAT released the *Notice on Certain Issues Concerning the Implementation of the Enterprise Income Tax Law*[2] ("**Notice 79**") on February 22, 2010.

Notice 79 provides guidance on recognition of several specific types of income for EIT purposes:

- Rental income derived from the provision of the right to use fixed assets, packing materials or other tangible assets should be recognized as taxable income when the payment is due pursuant to the relevant contracts. In cases where an advance lump-sum payment is made for a lease contract covering more than one year, such income may be evenly allocated and recognized as taxable income in each year of the lease term pursuant to the principle of matching income and expense under the EIT Law. This treatment also applies to non-resident lessors that have establishments in China and pay EIT on an actual basis.
- Income derived from a debt restructuring should be recognized as taxable income when the debt-restructuring contract comes into effect.
- Income derived from an equity transfer should be recognized as taxable income when the equity transfer agreement comes into effect and the official procedures for amending the share structure have been completed. The taxable income is the difference between the proceeds from the equity transfer and the original cost of obtaining the equity interest. The retained earnings and reserve funds of the target company cannot be deducted from the proceeds.

1 SAT Bulletin [2010] No. 4.
2 *Guo Shui Han* [2010] No. 79.

- Equity investment income such as dividends and other profit distributions should be recognized as taxable income when the relevant resolution is adopted. However, when capital reserve from share premium is converted to shareholder's equity, the shareholder does not need to recognize the increased equity as equity investment income, but also cannot adjust the cost basis of its investment.

Notice 79 also clarifies certain other issues related to the implementation of the EIT Law:

- If a fixed asset is put into use and an invoice for the full amount has not been obtained due to a delay in settling the construction payment, the fixed asset can be temporarily depreciated based on the value provided in the relevant contract, subject to adjustment when the invoice is available. The adjustment must be made within 12 months after the fixed asset is put into use.
- Unless otherwise provided, various costs and expenses incurred by enterprises related to deriving tax-exempt revenue can be deducted for EIT purposes[3].
- For enterprises engaged in equity investment (including headquarters of group companies and venture capital investment companies), business entertainment expenses can be deducted from the dividends and profits distributed by the investee enterprise and from gains from transfer of the equity interest, subject to the limitations prescribed by the EIT Law.

1.3 Losses From Equity Investment

On July 28, 2010, the SAT issued the *Bulletin Regarding Enterprise Income Tax Treatment of Losses from Equity Investment*[4] ("**Bulletin 6**"), which is retroactively effective from January 1, 2010.

Pursuant to Bulletin 6, losses from equity investment incurred by an enterprise are allowed as a one-time deduction for the tax year in which the losses are recognized. Losses incurred before the issuance of Bulletin 6 but not yet deducted can be deducted in 2010.

1.4 Asset Losses in Previous Years

The SAT issued the *Notice Regarding Enterprise Income Tax Treatment of Asset Losses Not Deducted in Previous Years*[5] ("**Notice 772**") on December 31, 2009.

Pursuant to Notice 772, asset losses that were incurred in previous years but were not deducted in that year can only be recognized in that year and cannot be carried forward to later years. If an enterprise has overpaid EIT due to the non-deduction of asset losses in previous years, it can offset its EIT payable for the current year upon approval of the tax authorities, and the excess amount can be carried forward to offset EIT payable for future years. In other words, although the losses themselves cannot be carried forward, the overpaid EIT can be carried forward as a credit in future years.

1.5 Transitional Preferential Policies

The SAT issued the *Notice Regarding Clarification of Implementation Criteria of Transitional Enterprise Income Tax Preferential Policies*[6] ("**Notice 157**") on April 21, 2010.

Some key clarifications in Notice 157 include:

- If an enterprise can enjoy a reduced EIT rate of 15% as a qualified High and New Technology Enterprise ("**HNTE**") and is also eligible for the transitional EIT preferential polices such as the "2+3 tax holiday" (a two-year tax exemption followed by a three-year 50% tax reduction), the enterprise can choose either (1) to enjoy the 15% EIT rate for the HNTE; or (2) to enjoy the tax holiday based on the original EIT rate for the transitional period (the rate for 2010 is 22% and the rate for 2011 will be 24%). The enterprise cannot enjoy tax exemption and reduction based on the 15% EIT rate.
- Similar to the above, if an enterprise can enjoy a reduced EIT rate of 15% as a qualified HNTE and is also eligible for the tax holidays for software enterprises or integrated circuit enterprises, the enterprise can choose either (1) to enjoy the 15% EIT rate for the HNTE; or (2) to enjoy the tax holiday based on the standard EIT rate of 25%. The enterprise cannot enjoy tax exemption and reduction based on the 15% EIT rate.
- If an enterprise derives income that is entitled to 50% tax reduction under the EIT Law (such as income from agricultural activities, infrastructure construction, environment protection projects and technology transfer), the enterprise must book such income separately and the tax reduction must be based on the standard EIT rate of 25%.
- An enterprise that was qualified as an HNTE before 2008 but has not met the HNTE requirements after 2008 must pay EIT at the standard rate of 25%.

2. NREs and Anti-avoidance

2.1 Taxation of Representative Offices

On February 20, 2010, the SAT issued the *Provisional Measures on Administration of Taxes on Representative Offices of Foreign*

3 As a contrast, under the *Implementation Rules to the Enterprise Income Tax Law*, expenses incurred by enterprises related to deriving revenue that is not subject to EIT (such as government allocations and administrative fees) cannot be deducted for EIT purposes.

4 SAT Bulletin [2010] No. 6.

5 *Guo Shui Han* [2009] No. 772.

6 *Guo Shui Han* [2010] No. 157.

Enterprises[7] ("**Notice 18**"), which is effective retroactively from January 1, 2010.

Notice 18 is the first tax rule that specifically addresses the taxation of representative offices of foreign enterprises since the promulgation of the new EIT Law, which came into effect on January 1, 2008.

2.1.1 Tax registration

A representative office must complete tax registration procedures within 30 days after obtaining its Business Registration Certificate or approval from the supervising authorities.

A representative office needs to submit the following documents in order to complete the tax registration procedures with the competent tax authorities:

- Original and copy of Business License (duplicate) or approval from the supervising authorities;
- Original and copy of Organization Code Certificate (duplicate);
- Original and copy of documents related to the registered address (such as real property certificate and lease agreement);
- Original and copy of chief representative's passport or other legal identification certificate; and
- Resolution of the foreign entity regarding the establishment of the representative office and relevant information (including name, address, contact information, name of the chief representative) of other representative offices established by the same foreign entity in China.

2.1.2 Taxation methods

From July 2003 until the effective date of Notice 18, representative offices were generally classified into three tax categories based on the business activities of their head offices. During the tax registration process, a representative office was required to perform a self-assessment and determine on its own the appropriate category and the corresponding method of taxation.

The new rules under Notice 18 repealed the previous taxation methods for representative offices. Instead, all representative offices are required to keep books and accounts in order to compute taxable income on an actual basis, in accordance with the principle that functions performed should be commensurate with risks borne. Representative offices should report and settle EIT based on the attributable profits. Representative offices should also report and settle BT or VAT, if applicable.

If a representative office has incomplete accounting books, is unable to accurately compute revenue or costs, or is unable to report taxes on an actual basis, one of the following two methods will be used to deem the taxable income:

- Cost-plus method. This is applicable to a representative office that can accurately compute its costs but not its revenue. The formulae are as follows:

  Taxable income = Costs of the current period / (1 - Deemed profit rate − BT rate)

  EIT payable = Taxable income × Deemed profit rate × EIT rate

- Deemed-profit method. This is applicable to a representative office that can accurately compute its revenue but not its costs. The formula is as follows:

  EIT payable = Gross revenue × Deemed profit rate × EIT rate

2.1.3 Deemed profit rate

The deemed profit rate for representative offices to determine taxable income under the cost-plus method and deemed-profit method is increased from 10% (under past rules) to no less than 15%. Most representative offices will have a higher tax burden because of the increased deemed profit rate, as they normally do not keep complete accounting books and therefore continue to be taxed using one of the above deeming methods.

2.1.4 Tax exemption and treaty application

Another significant development is that tax exemptions under the previous tax rules for representative office are abolished. A representative office can now apply for tax exemption only under an applicable tax treaty, e.g. because its activities are purely "preparatory and auxiliary" and thus do not constitute a permanent establishment of the head office. Such a representative office will need to complete a recordal procedure under *Guo Shui Fa* [2009] No. 124 in order to enjoy the tax treaty benefits.

2.2 Taxation of Establishments of NREs

On February 20, 2010, the SAT issued the *Administrative Measures for the Assessment and Collection of Enterprise Income Tax on Non-resident Enterprise*[8] ("**Notice 19**") to address the taxation methods for NREs with establishments in China. Notice 19 is effective from February 20, 2010.

Notice 19 applies to establishments of NREs other than representative offices. It requires such establishments to keep complete accounting books and records to calculate taxable income on an actual basis. If an NRE is unable to accurately calculate its taxable income due to incomplete accounting books or other reasons, the following three methods will be adopted to determine its taxable income:

- Deemed profit based on revenue. This is applicable where an NRE can accurately compute its revenue but not its costs.

  Taxable income = Gross revenue × Deemed profit rate

- Deemed profit based on costs. This is applicable where an NRE can

7 *Guo Shui Fa* [2010] No. 18.
8 *Guo Shui Fa* [2010] No. 19.

accurately compute its costs but not its revenue.

Taxable income = Total costs / (1 - Deemed profit rate) × Deemed profit rate

- Deemed profit based on expenses. This is applicable where an NRE can accurately compute its expenses but not its costs or revenue.

  Taxable income = Total expenditures / (1 - Deemed profit rate – BT rate) × Deemed profit rate

Notice 19 also provides a range of deemed profit rates for NREs based on their business function or industry:

- 15% to 30% for engineering, design, or consulting services;
- 0% to 50% for management services; and
- No less than 15% for other services or business activities.

The tax authorities may adopt a higher deemed-profit rate if there is sufficient evidence to support such a rate.

2.3 Issues Related to Services Provided by NREs

When an NRE provides installment, technical training or supervision services to a Chinese enterprise as part of the sale of equipment or other goods to a Chinese client, the price of the services must be separately listed. If the price is not separately listed or is considered unreasonable by the competent tax authorities, they may deem the service revenue by reference to pricing standards for similar services. If there is no such reference, the deemed service revenue must be no less than 10% of the total sales price. From a customs valuation perspective, if the service price is not separately list and is viewed as a condition for importing the equipment, the service price may be subject to customs duty and import VAT together with the price for the imported equipment. As a result, there could be double taxation (i.e. VAT and BT) on the service revenue.

For services provided by an NRE both onshore and offshore to an enterprise located within China, the NRE should divide the service revenue depending on the place where the service is rendered and pay EIT on the onshore service revenue. If the NRE cannot provide relevant supporting documents, the competent tax authorities may deem that all the services are provided onshore and impose tax on the entire service revenue. (If a tax treaty is applicable, EIT will be payable only if a permanent establishment has been created.)

2.4 Indirect Equity Transfers

Historically, holding companies for investments in Chinese subsidiaries were commonly established in low-tax jurisdictions and had little or no economic substance or business activity. Foreign investors used this approach for a number of reasons, but one of the major benefits was that the investor could exit from the investment in China by transferring the shares of the offshore holding company without triggering EIT on the capital gain from the transfer.

However, the *Notice on Strengthening the Administration of Enterprise Income Tax on Equity Transfer Income Derived by Non-resident Enterprises*[9] (“**Notice 698**”), issued by the SAT in December 2009 with retroactive effect from January 1, 2008, has led to great uncertainty about the use of offshore holding companies to indirectly transfer the equity interest in a Chinese subsidiary.

Notice 698 requires a non–resident seller to disclose an indirect transfer of a resident company to the Chinese tax authorities within 30 days after signing the share sale agreement if the actual tax burden in the intermediate holding company’s jurisdiction is less than 12.5%, or if that jurisdiction excludes foreign-sourced income from tax.

In such cases, the seller must provide all of the following documents to the Chinese tax bureau in the location of the underlying subsidiary:

- The share sale agreement;
- Documents substantiating the relationship between the seller and the intermediate holding company in respect of capital, operations, sales and purchases;
- Documents substantiating the operations, employees, bookkeeping and assets of the intermediate holding company;
- Documents substantiating the relationship between the intermediate holding company and the underlying Chinese subsidiary, in respect of capital, operations, sales and purchases;
- Documents substantiating a reasonable business purpose for the establishment of the intermediate holding company; and
- Other materials requested by the tax authorities.

The documents must be in Chinese.

Pursuant to Notice 698, where an overseas seller indirectly transfers a Chinese resident company through the use of an abusive organizational form, and a reasonable commercial purpose is lacking, and the seller thereby avoids the obligation to pay tax in China, the tax authorities may then disregard the existence of the intermediate holding company and re-characterize the indirect transfer as a direct transfer of the Chinese company. This results in the capital gain associated with the offshore transaction being subject to EIT. For more information on this topic, please refer to our paper for the session on Indirect Equity Transfer.

3. Tax Treaties

The Chinese tax regime related to tax treaties has undergone major developments in 2010, among which the interpretation of the China-Singapore tax treaty is the most significant.

3.1 Interpretations of China-Singapore Tax Treaty

On July 26, 2010, the SAT released

9 *Guo Shui Han* [2009] No 698.

the *Interpretations of the Provisions in the Agreement between the Government of the People's Republic of China and the Government of the Republic of Singapore for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and its Protocols*[10] ("**Notice 75**").

3.1.1 General application

Notice 75 provides a set of comprehensive interpretations of the China-Singapore tax treaty. More importantly, Notice 75 prevails over all of the SAT's previous interpretations of tax treaties generally and will be applied to all other tax treaties containing provisions that are the same as those in the China-Singapore tax treaty.

Below are some highlights of Notice 75:

3.1.2 Tax residency

Under most tax treaties, a "tax resident" includes individuals, companies and other entities, such as associations and foundations. Notice 75 provides that a trust will be treated as a tax resident if established in a contracting state where the domestic law also treats trusts as tax residents.

Under Notice 75, if a tax resident of a contracting state establishes a permanent establishment ("**PE**") in a third state, the PE should be treated as a part of that tax resident instead of being treated as an independent resident of the third state. Notice 75 also explains the definitions of "permanent home", "centre of vital interests" and "habitual abode" for determining the status of an individual resident if the individual may be a resident of both contracting states.

3.1.3 PE

Notice 75 gives detailed interpretations and illustrations for the treatment of PEs under the China-Singapore tax treaty, including the fixed place of business PE, construction PE, service PE and dependent agent PE. When the application of the PE article overlaps with other articles (such as those about dividends, interests or royalties), the PE article will prevail, i.e. the relevant income will be taxed as profits attributable to the PE.

Notice 75 also gives examples of how to determine how a PE may be established under various scenarios, such as the long-term lease of a hotel room to provide services.

3.1.4 Potential impact on secondment

Notice 75's provisions about the secondment of expatriates from a parent company to a Chinese subsidiary provide some clarity on the question of whether a secondment arrangement may create a PE. The tax treatment of secondments in China has been in a state of uncertainty since last year when the SAT launched an investigation of cross-border secondments into China.

- To determine whether a secondment arrangement creates a PE, it must first be decided whether the seconded expatriate is working for the overseas parent company or the local subsidiary of the parent. Notice 75 sets forth four factors to determine if a seconded expatriate is working for the parent company:
- Whether the parent has the right to direct the work of the secondee and bears the risks and responsibilities for the work;
- Whether the parent decides the number of and standards for the secondee(s) who are sent to the subsidiary;
- Whether the parent bears the salaries of the secondee; and
- Whether the parent derives profit from the subsidiary because of the activities of the secondee.

If any one of the above conditions is met, the tax authorities may determine that the seconded expatriate is working for the parent company. Then the treaty clauses regarding PE will be applied to determine whether the parent company creates a PE in the country where the subsidiary is located.

Notice 75 does not create a "safe harbor" for an overseas parent company to avoid creating a PE in China by seconding employees to Chinese subsidiaries, i.e. it does not state that the absence of the above four factors necessarily means a PE is not created. However, the provisions of Notice 75 are generally consistent with the tax bureau's practice in China before 2009 and also the common understanding of tax practitioners.

3.1.5 Business profits

Notice 75 follows the "independent enterprise" principle in regard to the attribution of business profits to a PE, i.e. the PE should be treated as an independent enterprise from the company that created it. Notice 75 specifically provides that a PE can deduct or share relevant expenses in calculating its attributable profits.

3.1.6 Dividends, interests and royalties

Notice 75 reaffirms the requirement that the recipient of dividend, interest or royalty income must be the "beneficial owner" (please refer to Section 3.2) of the income in order to qualify for treaty withholding rates.

Notice 75 also applies the "substance-over-form" principle when determining whether a payment is dividend income or interest income.

3.1.7 Capital gains

Generally, the transfer of shares in an offshore company is not subject to tax in China, regardless of whether the offshore company holds equity in a Chinese resident enterprise. But as discussed in Section 2.4 above, China has issued Notice 698, giving the tax authorities the power to levy EIT on capital gains from the indirect transfer of equity interests in Chinese resident enterprises. Notice 75 clarifies that, even where the China-Singapore tax treaty applies, China may initiate an anti-avoidance investigation if they deem that an indirect transfer of

10 *Guo Shui Fa* [2010] No. 75.

shares in a Chinese resident enterprise is an abuse of the corporate form to avoid taxes or to obtain tax treaty benefits.

We discuss in Section 3.1.8 how Chinese domestic anti-avoidance rules (such as Notice 698) will be applied under other tax treaties.

3.1.8 Anti-avoidance rules

Pursuant to Notice 75's interpretation of Article 26 (Miscellaneous Rule) of the China-Singapore tax treaty, domestic anti-avoidance rules are not affected by the tax treaty. But only a few of the tax treaties that China has signed have an article similar to Article 26. Therefore, it remains unclear how domestic anti-avoidance rules will be applied under tax treaties that do not have an article similar to Article 26 in the China-Singapore tax treaty.

By way of reference, we note that the Organization for Economic Co-operation and Development ("**OECD**") Commentary on the Model Tax Convention on Income and on Capital generally favors applying domestic anti-avoidance rules either on the ground that domestic rules are not affected by treaties or that abusive transactions should not be entitled to treaty benefits. Although China is not a member of the OECD, the government may nonetheless seek support from the above commentary for the application of its domestic anti-avoidance rules in the context of other tax treaties.

3.2 Beneficial Owner

Over the past years, China has substantially increased the level of guidance, and associated degree of enforcement, related to treaty shopping. The main goal of this guidance is to provide more detailed requirements and procedures for treaty benefits in order to prevent special purpose vehicles without economic substance from being able to enjoy such treaty benefits.

Guo Shui Han [2009] No. 81 was issued by the SAT on 20 February 2009, and provided the following conditions to enjoy a reduced withholding treaty benefit on dividends:

- The recipient of the dividend must be a tax resident of the other treaty jurisdiction;
- The recipient of the dividend must be the beneficial owner of the dividend;
- The dividend must qualify as a "dividend" under the tax law of China; and
- Other conditions that the SAT may impose.

Furthermore, the SAT issued the *Notice on Understanding and Determining "Beneficial Owner" in Tax Treaties*[11] ("**Notice 601**") on October 27, 2009 to provide guidance on the term "beneficial owner" and the approach to determining whether an individual or enterprise is the beneficial owner of dividends, interest and royalties.

"Beneficial owner" refers to a person that has the right to own and control the dividends, interest or royalties or the right or asset which generates such income. In general, a "beneficial owner" must be engaged in substantive operating activities. Agents and conduit companies are specifically excluded as beneficial owners. A conduit company is defined as a company established with the purpose of avoiding or reducing taxes or transferring or accumulating profits. It is considered to be a type of company that has fulfilled the registration formalities and other legal organizational requirements, but is not engaged in substantive operating activities such as manufacturing, sales or management.

A substance over form approach is adopted for the determination of whether a person is a "beneficial owner", with an examination of the actual circumstances of each application. A comprehensive assessment will be conducted, taking into account the following factors, which point against a person being the "beneficial owner":

- The applicant is obliged to pay or distribute the whole or the majority (for example, over 60%) of the income to a person resident in a third country within a prescribed period of time (for example, within 12 months from receipt of the income);
- The applicant has no or almost no operating activities other than holding the asset or right which generates the income;
- Where the applicant is an entity like a company, the applicant's assets value, scale and staffing level is relatively low (or low) and disproportionate to the amount of income;
- The applicant has little or almost no right to control or dispose and bears very little or no risk in relation to the relevant income or the right or asset which generates the income;
- The relevant income is not subject to tax, is exempt from tax or is taxed at a very low effective tax rate in the treaty partner country;
- In addition to the loan agreement pursuant to which interest income is generated and paid, there is a loan or deposit agreement between the creditor and a third party with similar loan amount, interest rate, execution date and the like; or
- In addition to the agreement for the licensing of copyright, patent and technology, pursuant to which royalties income is generated and paid, there is an agreement for the transfer or licensing of the relevant copyright, patent and technology, between the applicant and a third party.

An applicant should supply information on these matters when applying for treaty benefits. The tax authorities will also obtain information by the information exchange mechanism where necessary.

3.3 Royalties and Other Relevant Provisions

On September 14, 2009, the SAT issued the *Notice on Issues Relevant to the Implementation of Royalties Provisions in Tax*

11 *Guo Shui Han* [2009] No 601.

Treaties[12], which took effect on October 1, 2009, to interpret the royalties article in tax treaties. As a follow-up to that notice, the SAT issued the *Notice on Issues regarding the Implementation of Relevant Provisions in Tax Treaties*[13] on January 26, 2010 to further clarify the article of royalties and other relevant provisions in tax treaties.

3.3.1 Payments for the use of, or the right to use, industrial, commercial or scientific equipment

Payments for the use of, or the right to use, industrial, commercial or scientific equipment are regarded as rental income under the EIT Law. Where such payment is included in the specific definition of "royalties" in a treaty, the royalties article should apply to such payment to a resident in the treaty partner country. Where the treaty provides for a reduced withholding rate for such payment, the reduced rate should be adopted. Payments for the use of immovable properties are governed by the article on income from immovable properties rather than the article on royalties.

3.3.2 Information concerning industrial, commercial or scientific experience

Information concerning industrial, commercial or scientific experience should generally be understood as proprietary technology, i.e. non-public proprietary information or data essential for production or replication of process.

Payments for proprietary technology will be considered royalty payments where:

- The licensor licenses proprietary technology for the free use of the licensee;
- The licensor does not participate in the use of the proprietary technology; and
- The licensor does not guarantee the results of the use of the proprietary technology.

Although royalties are usually paid for proprietary technology that already exists, royalties can also be paid for proprietary technology not already in existence where the proprietary technology is developed by the licensor at the licensee's request and is subsequently licensed to the licensee subject to restrictions on use such as confidentiality.

3.3.3 Distinction between service fees and royalties

Where pursuant to a service contract, the service provider uses technology to provide services but the service recipient does not gain ownership or the right to use the technology, the payments made under the service contract are service fees. In contrast, where the services result in technology that falls within the treaty definition of "royalties", the service provider retains ownership of the resultant technology and the service recipient only gains the right to use the technology, the payments made under the relevant service contract are royalties.

Where in the process of transferring or licensing proprietary technology the foreign licensor sends employees to China to provide support and guidance services in relation to the use of the technology, such provision of technological services should be treated as part and parcel of the transfer or license of technology. Payments made for such services should be taxed as royalties, regardless of whether such payments are separately billed from the consideration of transfer or the license fees, unless the provision of services creates a permanent establishment. Where the provision of services are for a period that creates a PE of the licensor in China, payments for the services attributable to the permanent establishment should be taxed in accordance with the business profits article and income of the staff should be taxed in accordance with the dependent services article. The license fees should still be taxed as royalties.

3.4 Protocol to China-Barbados Tax Treaty

Historically, Barbados has been a popular intermediate holding company location mainly because of the capital gains exemption under the tax treaty between the two countries on disposal of shares in a Chinese company.

However, China and Barbados signed a new protocol on February 10, 2010 to amend the tax treaty. The major amendments include:

- Reducing the scope of the capital gains exemption. Under the new capital gains article, if a Barbados holding company has owned, directly or indirectly, more than 25% of the equity interest in a Chinese company in the past 12 months before the transfer of shares, the capital gains realized by the Barbados company on the sale of shares in that Chinese company will be taxable in China.
- Limiting the scope of application of the 5% withholding tax rate on dividends. Under the new dividend article, the 5% rate applies only if beneficial owner of the dividends directly holds at least 25% of the shares of the company paying the dividends.

The new protocol will come into force on January 1, 2011[14].

3.5 Protocol to Mainland-Macau Tax Arrangement

The SAT issued Bulletin [2010] No. 15 on October 8, 2010. Pursuant to the Bulletin, the central government of China and the Macau government have completed the necessary procedures required to bring into effect the protocol to the *Arrangement between Mainland China and Macau Special Administrative Region for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income* ("**Mainland-Macau Tax Arrangement**"). The protocol became

12 *Guo Shui Han* [2009] No. 507.
13 *Guo Shui Han* [2010] No. 46.
14 *Guo Shui Fa* [2010] No. 64.

effective on September 15, 2010 and will be applied to income derived during tax years beginning on or after January 1, 2011.

The protocol amended several provisions of the Mainland-Macau Tax Arrangement, which was signed in Macau on July 15, 2009. The amendments include:

- Adding the place of incorporation as one of tests for determining residency (other tests already listed in the Mainland-Macau Tax Arrangement include domicile, residence, place of head office, place of effective management or any other similar criterion);
- Changing the minimum threshold required to deem a service provider as having created a PE under the Mainland-Macau Tax Arrangement from six months to 183 days; for example, a resident enterprise of Macau may create a PE in mainland China if the Macau enterprise, through its employees or other personnel, provides services for the same or connected projects in mainland China for more than 183 days within any 12-month period;
- Reducing the withholding tax rate for dividends from 10% to 5% if the beneficial owner of the dividends directly holds at least 25% of the shares of the company paying the dividends;
- Reducing the withholding tax rate for interest to 7% (under the original provisions of the Mainland-Macau Tax Arrangement, the withholding tax rate for interest was 10%; the 7% rate only applied to interest received by banks or financial institutions);
- Reducing the withholding tax rate for royalties from 10% to 7%;
- Clarifying the capital gains clause of the original Mainland-Macau Tax Arrangement:
  - Under Article 13(4) of the arrangement, the government of one side may tax the gains from transferring shares of a company the property of which consists primarily of real property located in that side. Pursuant to a new definition in the protocol, a company will come within the scope of this article if real property comprises at least 50% of the company's property
  - When a resident enterprise of one side transfers shares or other interests in a resident company of the other side, the other side may tax the transferor if the transferor directly or indirectly held at least 25% of such company at any time during the 12 months before the transfer
- Adding an anti-avoidance clause that permits each side to apply its own anti-avoidance laws and measures.

With the new protocol coming into effect, the provisions of the Mainland-Macau Tax Arrangement have generally become in line with those of the Mainland-Hong Kong Tax Arrangement.

3.6 Second Protocol to China-Singapore Tax Treaty

China and Singapore signed the *Second Protocol to the China-Singapore Tax Treaty* on August 24, 2009. The time threshold sufficient to establish a "service PE" has been changed from six months to 183 days, which is the same as under the Mainland-Hong Kong Tax Arrangement. From China's outbound investment perspective, the ownership percentage required for a Chinese shareholder in a Singapore subsidiary to enjoy an indirect tax credit in China is raised from 10% to 20%. The protocol came into effect on December 11, 2009[15].

4. Business Tax ("BT") Exemption on Offshore Service-Outsourcing

On July 28, 2010, the MOF, the SAT and the Ministry of Commerce ("**MOFCOM**") jointly issued the *Notice Regarding Business Tax Exemption on Offshore Service-Outsourcing Business in Pilot Cities*[16] ("**Notice 64**").

Notice 64 grants BT exemption on revenue derived by enterprises located in 21 pilot cities if the revenue comes from the offshore service-outsourcing business. The BT exemption policy lasts from July 1, 2010 to December 31, 2013. The 21 cities are Beijing, Tianjin, Dalian, Harbin, Daqing, Shanghai, Nanjing, Suzhou, Wuxi, Hangzhou, Hefei, Nanchang, Xiamen, Jinan, Wuhan, Changsha, Guangzhou, Shenzhen, Chongqing, Chengdu and Xi'an.

Pursuant to Notice 64, revenue from qualified outsourcing services (such as Information Technology Outsourcing, Business Process Outsourcing and Knowledge Process Outsourcing) provided to overseas customers by companies in the pilot cities, or by their direct subcontractors, is exempted from BT.

The main points of comparison between the preferential policies for Technically Advanced Service Enterprises ("**TASEs**") and the BT exemption policy in Notice 64 are as follows:

- The BT exemption policy under Notice 64 covers the same 20 cities as the TASE rules and adds one additional city, Xiamen;
- There are no certification requirements under Notice 64; and
- Notice 64 does not grant the reduced EIT rate of 15% that TASEs can enjoy.

5. Value-Added Tax ("VAT")

5.1 General VAT Taxpayer Status Certification

On February 10, 2010, the SAT issued the *Administration Measures on General VAT Taxpayer Status Certification*[17] ("**Decree 22**"), which took effect on March 20, 2010.

15 *Guo Shui Fa* [2009] No. 158.
16 *Cai Shui* [2010] No. 64.
17 SAT Decree [2010] No. 22.

Under Decree 22, if a VAT taxpayer has reached the annual taxable sales revenue threshold (i.e. RMB 500,000 for manufacturing enterprises and RMB 800,000 for trading enterprises), it must file an application for general VAT taxpayer status certification within 40 working days after the latest VAT filings.

For an enterprise that has not reached the annual taxable sales revenue threshold or a newly established enterprise, it may still file the application if it has a fixed place of business and complete accounting books.

The competent tax authority will examine the applications and will also conduct on-site inspection for the general VAT taxpayer status certification. The certification process must be finished within 20 working days after the competent tax authority accepts the application.

For existing enterprises, the general VAT taxpayer status will be effective from the following month of the certification. For newly established enterprises, the general VAT taxpayer status will be effective from the month when the competent tax authority accepts the application.

5.2 Training Period for General VAT Taxpayers

As a supplementary notice to Decree 22, the SAT issued the *Administration Measures on General VAT Taxpayers Within the Training Period*[18] ("**Notice 40**") on April 7, 2010. Notice 40 also took effect on March 20, 2010.

Pursuant to Decree 22 and Notice 40, a newly certified small-scale wholesale enterprise that has not reached the annual taxable sales revenue threshold will be subject to a training period of three months. A "small-scale wholesale enterprise" is defined as a wholesale enterprise with registered capital of no more than RMB 800,000 and employees of no more than 10 people.

Enterprises with the following non-compliance will be subject to a training period of six months:

- VAT evasion of more than RMB 100,000 and more than 10% of the VAT payable;
- Claiming export VAT refund fraudulently;
- Issuing VAT invoices or credit certificates fraudulently; and
- Other situations stipulated by the SAT.

There are certain restrictions on the enterprises during the training period:

- Enterprises can only obtain no more than 25 VAT Special Invoices at one time from its competent tax bureau;
- Small-scale wholesale enterprises can only issue VAT Special Invoices of no more than RMB 100,000; and
- Enterprises purchasing invoices for more than once in a month need to prepay VAT at 3% of the invoiced sales revenue.

Enterprises certified as general VAT taxpayers are entitled to use VAT invoices for crediting input tax against output tax.

5.3 VAT Refund for Research & Development ("R&D") Centers

On January 17, 2010, the SAT issued the *Administrative Measures for Tax Refunds for R&D Centers to Purchase Domestically Manufactured Equipment*[19] ("**Notice 9**"), which provides detailed tax administrative procedures and documentation requirements for the tax refund policy set forth in *Cai Shui* [2009] No. 115.

For R&D centers that are general VAT taxpayers, relevant VAT invoices associated with the purchased equipment must be verified within 180 days (or 90 days if the VAT invoices were issued before December 31, 2009) after the issuance of the invoices.

After the R&D center obtains the VAT refund for purchasing domestically manufactured equipment, the equipment will remain under supervision by the competent tax authorities for five years. During this period, if the ownership of the equipment is transferred or if the equipment is used for non-prescribed purposes, the VAT refund will be clawed-back. The claw-back amount will depend on the remaining value of the equipment after depreciation.

Notice 9 is effective from July 1, 2009 to December 31, 2010.

As a follow-up notice, MOFCOM, the MOF, the General Administration of Customs and the SAT issued the *Notice Regarding Tax Exemption / Refund for Foreign-invested R&D Centers to Purchase Equipment*[20] ("**Notice 93**") on March 22, 2010.

Notice 93 further clarifies the detailed procedures and documentation requirements for the certification of foreign-invested R&D centers.

5.4 Tax treatment for Financial Sale and Leaseback

On September 8, 2010, the SAT issued the *Bulletin Regarding Certain Tax Issues Related to the Sale of Assets by Lessees in Financial Sale and Leaseback Transactions*[21], which clarified the tax treatment for financial sale and leaseback transactions.

Pursuant to the Bulletin, financial sale and leaseback refers to the business model where the lessee, for financing purposes, sells an asset to a licensed financial leasing enterprise and then leases the asset back from that financial leasing enterprise. Under this business model, when the lessee sells the asset, the ownership of the asset and the related compensation and risks are not fully transferred from the lessee to the financial leasing enterprise.

The Bulletin clarifies that the sale of an asset by the lessee in a financial sale and

18 *Guo Shui Fa* [2010] No. 40.
19 *Guo Shui Fa* [2010] No. 9.
20 *Shang Zi Fa* [2010] No. 93.
21 SAT Bulletin [2010] No. 13.

leaseback transaction is not subject to VAT or BT.

The Bulletin further clarifies that, for EIT purposes, the lessee does not need to recognize income for the sale of an asset in a financial sale and leaseback transaction. In addition, the lessee can depreciate the leased asset based on its pre-sale book value and deduct interest payments under the financial lease as financing expenses during the term of the lease.

The above tax treatment took effect on October 1, 2010. Taxes that have been collected based on a different tax treatment can be refunded to taxpayers.

6. Individual Income Tax ("IIT") Treatment of Pension Funds

Both Chinese employers and employees are required to contribute to various social insurance funds, including the unified pension fund, medical insurance fund, unemployment fund, maternity insurance and worker's injury insurance fund.

The SAT issued the *Notice Regarding the Individual Income Tax Collection and Administration of Enterprise Pension Funds*[22] ("**Notice 694**") on December 10, 2009.

Notice 694 clarifies the taxation of enterprise pension funds voluntarily established by an enterprise and its employees in addition to the basic pension fund in accordance with the *Trial Measures of Enterprise Pension Funds*.

The amount of individual contribution to enterprise pension funds cannot be deducted from the amount of wages when calculating IIT payable. This means that the individual contribution is regarded as a payment made by an employee from his after-tax wages. Enterprise contribution should also be considered taxable salary income to the employees:

- The enterprise should withhold and pay IIT for the individual when making enterprise contribution into the enterprise pension fund.
- In determining the amount of taxable income, the amount of enterprise contribution is taxed as a month's wages of the individual without any deduction. Where contribution is made quarterly, half-yearly or annually as opposed to monthly, the amount of the contribution is still taxed as a month's wages without any deduction in the month it is made.
- In determining the applicable tax rate, enterprise contributions to enterprise pension funds are considered as a separate item of income under the "wages and salaries" category and taxed separately from the normal monthly wages. Conversely, contributions to supplementary pension funds are added to the amount of normal monthly wages to be taxed together. Effectively, the separation in the case of enterprise pension funds allows enterprise contributions to be taxed at a lower rate under the progressive IIT tax rates applicable to income under the "wages and salaries" category.

7. Tax Administrative Procedures and Audits

7.1 Administrative Review

To improve China's tax administrative review mechanism, the SAT issued the *Tax Administrative Review Rules*[23] on February 10, 2010, with effect from April 1, 2010.

7.1.1 Scope of tax administrative review

If a taxpayer considers any specific administrative action by tax authorities has infringed the taxpayer's legal rights, the taxpayer can file a tax administrative review petition with the tax administrative reviewing authority.

The scope of tax administrative review covers the following:

- Tax collection actions;
- Tax administrative permits and approvals;
- Administration on invoices;
- Tax guarantee measures and enforcement measures;
- Tax administrative penalties; and
- Others specific tax administrative action.

Taxpayers must file tax administrative review petitions within 60 days after learning of the administrative action for which they seek review. Besides the disputed administrative action, taxpayers may also request the administrative review authority to review the legal basis (not including laws, administrative regulations and ministerial regulations) for such specific administrative actions.

7.1.2 Review authority

Normally, the tax administrative reviewing authority is the State Tax Bureau or Local Tax Bureau one level higher than the tax bureau which has conducted the original action. For actions made by a Local Tax Bureau, the taxpayer may also file the tax administrative review petition with the local government of the same level.

The tax review authority cannot make a decision that is less favorable for the petitioner than the original decision which is under review.

7.1.3 Public hearings and mediation

Public hearings and mediation are two new features in the updated *Tax Administrative Review Rules* in 2010.

Taxpayers can request the reviewing authority to hold a public hearing for important or complicated cases. The reviewing authority may also decide on

22 *Guo Shui Han* [2009] No. 694.
23 SAT Decree No. 21.

its own to hold a public hearing when reviewing the case.

Petitioners (taxpayers) and the respondents (tax authorities that make the original decision) can settle the case before the reviewing authority makes an official decision. The reviewing authority may also mediate the dispute during the review procedure.

7.2 Tax audits in 2010

On May 7, 2010, the SAT identified the following industries as key targets for tax audits in 2010[24]:

- Real estate, construction and installment;
- Pharmacy trading;
- Transportation; and
- Non-resident enterprises.

Besides, the following subjects have also been "red flagged" for tax audits:

- Organizations engaged in medical care, educational and training activities that are operating for profits;
- Individuals with annual income of more than RMB 120,000;
- The issuance of transportation invoices; and
- Fraudulent claims for export tax refund.

Another significant new trend is the substantial increase in enforcement against large-scale enterprises. In 2008, the SAT established a new department, the Department of Tax Collection and Administration for Large-scale Enterprises, to monitor tax compliance of large-scale enterprises. Since then, large-scale enterprises have become key targets of tax audits.

A number of large-scale taxpayers have been requested by tax authorities to conduct self-audits on themselves at first and to disclose any non-compliance discovered in the self-audits. If tax authorities are not satisfied with the results from self-audit and voluntary disclosure, they will initiate further audits.

7.3 Inspection of Contemporaneous Documentation

On July 12, 2010, the SAT started to launch a nationwide investigation of contemporaneous documentation of related party transactions[25]. Upon the SAT's request, local tax authorities all over the country selected as audit targets more than 10% of all taxpayers that have contemporaneous documentation filing obligations. The audit covered the contemporaneous documentation that was filed for 2008 and 2009.

8. Urban Maintenance and Construction Tax ("UMCT") and Education Surcharge

On October 18, 2010, the State Council of China issued the *Notice regarding Unifying Urban Maintenance and Construction Tax and Education Surcharge Systems for Domestic and Foreign Enterprises and Individuals*[26] ("**Notice 35**"), which imposed UMCT and Education Surcharge on foreign invested enterprises, foreign enterprises and foreign individuals starting from December 1, 2010.

UMCT and Education Surcharge are collected as a percentage of the amount of turnover taxes (i.e. Consumption Tax, VAT and BT) paid by taxpayers. UMCT has been levied since 1985, and the rate is 7%, 5% or 1% depending on where the taxpayer is located. Education Surcharge has been levied since 1986 and the current rate is 3%.

Under the authorization of the Standing Committee of the National People's Congress, the State Council decided in 1994 that foreign enterprises and foreign invested enterprises were not subject to UMCT and Education Surcharge. This situation has been changed by Notice 35 from December 1, 2010.

China has been aiming to unify its parallel tax systems for domestic enterprises and foreign invested enterprises for decades. By expanding the scope of application of UMCT and Education Surcharge, China is taking the final key step in these unification efforts.

According to an official interpretation by the MOF and the SAT, the new policy also intends to raise more revenue for China's urban construction (including public transportation and public housing) and education projects. Considering the overall economic environment, the Chinese authorities have expressed confidence that the new policy will not have a significant adverse impact on attracting foreign investment into China.

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24 *Guo Shui Fa* [2010] No. 35.
25 *Guo Shui Han* [2010] No. 323.
26 *Guo Fa* [2010] No. 35.

UNEXPECTED REACH OF CIRCULAR 698: CHINESE TAX ON NON-CHINESE TRANSFERS

A California buyer acquires from a Nevada company the shares of a Hong Kong company with a Chinese subsidiary. Did the seller comply with Chinese reporting requirements and pay tax on any capital gain attributable to the indirect transfer of the Chinese subsidiary? Is the California buyer liable for penalties in China if the seller did not report and pay?

These questions were of little concern before December 2009, when China's State Administration of Taxation issued a circular that set off alarms throughout the foreign investment community in China. Circular 698, "*Notice of the State Administration of Taxation on Strengthening the Administration of Enterprise Income Tax on Equity Transfer Income Derived by Non-Resident Enterprises*," sets out rules for the reporting and potential levy of tax on indirect transfers of companies established in China.

An indirect transfer occurs when a non-resident investor, such as the Nevada company, sells shares of an intermediate company located outside China, such as the Hong Kong subsidiary, that holds shares of a subsidiary company in China. Under certain circumstances, China now asserts the right to levy income tax on the capital gain that the Nevada seller derives or is deemed to derive from the indirect sale of the underlying Chinese subsidiary.

The broad wording of Circular 698 leaves considerable uncertainty about how vulnerable transactions involving several layers of holding companies will be to taxation in China. In this example, even the sale of the shares of the Nevada parent of the Hong Kong company could potentially be deemed an indirect transfer of the subsidiary in China. The wording does not exclude this interpretation, and Article 7 of the circular expressly requires the Chinese subsidiary to provide the tax authorities with a copy of contracts pertaining to a sale involving several holding companies.

The significance of Circular 698 for U.S. investors is that the vast majority with Chinese subsidiaries hold them through intermediate companies in jurisdictions such as Hong Kong, Singapore, the British Virgin Islands, the Cayman Islands, Barbados and Mauritius, and this holding structure will trigger the reporting requirement when the holding company is sold or otherwise transferred, and may expose the transaction to taxation in China.

The *Enterprise Income Tax Law of the People's Republic of China* introduced a general anti-avoidance principle in 2008 that empowers the tax authorities in China to make special adjustments to arrangements or transactions that lack a reasonable commercial purpose. This lack is defined in the implementing rules to the law as having a primary purpose to reduce, avoid or defer tax in China. The Chinese authorities have assertively implemented the anti-avoidance principle, taking strong enforcement measures against activities such as treaty shopping, and now indirect share transfers.

Circular 698, also effective from 2008, includes two main provisions. One creates a reporting obligation for the seller, and the other provides for recharacterization of the indirect transfer as a direct transfer, which is subject to withholding tax on the capital gain.

Article 5 of the circular requires a foreign investor to report the indirect sale of a subsidiary in China to the Chinese tax authorities within 30 days after signing a share sale agreement if the actual tax burden in the intermediate holding company's jurisdiction is less than 12.5 percent, or if that jurisdiction excludes foreign-sourced income from tax.

Examples of jurisdictions whose general income tax rate is less than 12.5 percent include Barbados, the British Virgin Islands, the Cayman Islands, Macau and Mauritius. The scope of the foreign-sourced income exclusion is not defined, but the wording suggests that Hong Kong and arguably Singapore have such exclusions. Most intermediate holding companies that foreign investors have used for investments in China are located in these jurisdictions.

If the reporting obligation is triggered, the seller must provide documents translated into Chinese to the tax authority where the underlying Chinese subsidiary is registered, including the share sale agreement and documents substantiating the relationships between the holding company and the seller and the holding company and the Chinese subsidiary. It must also substantiate the operations, employees, bookkeeping and assets of the holding company, as well as a reasonable business purpose for the establishment of the holding company.

Article 6 of circular permits the tax authority to disregard the existence of an intermediate holding company and to recharacterize its sale as a direct transfer of the underlying Chinese subsidiary where the foreign investor has avoided taxation in China through the abuse of organizational form and without a reasonable commercial purpose. "Reasonable commercial purpose" for both the holding structure and the sale of the holding company is thus a key test for determining whether to tax the indirect sale of a subsidiary in China.

Circular 698 states that the recharacterization should be done in accordance with economic substance, arguably a separate test from reasonable commercial purpose. In practice, the tax

authorities tend to conflate the concepts of reasonable commercial purpose and economic substance, and to emphasize the latter as determining reasonable commercial purpose. For this reason, intermediate holding companies without other functions are likely to be closely scrutinized as lacking substance, even if there are valid reasons for using them such as reducing management costs.

A U.S. company's main purpose for transferring an intermediate holding company is often not to sell it, but to implement an inter-group restructuring for administrative purposes or to position it for an initial public offering. Circular 698 applies even to sales where the buyer and seller are part of the same corporate group. Chinese reorganization rules permit tax-free transfers within a narrow scope, but the tax authorities have not provided guidance about whether those rules can be applied to an indirect sale recharacterized under Circular 698. To the extent they can be applied, they may provide relief in some Circular 698 cases.

U.S. companies are already feeling the impact of Circular 698 in pre-initial public offering restructurings. Many investments in China are initially held through companies registered in the British Virgin Islands and then transferred under a listing vehicle in another jurisdiction such as the Cayman Islands or Hong Kong prior to a public listing. These transfers, which are indirect share transfers of Chinese companies, are now subject to the Circular 698 reporting requirement and to potential taxation in China. While future investments may be planned to avoid these risks, it will be difficult for legacy structures to avoid them.

Although the seller in an indirect share sale is the potential taxpayer, the buyer should consider whether it can be held liable as a withholding agent if the transaction is later discovered and a tax assessment is issued. The question of the buyer's withholding obligation is not addressed in Circular 698, and other tax rules are ambiguous. However, the rules do not expressly state that a non-resident buyer cannot be treated as a withholding agent based on more general tax provisions, and some tax bureaus have asserted an obligation on non-resident buyers in situations where the seller is no longer available.

Circular 698 does not provide penalties for failure to pay or withhold tax. However, other notices issued by the State Administration of Taxation give the authorities tools to pursue non-resident parties to holding company transfers, including investigating other income sources of the parties in China and sending collection notices to those sources, seeking information from tax authorities in the parties' home jurisdictions under bi-lateral tax treaties, and handling failure to report or pay Chinese taxes in accordance with the *Administrative Law on the Levying and Collection of Taxes*, and other Chinese laws and regulations.

Penalties for failure to report are typically not substantial, ranging from RMB 2,000 (US$300) to RMB 10,000 (US$1,500). But if the Chinese tax authority recharacterizes a transaction and levies the capital gains tax, they may also impose interest on the unpaid tax at the central bank rate plus five percentage points.

Circular 698 has substantially increased the exposure of U.S. companies to Chinese reporting requirements and tax on the sale of a non-Chinese company directly or indirectly holding a subsidiary in China. Thoughtful planning may minimize or avoid this exposure with respect to future investments, but the impact of this circular will be difficult to avoid in many cases for legacy structures.

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NEW GUIDE FOR MULTINATIONALS IN CHINA

China is the economic story of our times. This year, China is the world's second largest economy (up from number 28 in 1981 and number nine in 2000) and the fastest growing. Other top players (USA first, Japan third, Germany fourth and France fifth) are flat or in decline and BRI, despite the hype, is relatively inconsequential with China larger than Brazil (eighth), India (eleventh) and Russia (twelfth) combined.

Multinationals and China

China is no longer just a factory to the world but also the biggest market opportunity. As such it is a profit foundation for multinationals. For example, according to the 2007 annual report, General Motors reported a loss of $3.3 billion in America but a profit of $681 million in Asia mainly due to its China joint ventures. This situation became even more pronounced in 2009 when GM went into bankruptcy in the US while its China business soared. Similarly, Apple, the third most valuable company in America, with a valuation of $222 billion, manufactures its iPods, iPhones and iPads in China using a third-party subcontractor (Hon Hai). The enormous locational savings, by making it in Shenzhen as opposed to Cupertino, contribute to the Apple bottom line.

Regulations versus Practice

The first lesson in China is that "all useful knowledge comes from practical experience". This is true in transfer pricing as well, where there is a major disconnect between national regulations and local actions.

As everyone in the transfer pricing world knows, transfer pricing in China was totally transformed by Circular Number 2 issued by the China State Administration of Taxation ("**SAT**") in 2009 *[Implementation Measures for Special Tax Adjustments Guo Shui Fa [2009] No. 2, 1/9/09]*. But how is this circular actually playing out? Right now, there is still widespread uncertainty in interpreting the new rules. The dust has not yet settled. But we can see patterns. Documentation is going by the book, but local tax authorities are still dragging their feet on APAs (despite clear timelines established in Circular 2) and completely ignoring the new cost-sharing regulations.

Being Graded on Documentation

China is taking a different tack on documentation enforcement. It is actually being collected. For example, the Beijing State Tax Bureau released a circular this year *[Jing Guo Shui Han [2010] No. 19]* stating that "all the district level tax bureaus should assess each documentation report and prepare an assessment report … The report should include the assessment of the potential for tax avoidance and a quality evaluation of the enterprise report." This has come as an unpleasant surprise to those who did not expect that their homework would ever be collected and graded.

Creating the Short Documentation Package

On the documentation front, there is good news for those who want a practical and cost-effective solution to this compliance burden. Some tax bureaus prefer a short report. Advisers recently received a sample abbreviated version of the transfer pricing documentation which is only five pages long and contains the following elements:

- Legal structure of the tested party;
- Financial statements;
- Short business overview outlining products (only one paragraph long in the tax bureau sample);
- Key related party transactions;
- Intercompany transaction flowchart;
- The method selected; and
- The list of the comparables with financial results (no request for accept-reject matrix).

Advisers suggest taxpayers also include an appendix with the SAT transfer pricing schedules. These schedules provide the core of the transfer pricing documentation when added to the benchmarking results.

APA Milestones and Statistics

The advance pricing agreement ("**APA**") concept was first introduced in China in 1998 under the Transfer Pricing Regulation (widely known as Circular 59). Since then we have seen many unilateral APAs and about 14 bilateral APAs being signed. Table 1 traces the evolution of APAs in China.

Why Getting an APA is Slow

APAs in China take too much time to implement for the following reasons:

- There is no special APA team in China and (no fee payable).
- SAT Constraint: There are only five transfer pricing specialists at SAT level and they are heavily burdened with many responsibilities.
- Local tax bureaus are also understaffed. In Shanghai, there are only two full-time transfer pricing specialists to handle about 15,000 foreign investment enterprises ("**FIEs**").
- Multiple entity issue: Each entity must be separately dealt with as there is no tax consolidation in China. This creates a real challenge for companies such as General Electric or Siemens who have about 100 separate legal entities in China.
- Local Resistance: The tax officials do not see much benefit in going for APAs. Local officials will not generally move forward on an APA that will reduce the tax payable. This perhaps is the biggest obstacle as it chokes the APA process off at the starting gate.

Table 1 – The evolution of APAs in China

Year	Description
1998	First unilateral APA was concluded in Xiamen.
2004	Within six years, 130 unilateral APAs were signed.
2005	First bilateral APA ("**BAPA**") was signed with Toshiba for a cost plus for its subsidiary in Shenzhen.
2006-2007	Various BAPAs were concluded, including with Samsung of Korea, and first Sino-US BAPA was completed with Wal-Mart in January 2007.
January 2009	Circular 2 at chapter 6 established new APA framework.
October 2009	First BAPA with Europe was signed with Novozymes of Denmark.
November 2009	According to SAT, total nine BAPAs are in effect as of this month.
2010	Additional BAPAs have been signed bringing total to 14 BAPAs in effect. Only 4 unilateral APAs are being considered by SAT.

Latest Audit Statistics and Self-examinations

During 2009, the SAT concluded 167 audit cases leading to RMB 16.09 billion ($2.3 billion) in income adjustments and RMB 2.09 billion in tax recovered, the average adjustment tax per case was RMB 12.5 million. This is a relatively low level of activity given that there are 458,372 FIEs in China. But it will likely get more intensive and it should be noted that some of these audits are national in nature.

More generally, China is becoming a far more challenging and combative tax environment. According to Xie Xuezhi, vice minister of the SAT, in 2009 the Chinese tax authorities recovered RMB 117.61 billion in tax revenue, an amount that exceeded total tax audit revenues received from 2006 to 2008. The tax authorities also instructed about 314,000 taxpayers to carry out self-inspections in 2009, obtaining RMB 51.37 billion in tax revenues from them. Companies doing self-inspection at the moment include Foxconn, General Electric, HSBC, McDonald's, Motorola, Nokia, Panasonic, Samsung, Siemens, and Wal-Mart.

New Ideas Taking Shape at SAT

The Personal Computing Industry Center ("**PCIC**") in California released an intriguing report that while an Apple iPod retails for $300, China only receives $3.70 for insertion, test and assembly, while Apple captures about $80 in gross profit. Some think this number is significantly understated, but the point is valid – China may only capture 10 cents on the dollar while contributing 90% of the labour. This goes to the question of labour saving.

The Glaxo Smith Kline ("**GSK**") transfer pricing case with its $3.3 billion settlement generated buzz even in China. GSK demonstrated that intangibles are not the exclusive property of the original developer but reflect the marketer (the US subsidiary of GSK) and the market premium (drug prices in the US are much higher than in Canada and other markets). The SAT officials learnt about the case and one of them even authored an article on the matter and its relevance to China.

The transfer pricing specialists at the SAT are smart and practical (led by a PhD economist). The SAT says that these are areas in which they are shaping their positions.

- Location savings: They believe that China needs to capture more of the profits realised by the great efficiencies created by its highly efficient labour force and they have raised this in competent authority discussion.
- Marketing intangibles: Luxury goods companies cannot be regarded as limited-risk distributors and it is not reasonable for foreign parents to claim that all the marketing intangibles belong to them.
- China market premium: In the automobile industry, many multinationals now generate most of their profits in China. The Chinese tax authorities believe that this premium should be taxable in China and are discussing ways to quantify this in a fair manner.

Selection of Audit Targets

At the Ningbo meeting of tax officials from across China, targets were selected – such as a famous company which had been in China for 11 years but always reported losses. Based on our discussions with the Tax Bureau, the targets selected will have the following characteristics:

- Perform a relatively limited set of functions;
- Sustained losses; and
- Have linkages with related parties located in tax haven jurisdictions.

Higher Profit Expectations and Safe Harbours

This year new deemed profit rates have been published which are much higher than those prevailing before. For example, representative offices starting in 2010 are expected to earn a minimum operating margin of 15% (versus a rate of 10% which had prevailed from 1986 over 20 years). The following intelligence was gathered through discussion with the tax bureaus administering rep offices and domestic enterprises and the transfer pricing specialists at SAT and local levels.

- They generally believe that profit rates in China are on the increase.
- The rep office deemed profit rate increase (the rate had been 10% since 1986) is a punitive measure to

encourage rep office to use the actual method of accounting as opposed to using the deemed method.

- Some of the local transfer pricing officials would welcome the publication of deemed profit rates or safe harbour rates for different types of entities (such as distribution, sales agents, contract manufacturers and so on) but the SAT refuses.

Handling the Special Forms Requested

The Chinese general Sun Zi warned that the "battle is won before the first shot is fired". This can be the case in audits. Once the assessment notice has been handed down, it is hard to get it adjusted.

As a first step, the tax authorities will ask the target to fill out certain forms. Fortunately, companies who prepared China transfer pricing documentation using the SAT template have these forms – but not those who took the shortcut of using a global template. The forms are as follows:

- Functional and risk analysis form
- Segmented financial analysis form of related party transactions
- Entity's comparability analysis form
- Relationship of related party confirmation form
- Related party transactions confirmation form
- Confirmation form of entity's comparability analysis

Computerised Tax System

China's regulators have gone high-tech and taxpayers need to catch up. If you get audited, the information in your documentation needs to match what is stored in CTAIS (China Taxation Administration Information System). No sense defending the wrong data.

CTAIS is the first tax collection and administration system that was used nationwide in China. Developed by the SAT and Digital China, it has gained widespread acceptance and more than 80% of the national tax revenue is collected by it.

In 2009, CTAIS was upgraded and the SAT issued *Guo Shui Han [2009] No. 72* to local tax bureaus to suggest that they can either adopt the upgraded version of CTAIS or modify other systems to handle the new and expanded TP disclosure requirements.

Approved Tax Filing Software

In many countries, tax returns can be filed electronically using any software that meets the specifications. In China, the local tax district will designate a list of approved software vendors. A sample list of approved vendors is presented in Table 2.

Defending Loss Making Entities

The rules have changed. The tax bureaus recently rejected a study done by Big 4 on loss making which had advanced the usual explanations (excess capacity and change in exchange rate). In Circular Number 363 *[Strengthening the Monitoring and Investigation of Cross-Border Related Party Transactions, Guo Shui Han [2009] No. 363, 7/06/09]* the SAT has staked out a position that loss-making in limited-function enterprises is basically unacceptable. Circular 363 states that limited function entities "shall not bear financial crisis, market and decision-making risks and, in keeping with the transfer pricing principle of correspondence between function/ risks and profit, shall maintain a reasonable profit level." Given this, what can a taxpayer do? Five broad strategies to deal with a loss-making situation are suggested:

- Argue that it is not a limited function or risk entity.
- Demonstrate that the losses are due to third-party transactions and not related party transactions.
- Use a CUT or CUP analysis.
- Identify loss factors that are due to local management or operational efficiencies, such as high defect rates and transitionary experience-curve issues.
- Use alternative accounting data (tax basis versus book basis) as tax basis is usually more favourable since many expenses in China may not be deductible.

Winning the Comparables Battle

One of the toughest parts of documentation in China is getting the right comparables and negotiating through the Chinese alphabet list of A share, B share, H share, and N share companies.

Frankly, many of the comparable studies out there even fail a layman's view of comparability and are unlikely to be persuasive in an audit situation. Part of it has to do with the process. Oftentimes, the task of selecting comparables is delegated to junior analysts, a year out of college, and there are even cases where the task of finding Chinese comparables has been outsourced to India. Here are our suggestions:

- Ensure that you have a good percentage of Chinese comparables

Table 2 – Sample approved tax and transfer pricing filing computer systems used in China

Company name	District
Zhong Xing Tong	Beijing - ChaoYang, HaiDian, FengTai and so on
Wo Qi Xin An	Beijing - XuanWu, ShiJingShan, SheWai, Yan Shan and so on
CS&S	Shanghai
Yi Qiao	Wuxi
Shen Zhou Hao Tian	Tianjin
Tong Shen	Guangdong

(definitely avoid using comparables from Australia and India).

- Database descriptions are meaningless. Go to original web sites to get more background on the company so as to present detailed business descriptions.
- Be flexible and creative in using profit level indicators ("**PLIs**").

Useful Databases and Websites

In China, the OSIRIS database is used by the SAT as per *Guo Shui Han [2005] No. 239* and is a good start. However, for more detailed information on Chinese companies – such as segmented profit and loss statements – it is necessary to go to the original sources for information. Listed in Table 3, by way of example, are websites that we use quite frequently in our practice.

Regulations to Consult

There are a number of regulations with relevance to transfer pricing and tax. But for the overseas tax advisers and taxpayers, table 4 is a short list of what you absolutely must know – all of which have been translated.

Consultants versus In-house Team

The transfer pricing consulting world has expanded. In 1999, when I arrived in China, only one firm – part of the Big 5 – had a transfer pricing practice. Now in addition to Big 4, there are a number of international boutique firms as well as local firms providing transfer pricing services. However, few, if any, of the transfer pricing consultants are technically trained in economics. They are former tax professionals who have made a switch. Consequently, in China it is quite important to manage and guide the consulting process for transfer pricing engagements such as setting the strategy, reviewing the comparables, and ensuring that the reports are well-grounded in fact and based on acceptable methodologies.

Even more important is the need to build up a strong in-house Chinese tax team. Most big US (and also European) multinationals have already done so by recruiting tax managers from the Big 4 accounting firms. Some have even designated individuals to specialise in customs, transfer pricing and government relations. Japanese and Korean companies lag far behind. In-house capabilities are a good investment. A local team member can develop relationships with the in-charge tax official and with their command of the inside business they can arguably produce a superior transfer pricing result, especially when working in tandem with the consultant.

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Table 3 – Sample exchange website clearinghouses for downloading annual reports

	Site	Address	Language	Coverage
1.	HK Exchanges and Clearing Limited	www.hkex.com.hk	English/Chinese	HK(and China)
2.	Juchaozixun	www.cninfo.com.cn	Chinese	China
3.	Shanghai Official Stock Exchange	www.sse.com.cn	Chinese	Shanghai
4.	Shenzhen Official Stock Exchange	www.szse.cn	Chinese	Shenzhen
5.	Yahoo China Finance	cnfinance.yahoo.com	Chinese	China
6.	Singapore Exchange	www.sgx.com	English	Singapore

Table 4 – Index of regulations on Chinese transfer pricing

Laws and Regulations	Enacted	Reference	Issued By	Description
Corporate Income Tax ("**CIT**") Law	March 16, 2007	*Zhu Xi Ling 63*	National People's Congress ("**NPC**")	It went into effect on January 1, 2008 and created same tax system for domestic and foreign enterprises. It replaces the 1991 CIT Law.
Corporate Income Tax Implementation Rules	December 6, 2007	*Guo Wu Yuan Ling 512*	State Council	It provides the details to implementing the CIT Law.
Implementation Measures for Special Tax Adjustments	January 9, 2009	*Guo Shui Fa No. 2*	SAT	Landmark circular that creates documentation requirement and establishes rules for cost sharing, APAs and so forth.
Strengthening the Monitoring and Investigation of Cross-Border Related Party Transactions	July 6, 2009	*Guo Shui Han No. 363*	SAT	It requires the loss-making entities with limited functions to prepare documentation.

CURRENT EQUITY AND EMPLOYMENT CHALLENGES FOR U.S. MULTINATIONALS IN CHINA

Doing business in China has always been a challenge for U.S. multinationals, and it continues to be so. Current compliance concerns include the restrictions on the grant of stock options in China, new difficulties with secondments into China, the rise of overtime claims, as well as increasing labor disputes.

U.S. multinationals hiring employees in China want to be able to offer stock options or other equity benefits as an incentive to hire and retain key individuals. Over the years, companies granting equity awards to employees in China have coped with tax laws that required reporting at grant and uncertainty around securities law registration issues. Now, however, U.S. public companies face a new challenge - Circular 78. This new challenge makes it very difficult and expensive to offer equity plans to Chinese national employees.

Since February 2007, a U.S. public company must comply with certain operational guidelines issued by the General Affairs Department of the State Administration of Foreign Exchange ("**SAFE**"), also known as Circular 78, and obtain an approval from the SAFE officials to offer equity rights to Chinese national employees. Among the many requirements of Circular 78 is the need to establish a bank account in China through which any funds used to purchase the company's shares and any proceeds from the sale of the shares must flow before they can be converted to local currency. The company must guarantee that all of the amounts the employees receive from the equity award are repatriated to China and do not remain in an off-shore bank or brokerage accounts. The company also must translate all of its equity plans and grant documents into Chinese and submit them with the SAFE application for approval.

In addition, to make the Circular 78 filing, the U.S. company must have a subsidiary operation, typically a wholly foreign owned enterprise that employs the individuals receiving the equity awards. Companies who employ individuals in China through a representative office or other entity are not able to file a Circular 78. If a company is new to doing business in China, it may take time to establish the wholly foreign owned enterprise and then obtain the SAFE approval before an option or other equity grant can be made to the employees of the wholly foreign owned enterprise. This can effect a company's ability to hire and retain employees because competitors may already have SAFE approval in place.

Although coping with Circular 78 and obtaining SAFE approval is challenging, there are some steps companies can take to deal with these challenges. Equity awards can be designed to ensure that funds used to purchase shares do not need to be converted into U.S. dollars or transferred out of China by employees. For example, options can be designed to restrict exercises solely by a cashless exercise conducted by the broker, and restricted stock units can be granted for no cash consideration. With these design changes to the options and restricted stock units, no funds need to flow out of China for the Chinese employees to receive shares, so the company needs to seek approval only for inflow of funds to China (and not the outflow).

Another possibility is for the U.S. company to offer some other type of employee benefit to Chinese national employees that is not subject to the requirements of Circular 78. One possibility is a vesting cash bonus award paid in local currency. This type of award should not require SAFE approval, provided it is not tied to the appreciation in the value of the company's shares and is not paid for by the U.S. parent company. However, providing a cash bonus award may raise other entitlement and employment issues.

Government and tax authorities in China have stepped up enforcement activity where non-compliance occurs. U.S. multinationals offering equity to employees in the China are not immune to such efforts and should proceed with caution. Coping with the legal challenges to granting equity in China means staying informed of all legal requirements and actively avoiding legal obstacles by the choice and design of awards and/or by completing the SAFE filing for the offerings.

A further development in China is the ongoing uncertainty about the tax treatment of expatriate secondment agreements.

During the last few decades, the tax authorities in China have recognized that a properly structured secondment arrangement does not create a permanent establishment of the host company seconding an expatriate employee to China, provided that the expatriate employee worked under the supervision and control of the Chinese subsidiary during the secondment, and the Chinese subsidiary reimbursed only the direct costs of the overseas employer related to the expatriate, without mark-up.

This is consistent with the interpretation of tax authorities in numerous jurisdictions, according to which the secondment of personnel (which does not create a permanent establishment) can be distinguished from the provision of services through personnel in another country (which may create a so-called

"services PE" under various tax treaties, including the U.S.-PRC tax treaty).

The ability of a foreign company to second employees to China without creating a permanent establishment was threatened, however, by the issuance in July 2009 of Notice 103 of the China State Administration of Taxation. Notice 103 launched an investigation of cross-border secondments to China with the purpose of evaluating whether or not they create permanent establishments of the overseas seconding company. If a permanent establishment is created, the overseas company may be deemed subject to business tax at a 5 percent rate of the gross amount of services fees (i.e. the amount of the reimbursement made from the Chinese host company to the home company plus a deemed profit determined by the tax authorities), and income tax at a 25 percent rate on the deemed income. This effectively results in an increased tax burden ranging from 8 percent to 15 percent of the payroll costs of expatriate employees. Most local tax authorities, including in Beijing and Shanghai, have interpreted these rules this broadly in their local regulations and implementation practices.

The investigations under Notice 103 were completed in the fall of 2009, but so far the tax authorities have not issued regulations to address the permanent establishment issue. Local tax bureau practices around China appear to vary widely, with some automatically levying tax on secondment reimbursements based on a permanent establishment, and others evaluating the permanent establishment issue on a case-by-case basis. At this point, many foreign companies have suspended remittances of reimbursements under secondment arrangements because they cannot obtain tax clearances (which are required for payments outside China) without withholding and paying taxes. Other companies have decided for the home company not to charge back the costs of the expatriate employees to the Chinese host company. Finally, other companies have attempted to deliver the salary through the Chinese entity directly in a secondment arrangement, or to even engage the expat employee directly through this entity.

Unfortunately, none of these approaches are without downsides and legal risks. At this point, most companies hope that the Chinese government will revert back to its old interpretation, but there is no certainty in this regard.

The Chinese employment law landscape is in constant flux in many other areas as well. While the implementation of the Employment Contract Law in January 2008 raised some hopes of creating a consistent labor and employment law landscape in China, uncertainties have continued. Accordingly, labor and employment in China continue to be fragmented across provinces and even cities.

Also, consistent with the trend in many other jurisdictions around the world, wage and hour disputes are on the rise in China. For instance, labor disputes have doubled in the major cities in the last year, with 60 percent of claims in Beijing, and 34 percent of claims in Shanghai being overtime claims. Unfortunately, there is still a lot of uncertainty about wage and hour requirements in China, what employees are exempt, or what working time systems are permissible. For instance, Shenzhen regulations have recently provided that senior managers are automatically exempted from overtime requirements, but there is no consistency in such interpretation among the other provinces.

Another important development is the declaration by the March 2010 National People's Congress that the increase in employee wages is a new key policy of the Chinese government. This has resulted in an increase of minimum wages in various locations in China pursuant to local regulations, as well as focus on employee wages in collective bargaining negotiations.

China remains a challenging jurisdiction in which to do business. Opportunities abound, but the legal risks and business uncertainties continue to be substantial.

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ENTEPRISE NAMES

Notice on the Conduct of an Examination of Foreign-invested Enterprise Names

The Notice on the Conduct of an Examination of Foreign-invested Enterprise Names, 关于对外商投资企业有关名称进行核查的通知, were issued by the Bureau for Registration of Foreign-Invested Enterprises of the State Administration for Industry and Commerce as document *Wai Qi Zhu Zi* [2010] No. 2 on August 13, 2010.

Administrations for industry and commerce and market supervision administrations of the provinces, autonomous regions, municipalities directly under the central government and municipalities with independent development plans:

Since the issuance by the State Administration for Industry and Commerce (the "**SAIC**") of the *Regulations for Administration of the Registration of Enterprise Names* (Order [1991] No. 7 of the SAIC; hereinafter referred to as the "**Regulations**"), administrations for industry and commerce everywhere have, in due accordance with the requirements of the Regulations, registered the names of foreign-invested enterprises ("**FIEs**") requiring SAIC approval after such approval, which has had a positive effect on standardizing the use of FIE names and promoting the administration of the registration of FIEs.

However, at present, some problems remain in the registration and use of FIE names, the major ones being the unauthorized approval in some regions of the use of names that do not include the administrative division or place name and of enterprise names that contain such words as "中国",[1] "中华",[2] "全国",[3] "国家",[4] etc.; some FIE names approved by the SAIC not being used in registration, resulting in such name resources being tied up and unavailable to others; some FIE names approved by the SAIC being used in a non-compliant manner, resulting in inconsistency between the approved name and the name registered and being used, etc. These problems in the registration and use of FIE names affect the normal administration of the registration of FIEs.

With a view to strictly implementing the Regulations and the *Implementing Measures for Administration of the Registration of Enterprise Names*, making the administration of the registration of enterprise names compliant, protecting the lawful rights and interests of enterprises, avoiding the tying-up and waste of foreign-invested enterprise name resources and promoting the digitalization of enterprise name registration, we have decided that a comprehensive examination of FIE names approved by the SAIC will be conducted. We hereby notify you on relevant matters as follows:

1. Scope of FIE Names To Be Examined and Reported

   (1) Enterprise names that do not contain the administrative division or place name.

   (2) Enterprise names that commence with such words as "中国",[1] "中华",[2] "全国",[3] "国家",[4] "国际",[5] etc.

   (3) Enterprise names that contain "(中国)"[6] in the body of the name.

The foregoing list of FIE names includes FIE names that have remained in normal existence, those that have been changed and those that have been deregistered or revoked.

2. The administrations for industry and commerce and market supervision administrations of the provinces, autonomous regions, municipalities directly under the central government and municipalities with independent development plans should duly organize the name examination and reporting exercise, and assign specific persons to be responsible for checking enterprise registration particulars, accurately completing a Foreign-Invested Enterprise Name Examination and Registration Form and ensuring that no names are omitted from the enterprise names that are to be reported and that there are no errors in such names. Additionally, if a name was approved by the SAIC, a photocopy of the approval document should be attached.

3. We will examine in accordance with relevant regulations the FIE names

1 Translator's note: These Chinese characters mean "China".
2 Translator's note: These Chinese characters mean "China".
3 Translator's note: These Chinese characters mean "national".
4 Translator's note: These Chinese characters mean "state".
5 Translator's note: These Chinese characters mean "international".
6 Translator's note: These Chinese characters mean "China".

reported by every authority. We will issue written confirmation of those FIE names that comply with regulations and are fully documented, and order rectification of those FIE names that do not comply with regulations. Names that have been changed, de-registered or revoked will be marked as such in the SAIC's name database in accordance with relevant regulations.

4. The administrations for industry and commerce and market supervision administrations of all provinces, autonomous regions, municipalities directly under the central government and municipalities with independent development plans are asked to submit the Foreign-Invested Enterprise Name Examination and Registration Forms (including the electronic versions) to the Registration Section of the Bureau for Registration of Foreign-Invested Enterprises of the SAIC by September 1. If you encounter any problems in the course of the examination, please promptly contact the Bureau for Registration of Foreign-Invested Enterprises.

   Contact persons: Hong Jun and Zhang Yuxi, Registration Section, Bureau for Registration of Foreign-Invested Enterprises, SAIC

   Contact telephone: 010-68012268, 88650162, 68050291

   Contact address: Registration Section, Bureau for Registration of Foreign-Invested Enterprises, SAIC, 8 Sanlihe Dong Lu, Xicheng District, Beijing

   Postal code: 100820

   E-mail address: hongjun@saic.gov.cn

CONTRACTS

Measures for the Supervision and Handling of Contract-Related Illegal Acts

The Measures for the Supervision and Handling of Contract-Related Illegal Acts, 合同违法行为监督处理办法, were issued by the State Administration for Industry and Commerce with Order No. 51 on October 13, 2010, and effective from November 13, 2010.

Article 1. These Measures are formulated pursuant to the *Contract Law of the People's Republic of China* and relevant laws and statutes in order to safeguard market and economic order, protect the interests of the state and the public, and uphold the legitimate rights and interests of the relevant parties.

Article 2. For the purposes of these Measures, "contract-related illegal acts" means the use of a contract by a natural person, legal person or other organization to commit acts which violate laws, regulations or these Measures for the purpose of obtaining illegal benefits.

Article 3. When concluding and performing contracts, the parties shall comply with laws and administrative regulations and respect public morals. They may not disturb the social or economic order or harm the interests of the state or the public.

Article 4. The administrative authorities for industry and commerce at all levels are, within their respective jurisdictions, in charge of supervising and handling contract-related illegal acts pursuant to relevant laws and regulations and these Measures.

Article 5. The administrative authorities for industry and commerce and all levels shall supervise and handle contract-related illegal acts according to law. They shall integrate guidance into investigation activities and education into punishment, introduce administrative guidance, supervise and instruct contracting parties to conclude and perform contracts according to law, and uphold the interests of the state and the public.

Article 6. No one may make use of a contract to carry out the following fraudulent acts:

(1) forging a contract;

(2) forging one's qualification to conclude a contract, or stealing or assuming the identity of another to conclude a contract;

(3) forging the subject matter of a contract, or forging the origin of the goods or sales channels in order to persuade another to conclude or perform a contract;

(4) publishing or using of sham information to persuade another to conclude a contract;

(5) concealing important facts to mislead the counterparty into concluding a contract that is an incorrect expression of his intention or to mislead the counterparty into concluding or performing a contract;

(6) misleading the counterparty into concluding or performing a contract when one does not actually have the ability to perform the same by first performing a contract for a small amount or by partially performing a contract;

(7) maliciously proposing conditions which are in fact impossible to perform thereby making the counterparty unable to perform the contract;

(8) creating sham grounds for suspension (or termination) of a contract in order to obtain property by deceit;

(9) providing sham guarantees;

(10) using other fraudulent means to conclude or perform a contract.

Article 7. No one may use a contract to do the following things which jeopardize the interests of the state and/or the public:

(1) securing the conclusion or performance a contract through such means as bribery or coercion, thereby harming the interests of the state and the public;

(2) securing the conclusion or performance a contract by conspiring maliciously with others thereby harming the interests of the state and the public;

(3) illegally purchasing or selling property whose purchase and sale is prohibited or restricted by the state;

(4) failing to perform contractual obligations which are in the nature of an order from the state without legitimate cause;

(5) committing other illegal acts involving a contract which jeopardize the interests of the state and/or the public.

Article 8. No unit or individual may provide a certificate, license, seal, bank account or other convenience if it is aware or should have been aware that the same will be used by others for the illegal

acts contemplated in Articles 6 and/or 7 hereof.

Article 9. If a business operator and a consumer conclude a contract containing standard terms, the operator may not exempt itself under such standard terms from the following liabilities:

(1) liability for personal injury sustained by the consumer;

(2) liability for damage to the consumer's property sustained as a result of deliberate act or gross negligence on the part of the business operator;

(3) liability for the warranties to be borne according to law in respect of the goods or services provided;

(4) the liability for breach of contract to be borne according to law for a breach of contract by the business operator;

(5) other liability to be borne by the business operator according to law.

Article 10. If a business operator and a consumer conclude a contract containing standard terms, the business operator may not increase the consumer's liability under such standard terms as described below:

(1) the amount of liquidated damages or damages exceeds the statutory amount or a reasonable amount;

(2) the consumer is made to bear business risks or liability which should be borne by the party providing the standard terms;

(3) the consumer is made to bear other liabilities which, pursuant to laws and regulations, should not be borne by the consumer.

Article 11. If a business operator and a consumer conclude a contract containing standard terms, the business operator may not exclude the following rights of the consumer under such standard terms:

(1) the right to modify or terminate the contract according to law;

(2) the right to claim liquidated damages;

(3) the right to claim damages;

(4) the right to interpret standard terms;

(5) the right to institute litigation in any dispute concerning standard terms;

(6) other rights to be enjoyed by consumers according to law.

Article 12. If anyone breaches Article 6, 7, 8, 9, 10 or 11 hereof and the handling of such breach is provided for in existing laws and regulations, the breach shall handled in accordance therewith; if such breach is not provided for in existing laws and regulations, the administration for industry and commerce shall, depending on the seriousness of the offense, issue a warning, or impose a fine of not more than three times the amount of illegal income up to a maximum of RMB 30,000 or, if there is no illegal income, impose a fine of not more than RMB 10,000.

Article 13. If a party's breach of contract is minor, remedied in a timely manner and has no dangerous consequences, no administrative punishment shall be imposed according to law; if the party in breach pro-actively eliminates or mitigates any dangerous consequences, a lenient or mitigated administrative punishment may be imposed; if the party in breach is able to pro-actively rectify or timely suspend its breach of contract after supervision or guidance, a lenient administrative punishment may be imposed.

Article 14. If the administration for industry and commerce suspects that a breach of these Measures constitutes a crime, it shall transfer the matter to the judicial authorities for prosecution of criminal liability, in accordance with relevant regulations.

Article 15. The State Administration for Industry and Commerce is in charge of interpreting these Measures.

Article 16. These Measures shall be implemented from November 13, 2010.

E-PUBLICATIONS

Notice on Subjecting E-Books to Examination, Approval and Administration In Accordance with Laws and Regulations

The Notice on Subjecting E-Books to Examination, Approval and Administration In Accordance with Laws and Regulations, 关于依法依规将电子书纳入审批管理的通知, were issued by the General Office of the General Administration of Press and Publishing as document *Xin Chu Ting Fa* [2010] No. 4 on October 9, 2010.

Bureaus of press and publishing of the provinces, autonomous regions and municipalities directly under the central government, Bureau of Press and Publishing of the Xinjiang Production and Construction Corp and Bureau of Press and Publishing of the Publicity Department of the General Political Department of the People's Liberation Army:

With a view to further promoting the healthy and orderly development of China's E-Book industry, the General Administration of Press and Publishing issued the *Opinions on Developing the E-Book Industry* (ref. *Xin Chu Zheng Fa* [2010] No. 9; the "**Opinions**") which expressly proposed the establishment in accordance with laws and regulations of an E-Book industry access system. In keeping with the spirit of current state policies and regulations on press and publishing and the Opinions and while taking into account the actual state of development of the E-Book industry in China at present, we hereby notify you on subjecting E-Books to examination, approval and administration in accordance with laws and regulations as follows:

I. Subjecting E-Book Industry Activities to Examination, Approval and Administration in Accordance With Laws and Regulations

For the purposes of this Notice, the term "E-Book" means a handheld reading device that combines a storage medium and display terminal and that embeds or permits the downloading of digitized information content, such as text, pictures, sound, video, etc. The production chain for E-Books, as a new publication format, mainly includes such stages as content creation, compilation and processing, digitization, chip embedding, submission to platform, equipment production, market sale and import trade. The basic attributes of these specific publication industry activities shall be included within the scope of the administration of publishing in accordance with the law.

E-Books incorporate both traditional publication features and online publication features, and are an extension of traditional publication media and reading methods under digital publication technology conditions. Pursuant to relevant provisions of the *Regulations for the Administration of the Publishing of Electronic Publications and the Provisional Regulations for the Administration of Online Publishing*, E-Books that contain digital content of a knowledge and ideological character are electronic publications, and the online transmission act of providing to E-Book users access to, reading, use or downloading of content via the Internet constitutes an online publication activity. The establishment of E-Book content creation, compilation and publication entities, enterprises operating platforms for the submission of E-Book content resources, enterprises that digitize and process E-Book content, enterprises that produce handheld reading terminals, enterprises that sell E-Books and enterprises that import E-Books that are involved in the E-Book production chain shall, in accordance with relevant statutes, rules and regulations for enterprises that publish, reproduce, distribute and import electronic publications and for online publishers, be subject to advance examination and approval.

II. Clarifying the Establishment of E-Book Examination and Approval Particulars and the Legal Basis for Examination and Approval

1. Depending on their method of publication, the establishment and administration of E-Book publishers shall be handled in accordance either with the regulations for electronic publication publishers or those for online publishers.

   The term "E-Book publisher" means an entity that engages in E-Book content creation, compilation and publication or one that operates a platform for the submission of E-Book content resources. E-Book content is published mainly either through pre-embedding or submission to an online platform.

Pursuant to the *Regulations for the Administration of the Publishing of Electronic Publications*, an E-Book pre-embedded with digital content of a knowledge and ideological character is a digital publication, must be published by a lawfully established electronic publication publisher and is required to use a China standard book code for electronic publications. Pursuant to the requirements of the *Provisional Regulations for the Administration of Online Publishing*, an enterprise that provides online submission services to E-Book users through its online platform for access to, reading, use or download of content resources is considered to be engaging in online publication activities, and is required to secure online publication qualifications for the relevant scope of business and obtain an Online Publication Permit issued by the press and publishing authority.

2. The establishment and administration of E-Book reproducers shall be handled with reference to regulations for enterprises that reproduce read-only optical disks (optical disks with stored content).

   The term "E-Book reproducer" means an enterprise that engages in the digitization, compilation or processing of publication content or that embeds digital chips. Engagement in the digitization, compilation or processing of publication content or the embedding of digital chips are electronic publication reproduction activities and, pursuant to relevant provisions of the *Measures for the Administration of Reproduction and the Regulations for the Administration of the Publishing of Electronic Publications*, an E-Book reproducer is required to obtain in accordance with the law a Reproduction Business Permit issued by the press and publishing authority.

3. The establishment and administration of sellers of E-Books with pre-embedded content shall be handled in accordance with regulations for electronic publication distributors.

   The term "E-Book seller" means a seller that engages in the general distribution, wholesale or retail sale of E-Books. The sale of E-Books with pre-embedded content is an electronic publication distribution activity and, pursuant to the requirements of the *Regulations for the Administration of Publishing and the Regulations for the Administration of the Publishing Market*, engagement in such distribution activities as the general distribution, wholesale and retail sale of, and chain store operations involving, electronic publications requires securing the permission of the press and publishing authority in accordance with the law. Enterprises that sell E-Books shall obtain in accordance with the law a Publication Business Permit with a scope of business that includes the general distribution, wholesale or retail sale of electronic publications.

4. The establishment and administration of importers of E-Books that contain pre-embedded content or that transmit foreign databases by way of the Internet shall be handled in accordance with regulations for importers of publications.

   The term "E-Book importer" means an enterprise that engages in the import of E-Books. The import of E-Books containing pre-embedded content is electronic publication import business and, pursuant to the requirements of the *Regulations for the Administration of Publishing and the Regulations for the Administration of the Publishing Market*, the engagement in electronic publication import business requires securing the permission of the press and publishing authority in accordance with the law. Enterprises that import E-Books that contain pre-embedded content or that transmit foreign databases by way of the Internet are required to obtain in accordance with the law a Publication Import Permit with a scope of business that includes the import of electronic publications. Entities that distribute imported E-Books that contain pre-embedded content or that transmit foreign databases by way of the Internet must order from lawfully established electronic publication importers that have a scope of business that includes the import of electronic publications.

III. Duly Carrying out the Examination, Approval and Administration of E-Books

Upon receipt of this Notice, press and publishing authorities everywhere shall incorporate in accordance with the law E-Book industry activities into the scope of their publication administration duties as soon as possible, ensure that their organizations and personnel investigate and come to a full understanding of the state of development of the E-Book industry and the engagement in E-Book related business by enterprises in their regions, classify such enterprises into categories and keep statistics thereon and administer the same accordingly and establish an information database of entities involved in the E-Book business.

Press and publishing authorities everywhere shall, in line with their examination approval authority and in accordance with the prescribed procedure, carry out approval procedures for the various types of E-Book enterprises that satisfy the permission qualifications and requirements, duly review application particulars and carry out the approval work and provide high quality and efficient service to applying entities. They shall, in respect of enterprises that have secured the appropriate qualifications, duly perform their oversight duties in accordance with the law, regulate corporate acts, ensure the quality of the publication and transmission of E-Books, safeguard good market order and promote the healthy and rapid development of the E-Book industry.

Highlights of New Legislation

Customs

Decision of the General Administration of Customs on Revising the *Measures of Customs of the People's Republic of China for Supervision of the Entry and Exit of Non-Private Articles of Resident Offices*.

海关总署关于修改《中华人民共和国海关对常驻机构进出境公用物品监管办法》的决定

Issued on: November 1, 2010
Effective from: December 5, 2010

Measures of Customs of the People's Republic of China for the Supervision of Inbound and Outbound Means of Transportation.

中华人民共和国海关进出境运输工具监管办法

Adopted on: October 14, 2010
Issued on: November 1, 2010
Effective from: January 1, 2011

E-Commerce

Notice of the Ministry of Commerce on Developing E-Commerce Examples.

商务部关于开展电子商务示范工作的通知

Issued on: October 27, 2010

Environment

Letter of the Ministry of Environmental Protection on Soliciting Comments on the *Regulations on the Administration of Environmental Protection in Connection With the Import of Solid Waste (for Trial Implementation) and the Regulations on the Administration of Environmental Protection in Connection With the Import of Silicon Waste and Scrap (for Trial Implementation)*.

环境保护部办公厅关于征求《进口固体废物环境保护管理规定（试行）》和《进口硅废碎料环境保护管理规定（试行）》意见的函

Issued on: October 21, 2010

Foreign Exchange

Notice of the State Administration of Foreign Exchange on Issues in the Strengthening of the Control of Foreign Exchange Transactions.

国家外汇管理局关于加强外汇业务管理有关问题的通知

Issued on: November 9, 2010

Government Procurement

Measures for the Accreditation of Government Procurement Agencies.

政府采购代理机构资格认定办法

Issued on: October 26, 2010
Effective from: December 1, 2010

Insurance

Notice of the China Insurance Regulatory Commission on Issuance of the *Implementation Guidelines for Comprehensive Risk Management in Life Insurance Companies*.

中国保监会关于印发《人身保险公司全面风险管理实施指引》的通知

Issued on: October 24, 2010

Intellectual Property

Notice of the General Office of the State Council on Issuance of the Special Action Plan for Combating Intellectual Property Right Infringements and the Production and Sale of Counterfeit or Shoddy Goods.

国务院办公厅关于印发打击侵犯知识产权和制售假冒伪劣商品专项行动方案的通知

Issued on: October 27, 2010

Investment Fund

Notice of the China Securities Regulatory Commission on Publicly Soliciting Comments on the *Measures for Administration of the Sale of Securities Investment Fund Units (Amended Draft)*.

中国证券监督管理委员会关于《证券投资基金销售管理办法（修订稿）》公开征求意见的通知

Issued on: November 1, 2010

Judiciary

Regulations of the Supreme People's Court on Issues Concerning the Application of the Law in the Trial of Travel Disputes.

最高人民法院关于审理旅游纠纷案件适用法律若干问题的规定

Adopted on: September 13, 2010
Issued on: October 26, 2010
Effective from: November 1, 2010

Processing Trade

Decision (II) of the General Administration of Customs on Amending the *Measures of Customs of the People's Republic of China for the Supervision of Goods in Connection With Processing Trade*.

海关总署关于修改《中华人民共和国海关对加工贸易货物监管办法》的决定（二）

Adopted on: October 14, 2010
Issued on: November 1, 2010
Effective from: December 5, 2010

Transportation

Regulations on the Administration of the Transportation of Radioactive Articles by Road.

放射性物品道路运输管理规定

Issued on: October 27, 2010
Effective from: January 1, 2011

Seminars, Publications and Other News

Baker & McKenzie will organize a complimentary breakfast briefing entitled "Navigating the Tax and Investment Treaty Maze – Heading off China's Anti-Avoidance Rules" on January 13, 2011 in Palo Alto, California. For more information and to register, please contact Lillian Han at china.desk@bakermckenzie.com.

Baker & McKenzie hosted a series of Eye-on-China webinars entitled "Anti-Corruption and State Secret Laws" on October 6, 2010; "Taxation of Foreign Investors in China" on November 3, 2010; and "Litigating in China" on December 1, 2010.

Baker & McKenzie hosted a complimentary seminar "A Year-End Review of Import/Export Developments" at the Hyatt Regency Hotel in Santa Clara, California on November 30 and December 1, 2010.

Baker & McKenzie's Annual Hong Kong and China Employment Law Seminar was held at the Four Seasons Hotel in Hong Kong on December 1, 2010.

Baker & McKenzie's Annual Hong Kong and China Property Update will be held on December 16, 2010. The seminar will take place at Baker & McKenzie's Hong Kong office.

Bing Ho, **John McKenzie** and **Allan Marson** discussed updates and insights on China's M&A laws and regulations at the "China M&A: Opportunities in the Middle Kingdom" seminar held at the Hyatt Regency in Santa Clara, California on September 21, 2010.

Andreas Lauffs spoke at the seminar "Evolving Labor Issues in China" organized by the US- China Business Counsel in Washington on September 29, 2010.

On October 6, 2010, Andreas spoke on "How to Handle Labor Unions in China" at the AmCham Hong Kong office.

Harvey Lau spoke on the topic "Recent Structures in PRC Aircraft Finance" at the IBA Conference held in Vancouver on October 5, 2010.

Glenn DeSouza spoke at the "Noppen 4th International Taxation Summit 2010" held in Beijing on October 13-14, 2010.

Michelle Gon presented at the "LexisNexis 2nd Procurement Fraud Conference 2010" held at the Pullman Shanghai Skyway Hotel, Shanghai on October 13-14, 2010.

Joseph Simone was a panel moderator at the INTA Conference held in Hong Kong on October 19-22, 2010 and the Ambassador's IPR Dialogue held on November 10, 2010.

Martin Commons presented at the "Competition Law Developments in Hong Kong and China" seminar organized by ALB on October 20, 2010.

Baker & McKenzie and Standard Chartered Bank jointly organized seminars entitled "Offshore RMB Business in Hong Kong - Are You Ready?" which was held in Hong Kong, Taipei and Shanghai respectively on November 4, November 12 and November 15, 2010. Speakers include **Harvey Lau**, **Eugene Lim**, **Rossana Chu**, **Brian Spires**, **Steven Sieker**, **Maureen Chow** and **Xiaoming Chen**.

Danian Zhang, **Michelle Gon**, **Brendan Kelly**, **Bing Ho**, **Harvey Lau**, **Joseph Deng**, **Chunfai Lui** and **Simon Hui** took part in the seminar entitled "A 360 Degree Look at China Compliance" to examine compliance issues in China from different angles, ranging from FCPA, M&A, to employment and environmental compliance. The half-day seminar was held on November 23, 2010 at the Ritz-Carlton Hotel in Pudong, Shanghai.

Harvey Lau and **Charles Chen** co-authored an article on China's foreign exchange regime to the November issue of China Law & Practice.

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