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Newsletter

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Insights & Ideas

Legal Updates

Notice of the General Office of the State Council regarding the Establishment of the Security Review System for Mergers and Acquisitions of Domestic Enterprises by Foreign Investors (Author: Minyu SUN; Xu LIU)

On February 3, 2011, the Notice of the General Office of the State Council regarding the Establishment of the Security Review System for Mergers and Acquisitions of Domestic Enterprises by Foreign Investors (the "Notice") was issued by the General Office of the State Council. The Notice, effective 30 days thereafter, requires for a national security review by a ministerial panel (the "Ministerial Panel") for any merger or acquisition of a domestic enterprise by a foreign investor (an "M&A") that may have potential impact on China's national security. If an M&A transaction has exerted, or is likely to exert, significant impact on China's national security, the Ministerial Panel would order relevant departments to take measures to eliminate the influence of the transaction on the national security, including termination of the transaction and transfer of relevant equity or assets.

M&A Transactions Subject to National Security Review

(1) Mergers and acquisitions of military industrial enterprises or military related supporting enterprises, enterprises located near key and sensitive military facilities, and other entities in relation to national defense security;

(2) Mergers and acquisitions of entities involved in industries such as major agricultural products, energy and resources, infrastructure, transportation, technology and assembly manufacturing of national security importance, whereby the foreign investors may acquire the actual controlling right thereof.

It should be noted that, in respect of an M&A, the Notice sets forth a broader scope than that specified in the Decree No.10 (i.e. the Regulations of the Ministry of Commerce regarding Mergers and Acquisitions of Domestic Enterprises by Foreign Investors). 'Foreign investors' acquisition of Chinese shareholders' equity interest in foreign invested enterprises" is covered under the Notice, but not specifically under the Decree 10.

M&A transactions involving domestic financial institutions will be separately addressed by regulations to be formulated.

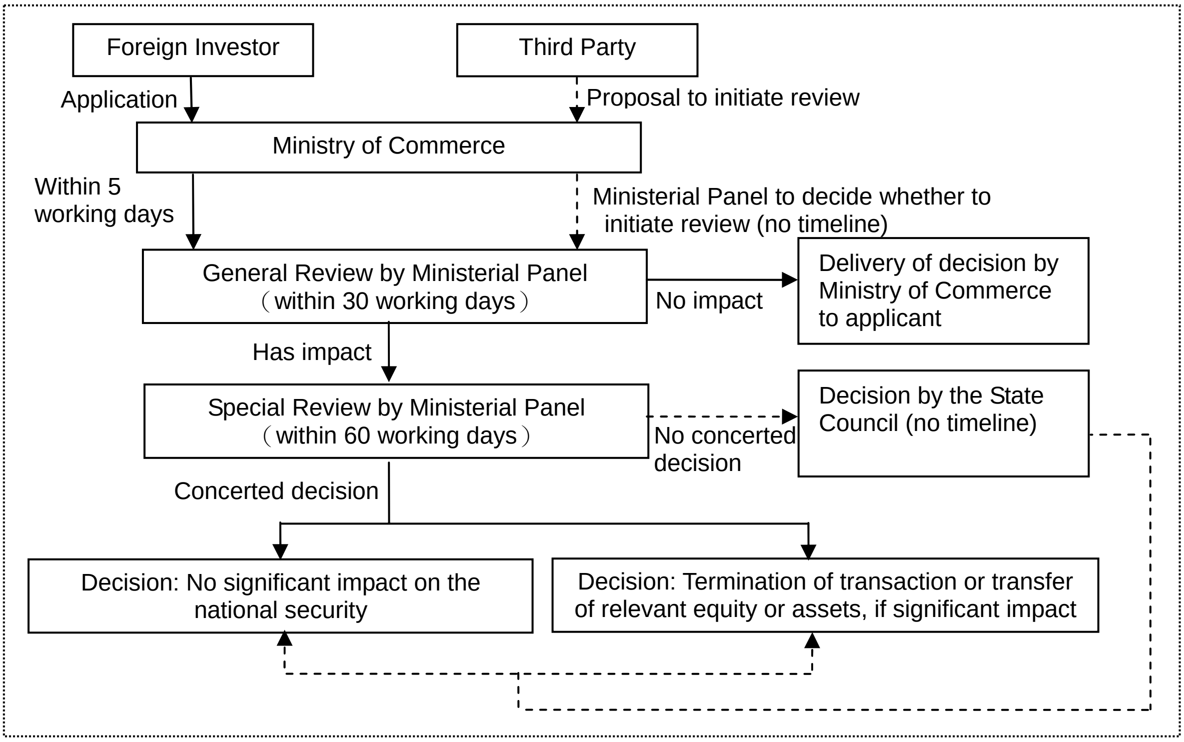
No clarification is made under the Notice regarding "major agricultural products, energy and resources, infrastructure, transportation, technology and assembly manufacturing". By common sense, grain and oil, sugar, cotton, water, electricity, petroleum, natural gas, highway transportation, telecommunication, power grid and irrigation would likely be included.

Under the Notice, "a foreign investor's acquisition of actual controlling right" is interpreted as follows: (a) a foreign investor, or its parent company or subsidiary holds a 50% stake or more in the newly-established foreign-invested company after the M&A; (b) more than one foreign investor holds an aggregate of 50% stake or more in the newly-established foreign-invested company after the M&A; (c) a foreign investor holds less than 50% stake in the newly-established foreign-invested company after the M&A, but the voting rights actually enjoyed by the foreign investor is sufficient to exert major impact on the resolution of the shareholders' meeting, general meeting of shareholders, or the board of directors; or (d) other circumstances that may result in the actual controlling right in business decision-making, financial affairs, human resources, technologies, etc. being transitioned to the foreign investor.

Procedures of National Security Review

The Ministerial Panel is responsible for the review work. Under the guidance of the State Council, the Ministry Panel is consisted of the National Development and Reform Commission, the Ministry of Commerce(or "the MOC"), and other concerned departments based on the specific industries or fields of the transaction. Not only the foreign investor involved in the M&A may apply with the Ministry of Commerce for a national security review on the transaction, but also the third parties (such as the target company, relevant departments of the State Council, national industrial associations, enterprises in the same trade, and other enterprises on the upstream and downstream sides) may make proposal to the Ministry of Commerce for the Ministerial Panel to decide whether to initiate a review. There are uncertainties with respect to reviews triggered by a third-party's proposal, especially whether the Ministerial Panel may decide to initiate a review solely based on the documents provided by the third party or take any initiatives to verify the details of the transaction before the review.

The two stages of the review - general review and special review – are illustrated in the chart below based on our understanding of the Notice. In the general review stage, which may take up to 30 working days (based on the literal interpretation of the provisions of the Notice), each participant of the Ministerial Panel will review the case and submit written opinions to the Ministerial Panel. If any participant believes that the transaction may impact the national security, the Ministerial Panel will initiate a special review. The special review may take up to 60 working days. If no concerted decisions are made by the participants of the Ministerial Panel, the case should be submitted to the State Council for final decision. It remains unclear, however, if the State Council will have to make its decision within any specific timeline. Decisions made in the reviews will be delivered by the Ministry of Commerce to the applicants. In the course of the reviews, the foreign investor may apply to the Ministry of Commerce for any modification to or cancellation of the transaction.



Summary

While the Notice protects China's national security interest, it will increase foreign investors' costs in acquiring Chinese domestic enterprises in certain industries. The Notice only provides for an outline of the scope and procedures of the national security review, and we are yet waiting for implementation details. Whether the review system may be made use of by bad-faith competitors will also depend on the practice, especially in relation to the system for reviews triggered by third party proposals. Besides, it is worthwhile pointing out that the Notice does not target greenfield foreign-investment in the industries relating to national security.

Legal Updates

1. NDRC Requires Large and Medium-sized Private Equity Funds in Pilot Areas to Make Mandatory Filing (Author: Yong WANG; Shaokai WANG)

On January 31, 2011, National Development and Reform Commission ("NDRC") issued "NDRC Notice on Further Regulating the Administration on Development and Filing of Equity Investment Enterprises" (Fa Gai Ban Cai Jin [2011] 253 Hao)(the "Notice"), which came into effect on the date of issuance. The Notice mainly specifies the filing procedures for equity investment enterprises registered in pilot areas (defined as follows) and their management enterprises.

Scope of Application

The Notice applies to equity investment enterprises registered in Beijing Zhongguancun Science and Technology Park, Tianjin Binhai New Area, Wuhan Donghu New Technological Industries Developing zone and the Yangtze River Delta region (the "pilot areas").

Regulating the Establishment, Capital Raising, Investment Fields and Risk Control of Equity Investment Enterprises

The Notice emphasizes that equity investment enterprises must be established in accordance with relevant provisions of the PRC Company Law or the PRC Partnership Enterprise Law.

The Notice stipulates that equity investment enterprises may only raise capital through private placement from specific offerees possessing risk identification and tolerance, and are not allowed to directly or indirectly market to unspecific offerees by issuing announcements in the media (including on the company websites), putting up notices in the community, distributing leaflets to the general public, sending text messages to unspecified recipients or holding seminars, lectures and other public or disguised public offering. The capital raisers of equity investment enterprises should fully disclose investment risks and possible investment loss and are forbidden to promise investors guaranteed return of capital or guaranteed fixed return. All investors are only allowed to use their own capital for the subscription. Capital payment may take the form of commitment approach, which means that investors make capital commitments by signing subscription agreements during the fundraising period of equity investment enterprises and pay their commitments in installments according to the articles of association or partnership agreements of the enterprises.

The Notice points out that the investment scope of equity investment enterprises is limited to equity of non-public traded enterprises. Idle capital during the investment may only be deposited with banks or be used to purchase fixed income type investment products such as treasury bonds.

The Notice stresses that equity investment enterprises should not provide guarantee to other enterprises except their portfolio companies. When equity investment enterprises invest into affiliated entities, the affiliated parties shall withdraw from the investment decision-making, and such mechanism should be prescribed in the company's articles of association or partnership agreement and entrusted management agreement and entrusted custody agreement.

Building Equity Investment Enterprises' Information Disclosure System

The Notice prescribes that, in addition to the disclosure of information regarding the investment operation to the investors according to the articles of association or partnership agreement of the enterprises, equity investment enterprises should submit an annual business report and annual financial statements audited by an accounting firm to the NDRC as well as the local assisting filing authorities within four (4) months after the end of every fiscal year. The entrusted management and custodian institutions of the equity investment enterprise are also required to provide an annual asset management and asset custody report to NDRC as well as the local assisting filling authorities within four (4) months after the end of every fiscal year. Equity investment enterprises must also promptly report the following events occurring in the course of investment activities to NDRC as well as the local assisting filing authorities within ten (10) business days of occurrence: (1) amendments of the articles of association, partnership agreement and entrusted management agreement of the equity investment enterprise or entrusted management institutions; (2) Increase or decrease of the capital or external financial financing of the equity investment enterprises or entrusted management institutions; (3) Divisions or mergers and other material events of equity investment enterprises or their entrusted management institutions.

Improving the Filing Procedures and Supervision of Equity Investment Enterprises

The Notice specifies that all equity investment enterprises registered with the Administration of Industries and Commerce in pilot areas that mainly engage in equity investments in non-publicly traded enterprises and equity investment funds of funds are subject to the mandatory filing requirement according to the Notice except the following situations: equity investment enterprises (1) that have are registered as venture capital enterprises pursuant to the Interim Management Measures on Venture Capital Enterprises; (2) the size of which falls below RMB 500,000,000 or its foreign exchange equivalent; (3) that are funded and established by one single entity or natural person, or by two or more investors that are wholly owned subsidiaries of the same entity.

Should the equity investment enterprises entrust their assets to be managed by other equity investment enterprises or equity investment management enterprises, the entrusted management institutions should apply for supplemental filings and be subject to the relevant filing administration.

The Notice points out that equity investment enterprises that fail to file according to the Notice will be publicly announced on NDRC's website as "equity investment enterprises and entrusted management institutions evading filing administration". Equity investment enterprises that fail to comply with the Notice should be urged to correct within six (6) months; otherwise, they should be publicly announced on NDRC's website as "non-compliant equity investment enterprises and entrusted management institutions".

2. The Supreme People's Court Released the Provisions on Several Issues Concerning the Application of the "Company Law of the PRC" (III) (Author: Qiuju WEI; Yuchun TANG; Shaokai WANG)

On December 6, 2010, the Judicial Committee of the Supreme People's Court adopted the "Provisions of the Supreme People's Court on Several Issues Concerning the Application of the 'Company Law of the People's Republic of China' (III)" (the "Interpretation (III)"), which shall come into effect on February 16, 2011. The Interpretation (III) specifies the duty of entities who should be responsible for the debt in the process of the company's establishment; the bona fide acquisition system during the contribution and equity disposition; the non-monetary assets capital contribution standard and remedy approach; the definition of failure in fully performing the obligation of capital contribution and illegal withdrawal of capital contribution, the litigation remedy method and civil liability; and also the balance of the interests among the nominal shareholders, the actual owners of equity and the company's creditors, etc.

The Duty of Entities be Responsible for the Debt Incurred During the Company's Establishment Process

The "Company Law of the People's Republic of China" (the "Company Law") has not explicitly indicated the entities who should bear the obligation of debts caused during the company establishment process, however, the Interpretation (III) has clearly specified so as to this issue. Firstly, for the contractual obligation, in order to appropriately reduce the verifying obligations of the contract counterpart and strengthen the protection of the interests of the counterpart, as to whether the promoters or the duly established company should bear the debts, the Interpretation (III) prescribes it should be determined by the entities who signed the contract Secondly, we should determine who should bear the obligation based on the standard of attribution of the contract interests. Specifically, if the promoters enter into the contract in their own names in order to incorporate the company, basically the promoters should bear the contractual obligations. But if the company confirms the contract after its due establishment or becomes the main party of the contract which means that the company enjoys the contractual rights and bears the contractual obligations, and if the contractual counterpart requires the company to bear the obligations, the company should bear the contractual obligations. If the promoters conclude the contract in the name of the company in the stage of setting up, basically the contractual obligations should be borne by the established company, unless the company has the evidence that the promoters sign the contract for their own interests, and the contract counterpart is not in good faith which means the counterpart signs the contract while knowing that the promoters sign the contract for their own interests, the responsibility should still be borne by the promoters.

The Company Law generally provides that the promoters' obligations when the company limited by shares cannot be established and when the company's interests are damaged as a result of the promoters' fault, the promoters should make compensation to the company. The Interpretation (III) also incorporates into the definition of "promoter" the shareholders who conduct as a shareholder during the establishment of a company with limited liability. The Interpretation (III) provides that the promoters bear several and joint liability for the costs and debts of setting up process if the company limited by shares and the company with limited liability cannot be established for some reason. The Interpretation (III) also clarifies the principle of the internal division of responsibilities of the promoters after the promoters have externally taken responsibilities. In the meanwhile, the Interpretation (III) provides that when the promoters harm other's interests because of performing the establishing obligations, the victim may request the established company or all of the promoters to take the several and joint liabilities. After the compensation by the company or the no-fault promoters, they can claim to the promoters in fault.

The Bona Fide Acquisition System during the Process of Contribution

The behavior of investment is disposition in nature. If the investors make contribution with non self owned property, the disposition should be deemed as an unauthorized disposition. The Interpretation (III) provides that when any capital contributor makes the contribution with the property of which it has no right to dispose, viz. the contributor is the unauthorized disposition contributor, their contribution cannot be simply denied. Furthermore, if the third party (including companies and other investors and creditors) has no idea that contributor is making contribution with the property of which it has no right to dispose, the owners can only require the compensation from the investors instead of claiming to the third party. The Interpretation (III) provides that the stock right shall be on auction or sale instead of withdrawing from the company if the investors using the money (note for money only, excluding other non-monetary assets) gained from corruption, bribery, embezzlement, misappropriation and other criminal behaviors. The aforesaid rules are for the purpose of capital maintenance and the protection of creditors' rights.

The Non-monetary Assets Capital Contribution Standard and Remedy Approach

The Company Law allows shareholders to invest in non-monetary assets in a certain proportion of the registered capital, but there are only general provisions concerning the characteristics of non-monetary assets usable in contribution, which limit the assets to those can be evaluated by currency and be transferred in accordance with the laws, while clear instructions on the standard and procedure of non-monetary asset contribution are missing.

The Company Law makes clear that the non-monetary assets involved in capital contribution should be correctly assessed and appraised. Without the required assessment and appraisal, it could not be determined whether the actual value of the non-monetary asset matches its valued price in the Articles of Associations. The Interpretation (III) specifies that under the situation that non-monetary assets have not been assessed and appraised, and if a party pleas to rule that an investor has not fulfilled his or her capital contribution obligation, the court should appoint a legally qualified assessment agency to perform the appraisal, and in case the amount of the actual price was significantly lower than the amount provided in the Articles of Associations, the contributor should be regarded as he/she has not fully fulfilled the contribution obligations in accordance with the law.

As to the registration change of the ownership of non-monetary assets (including land use rights, other companies equities etc.), the Interpretation (III) prescribes that the non-monetary assets should fulfill the twofold requirements including the finished ownership transfer procedure and the actual delivery of the asset. If the aforesaid assets have already been transferred to the company but the corresponding ownership registration for transfer has not been completed, then during the litigation, the court should order the capital contributor to finish the ownership transfer registration within a designated reasonable time; if the capital contributor completed the ownership transfer procedure within a designated period appointed by the court, then he or she shall be able to enjoy the corresponding shareholder's right since the assets being actually transferred to the company; if the ownership transfer procedure of the non-monetary asset has already been completed but has not yet to be delivered to the company to be used in reality, the court could rule the capital contributor to deliver the assets to the company and he/she may not enjoy the shareholder's right prior to the delivery.

The Recognition of Failure in Fully Performing the Obligation of Capital Contribution and Illegal Withdrawal of Capital Contribution, the Relevant Litigation Remedies and Civil Liability

For the sake of defining contribution with non-monetary assets, the Interpretation (III) gives a further explanation to failure in full performance of the obligation of capital contribution. According to Article 36 of the Company Law, shareholders may not withdraw the paid-in capital after the incorporation of company. However, Article 36 has not defined the specific manners of withdrawal of paid-in capital. For the purpose of stabilizing and maintaining the capital of the company and giving guidance to the practice of the courts, the Interpretation (III) expressly defines certain capital erosion conducts as withdrawal of paid-in capital, including to transfer the paid-in capital out of company's account right after capital verification; to transfer the paid-in capital out of company's account by fabricating creditor's rights and debts; to falsely increase profits for distribution by making up false financial and accounting statements; to transfer paid-in capital out of company's account by conducting affiliate transactions; other conducts of withdrawing the paid-in capital without due legal process.

Pursuant to Article 28, Article 31 and Article 94 of the Company Law, any shareholders/promoters, who fail to make full capital contribution in time, shall fully perform the obligation of capital contribution and be liable for the acts of breach to those who have fully contributed. Where the actual value of non-monetary assets contributed to incorporate the company is remarkably lower than that provided in the Article of Association after the company's establishment, the one who made such contribution shall fully contribute the difference between the actual value and the provided value, and the shareholder/promoter who has set up the company shall bear joint and several liabilities for such difference. For the purpose of supervision, shareholders or promoters' legal liabilities for their failures in full performance of capital contribution have been stipulated in the Company Law. The Interpretation (III) has made the following breakthrough in urging shareholders/promoters to perform their capital contribution obligations:

a) broadening the scope of entities of legal liability. According to the Interpretation (III), in case that shareholders/promoters fail to make their capital contribution in compliance with Articles of Association, other shareholders/promoters who have together set up the company shall bear joint and several liability; in case that shareholders/promoters fail to fully perform their capital contribution obligation in the process of capital increase, the directors and senior executives in breach of their diligence duty shall bear the corresponding liabilities; shareholders, directors, senior executives or actual controllers who have assisted other shareholders to withdraw paid-in capital shall bear joint and several liability with the other shareholders; a third party, who has assisted shareholders in making capital contribution to set up company, shall bear joint and several liability with the shareholders in case that the third party and the shareholders agree to withdraw the paid-in capital to repay such third party, and such shareholders cannot pay up the withdrawal capital; in case that shareholders, who fail to fully perform their capital contribution obligation, assign their equities to assignees, the assignees who are aware of the failure in fully making capital contribution shall bear joint and several liability with such shareholders.

b) expressly providing and broadening the scope of entities who can claim for shareholders' full performance of the capital contribution. The Company Law has not specified who are entitled to request the shareholders who have not performed the obligation of capital contribution or have withdrawn the contribution to perform the relevant obligations, but it is well recognized that the company may request. The Interpretation (III) specifies and broadens the scope of plaintiff in the following aspects: (a) specifying that a company can require its shareholders who fail to fully contribute the capital to perform their obligations of making full contribution; can require shareholders who have withdrawn the paid-in capital to return the principal and interest of the capital contribution to the company; can require directors and senior executives, due to whose default of diligence duty the registered capital has failed to be fully contributed, to assume the relevant liabilities; and require other shareholders, directors, senior executives or actual controllers, who have assisted in withdrawal of the capital contribution, to assume joint and several liabilities therefrom; (b) prescribing that other shareholders are entitled to claim the same as the company; (c) specifying the creditors can enjoy the right of action in many situations, for example, the creditors are entitled to require shareholders who fail to perform or fully perform their capital contribution obligations or have withdrawn the capital contribution to assume joint and several liabilities for the portion of the debts which cannot be paid off by the company to the extent of the principal and interest of the capital that is unpaid or withdrawn; to require promoters to assume joint and several liabilities with the shareholders being sued; to require directors and senior executives, due to whose default of diligence duty the registered capital has failed to be fully contributed, to assume the relevant liabilities; and to require other shareholders, directors, senior executives or actual controllers, who have assisted in withdrawal of the capital contribution, to assume joint and several liabilities therefrom.

c) expressly providing that the liabilities for failure in full contribution of capital and withdrawal of capital contribution include liabilities to pay up interest, which means creditors are entitled to require shareholders, who fail to fully perform their capital contribution obligations or have withdrawn the capital contribution, to bear supplementary liabilities for the portion of company's debts which cannot be paid off by the company to the extent of the principal and interest of the capital that is unpaid or withdrawn.

d) restricting the shareholders, who fail to fully perform the capital contribution obligation or have withdrawn the capital contribution, from defending themselves by resorting to statutory limitation in two aspects: (a) the company or other shareholders require such shareholders to fully perform their capital contribution obligations or return the withdrawn capital contribution to company; (b) a claim of a company's creditor, which has not exceeded the period of statutory limitation, requires such shareholders to assume liabilities for the portion of the company's debts which cannot be paid off by the company.

e) expressly providing that the company is entitled to raise capital or otherwise accept the relevant capital contributed by other shareholders or a third party when the shareholders have not fulfilled capital contribution obligation or have withdrawn their contribution. For the purpose of bolstering the corporation capital stock as soon as practicable, the Interpretation (III) gives the promoters the additional capital raise right. Article 6 expressly prescribed that if the subscribers of a stock corporation failed to contribute the capital to the corporation in time and still fail to make up the capital contribution after the receipt of a call from the promoters for payment thereof, the promoters may raise such capital otherwise from others and such conduct of raising capital shall be deemed valid by the court. Accordingly, the Article 18 paragraph 2 of the Interpretation (III) also provides that if the shareholders of a limited liability company fail to fully contribute the capital to the company in time or withdraw all the capital contribution from the company, and still fail to make up the capital contribution or return the same within a reasonable period of time after the receipt of a call from the company for payment or return thereof, such capital can be contributed by other shareholders or a third party.

f) The Interpretation (III) permits certain restrictions imposed by company on the shareholders who fail to fully contribute capital or have withdrawn capital contribution from the company. The Interpretation (III) expressly provides that a company is entitled to reasonably impose restrictions on the foresaid shareholders' rights, such as claim for profits distribution, first refusal rights for new shares, and claim for surplus property distribution.

g) The Interpretation (III) confirms the rules for disqualifying shareholders who fail to fully contribute capital or have withdrawn capital contribution and provides the relevant procedures. If any shareholder of a limited liability company fail to perform its capital contribution obligation or withdraw all its paid-in capital contribution, and still fail to pay up or return the paid-in capital within a reasonable period of time after the receipt of a call from the company for payment or return thereof, the company is entitled to disqualify such shareholder through a board resolution, and shall reduce the registered capital accordingly through legal procedures.

Balancing the Interests Among the Nominal Shareholders, Actual Investors, Other Shareholders and Company's Creditors

In practice, it is not bizarre that disputes arising from the inconsistency between the nominal shareholders and the actual investor. The Interpretation (III) has made several provisions to clarify the interest of the nominal shareholder, the actual investor, the other shareholders and the company's creditors in a limited liability company, but there are no explicit instructions addressing whether the aforesaid regulations are applicable to the similar arrangements in the company limited by shares.

Firstly, an agreement could be entered into between the nominal shareholder and the actual investor of a limited liability company stipulating that the actual investor contributes capital and hence enjoys capital contribution rights. As for the validity of the contract between the nominal shareholder and the actual investor, the Interpretation (III) adheres to the principle of the freedom of contract, which means that the aforementioned contract is regarded valid provided that the contract does not contradict with the stipulation of the Article 52 of the Contract Law, and the actual investor could claim his correlative shareholder rights from the nominal shareholder according to the contract. If any dispute arose between the nominal shareholder and the actual investor regarding the attribution of the investment interest, the actual investor may raise his claim to the nominal shareholder on the grounds that he has practically performed the contribution obligations, whilst the nominal shareholder shall not deny the actual investor's shareholder rights for the reasons that the company's record of the shareholders register and the registration with the company registration authority. Nevertheless, if the actual investor demands the company either to replace a shareholder, issue an investment certificate, have his own name recorded in the register of shareholder or the Article of Association or to perform the registration of the company registration authority etc., the aforesaid requirements of the actual investor have already been beyond the scope of the aforementioned agreement between both of the parties, leading to an intrusion from the company exterior to the company interior by the actual investor who becomes the member of the company. Under this circumstance, the relevant stipulation regarding to the transfer of the limited liability company shares under article 72, paragraph 2 of the Company Law should be applied by reference, which means it comes with majority consent of the other shareholders.

Secondly, the Interpretation (III) stipulates that in the disposal of the equity interest of the nominal shareholder (e.g. transfer, pledge of equity interests registered under its name) should refer to the provision of bona fide acquisition of the Property Law. Pursuant to Article 33 Paragraph 3 of the Company Law, any nominal shareholder whose name has not been registered with the company registration authority may not challenge the third party. If any third party, reasonably believe that a nominal shareholder is a de facto investor in general out of its confidence to the content of the registration, under such circumstances, the de facto investor may not plead for the nullity of the disposal behavior; however if the third party accept the transfer of the equity interest with a clear knowledge that it is nominal share which is registered on the shareholder's register, then the de facto investor is entitled to claim for the nullity of the disposal behavior. After the third party acquired the equity interest, the de facto shareholder can request the nominal shareholder to assume liability for compensation. Similarly, in case after the transfer of the equity interest and yet the transfer has not been registered to the company registration authority, the original shareholder transfers, pledges or other disposes the equity interest which is still registered under its name, if the transferee shareholder plead for a nullity of the disposal behavior on the ground that he enjoys the actual shareholder right of the equity interest, the petition shall be handled in accordance with the Property Law's provision of bona fide acquisition.

Thirdly, if any creditors of the company petition the court to rule that any shareholders registered with the company registration authority shall assume supplementary compensation liability for the portion of the company's debts that are unable to be repaid to the extent of the principal and interest of their unpaid-in capital on the ground that such shareholders have failed to perform their obligations for capital contribution, such nominal shareholders may not defend themselves on the ground that they are only nominal shareholders and not de facto investors.

3. Will "Foreign-invested Venture Capital Investment Enterprise" (FIVCIE) Fade Away? - Tax Pass-through Status of FIVCIEs Officially Ended (Author: Yong WANG, Bing XUE; Chuqi ZHANG)

On January 4, 2011, the State Administration of Taxation ("SAT") promulgated *Circular on Publishing the Catalogue of Normative Taxation Documents Which Are Totally or Partially Abolished* (SAT Public Notice [2011] No.2, "Bulletin 2"). According to Bulletin 2, Article I, Article II, paragraph 1 and the first sentence of paragraph 2 of Article 3 (collectively, "Abolished Provisions") of the Circular of the State Administration of Taxation on Relevant Issues Concerning the Payment of Enterprise Income Taxes by Foreign-Invested Venture Capital Investment Enterprises (Guoshuifa [2003] No.61, "Circular 61") were abolished effective as of January 4, 2011.

Circular 61, issued on June 4, 2003 under the direction of the Regulation on the Administration of Foreign-Invested Venture Investment Enterprises, governs the enterprise income taxation of foreign-invested venture capital investment enterprises ("FIVCIE"). Of critical importance is the provision establishing the tax pass-through principle with regard to the income taxation of non-legal-person FIVCIEs, which was abolished by Bulletin 2. Under Circular 61, a non-legal-person FIVCIE used to be allowed to choose to have its investors pay income tax on their shares of income from the FIVCIE or, alternatively, apply to the local tax authority to pay income tax at the FIVCIE level. If a non-legal-person FIVCIE chose to have its investors pay income tax, its foreign investors generally shall pay income tax as though such foreign companies had a permanent establishment in China, except where the non-legal-person FIVCIE did not directly engage in venture capital management or consulting business through an internal management and operation organ but delegated its daily investment management and operation to another venture capital investment management enterprise or venture capital investment enterprise, in which case foreign investors of such a FIVCIE may pay tax as foreign investors without a permanent establishment in China ("No-PE Tax Treatment"). Many FIVCIEs are structured to fall into this exception. The Non-PE Tax Treatment provision remains intact after the partial abolishment of Circular 61. However, whether foreign investors can enjoy no-PE tax treatment requires a case-by-case analysis, taking into account the definition of "permanent establishment" under the relevant tax treaty between China and the country of residence of the particular investor, whether such investor falls under the purview of PRC tax rules governing the taxation of so-called "PRC-controlled offshore enterprises", among other things.

As a matter of fact, the validity of Circular 61, in particular the pass-through treatment provision, has been in question for some time. Circular 61 was issued under the authority of the PRC Income Tax Law for Foreign-Invested Enterprises and Foreign Enterprises ("Foreign Enterprise Income Tax Law"), which was invalidated on January 1, 2008 with the adoption of the PRC Enterprise Income Tax Law (the "Unified EIT Law"), which clearly provides that all enterprises and other organizations with PRC-sourced income, with the exception of sole proprietorships and partnerships, shall pay enterprise income tax in accordance with the Unified EIT Law. Non-legal-person CJV or FIVCIE is not among the enumerated exceptions.

In parallel with the unfavorable development with respect to rules governing non-legal-person FIVCIEs is the emergence of limited partnerships as a major entity form for private equity and venture capital funds in recent years. Partnerships enjoy tax pass-through status granted by the PRC Partnership Enterprise Law, effective as of June 1, 2007, and subsequent related tax rules. Since March 1, 2010, foreign investors have also been allowed to form foreign-invested partnership enterprises in China. More recently, Shanghai released trial regulations on its QFLP ("Qualified Foreign Limited Partner") pilot program, which allow qualified funds formed in Shanghai with QFLPs to conduct foreign exchange settlement at the fund level rather than portfolio company level and allow such funds whose sole foreign currency capital comes from the general partner or the management company in the amount of no more than 5% of the fund's capital to be generally treated as a domestic RMB fund free from restrictions applicable to foreign investors. With the official end of the tax pass-through status of non-legal-person FIVCIEs, foreign fund sponsors currently operating FIVCIEs or will be raising a fund soon should think carefully about the impact of such developments on their funds.

4. New Incentives for the Software Industry and the Integrated Circuit Industry Introduced (Author: Bing XUE; Jiaxin LIU)

On January 28, 2011, the State Council promulgated the "Circular of the State Council on Printing and Distributing Certain Policies for Further Encouraging the Development of the Software Industry and the Integrated Circuit Industry" (Guo Fa [2011] No. 4) ("Circular No. 4"), which formulates a series of preferential and supporting policies covering finance and tax, investment and financing, research and development, export and import, human resources and intellectual property to further encourage the development of the software industry and the integrated circuit industry. This article will mainly analyze the background of Circular No. 4 and the preferential financial and tax policies therein.

Background

To promote the development of software industry and the integrated circuit industry, the Sate Council promulgated in 2000 "Policies on Encouraging the Development of the Software and the Integrated Circuit Industries" (Guo Fa [2000] No. 18)("Circular No. 18"), which specifies various preferential policies to aforesaid industries including tax incentives regarding value-added tax and enterprise income tax. And the Ministry of Finance ("MOF"), State Administration of Taxation ("SAT") and General Administration of Customs issued a series detailed implementation rules afterwards.

The implementation of Circular No. 18 and the subsequent detailed implementation rules has fostered the rapid development of the software industry and integrated circuit industry in China and dramatically promoted the national informatization. However, as the preferential value-added tax on software industry as set forth in Circular No. 18 expired at the end of 2010, the industry are concerned about whether the preferential financial and tax policies on software industry and integrated circuit industry will be extended.

To reaffirm the supportive attitude of the State Council towards software industry and integrated circuit industry, Circular No. 4 introduces several new preferential policies on software and integrated circuit industry following the original financial and tax policies implemented over recent years, and further specifies that the State Council will further encourage and support the development of the two aforesaid industries via incentive policies during the "Twelfth Five-Year" plan period.

Highlights of Preferential Financial and Tax Policies under Circular No. 4

The salient points of preferential financial and tax policies introduced by Circular No. 4 are mainly as follows:

(1) Extension of Original Preferential Policies

(a) Preferential Value-added Tax Policies

Circular No. 4 specifies that preferential value-added tax policies will survive beyond 2010. In this case, although the full tax rate for general value-added taxpayers selling their self-developed software products is 17%, a refund can be immediately provided once the actual payment of tax exceeds 3% of their turnover, which shall be used by the enterprises for R&D of software products and expansion of reproduction.

(b) Preferential Enterprise Income Tax Policies

Circular No. 4 extends existing preferential enterprise income tax policies, which mainly includes:

➢ Two-year exempt and three-year halve

Upon recognition and since the profit-making year, integrated circuit manufacturing enterprises that produce integrated circuit with the line width of less than 0.8 micron (inclusive) shall be eligible for the enterprise income tax exemption in the first two years and a 50% tax reduction on the basis of the statutory tax rate of 25% in the following three years ("two-year exempt and three-year halve" preferential policy on enterprise income tax).

➢ Five-year exempt and five-year halve

Upon recognition, integrated circuit manufacturing enterprises producing integrated circuit with the line width of less than 0.25 micron or with investment of over RMB 8 billion shall be eligible for the enterprise income tax at the reduced rate of 15%; for the aforesaid enterprises with the operation term of over fifteen years, they shall, since the profit-making year, be eligible for the enterprise income tax exemption in the first five years and a 50% tax reduction on the basis of the statutory tax rate of 25% in the following five years.

➢ Preferential policies for newly-established enterprises

Upon recognition, integrated circuit design enterprises newly established and eligible software enterprises in China may enjoy the "two-year exempt and three-year halve" preferential policy on enterprise income tax since the profit-making year. The recognized integrated circuit design enterprises and eligible software enterprises' imported materials and parts in line with the current laws and regulations may enjoy the bonded policies.

(2) Additional Preferential Financial and Tax Policies Newly Introduced

The additional preferential financial and tax policies newly introduced by Circular No. 4 mainly includes:

(a) Preferential business tax policies

Eligible software enterprises and integrated circuit design enterprises, which engage in software development and testing, information system integration, consulting and operation maintenance, integrated circuit design and other businesses, shall be exempted from business tax and relevant procedures for them shall be simplified.

(b) Preferential value-added tax policies

For major integrated circuit projects approved by the State, special measures shall be adopted to appropriately settle capital use problems resulted from difficulty in offsetting VAT input tax within a short period in the case of centralized procurement.

(c) Expansion of preferential enterprise income tax

For the purpose of improving integrated circuit industry chain, preferential enterprise income tax shall be granted to eligible integrated circuit sealing, testing and key special material enterprises and relevant special integrated circuit equipment enterprises.

It is noteworthy that Circular No. 4 only sets forth general principles regarding relevant preferential financial and tax policies and the detailed implementation rules are subject to further formulation and promulgation by the MOF, SAT and other departments.

Important Announcement

This Newsletter has been prepared for clients and professional associates of Han Kun Law Offices. Whilst every effort has been made to ensure accuracy, no responsibility can be accepted for errors and omissions, however caused. The information contained in this publication should not be relied on as legal advice and should not be regarded as a substitute for detailed advice in individual cases.

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