



# China Practice Global Vision



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## ■ ■ Insights & Ideas

### **China Strengthens Management of Enterprise Income Tax Collection of Proceeds from Equity Transfers by Non-resident Enterprises (Author: Yue ZHENG)**

On December 10, 2009, the State Administration of Taxation (“SAT”) issued the *Circular of the State Administration of Taxation on Printing and Distribution of Provisional Administrative Measures on Enterprise Income Tax Withholding at Source for Non-resident Enterprises* (Guoshuihan [2009] No. 698, the “Circular”). The Circular will take effective retroactively as of January 1, 2008. Among other things, the most significant breakthrough of this Circular is that, in certain cases, Chinese tax authorities may levy enterprise income tax on proceeds from the transfer of the equity interest of an offshore holding company owning a Chinese resident enterprise (i.e., an indirect transfer). The promulgation and implementation of the Circular will have a profound impact on enterprises which invest in China through offshore holding companies. Highlights of the Circular are addressed as follows:

- (1) Under the Circular, Chinese tax authorities may not only have jurisdiction to levy enterprise income tax on the sale of a Chinese resident enterprise by a foreign nonresident enterprise (i.e., a direct transfer), but may also have jurisdiction to impose enterprise income tax on indirect transfers (as defined above) in certain cases.
- (2) The Circular is not applicable to the purchase and sale of the stock of Chinese resident enterprises on public securities markets by non-resident enterprises.
- (3) Where the withholding agent fails or is unable to fulfill its withholding obligations, nonresident enterprises shall file and pay the enterprise income tax to the competent tax authority supervising the Chinese resident enterprises whose equity interests are transferred (i.e., the tax authority in charge of collecting enterprise income tax of such resident enterprise) within seven days after the equity transfer date as agreed in the contracts or agreements (or after the date when the proceeds are actually obtained, if the transferors receive the proceeds of equity transfers in advance). If non-resident enterprises fail to file timely and accurately, the relevant provisions in the *Tax Collection and Management Law of the People’s Republic of China* shall apply.
- (4) Proceeds from equity transfer refer to the difference between the consideration of the equity transfer minus the cost of the equity interest, without taking into account any retained earnings or after-tax reserves being transferred.
- (5) Cost of the equity interest represents the capital contribution actually paid to the Chinese resident enterprises when the transferor made such investment, or the consideration actually paid to the prior transferor when the equity interests were purchased.

- (6) If the actual tax burden in the jurisdiction of the offshore holding company being transferred is less than 12.5%, or if such jurisdiction exempts income tax on foreign-sourced income for its tax residents, all relevant documents in relation to the equity transfer and the relationship between the offshore investor and the offshore holding company being transferred should be provided to the tax authority supervising the Chinese resident enterprise whose equity interests are transferred, within 30 days after signing the equity transfer agreement.
  
- (7) If an indirect transfer occurs, an offshore holding company lacks a reasonable business purpose and was established for tax avoidance purposes, after being reported to higher authorities and reviewed by the SAT, the supervising tax authority can re-characterize such equity transfer transaction and deny the existence of the offshore holding company by using the principle of “substance-over form”.
  
- (8) If the capital gain derived from an equity transfer by a non-resident enterprise is qualified for special tax treatment provided by Caishui [2009] No. 59 (i.e., the *Circular on Several Issues Regarding the Enterprise Income Tax Treatment of Enterprise Re-organizations* issued by the Ministry of Finance and the State Administration of Taxation) and such non-resident enterprise chooses the special restructuring method, written documentations should be submitted to the supervising tax authority to prove such qualification, subject to approval from the provincial tax authority.

Since Chongqing Yuzhong District Taxation Bureau imposed enterprise income tax on a foreign-to-foreign transfer of the equity interest in an offshore holding company incorporated in Singapore owning a Chinese resident enterprise (i.e., an indirect transfer) in 2008, many people were wondering whether SAT would formally adopt Chongqing Yuzhong District Taxation Bureau’s opinion. The issuance of the Circular helped address this concern and speculation. Despite any uncertainties and ambiguities it may have, the promulgation and implementation of the Circular will no doubt place greater administrative and compliance burdens on foreign investors who invest in China through offshore holding companies.

## Legal Updates

### 1. China's New Tort Liability Law (Author: Kun MA; Yeting CAI)

On December 26, 2009, the Standing Committee of the National People's Congress passed the *Tort Liability Law of the People's Republic of China* (the "**Tort Liability Law**"), which shall come into force on July 1, 2010. The promulgation and implementation of the Tort Liability Law are of significant implications in protecting the legitimate rights and interests of citizens and legal persons and clarifying the tort liabilities. It is another important law in the Civil Code subsequent to the PRC Property Law. Set forth below is a brief analysis of the main content of the newly issued Tort Liability Law.

#### **Joint tort and joint and several liability**

Joint tort and joint liabilities is one of the major contentious issues in the process of the enactment of the Tort Liability Law. Article 130 of the *General Principal of the Civil Law of the People's Republic of China* prescribes that "where two or more persons jointly commit a tort and cause damages, they shall bear joint and several liability." Nevertheless, this Article 130 is too simple and lacks specific rules for identifying joint tort. Articles 3 through 5 of the *Interpretation of the Supreme People's Court of Some Issues concerning the Application of Law for the Trial of Cases on Personal Injury Compensation* (the "**Interpretation on Personal Injury Compensation**") give further guidance on the issue of joint tort and joint liabilities, however, the guidance is too abstract to understand and apply in practice.

The Tort Liability Law explicitly states that where two or more persons jointly commit a tort, causing harm to another person, they shall be jointly and severally liable for the tort. One who abets or assists another person in committing a tort shall be jointly and severally liable with the tortfeasor. One who abets or assists a person who does not have civil capacity or only has limited civil capacity in committing a tort shall be liable for the tort. If the custodian of such person fails to fulfill his/her custodial responsibilities, the custodian shall assume the relevant liability. The compensation amount of each person who have joint and several liabilities depends on their respective obligations. If it is difficult to define the obligations of each person, the compensation liabilities shall be equally apportioned among them.

The Tort Liability Law further provides that where two or more persons commit a conduct that endangers the personal or property safety of another person and cause damages to the other person, if it can be determined that the act of which person has caused the damages, such person shall be liable; if not, all of them shall be jointly and severally liable for the damages caused therefrom.

#### **Mental injury compensation**

There are no specific provisions on mental injury compensation in China's current civil law regime. In practice, it is regulated by the *Interpretation of the Supreme People's Court on Several Issues Regarding Ascertaining Compensation Liability for Mental Impairment in Civil Torts*. Article 22 of the Tort Liability Law states that where a tort causes damages to others' personal rights, subjecting others to serious mental injuries, the victim may seek for mental injury compensation. This indicates that mental injury compensation has been expressly written into the PRC law, and that it is strictly limited to infringements on personal rights.

### **Internet infringements**

The websites in concern shall assume the tort liability for internet infringements. Compared with the traditional type of infringement, the modern internet infringement has some new characteristics. In view of this situation, Paragraph 1, Article 36 of the Tort Liability Law prescribes that "an internet user or internet service provider that uses the Internet to infringe upon the civil rights and interests of another person shall assume tort liability." Paragraphs 2 and 3 of Article 36 state that where an internet user commits a tort by using internet services, the victim shall be entitled to notify the internet service provider to take such necessary measures as deletion, block or disconnection. If, after being notified, the internet service provider fails to take necessary measures in a timely manner, it shall be jointly and severally liable for any enlarged harm with the internet user. The foregoing provisions aim to protect the interests of the victim to maximum extent without limiting the development of internet technologies.

### **Product liability and punitive damages**

Given new circumstances occurred in practice, the Tort Liability Law provides for the following types of product liabilities: (i) eliminating a product's dangerous propensities and impediments; (ii) warning defects in the product and recalling defective products. Article 45 of the Tort Liability Law stipulates that: "where personal or property safety is jeopardized by a product's defects, the victim is entitled to request the producer and the seller to be liable for eliminating the product's dangerous propensities and the impediments, etc." Article 46 stipulates that where a product launched into circulation is found to be defective, the producer and the seller shall take such remedial measures as warning and recalling the product in a timely manner. In the event that no timely or effective remedial measures have been taken, and such failure causes damages, the producer and the seller shall assume tort liability.

However, the Tort Liability Law is silent on how to calculate punitive damages, and it is expected that further judicial interpretation may be issued to clarify this issue.

### **Motor vehicle traffic accident liability**

Tort Liability Law clarifies the issue of liability attribution between a motor vehicle owner and its actual user in a situation where a leased or borrowed vehicle causes an accident. Pursuant to Article 49 thereof, an insurance company is liable up to a maximum amount of compulsory motor vehicle insurance covering a motor vehicle involved in a traffic accident if a leased or borrowed vehicle causes an accident. If the compulsory motor vehicle insurance is insufficient to cover the damages, the remaining amount shall be assumed by the user. If the vehicle owner is at fault for the occurrence of the accident, it shall assume corresponding compensation liabilities as well.

### **Medical damages liability**

The Tort Liability Law provides that during medical treatment, damages incurred by a patient arising from the usage of defective or unqualified medical apparatus, disinfected pharmaceuticals, medicines, blood, blood products and other medical products shall be attributed to medical product tort liability. The victim is entitled to either claim compensation from the relevant producer or blood provision institution, or from the medical institution, which has a recovery right after paying the compensation.

In addition, considering the phenomena that the hospital refuses to operate on a patient, due to his/her relative's refusal to sign on the Risks Notice of the Hospital, which leads to the patient's death, the Tort Liability Law explicitly stipulates that: "medical staff shall advise the patient of his/her illness condition and medical measures during medical treatment activities. In the event that an operation, special examinations or special treatments are required, medical staff shall timely advise the patient of the medical risks, substitute medical plans and obtain written consent. If it's inappropriate to advise the patient, medical staff shall advise close relatives of the patient and obtain written consent from the same. In the event of an emergency inability or failure to obtain consent of the patient's close relative, corresponding medical measures shall be timely adopted after approving by the responsible or authorized person of the medical institution."

### **Environmental contamination liability**

The Tort Liability Law also provides for environmental contamination liability. It stipulates the contaminator's burden to prove the statutory circumstances of liability exemption, mitigation and non-existence of causality between behaviors and damages, as well as liability sharing of joint tort and liability undertaking in case of contamination damages caused by a third party. Article 67 of the Tort Liability Law provides that in the event of environmental contamination caused by two or more contaminators, liabilities depend on categories or discharges of the contaminants of each tortfeasor. Pursuant to Article 68 thereof, in the event of damages arising from environmental contamination by a third party, the victim is entitled to claim

compensation from both the contaminator and the third party. If the contaminator pays the compensation, it has the right to recover the amount from the third party.

## **2. Incomes Received by Individuals from Transferring Restricted Shares of a Listed Company Subject to Individual Income Tax in China (Author: Hong JIANG)**

On December 31, 2009, the Ministry of Finance, the State Administration of Taxation and the China Securities Regulatory Commission jointly issued the *Notice on Relevant Issues Concerning Collecting Individual Income Tax on Income from the Transfer by Individuals of Restricted Shares of Listed Company* (the “**Notice**”). Pursuant to the Notice, starting from January 1, 2010, incomes received by an individual from transferring restricted shares in a listed company are subject to an individual income tax at the rate of 20%.

“Restricted Shares” are referred to as: i) the non-tradable shares held by individual shareholders after the completion of the split share structure reform in 2006 and before the day when trading resumed, and the allocated or converted shares which are attributable to the aforesaid shares during the period from the day when trading resumed to the lock-up expiration date; ii) the restricted share attributable to initial public offerings after the split share structure reform in 2006, and the allocated or converted shares in relation to the aforesaid shares during the period between the first trading day to the lock-up expiration day; and iii) any other shares jointly stipulated by the Ministry of Finance, the State Administration of Taxation, the Legislative Affairs Office and the China Securities Regulatory Commission.

The Notice stipulated that, in case of individual transferring restricted shares, the taxable income shall be the balance derived from the total income from such shares’ transfer, after deduction of original value and reasonable taxes and charges. Total income shall refer to actual income from such shares’ transfer. Original value shall refer to the purchase price and relevant charges paid according to law. Reasonable taxes and charges shall refer to stamp duty, commission, transfer fee and other taxes and charges relating to the transaction which occur in the share transfer process. Where the taxpayer is unable to submit true and complete certificates of the original value or unable to accurately calculate the original value, the competent tax authority shall take 15% of total income from the share transfer as the original value and reasonable charges.

The Notice further states that the securities institutions where an individual shareholder opens its accounts shall have a withholding liability thereof. Taxes may be collected via the following methods: i) the securities institutions withhold individual income tax, while the taxpayer declares and settles by himself; and ii) the securities institutions directly withhold individual income tax. In addition, where the taxpayer holds both restricted shares and

tradable shares of a same listed company, any transfer of his/her shares shall comply with the principle of “Restricted Shares First”, i.e. the transfer of shares shall first be regarded as transferring restricted shares, subject to individual income tax in accordance with law.

Following the enactment of the Notice, under current PRC tax law regime, the transfer by both individual and enterprise shareholders of shares in a non-listed company or restricted shares of a listed company are subject to income tax. However, under the Notice, the transfer by individual shareholders of shares of listed company which are acquired from public offerings or securities markets shall continue to be exempted from individual income tax.

### **3. SPC Interpretation on Some Issues concerning the Application of Laws in Adjudicating Patent Infringement Disputes (Author: Ning LI)**

On December 21, 2009, the 1480th Meeting of the Judicial Committee of the Supreme People’s Court passed the *Interpretation of the Supreme People’s Court on Some Issues concerning the Application of Laws in Adjudicating Patent Infringement Disputes* (the “**Interpretation**”), effective as of January 1, 2010. The Interpretation addresses major issues on application of laws in the trial of disputes over patent infringement, which include the determination of the protection scope of invention or utility model patents, the principle for judging infringement of invention, utility model and design patents, the application of defenses of prior art and prior user rights, the acceptance of non-infringement actions, etc.

#### **Determination of the protection scope of invention or utility model patents**

The Interpretation restates the provision of Section 1, Article 59 of the *PRC Patent Law* as amended on December 27, 2008 (the “**Patent Law**”), which states that the protection scope of the invention or utility model patents shall be determined pursuant to the terms of the claim, and the specifications and the appended drawings may be used to interpret the claim. The court shall permit the right holder to modify the claims before the court debate in the trial of first instance closes, i.e., modifications made after the court debate in the first instance trial closes will be denied. Notwithstanding the foregoing, the right holder’s right to bring a new lawsuit pursuant to his/her other claims shall not be interfered.

The court shall determine the content of the claim in accordance with the terms of the claim, the understanding of the claim by an ordinary technician in this field after reading the specifications and the appended drawings, and utilizing the specification and appended drawings, the relevant claims in the patent claim and patent prosecution documents, among which, the specification shall be the most crucial portion. The terms of the claim shall have the meanings as specifically set forth in the specification, where applicable. With respect to



technical features described with its functions or effects in the patent claim, the court shall determine their contents by considering the specific implementation methods of the said functions or effects as shown in the specifications and appended drawings, and their equivalent methods.

*Several Provisions of the Supreme People's Court on Some Issues concerning the Application of Laws in Adjudicating Patent Disputes*, coming into effect on July 1, 2001, sets forth that the protection scope of patent rights includes not only the scope defined by the technical features in the claim, but also the scope defined by the equivalent technical features (i.e. the "Doctrine of Equivalents"). Article 5 and Article 6 of the Interpretation imposes certain restrictions on this Doctrine of Equivalents that (i) where a right holder attempts to include any technical solutions into the protection scope of the patent in a patent infringement case, the court shall not favor it, if such solutions are only described in the specifications or appended drawings but not set forth in the claim; (ii) the court shall not favor any technical solutions which a right holder attempts to include into the protection scope of the patent in a patent infringement case, if such solutions have already been abandoned by the patent applicant or right holder through modifications to the claim or specifications or representations in the patent prosecution or invalidation declaration proceedings.

### **Trial of patent infringement disputes**

Article 7 of the Interpretation provides for basic principles in determining infringement of invention or utility model, i.e., as long as the accused technical solution contains all elements within the protection scope, the accused technical solution shall fall within the protection scope, irrespective of whether it contains any additional elements. If the accused technical solution lacks one or more elements of the patent claim, or has one or more elements that are not same with nor equivalent to that of the patent claim, then the accused technical solution shall not fall within the protection scope.

The principle for adjudicating design patent infringement disputes differs from that used for infringement of invention and utility model patents. Where products the same as or similar to the products incorporating the patented design uses any design which is the same as or similar to the patented design, the court shall hold that the accused design fall within the protection scope of design patents. The court shall determine whether the accused design is "the same as or similar to" the patented design by considering the overall visual effect, based on the knowledge and cognitive competence of ordinary consumers of the products incorporating the patented design and the design features of the patented design and the accused design. Design features mainly determined by technical functions and features such as the materials or internal structure of the products which do not affect the overall visual effect, will not be considered.

### **Infringement of components and parts**

According to Article 12 of the Interpretation, using products infringing patented inventions or utility models as components or parts of other products is an act of using patent(s). Article 11 of Patent Law provides that the act of using products with patented designs does not constitute an infringement of patented designs. Hence, the act of using a product infringing a design patent as a component or part of another product and selling such other product constitute a selling activity prohibited by the Patent Law. However, the aforesaid act shall not be regarded as a selling activity prohibited by the Patent Law, if the component and part only has technical functions in the normal use of the final products and has no visual effects, considering that design patents only protects the appearance of a product. In addition, if the manufacturer of the infringing product and that of the forgoing “another product” cooperate and coordinate with each other, then both of them shall be jointly liable for the infringement.

### **Defenses of prior art and prior user rights**

The new Patent Law (i.e., the *PRC Patent Law* recently amended on December 27 2008 and effective as of October 1, 2009) sets forth the defense of prior art, a defense made available to the accused infringer against infringement allegations made by the patent holder. Under Article 14 of the Interpretation, if all the technical features claimed to fall within the protection scope of patent right are the same as or of no substantial differences from the corresponding technical features in an existing technical solution, the court shall hold that the technology carried out by the accused infringer is a prior art and does not constitute a patent infringement. If the accused design is the same as or of no substantial differences from a prior design, then the court shall hold that such design is a prior-art design.

The Interpretation sets forth that, after the application date, the prior user may only transfer or assign, together with the original enterprise, his/her technologies or designs which have already been carried out or necessary preparation for whose implementation have been completed, otherwise it will constitute an infringement. However, transfer or licensing by the prior user prior to the application date is not subject to such restriction. Nevertheless, defenses of prior art and prior user’s right are not available to technologies or designs obtained through illegal means; instead, they shall be developed on one’s own or acquired through legal means.

### **System of confirmation of non-infringement**

This system is explicitly adopted by judicial interpretations for the first time. Article 18 of the Interpretation provides that if the right holder gives other person a warning of an infringement of patent right, the warned person or the interested person then makes an interpellation in

written requesting the right holder to exercise his/her right of action, and the right holder fails to either withdraw his/her warning or file a lawsuit within one month from the right holder's receipt of such written interpellation or two months from sending such written interpellation, the court shall accept the lawsuit filed by the warned person or the interested person requesting a confirmation that his/her act does not constitute an infringement of any patent rights.

#### **Application of the Patent Law**

Pursuant to the Interpretation, the old Patent Law (i.e., the *PRC Patent Law* as amended on August 25, 2000) shall apply to patent infringements occurring before October 1, 2009, and accordingly, the new Patent Law (i.e., the *PRC Patent Law* recently amended on December 27 2008 and effective as of October 1, 2009) shall apply to patent infringements occurring after October 1, 2009. In the event that the accused patent infringement act occurred before October 1, 2009 but continued beyond October 1, 2009, and in accordance with both the old and new Patent Law, the infringer shall bear compensation liability, the court shall apply the new Patent Law in determining the specific amount of compensation.

#### **4. CNNIC Released Notifications on Further Enhancement of Auditing Domain Name Registration Information (Author: Xiaolin TENG)**

In order to further enhance the auditing on domain name registration information, China Internet Network Information Center ("**CNNIC**") released on December 10, 2009 the Notification about Initiating Special Control over Domain Name Registration Information (the "**Notification**") which took effect as of the date of its promulgation, and the Announcement about Further Enhancement of Auditing Domain Name Registration Information (the "**Announcement**") on December 11, 2009, which became effective at 9:00 am, December 14, 2009.

The Notification and the Announcement have set forth the following rules and requirements, aimed at ensuring that the domain name registration information is authentic, accurate and complete.

- (1) To apply for registration of a domain name, the applicant shall submit the formal paper based application material when making the online application to the registry. The registry shall then submit the paper based application material via email or fax to CNNIC for its review. If CNNIC does not receive the formal paper based application material within five days from the date of submitting the online application or the application material does not meet CNNIC's requirement, the domain name to be applied will be deleted.

- (2) The application material shall include the original application form sealed with company chop, the photocopy of the applicant's enterprise business license or certificate of organization code and the photocopy of the contact person's identification documents. As such, individual users who cannot submit enterprise business licenses or certificates of organization code will not be qualified to apply for registration of a domain name.
- (3) CNNIC will audit the registration information of the registered domain names. If the registration information of a domain name submitted by a domain name holder is found to be unauthentic, inaccurate or incomplete, the domain name holder will be notified within five business days to correct the information. If the domain name holder does not make the correction within required periods, the original domain name registry will revoke the registration of the domain name and notify the domain name holder in written forms.
- (4) In addition, CNNIC will inspect the implementation of the Notification and the Announcement by the registry. Any registry who does not strictly carry out the relevant requirements of the Notification and the Announcement will be subject to default liabilities under the .CN English Domain Name Registration Service Certification Agreement, the .CN English Domain Name Registration Service Market Administration Standards, the Chinese Domain Name Registration Service Certification Agreement and the Chinese Domain Name Registration Service Market Administration Standards.

## **Important Announcement**

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