

# Legal Commentary

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## “Illegal Gains” Formula to Change for Administrative Penalties by Administrations for Market Regulation

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On December 6, 2021, the State Administration for Market Regulation issued a circular to seek public comments on a draft of the *Measures for Determination of Illegal Gains in Administrative Penalty Cases by Administrations for Market Regulation (Draft for Comment)* (the “**Draft Measures**”), which is open for public comment until January 5, 2022. The Draft Measures are intended to support the recently revised *Law of the People’s Republic of China on Administrative Penalty* (the “**Administrative Penalty Law**”), which took effect on July 15, 2021, and would replace the existing *Measures for Determination of Illegal Gains in Administrative Penalty Cases by Administrative Organs for Industry and Commerce* (“**Decree 37**”). The Draft Measures aim to resolve the problem of inconsistent criteria for determining illegal gains in administrative law enforcement practice.

“Illegal gains” has been a long-standing, closely watched source of concern among enterprises subject to penalty in administrative penalty cases. In commercial bribery cases, for example, the *Anti-Unfair Competition Law* currently imposes an administrative fine for commercial bribery of between 100,000 and 3 million RMB, but does not limit the amount of the “illegal gains” to be “confiscated”. This contrast was even starker under an earlier version of the *Anti-Unfair Competition Law*, where the upper limit for administrative fines for commercial bribery was merely 200,000 RMB, which actually led to extreme cases where an administrative fine was imposed of tens or hundreds of thousands of RMB while the illegal gains confiscated reached tens of millions of RMB. As a result, in law enforcement practice, the determination of “illegal gains” is usually hotly disputed between enterprises subject to penalty and law enforcement authorities. The issues at stake are normally the calculation method, reasonable criteria, and deductible items; however, the scope of and calculation formula for deductible items vary significantly across regions due to different approaches by law enforcement. Given the above, even though the Draft Measures contain only 13 articles and are merely issued for public comment, their importance cannot be underestimated. Following the issuance of the Draft Measures, this commentary provides a comparison between the Draft Measures and Decree 37 in an effort to share our initial interpretation of the Draft Measures and to analyze the potential impact of the Draft Measures.

## What are illegal gains?

The Draft Measures define “illegal gains” by directly citing Article 28 of the current *Administrative Penalty Law*, namely **gains obtained from a violation of law**. The definition is substantially the same as that in Decree 37, but the Draft Measures would further specify “gains” as mainly referring to **cash, bank deposits** and **other monies deemed as cash and bank deposits**.

## How are illegal gains calculated?

The basis for calculating “illegal gains”, as stipulated in both the Draft Measures and Decree 37, is all the gains a party derives from engaging in illegal conduct. The Draft Measures would modify the approach of Decree 37 with respect to items deductible in determining the “illegal gains” subject to confiscation (please see the comparison below for reference). In addition, the Draft Measures further clarify that “**all gains**” as mentioned above should include **accounts receivable that have not been actually received, bills receivable that have not been cashed**, as well as **expense reductions due to the illegal conduct**.

### Draft Measures

All gains obtained from violations of law			
Necessary expenditures directly used for production and business activities	Taxes and fees lawfully paid	Monies lawfully returned or used for compensation	Illegal gains

### Decree 37

Total income derived from illegal manufacture and/or sale of commodities or from illegal provision of services		
Proper and reasonable expenditures directly used for business activities	Taxes and fees lawfully paid	Illegal gains

## Which items are deductible?

### I Taxes and fees lawfully paid

Article 7 of the Draft Measures provides that, “*In determining illegal gains, **taxes and fees paid** by the party concerned shall be deducted **before** the administrative authorities for market regulation **decide to impose any administrative penalty.***”

This deductible item is consistent with that set forth in Decree 37, and law enforcement authorities rarely disallow this deduction in practice.

### II Monies lawfully returned or used for compensation

Article 8 of the Measures provides that, “***The sum of monies that has been returned or used for compensation in accordance with law** by the party concerned shall not be confiscated by the administrative authorities for market regulation, but shall be counted as illegal gains.*”

Decree 37 does not touch on deducting monies that the party subject to penalty should lawfully return or use for compensation. The Draft Measures would add this provision to echo Article 28, paragraph 2 of the *Administrative Penalty Law* (i.e., the illegal gains obtained by a party shall be confiscated, except for those that should be returned or used for compensation in accordance with law). The Draft Measures would also provide the legal foundation necessary for justifying the reasonable deduction of returns and compensation made in the confiscation of “illegal gains”, which has been absent in previous law enforcement practice.

### III Necessary expenditures directly used in production and business activities

Article 3 of the Measures provides that, “*The basic method for the administrative authority for market regulation to determine illegal gains is: the illegal gains shall be all the monies derived by the party concerned from engaging in the illegal conduct less the **necessary expenditures directly used for production and business activities.***”

The counterpart provision in Decree 37 uses the expression “**proper and reasonable expenditures**”, as in “[t]he **basic principle** for the administrative department for industry and commerce to determine illegal gains is: the illegal gains shall be the total income derived by a party concerned from engaging in the illegal manufacture and/or sale of commodities or from illegal provision of services less **the proper and reasonable expenditures directly used for business activities** by the party concerned.” In practice, the application of this basic principle is a focus of dispute in determining illegal gains, because both the absence of a uniform standard and the relatively subjective “proper” and “reasonable” test have resulted in varying criteria for determining illegal gains.

For example, in the case of a manufacturing enterprise:

- A strict law enforcement authority may insist that no items other than those expressly set forth in Decree 37 is deductible when calculating illegal gains (i.e., the purchase price of raw materials for manufacturing the commodities), not even the costs of water, electricity, and gas that are indispensable for the manufacture. As a result, the confiscated illegal gains may be higher than the enterprise’s gross profits.
- Even law enforcement authorities that are open to considering other types of “proper and reasonable expenditures” can hardly reach a uniform standard. Some allow deduction of the costs of water, electricity, and gas required for manufacture; some further extend the scope to cover salary and plant and equipment leasing costs; and others allow the deduction of storage and logistics costs and even partial sales expenses. A small difference in those items could result in a disparity of tens of thousands to millions of RMB for illegal gains subject to confiscation.

To resolve the problem of inconsistent criteria, the Draft Measures stipulate as follows:

First, they change “**proper and reasonable expenditures**” to “**necessary expenditures**”;

Second, they further define “**necessary expenditures**” by categorizing the term into two parts:

- The purchase price of raw materials or commodities involved in the relevant production and business activities; and

- Other expenses directly related to the illegal conduct that can be evidenced by relevant bills, notes, account books, or other evidence provided by the party concerned (A point to consider: The party concerned has the burden of proving such other expenses. Although, in practice, there may still be different interpretations of such “other directly related expenses”, the necessary expense principle and the burden of proof would define a much clearer scope and boundary for deduction compared with “proper and reasonable expenditures”);

Furthermore, they **provide exceptions** for the deduction of “**necessary expenditures**”, namely circumstances where “necessary expenditures” cannot be deducted:

- The raw materials or commodities involved in production and business activities that were obtained from illegal sources;
- The raw materials or commodities involved in production and business activities that do not meet the requirements for protecting personal and property safety;
- The party concerned has carried out activities in violation of laws on food and drug safety or special equipment safety, which severely endangers life and health of citizens, property safety, or social public interests;
- The party concerned refuses, obstructs, or disrupts the investigation of the illegal conduct by administrative authorities for market regulation, or maliciously conceals, falsifies or destroys bills, notes, account books, or other evidence (A point to consider: This exception would mean that the degree of cooperation of the party concerned with relevant investigation will have direct and outsized pecuniary impact on the findings of an investigation);

Then, the Draft Measures provide that, for cases with complicated circumstances or that involve serious illegal conduct, the law enforcement authority may entrust a third-party audit institution to audit the illegal gains (A point to consider: In fact, it has been a practice for years for law enforcement authorities to engage third party audit institutions to audit illegal gains of uncooperative companies or in complicated cases. This article would provide the legal foundation for such third-party audits. In the future, some audit institutions may set up forecasting or evaluation services specially for illegal gains audits as a reference for corporate risk assessment);

Finally, the Draft Measures affirm that law enforcement authorities may use to determine illegal gains reference information such as data confirmed in effective judgments or awards issued by people’s courts or arbitration institutions, audited production and operation data, and statistical data published by statistics departments (A point to consider: Legal counsel to enterprises are advised to consider one more dimension when analyzing materials such as court judgments and arbitration awards containing financial data, statistical data and audit data, and be alert to materials that may relate to the calculation of illegal gains involved in administrative penalties).

## Conclusion

We conclude this commentary with the following chart for your reference when calculating illegal gains. We will continue to monitor the public comments on and promulgation of the Draft Measures, as well as other supporting rules to the recently revised *Administrative Penalty Law*.

All gains obtained from violations of law			
Necessary expenditures directly used for production and business activities	Taxes and fees lawfully paid	Monies lawfully returned or used for compensation	Illegal gains
Necessary expenses that are deductible		Circumstances where necessary expenses cannot be deducted	
The purchase price of raw materials or commodities	Raw materials or commodities obtained from illegal sources		
	Raw materials or commodities that do not meet requirements for protecting personal and property safety		
Other expenses directly related to the illegal conduct that can be evidenced by the party concerned	The party concerned has engaged in violations of law in respect of food and drug safety or special equipment safety, which severely endangers life and health of citizens, property safety or social public interests		
	The party concerned refuses, obstructs or disrupts the investigation of illegal conduct by administrative authorities for market regulation, or maliciously conceals, falsifies or destroys bills, notes, account books or other evidence		

## ***Important Announcement***

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