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Insights & Ideas

MOFCOM Released Draft Rules on the Administration of Equity Contribution of Foreign-invested Enterprises (Author: Huan WANG; Qi LUO)

With a view to meeting the demands of foreign direct investment development and improving the convenience of investment, on May 4, 2011, the Ministry of Commerce(MOFCOM) has published the *Measures on the Administration of Equity Contribution of Foreign-invested Enterprises (Draft for Comment)* (“Draft”) on its official website, soliciting public opinions and suggestions. The deadline of opinion submission is May 20, 2011.

Set forth below are salient points of the Draft:

Clarification of Applicable Scope

The Draft explicitly clarifies that it shall apply to the establishment of foreign-invested enterprises (the “Invested Enterprises”) by domestic and overseas investors (“Equity Contributor”) making capital contribution with the equity held by them in the domestic enterprises in China (the “Equity Enterprises”). Forms of establishment applicable under the Draft include establishment of foreign-invested enterprises (FIEs) through setting up new corporate legal persons, transforming domestic-funded enterprises into FIEs through capital increase, and changing the equity structure of FIEs through capital increase.

Limitations for Equity Contribution

To ensure the integrity and avoid defects of equity to be invested, the Draft states that equity shall not be used for capital contribution under any of the following circumstances: (a) the registered capital of an Equity Enterprise has not been paid in full; (b) the equity has been pledged; (c) the equity has been frozen according to law; (d) the equity shall not be transferred under the articles of association (contract) thereof; (e) the equity of a FIE that fails to participate in or fails to pass the joint inspection for FIEs in the previous year; (f) the equity of foreign investment companies and foreign-invested venture capital (equity) investment enterprises; (g) the equity transfer shall be but has not been reported for approval in accordance with the laws, administrative regulations or the decision of the State Council; and (h) other circumstances wherein the equity shall not be transferred in accordance with laws, administrative regulations or the decision of the State Council.

Appraisal for Equity Contribution

The Draft stipulates that equity used for capital contribution shall be appraised by a legally established domestic appraisal institution. An Equity Contributor may, on the basis of equity appraisal, negotiate with the shareholders or other investors of the Invested Enterprise on the

amount of equity price (the trading price of the equity used for capital contribution jointly recognized by above-mentioned parties on the basis of equity appraisal) and the amount of equity contribution (the part of the amount of equity price that is included in the registered capital of the Invested Enterprise).

The Draft further sets forth that the amount of equity price shall not exceed the appraised value of equity, and also the amount of equity contribution shall not exceed the amount of equity price. The balance between the amount of equity price and the amount of equity contribution may be included in the capital reserve fund of the invested company.

Market Thresholds and Change of Company Organizational Forms

The Draft states that, after equity contribution, the business scope of an Equity Enterprise and an Invested Enterprise as well as the direct or indirect holding enterprises thereof shall conform to the Provision Guiding Foreign Investment Direction, the Catalogue of Industries for Guiding Foreign Investment and other provisions on foreign investment; in case of any nonconformity, the relevant assets or equity shall be stripped off prior to the application for equity contribution.

In case the shareholders of an Equity Enterprise comprise no foreign investors (including foreign investment companies, foreign-invested venture capital (equity) investment enterprises or foreign-invested partnerships) after the equity contribution, the enterprise shall complete the relevant formalities for approval or record-filing in accordance with the *Regulations on Changes in Equity of Foreign-Invested Enterprises and the Interim Provisions on Investment Made by Foreign-Invested Enterprises in China*, and apply for cancelling or changing the Approval Certificate for Foreign-invested Enterprises.

Examination, Approval, and Registration Procedures

The examination and approval authority for equity contribution of FIEs is the provincial commerce department at the place where the enterprise is located or the MOFCOM. Set forth below are the steps of procedure for examination, approval, and registration:

- An investor or Invested Enterprise shall submit equity contribution documents to the examination and approval authority. Where the authority makes a decision on approval and the Invested Enterprise is newly established or a non-FIE prior to the equity contribution, the authority shall issue the Approval Certificate for Foreign-invested Enterprise (indicate “Equity contribution has not been fully made, and the certificate shall remain valid for one year as of the date of issuance of the business license” in the remarks column); where an Invested Enterprise has been in existence prior to the equity contribution, and the name or legal address thereof has not changed, the examination and approval authority shall give an official reply.

- The enterprise shall, by presenting the Approval Certificate for Foreign-invested Enterprise with remarks of the Invested Enterprise or the official reply, complete the formalities for record-filing or approval (where an Equity Enterprise is a non-FIE, it shall complete the formalities for record-filing or approval in accordance with the *Interim Provision on Investment made by Foreign-Invested Enterprise* in China and other relevant provisions; where an Equity Enterprise is a FIE, it shall apply with the concerned examination and approval authority in accordance with *Certain Provision on Change of the Equity Interests of the Investors of A Foreign-Invested Enterprise* and other provisions), and file an application for changing the holder of the equity used for capital contribution into the Invested Enterprise.

- An Invested Enterprise or investor shall, by presenting the Corporate Business License and a Copy thereof as well as the certificate of capital verification (where an Equity Enterprise still exists as a FIE after the equity change, it shall also submit a photocopy of the changed Approval Certificate for Foreign-invested Enterprise; where an Equity Enterprise is a non-FIE but the business scope thereof involves the restricted fields as specified in the Catalogue of Industries for Guiding Foreign Investment, it shall also submit the approval document for domestic reinvestment by a FIE), apply with the examination and approval authority for renewing the Approval Certificate for Foreign-invested Enterprise (indicate “Equity contribution has been made” in the remarks column).

It should be noted that, according to the Draft, where an Invested Enterprise is a FIE and the controlling stake thereof will not be transferred from a Chinese enterprise to a foreign enterprise after the equity contribution, such equity contribution shall be approved by the competent provincial department in charge of commerce at the place where the Invested Enterprise is located. However, as for where the controlling stake will be transferred from a Chinese enterprise to a foreign enterprise after the equity contribution, the Draft does not explicitly clarify whether such equity contribution shall be approved by the MOFCOM.

The Draft also sets forth that, except where the laws and regulations expressly specify that it shall be examined and approved by the MOFCOM, the equity contribution in the service industry shall be approved by the competent provincial department in charge of commerce at the place where the Invested Enterprise is located. Therefore, it is unclear whether the examination and approval authority shall be the competent provincial department in charge of commerce at the place where the Invested Enterprise is located or the MOFCOM, where the equity contribution is in the service industry and the controlling stake will be transferred from a Chinese enterprise to a foreign enterprise.

Tax Administration

The Draft sets forth that equity contribution shall conform to the provisions on tax administration, but does not explicitly clarify what provisions shall be applicable to equity contribution. Our focus is that, in the event that the amount of equity contribution exceeds the original amount acquired by the investor, whether the investor shall pay the relevant corporate/individual income tax for the premium of the amount. Now tax authorities are reinforcing tax regulation regarding such non-monetary capital investment through value-added appraisal, but no relevant provisions specifically addressing tax administration of equity contribution of FIEs have ever been promulgated. If the MOFCOM, on the basis of the Draft, has any modification or improvement on this issue, we will update such progress promptly.

Conclusion

The Draft clarifies relevant requirements and examination, approval and registration procedures for equity contribution of FIEs. Before the publication of the Draft, there is no applicable operation rule for equity contribution of FIEs. Most measures promulgated by local governments on the administration of equity contribution exclude overseas investors as Investors and FIE as Equity Contributor or Invested Enterprise in the applicable scope of such measures. In practice, so far by now, no public case of equity contribution of FIE has been known. The publication of the Draft implicates that equity contribution of FIEs shall probably be regulated in the examination and approval system of departments in charge of commerce, which is conducive for integration and transformation between FIE and domestic enterprise, regulating normal capital flows between various economic entities.

Legal Updates

1. Shanghai Issued Amended Version of Notice on AIC Registration for Equity Investment Enterprises (Author: Yong WANG; Taoran WANG)

On May 3, 2011, the Financial Service Office, Administration of Industry and Commerce, Administration of Finance and Local Taxation Bureau of Shanghai, a city that has been at the forefront of private equity in China recently, jointly issued *Notice on Industrial and Commercial Registration for Equity Investment Enterprises in Shanghai (amended)* (the “**New Notice**”). The New Notice, which came into effect on June 3, 2011 and will remain effective through June 2, 2016, made certain changes to *the Notice on Industrial and Commercial Registration for Equity Investment Enterprises in Shanghai* (the “**Previous Notice**”) jointly issued by the same government authorities in 2008 as outlined below:

Equity Investment Enterprises and Equity Investment Management Enterprises Invested by Trust Companies

The New Notice imposes new requirements on the registration of equity investment enterprises and equity investment management enterprises (the “**EIEs/EIMEs**”) invested by trust companies with the administration of industry and commerce (“**AIC**”) and provides that for those enterprises that make equity contributions with trust assets, the nature of such capital should be expressly specified in the registration documents to ensure the risk isolation function of trust assets and enhance the independency and transparency of trust assets. In addition, the New Notice expressly brings EIEs/EIMEs invested by trust companies that are primarily engaged in the secondary securities investments within its purview.

Certain Rules for Enterprise Registration Loosened

Firstly, the New Notice expanded the permissible names and description of business scope of EIEs/EIMEs under the Previous Notice to include “equity investment fund” and “equity investment fund management” in addition to “equity investment” and “equity investment management”. The reference to “fund” has critical importance in China as an entity that is called a “fund” is supposed to be specially regulated in China. Several ministry-level departments such as China Securities Regulatory Commission and National Development and Reform Commission as well as local authorities have been trying to claim jurisdiction over private equity funds.

Secondly, according to the New Notice, for those enterprises that satisfy certain conditions, their trade names incorporated in their enterprise names will be allowed to be suffixed with Fund I, Fund II, Fund III, etc. to allow the firms to build the brand name and intangible assets in their trade names.

Addition of Rules concerning AIC Registration of Foreign-invested EIEs

The New Notice clarifies the basis of implementation for the AIC registration of foreign-invested EIEs and provides that such registration shall be conducted pursuant to the *Implementation Measures for the Launch of a Pilot Foreign-invested Equity Investment Enterprises Project in Shanghai* (please refer to *Han Kun Private Equity Commentary on Summary of Recent Regulation Interpretation Seminar on Qualified Foreign Limited Partner Pilot Program in Shanghai* dated April 28, 2011 for details).

Adjustment of Tax Policies Applicable to Partnerships

According to the Previous Notice, different tax rates are applicable to general partners and limited partners who are individuals. The income of individual general partners is deemed operating income of individual industrial and commercial households subject to progressive tax rates ranging from 5% to 35% whereas income of individual limited partners is deemed investment income subject to a tax rate of 20%. Such distinction of individual income tax treatment between general partners and limited partners is suspected by many to be in conflict with Circular No. 159 issued by the State Administration of Taxation in 2008, which does not impose different tax rates on individual general partners and limited partners. The New Notice removed such conflicting provision and instead provides that the manufacturing, operating and other income of partnership enterprises shall be allocated to its partners, who shall then pay their own income tax on their shares of such allocated income, consistent with Circular No. 159.

2. Comparison of Catalogue of Industries for Guiding Foreign Investment (Revision Draft for Soliciting Opinions) in 2011 to Catalogue of Industries for Guiding Foreign Investment in 2007(Author: Yang CHEN; Qi LUO)

On April 1, 2011, the National Development and Reform Commission, in conjunction with the Ministry of Commerce and other relevant departments, revised the *Catalogue of Industries for Guiding Foreign Investment (revised in 2007)* (hereinafter referred to as the “2007 Catalogue”), and formulated the opinion solicitation draft (hereinafter referred to as the “Draft”) to solicit opinions from the public. Set forth below is a summary of major revisions made by the Draft to the 2007 Catalogue.

Encourage Investment in Environment-friendly Industries

The Draft encourages foreign investment in environment-friendly industries, by adding into the encouraged category of the manufacturing of such environmental protection equipment as wind turbine generator set, air pollution prevention and control, water pollution prevention and control, solid waste treatment and disposal, reclamation of waste industrial products, and marine ecosystem protection equipment. Meanwhile, for the purpose of encouraging the

development and use of new energy, the Draft puts manufacturing of key parts and components of new energy automobiles as well as energy saving technology development and services in the encouraged category for foreign investment.

Restrict Investment in “Three High” Corporations

The Draft indicates legislature’s intent to restrict foreign investment on “three high” corporations in relation to high pollution, high energy depletion, and high water including. For example, it places “production of dyes and paints that adopt obsolete process, contain hazardous substance, and are of limited output”, “production of inorganic salt which occupies large amount of resources, causes environment pollution, and adopts obsolete process”, and “production of calcined soda and caustic soda, as well as sulfuric, nitric and potassium carbonate of limited output or with obsolete process” into the restricted category.

Restrict Investment into Industries Concerning National Security

The Draft introduces additional restrictions on some industries concerning national security. For example, it puts exploration and mining of high-aluminum fireclay, wollastonite, graphite and other important nonmetallic metals, mining and mine selection of lithium mines and iron sulfur mines, as well as extraction of brine resources from salt lake in the restricted category. For the sake of food security, the Draft puts purchase, storage, wholesale, retail, and distribution of grains into the restricted category as well.

Other Hot Issues

The Draft has certain manifestation regarding some hot issues now in China, such as real estate development, healthcare, venture capital, and education.

- The Draft removes “construction and operation of villas” from the restricted category to the prohibited category, reflecting the policy to restrict foreign capital in domestic real estate development against the backdrop of the overheated real estate development market.
- The Draft removes the provision of “Medical institutions (limited to Sino-foreign equity joint ventures and cooperative joint ventures)” from the restricted category, which means wholly foreign owned medical institutions are permitted now, corresponding with relevant provisions in *the Notice of the General Office of the State Council on Forwarding the Opinions of the National Development and Reform Commission, the Ministry of Health, the Ministry of Finance, the Ministry of Commerce and the Ministry of Human Resources and Social Security on Further Encouraging and Guiding Social Capital in Setup of Medical Facilities*.

- The Draft adds venture capital investment companies, intellectual property rights services and logistics information consulting services and “occupational skills training” into the encouraged category.
- The Draft still lists “direct sales, mail orders, and online sales” in the restricted category of foreign investment, however, removes “franchising, commissioned business and business management”, “Goods auction”, and “financial leasing companies” from that category. Further, distribution of audio and video products (excluding movies) does not require Chinese parties as the controlling shareholders any longer. For ordinary senior high schools, “Limited to Sino-foreign equity joint ventures and cooperative joint ventures” changes to “limited to cooperative joint ventures”, which means ordinary senior high schools in the form of Sino-foreign equity joint ventures are not permitted.
- According to the Draft, foreign capital is still prohibited from investing in “Provision of audio and video programs on news websites and network, operation of business premises for Internet-access services, and operation of Internet cultural business”; however, music is not prohibited as an exception.
- The Draft lists “domestic express delivery business of mails” in the category of prohibited industries for foreign investment.
- The Draft removes the restriction on wholesale, retail, and distribution of automobiles (in the case of chain stores having established more than 30 stores and selling products of different varieties and brands from multiple suppliers, the Chinese parties shall be the controlling shareholders) from the restricted category of investment, which is compatible with China’s WTO commitment.

3. The State Administration of Radio Film and Television promulgates the Administrative Rules on Digital Master Technology Examination (Interim) (Author: Ying YANG; Guanglei ZHANG)

The State Administration of Radio Film and Television (the “SARFT”) promulgates the *Administrative Rules on Digital Master Technology Examination (Interim)* (the “Rules”) on May 13, 2011. The Rules became effective on the same day. The *Notice on Publishing Administrative Rules on Digital Master Technology Quality* ([2008] Ying Zi No.404), the *SARFT Film Bureau’s Notice on implementing Paid Collection of Digital Master* ([2008] Ying Zi No.863), and the *SARFT Film Bureau’s Notice on Collection of Digital Master* ([2008] Ying Zi No.424) were abolished at the same time.

The Rules integrate the stipulations of the aforesaid three abolished notices and

systematically regulate technology examination of digital master, which mainly include the following points:

- Licenses. The Rules adopt same requirements with the former rules in relation to license issues, i.e. any released film in digital form must pass the digital master technology examination organized by film administrative departments, and obtain the License of Film Release and the Certificate of Film (Digital) Technology.
- Examination Authorities Level. The Rules modify prior stipulations that all the films should be examined by the SARFT, stating that the digital master technology examination in the localities adopting territorial examination and administration shall be conducted by competent local film administrative departments in these localities, whereas the Film Bureau of the SARFT is responsible for examinations in other localities. Also, the Rules clarify the applicable laws of examination, stipulating that technology examination should be implemented in accordance with the *Rules on Film Digital Master Submitted for Examination Sound and Picture Quality Subjective Examination* (GD/J033-2010).
- Collection. The Rules keep the former stipulations that the Film Bureau of the SARFT is responsible for collecting film digital master which has passed the technology examination. The film administrative departments in the localities adopting territorial examination and administration shall seal the digital master which has passed the technology examination, and then entrust reporting institutions to submit it, together with the photocopies of the Certificate of Film (Digital) Technology and the Digital Film Making Report for Examination, to the Film Bureau of the SARFT. The Film Bureau of the SARFT shall entrust relevant institutions to connect the digital film of the Certificate of Film (Digital) Technology to the end of the film digital master.
- The *SARFT Film Bureau's Notice on implementing Paid Collection of Digital Master and the SARFT Film Bureau's Notice on Collection of Digital Master* both stipulate that China Film Archive is responsible for collecting digital master and paying fees to reporting institutions. The Rules do not include stipulations on paid collection.

Important Announcement

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