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Newsletter

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Insights & Ideas

Central Financial Funds May be Invested into Venture Capital Enterprises or Used for Equity Participation in Venture Capital Investment Funds (Authors: Ping ZHANG; Lu RAN)

On August 17, 2011, the Ministry of Finance and the National Development and Reform Commission jointly issued the *Interim Measures for the Administration of Investment Fund of Enterprises Participating in the New Industry Venture Capital Program* (Cai Jian (2011) No.668, the “**Interim Measures**”), specifying that central financial funds may be directly invested into start-up enterprises and/or used for equity participation in venture capital investment funds (the “**Participation Fund**”) under the principles of “guidance by the government, standardized management, market-based operations and encouragement of innovation” so as to foster the new industry and promote its development.

It is foreseeable for the Interim Measures to come out. Since the establishment of China’s first venture guide fund (with an amount of \$1 billion) in the Sino-Singapore Suzhou Industrial Park in March 2006, many local governments in China have changed the way of using the governmental guide funds from traditional risk subsidies to market-oriented investment and then guide the social capital to invest into the venture investment fields through encouraging and supporting the development of start-up investment enterprises. On November 26, 2009, the Ministry of Finance and the National Development and Reform Commission jointly issued the *Notice for Pilot Work on Implementation of New Industry Plan, Carrying Out Industry Research, and Raising Fund for Equity Participation Venture Capital Funds* (the “**Notice**”) which officially launched the New Industry Venture Capital Program nationally. According to the Notice, 20 national venture capital funds have been or would be established in Beijing, Jilin, Shanghai, Anhui, Hunan, Chongqing, Shenzhen as selected provinces or cities to promote the program. To keep pace with such development tendency in China’s finance industry, Han Kun Law Offices has participated actively in the establishment of some of those funds. Now, to a large extent, the *Interim Measures* is regarded as a kind of affirmation of such a operation model where the central government funds are combined with the local government funds and then the state power is directly involved in government guidance venture funds (the “National Guide Fund”) to push high and new technology industry forward.

With regard to the establishment of a National Guide Fund, one key point is how to deal with different roles played by the central finance department, the local government, the private investors and the fund management team. Taking into consideration the provisions in the relevant regulations and the practice of the first 20 national venture capital funds, the state mainly takes an approach namely as “participation without intervention”, which emphasizes a leading, professional and market-oriented role played by the National Guide Fund.

With respect to the role as leading fund, the Notice says the national capital equity participation shall not exceed a proportion of 20%, and shall not be an equity controlling party. Meanwhile, the capital invested by the local government shall not be less than the amount invested by the state funds and the capital collected from the society shall be more than 60%. But for angel fund established through equity participation, the state capital equity ratio can be increased appropriately. The Interim Measures makes it much more clear to support the high and new technology enterprise policies, and the Participation Fund shall mainly make investments into innovative enterprises which have the capability to make original innovations, integrate innovations or make new innovations after digestion and absorption and are newly established or at the beginning or middle stage and the proportion of funds invested into such enterprises shall not be less than 60% of the registered capital or the promised capital contribution of the fund.

To establish a professional fund, the Notice only mentions that the investment made by the fund shall coordinate with the guidance of the state policy to encourage the new and high technology industry. By contrast, the Interim Measures not only specifically sets forth that each participating fund shall focus on making investments into such new strategic industries as energy conservation and environmental protection, information, biology, new medicine, new energy, and the like, but also provides that the fund shall not be engaging in such businesses as guarantee, mortgage, entrusted loan and real estate business or be invested into listed companies, real estate, stocks, futures, corporate bonds, trust products, wealth management products, insurance programs and any other financial derivatives and so on.

To make sure the market-based operations of the fund, a professional management agency is required in the Notice to manage the fund with a simple description of qualified staffs. However, the Interim Measures explicitly indicates that the management structure of the Participation Fund includes the Participation Fund enterprise, the Participation Fund management institution and the custodian bank and the three parties shall perform their respective duties and fulfill their respective responsibilities in accordance with their stipulations. The Participation Fund management institution shall be registered in the mainland of China with the registered capital of not less than RMB 5 million, and has the capability to raise funds, possess rich investment management experience, and is able to provide business start-up tutorship, management consultancy and other value-added services to the invested enterprise. Furthermore, the custodian bank shall meet the proscribed conditions. As refer to the rights and interests in the capital contribution of the central finance, the Interim Measures states that the capital contribution of the central finance shall assume liability for the debts of the Participation Fund to the extent of the amount of the capital contribution. Unless stipulated in the articles of association for the Participation Fund, clauses required for the Participation Fund shall not be more preferential than any other contributors. If there is any loss arising from the liquidation of the Participation Fund, the Participation Fund management institution shall first make up the loss with the capital contribution

of the Participation Fund and the remainder shall be made up by the central finance, the local government and other capital contributors according to the proportion of capital contribution. Through such a kind of structure and arrangement, the Participation Fund shall be independently operated according to the market-based methods and it shall be responsible for its own management and profits and losses.

The goal for the National Guide Fund is to clarify an investment direction for the social capital and encourage venture investment enterprises to increase investment into new and high technology fields, especially new-born enterprises full of potential for further growth. Compared with the Notice, the Interim Measures emphasizes that the government shall stick to its own position in the market through a much more institutionalized managing method. The capital contributed by the government functions as guidance while the main body of the fund lies in the social capital collection, including overseas capital. After establishment, the fund shall be managed by a professional team in accordance with the articles of association agreement, and overseas management teams are welcomed as well.

However, attentions should also be paid to some restrictive conditions by potential enterprises to take advantage of such policy which is in favor of small and medium size innovative enterprises.

There are two ways to establish a Participation Fund as mentioned in Interim Measures: central finance with local government funds and social capital, jointly establishing a venture capital fund by promotion or participating in any existing venture capital fund. Whichever way to be taken, the venture capital fund shall be filed for the record in accordance with the *Interim Measures for the Administration of Venture Capital Enterprises*. For any newly established venture capital fund which applies for the capital contribution of the central finance, the total amount of funds raised for each Participation Fund is not less than RMB 250 million; the registered capital or net assets of the major promoter is not less than RMB 50 million; the total capital contribution of capital contributors other than the central finance and the local government is not less than RMB 150 million; while for any applicant who applies to increase the capital of any existing venture capital fund with the central financial funds, in addition to conditions for newly established venture capital fund, the initial capital contribution or initially subscribed capital contribution made by all of the capital contributors of the venture capital fund has been paid in and is not less than 20% of the registered capital or the promised capital contribution.

As investment guidance, each Participation Fund is required to focus on making investments into new and high technology industries with potential to fully develop. To receive the investment as a qualified key innovative enterprise, the so-called Innovative Enterprises Newly Established or Innovative Enterprises at the Beginning or Middle Stage should satisfy the proscribed conditions in the Interim Measures.

The incentive mechanism designed by the Interim Measures is known as performance awards adhering to the principle of “first recovering the principal and then distributing the profits”. 20% of the value-added income of the Participation Funds (the recovered funds less the capital contribution to the Participation Fund) shall in principle be given to the Participation Fund management institution as awards, and the remainder shall be distributed by the central finance, the local government and other capital contributors according to the proportion of their capital contribution.

A new venture guide fund mode has been formed under the Interim Measures. The guidance of central finance capital, the authority of the local government, the power of private investors, and the professional skills of the management team will be integrated to provide new funding and financing channels for some venture fund, create a much better market environment for private equity investors and also bring out new opportunities for small and medium-sized innovative enterprises in an underdeveloped market.

Legal Updates

1. China Released Notice on Relevant Issues Relating to the Stamp Duty on the Return of Transferred State-Owned Shares by National Social Security Fund Council (Authors: Ping ZHANG; Chu LIU)

On August 23, 2011, the Ministry of Finance and State Administration of Tax jointly issued *the Notice on the Relevant Issues Relating to the Stamp Duty on the Return of Transferred State-Owned Shares by National Social Security Fund Council* (CAISHUI [2011] No. 65), which provides that National Social Security Fund Council (the “**NSSFC**”) suffers no stamp duty when returning the state-owned shares to state-owned venture capital enterprises (the “**State-Owned VCEs**”) and state-owned venture capital guiding funds (the “**State-Owned VC Guiding Funds**”).

Mandatory transfer of state-owned shares

According to *the Notice on the Measures on Enriching the Social Security Fund by Transferring Some State-Owned Shares in the Onshore Securities Market* (CAIQI [2009] No.94) (the “**Notice 94**”) jointly promulgated on June 19, 2009 by the Ministry of Finance, State-Owned Assets Supervision Administration Commission (the “**SASAC**”), China Securities Regulatory Committee (the “**CSRC**”) and NSSFC, it is obligatory to transfer 10% of the total shares to be listed to the NSSFC in the case of initial public offerings of corporations fully or partially owned by the state-owned shareholders (but not to exceed the shares actually owned by the state-owned shareholders), subject to the same lock-up period as they are in the hands of the transferring state-owned shareholders. For initial public offerings occurring after the 2006 reform of the non-tradable shares (state-owned shares) and prior to the promulgation of the Notice 94, ten percent (10%) of the shares actually publicly issued at that time should be transferred to the NSSFC retroactively, which shares shall be subject to three (3) more years of lock-up in addition to the transferring shareholders’ lock-up period.

Waiver of the obligation to transfer state-owned shares

According to *the Notice on the Relevant Issues Relating to the Waiver of the Obligation to Transfer State-Owned Shares Held by State-Owned Venture Capital Enterprises and State-Owned Venture Capital Guiding Funds* (CAIQI [2010] No. 278) (the “**Notice 278**”) jointly promulgated on October 13, 2010 by the Ministry of Finance, SASAC, CSRC and NSSFC, qualified State-Owned VCEs and State-Owned VC Guiding Funds investing in privately held small or medium-sized enterprises (the “**SMEs**”) may apply for the waiver of the obligation to transfer shares to NSSFC.

Eligibility requirements:

- (1) Business scope limitation: the business scope of State-Owned VCEs should be limited to: (i) making venture capital investments (for its own account); (ii) making venture capital investments on behalf of other venture capital enterprises, organizations or individuals; (iii) conducting venture capital consulting business; (iv) providing venture capital management service to venture enterprises; (v) participating in the establishment of venture capital enterprises and venture capital management consulting institutions.
- (2) Name limitation: the registered name should include the words “venture capital”.
- (3) The past venture capital filing is lawful: the State-Owned VCEs and State-Owned VC Guiding Funds should have filed information in accordance with the *Temporary Measures on Venture Capital Enterprises* (the “**Measures**”) and their investment and operation complies with the Measures upon annual inspections conducted by the relevant authorities.

In the meantime, the investees, or the unlisted SMEs should also meet the following conditions: (i) having no more than 500 employees; (ii) annual sales volume/turnover not exceeding RMB 200million; and (iii) total assets not exceeding RMB 200 million.

Return of transferred state-owned shares

According to Notice 278, qualified State-Owned VCEs and State-Owned VC Guiding Funds which have already transferred the state-owned shares may apply directly for the return of the shares to the Ministry of Finance.

According to *the Notice on the Relevant Issues Relating to the Waiver of the Obligation to Transfer State-Owned Shares Owned by State-Owned Venture Capital Enterprises and State-Owned Venture Capital Guiding Funds* (CAIQI [2011] No. 14) promulgated on February 22, 2011 by the Ministry of Finance, if the State-Owned VCEs and the State-Owned VC Guiding Funds are eligible for the waiver of the obligation to transfer state-owned shares after being examined by the Ministry of Finance and the NSSFC, the shares will be returned, which include: (i) the state-owned shares transferred by State-Owned VCEs and State-Owned VC Guiding Funds to the NSSFC; (ii) the derivative benefits due to the dividend distribution and capital increase of the listed corporation throughout the holding period of the NSSFC, including stock dividend, capital increase from profits and cash dividend. The State-Owned VCEs and State-Owned VC Guiding Funds shall apply for the return of the transferred shares or the exemption of the lock-up period before October 31, 2011. Applications made after this submission deadline will not be accepted.

2. Brief of Circular on Value-added Tax Policy on Software Products (Authors: Bing Xue; Jiixin Liu)

In order to promote the development of software and integrated circuit industries, the State

Council issued the Circular on Certain Policies to Encourage the Development of the Software and Integrated Circuit Industries (Guo Fa [2000] No.18, "Circular No.18"). Subsequently, the Ministry of Finance ("MOF"), the State Administration of Taxation ("SAT") and General Administration of Customs jointly issued the Circular on Taxation Policies for Encouraging the Development of the Software and the Integrated Circuit Industries (Cai Shui [2000] No.25, "Circular No.25") to further clarify the preferential tax treatment for the software and IC enterprises. According to Circular No.18 and Circular No.25, for the 10 years up to the end of 2010, software products developed and sold by a general value-added tax ("VAT") payer are subject to the stipulated VAT rate of 17%, and an "immediate levy, immediate refund" policy was implemented whereby the portion of effective VAT burden in excess of 3% of the sales revenue would be immediately refunded to the VAT payer. As the said preferential VAT refund policy expired at the end of 2010, the State Council issued 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") in January 2011, officially confirming the extension of this VAT refund policy.

To further encourage the development of the software industry and clarify the scope and requirement for the preferential VAT policy, the MOF and SAT jointly issued the Circular on Value-added Tax Policy on Software Products on October 13, 2011 (Cai Shui [2011] No.100, the "Circular"), which comes into effect as of January 1, 2011. We set out below some of the key issues in relation to the tax policies stated in the Circular:

Definition of software products

For the purpose of the Circular, software products refer to information processing programs and relevant documents and data. In terms of software products, they shall include computer software products, information systems and embedded software products. And embedded software products shall refer to software products which are embedded in computer hardware, machines and equipment, are sold with them and constitute a part of the computer hardware, machines and equipment.

According to the Circular, the VAT refund policy is applicable to qualified embedded software products. Nevertheless, such VAT refund policy, as provided by the Circular, shall not be applicable to the embedded software products provided that the cost of such embedded software products and related computer hardware, machines and equipment fails to be clearly accounted for respectively in the case that the sales amount of such computer hardware, machines and equipment is determined by calculation according to the composite assessable price stated in the Circular.

Conditions to preferential policies

The software products shall meet the following conditions simultaneously to enjoy the VAT preferential policies:

- (1) The software products shall be developed and produced by the general VAT taxpayers, or imported and sold by the general VAT taxpayers after localization processing, such as re-design, improvement or transformation (excluding pure translation treatment into Chinese on the imported software products);
- (2) Testing proof materials for the software products issued by a software testing institution recognized by the competent provincial authority for the software industry have been obtained; and
- (3) The registration certificate for software products issued by the competent authority for the software industry or the registration certificate for the copyright of software products issued by the administrative authority for copyright has been obtained.

The applicable conditions to the VAT preferential policies on software products varied among different regions prior to promulgation of the Circular as some local practices require completion of both certification of software enterprise and registration of software products. We understand that the Circular does not require completion of certification of software enterprise as condition to preferential treatment, which is beneficial to more software enterprises to enjoy the VAT preferential policies.

Refund policy

Upon examination and approval by the competent tax authorities, the qualified software products under the Circular shall be subject to the stipulated VAT rate of 17% and the portion of effective VAT burden in excess of 3% of the sales revenue would be immediately refunded to the VAT payer. In addition, the Circular provides that if taxpayers are entrusted to develop software products, VAT shall be collected in the case that the copyright of the software products is owned by the entrusted party and no VAT shall be collected in the case that the copyright of the software products is owned by the entrusting party or jointly owned by the two parties. Further, no VAT burden shall be incurred in connection with the software products which have been registered with the State Copyright Administration and the copyright and ownership of which are transferred when taxpayers sell them.

Others

In addition to the said matters, the Circular also specifies the respective formulas for calculating the refund amount applicable to general isolated software products and embedded software products as well as restriction on deduction of input tax. Further, if any taxpayer gets to enjoy the preferential policy by way of deceptive or fraudulent means, the tax authority shall, in addition

to imposing any applicable punishment, cancel the qualification of such taxpayer to enjoy the preferential treatment from the year in which the aforesaid misconduct takes place and the taxpayer shall not submit any application for such qualification within three years.

Important Announcement

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If you have any questions regarding this publication, please contact:



Contact Us

Beijing Office

Tel.: +86-10-8525 5500
Suite 906, Office Tower C1, Oriental Plaza
No. 1 East Chang An Ave.
Beijing 100738, P. R. China

Rong CHEN Attorney at-law

Tel.: +86-10-8525 5541
Email: estella.chen@hankunlaw.com

Shanghai Office

Tel.: +86-21-6080 0919
Suite 5709, Tower 1, Plaza 66, 1266 Nanjing
West Road,
Shanghai 200040, P. R. China

Anita SUN Attorney-at-law

Tel.: +86-21-6080 0907
Email: anita.sun@hankunlaw.com

Shenzhen Office

Tel.: +86-755-3680 6500
Suite 4709, Excellence Times Plaza, 4068
Yitian Road, Futian District,
Shenzhen 518048, P. R. China

Jason WANG Attorney at-law

Tel.: +86-755-3680 6518
Email: jason.wang@hankunlaw.com