Newsletter

10th Edition of 2012

Insights & Ideas

1. Shanghai RQFLP Pilot Program in Sight

Legal Updates

1. MOFCOM Released Interim Provisions on Equity Contribution Involving Foreign-Invested Enterprises
2. Detailed Rules for the Overseas Investment with Insurance Capital to Broaden the Fundraising Channels for Overseas Private Equity
3. CSRC Issued Decision on Amending the Rules for the Establishment of Foreign-Invested Securities Companies
4. New Individual Income Tax Policy on Dividends and Bonuses from Listed Companies

Shanghai RQFLP Pilot Program in Sight (Authors: James WANG, Sheldon CHEN, and Jialin ZHONG)

According to relevant sources, following the Qualified Foreign Limited Partner ("**QFLP**") Pilot Program launched in December of 2010, Shanghai has recently been approved as the first city for the RMB Qualified Foreign Limited Partner Pilot Program (the "**RQFLP Pilot Program**").The RQFLP Pilot Program will be initially implemented in Pudong New District. The detailed rules of the RQFLP Pilot Program will be jointly created by the State Administration of Foreign Exchange Shanghai Branch, the Shanghai Municipal Development & Reform Commission, the Shanghai Financial Services Office and other relevant authorities.

Introduction of RQFLP Pilot Program

Yet another new measure adopted in Shanghai to promote the backflow of offshore RMB funds, the RQFLP Pilot Program is based on the QFLP pilot program with respect to the RMB Qualified Foreign Institutional Investor ("**RQFII**") program. In short, under the RQFLP Pilot Program, institutional investors satisfying relevant eligibility requirements may directly remit RMB funds raised overseas to Shanghai to set up private equity funds for private equity investments.

Although the RQFLP Pilot Program inherits certain characteristics of the QFLP pilot program and the RQFII program, there exist noticeable differences among them. Compared to the QFLP program, the RQFLP Pilot Program will broaden the channels for capital contribution, under which qualified foreign limited partners may use offshore RMB (as opposed to foreign currency) funds to set up private equity funds in China. As a result, the capital contribution and investment procedures are expected to be simplified to some extent. Compared to the RQFII program that is geared toward securities market investments, qualified foreign limited partners under the RQFLP Pilot Program may deploy offshore RMB capital for making equity investments in non-listed enterprises and private placements in listed enterprises.

Key Issues Concerning RQFLP Pilot Program

1. Who Can Apply

While details of the RQFLP Pilot Program are not known yet, it is very possible that the applicants will initially be limited to the Hong Kong subsidiaries of Chinese asset management companies and brokerage firms, which is similar to the RQFII program. Haitong International, the Hong Kong subsidiary of the Shanghai-based brokerage firm Haitong Securities, has been reported to have entered into a memorandum of understanding with Bank of Shanghai and will apply for a RQFLP quota of the USD 100 million equivalent of RMB.

2. National Treatment

In response to Blackstone's request to clarify the domestic nature of its Shanghai-based RMB fund[1], in April 2012 the National Development and Reform Commission issued the *Reply Letter of the General Office of NDRC on Relevant Issues Relating to Foreign-invested Equity Investment Enterprises(FaGai Ban WaiZi [2012] 1023)* (the "**Reply Letter**"). The Reply Letter clarified that Blackstone's RMB fund and similar limited partnership funds with a general partner that is a foreign-invested enterprise and limited partners that are domestic investors shall be subject to foreign investment laws and policies and the *Catalogue for Guiding Foreign Investments*. As a result, this Reply Letter has dealt a major blow to the foreign private equity community in China, significantly reducing the interest of foreign private equity firms in the QFLP program.

While the detailed rules are yet to come, according to relevant officials in the financial bureaucracy in Shanghai, RMB funds set up through the RQFLP Pilot Program will still be considered foreign capital subject to the relevant rules and restrictions on foreign investments.

3. Extent of Regulation

To prevent the excessive inflow of offshore hot money, the regulatory authorities in the beginning generally adopt a cautious approach towards the pilot programs of new policies involving foreign exchange, offshore RMB and their implementation, only to relax restrictions as the pilot programs progresses. For example, the RQFII policy implemented at the beginning of this year was subject to significant restrictions on its size, scope of allowed investments and portfolio allocation at the initial stage imposed by regulators. The initial size of the total approved RQFII quota was only RMB 6 billion, but it was quickly increased by RMB 50 billion in just a few months after the implementation of the program.

As a new measure for the backflow of offshore RMB funds, the RQFLP Pilot Program will further broaden the channels for the backflow of offshore RMB and permit offshore RMB to be deployed for investing in the domestic real economy. However, given the current relative chaotic situation in the national and local regulation of domestic private equity funds and to prevent the overheating of certain parts of the real economy, the regulators likely will initially take small steps with respect to the RQFLP Pilot Program.

We will continue to closely watch the implementation of the RQFLP Pilot Program and will update you on its latest developments.

.

[1] The Blackstone's Shanghai-based RMB fund raised most of its capital from domestic RMB investors, with its foreign element limited to its GP contribution in the amount of no more than 5% of the size of the fund, which under the Shanghai QFLP regulation would not affect the nature of its portfolio companies.

Legal Updates

1. MOFCOM Released Interim Provisions on Equity Contribution Involving Foreign-Invested Enterprises (Authors: Yixin LIN, Alan LUO)

In order to meet the demands of foreign direct investment development and improve the facilitation of investments, on May 4, 2011, the Ministry of Commerce (MOFCOM) has published the *Measures on the Administration of Equity Contribution Involving Foreign-invested Enterprises (Draft for Comment)* ("Draft"[2]) on its official website, soliciting public opinions and suggestions. On September 21, 2012, MOFCOM officially promulgated the *Interim Provisions* of the *Ministry of Commerce on Equity Contribution Involving Foreign-invested Enterprises* ("Interim Provisions"), which has been in effect since October 22, 2012.

Before the promulgation of the Interim Provisions, on April 1, 2009, the State Administration for Industry and Commerce issued the *Measures for Registration Administration of Capital Contribution with Equity Interests*, stating the relevant requirements and operating procedures for equity interests to become a legal form of capital contribution. However, most of the measures issued by local governments on the administration of equity contributions before the promulgation of the Interim Provisions exclude overseas investors as being investors, and foreign-invested enterprises ("FIEs") as being Equity Contributors or Invested Enterprises. The promulgation of the Interim Provisions illustrates that equity contributions involving FIEs shall be regulated within the examination and approval system of MOFCOM and its branches. Therefore, these Interim Provisions would benefit the integration and transformation between FIEs and domestic enterprises, and regulate normal capital flows between various economic entities.

In comparison with the Draft, the Interim Provisions make the following adjustments in regards to equity contributions involving FIEs:

1) Based on the Draft, the Interim Provisions clearly stipulate that domestic or overseas investors should not avoid the administration of foreign investment by means of equity contributions. As a result, this regulation indicates the gradual improvement on the administration of foreign investment and the maturity of the legislative technology used by MOFCOM.

2) When compared to the Draft[3], the Interim Provisions adopt a fairly simple and clear approach in

2 Please refer to the article issued by our law firm MOFCOM Release Draft rules on the Administration of Equity Contribution of Foreign-invested Enterprise (http://www.hankunlaw.com/backuser/picinfo/201163092657.pdf)

3 The Draft stipulates that if an Invested Enterprise is a limited liability company, such Enterprise shall be subject to the determination of the examination and approval authorities, based on the total investment of the company. If an Invested Enterprise is a joint stock limited company, such Enterprise shall be subject to the determination of the examination and approval authority, based on the registered capital of the company.

regards to the level of authority in examination and approval. It states that except for equity contributions that shall be subject to the approval of MOFCOM as prescribed by the relevant provisions on foreign investment examination and approval, equity contributions involving FIEs shall be subject to the approval of the provincial examination and approval authorities where the Invested Enterprises are located.

3) The Interim Provisions also enhance Article 22 Paragraph 1 by stating that "whenever the equity contribution involves any of the circumstances specified in the *Notice of the General Office of the State Council on Launching the Security Review System for Mergers and Acquisitions of Domestic Enterprises by Foreign Investors*, the foreign investor shall file an application for the merger and acquisition security review in accordance with the relevant provisions." Therefore this provision indicates MOFCOM's attention on the newly implemented security review system.

In addition, the Interim Provisions reflect MOFCOM's policy orientations towards foreign investments, stating that the equity of real estate enterprises should not be used for capital contributions.

The main points of the Interim Provisions are as follows:

Clarification of Applicable Scope

The Interim Provisions shall apply to the establishment and change of foreign-invested enterprises ("Invested Enterprises") by domestic or overseas investors ("Equity Contributors") making capital contributions with the equity held by them in domestic Chinese enterprises ("Equity Enterprises"). The applicable forms of establishment or change include:

1) establishing FIEs in the form of incorporating new companies;

2) changing non-foreign-invested enterprises into FIEs through capital increases; and

3) changing the equity of FIEs through capital increases.

Limitations of Equity Contributions and Compliance Requirements Regarding the Administration of Foreign Investments

The Interim Provisions restrict equity contributions involving FIEs in two ways. First, equity used for capital contributions shall be legally transferable with indisputable ownership and complete rights and power. Second, the relevant enterprises shall comply with the duly provisions regarding the administration of foreign investments. The Interim Provisions stipulate that equity shall not be used for capital contributions in any of the following circumstances:

1) The registered capital of the equity enterprise has not been fully paid;

2) The equity has been pledged;

3) The equity has been frozen in accordance with the laws;

4) The equity shall not be transferred according to the articles of association;

5) The equity of an FIE that fails to participate or fails to pass the joint annual inspection for FIEs in the previous year;

6) The equity of real estate enterprises, foreign investment companies or foreign-invested venture capital (equity) investment enterprises;

7) The equity transfer should be reported for approval, but failed to be approved in accordance with the laws, administrative regulations or decisions of the State Council; or

8) Other circumstances prescribed by the laws, administrative regulations or decisions of the State Council wherein the equity shall not be transferred.

It should be noted that, according to Article 24 of the Interim Provisions, when a domestic investor makes a capital contribution to a domestic-funded enterprise with the equity of an FIE, the above limitations shall be applied as well.

In addition, the Interim Provisions highlight that after an equity contribution is made, the Invested Enterprise, the Equity Enterprise, and the direct or indirect holding enterprise thereof shall conform to the *Provisions Guiding Foreign Investment Direction*, the *Catalogue of Industries for Guiding Foreign Investment,* and other regulations on foreign investment. In the event of any non-conformity, the relevant assets or business should be removed or the relevant equities should be transferred prior to the application for making an equity contribution. Again, domestic or overseas investors shall not avoid the administration of foreign investment by means of equity contributions.

Appraisal and the Maximum Amount of Cap Requirements for Equity Contributions

The Interim Provisions state that equity used for making capital contributions 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 equity price[4] and the amount of equity contribution[5], which shall not exceed the appraised value of the equity.

In addition, the Interim Provisions promote limitations on the proportion of equity contributions in the registered capital of the Invested Enterprise, requiring that the aggregate amount of equity contributions by all the shareholders of an Invested Enterprise and other non-monetary contributions

4 Refers to the trading price of the equity used for a capital contribution jointly recognized by the above-mentioned parties on the basis of equity appraisal.

5 Refers to the part of the equity price that is included in the registered capital of an invested enterprise.

shall not exceed 70 percent of the registered capital of the Invested Enterprise.

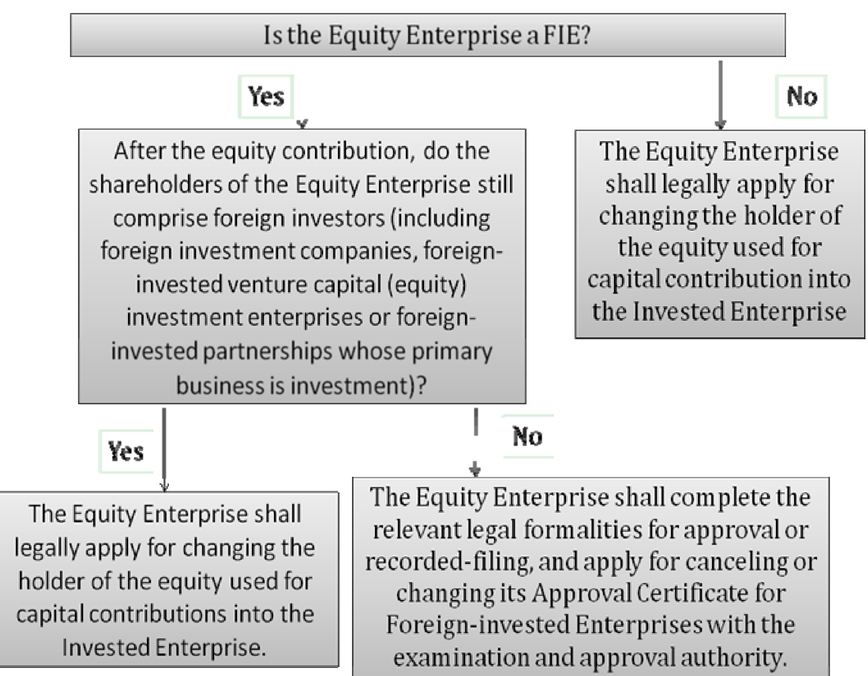
The Examination and Approval Authority and Its Authorization and Relevant Examination and Approval Procedures

The Interim Provisions refer to MOFCOM and its local commercial departments as the examination and approval authority for equity contributions involving FIEs. Except for those that shall be subject to the approval of MOFCOM as prescribed by the relevant provisions on foreign investment examination and approval, equity contributions involving FIEs shall be subject to the approval of the provincial examination and approval authorities where the Invested Enterprises are located. The following three steps illustrate the examination and approval procedures:

1) The investor or the Invested Enterprise shall submit equity contribution documents to the examination and approval authority. In addition to the equity contribution agreement and the Equity Enterprise's business license, the application documents should also include a legal opinion issued by a law firm and a lawyer assigned thereby in accordance with the aforementioned limitations promoted for equity contributions and the compliance status regarding the administration of foreign investments.

   In the event of an approval in accordance with the laws, the examination and approval authority shall issue or replace the Approval Certificate for Foreign-Invested Enterprises with "equity contribution has not been fully made" indicated in the remarks column. If the Equity Enterprise is an FIE and is approved by the examination and approval authority different from that of the Invested Enterprise, the examination and approval authority of the Invested Enterprise shall seek the opinions of the provincial examination and approval authority at the place where the Equity Enterprise is located.

2) After being approved by the examination and approval authority where the Invested Enterprise is located, the second step of the procedure is followed:



3) After the above-mentioned step, the Invested Enterprise shall apply for changing the Approval Certificate for Foreign-Invested Enterprises with the examination and approval authority together with relevant documents, and make sure that "equity contribution has been fully made" is indicated in the remarks column. In the event that the Equity Enterprise is a non-foreign-invested enterprise and its business scope includes industries in the restricted catalogue for the guidance of foreign investment industries, the Invested Enterprise shall also submit the document approving the domestic reinvestment of the FIE.

Tax Administration

Interim Provisions state that equity contributions shall conform to the provisions on tax administration, but they do not explicitly clarify what provisions shall be applicable to equity contributions. Our focus is that, in the event that the amount of an equity contribution exceeds the original amount acquired by the investor, whether or not the investor shall pay the relevant corporate/individual income tax for the premium of the amount. Currently tax authorities are reinforcing tax regulation regarding such non-monetary capital investments through value-added appraisals. However, no relevant provisions specifically addressing tax administration of the equity contributions of FIEs have been promulgated. If MOFCOM, on the basis of the Interim Provisions, has any modifications or improvements on this issue, we will promptly update such progress.

2. Detailed Rules for the Overseas Investment with Insurance Capital to Broaden the Fundraising Channels for Overseas Private Equity (Authors: James WANG, Florine GU)

Following the joint issuance of the *Interim Measures for the Administration of Overseas Investment*

with Insurance Capital (the "**Interim Measures**") by the China Insurance Regulatory Commission (the "**CIRC**"), the People's Bank of China and the State Administration of Foreign Exchange on June 28, 2007, the CIRC announced the *Detailed Implementing Rules for the Interim Measures for the Administration of Overseas Investment with Insurance Capital* (the "**Implementing Rules**") on October 12, 2012. On the basis of the Interim Measures, the Implementing Rules, by means of specifying the qualification of the parties to, investment products, and investable countries and regions of overseas investments with insurance capital, further broadens the methods for using insurance capital.

Investment Scope

The appendices of the Implementing Rules list 25 developed markets, 20 emerging markets, and 14 futures and options exchanges that are investable for insurance capital, which cover nearly all of the major markets worldwide. Although insurance capital has already been permitted to be invested into mature capital markets "globally" by the Interim Measures, no definition of "mature" was given under the Interim Measures, and in practice, overseas investments with insurance capital have been limited to stocks and bonds in the Hong Kong market. The Implementing Rules are widely believed to serve to expand the investable regions of overseas investments with insurance capital from the Hong Kong markets to 25 developed markets and 20 emerging markets. Notwithstanding any possible misunderstandings by the media towards the Interim Measures, it is apparent that since the introduction of the Interim Measures in 2007. The refinement and clarification of the investable market by the Implementing Rules is undoubtedly a sign of strong support for establishing a broader overseas investable market for insurance capital.

Investment Types

With respect to investment types, the Implementing Rules, for the first time, propose that insurance capital can be directly invested into overseas real estate, provided that such investment shall be limited to mature commercial and office real estate that have the potential to provide stable income and are located in the core areas of major cities in developed markets. The Implementing Rules also further refine the three investment types provided under the Interim Measures. In particular, the Implementing Rules clarify that insurance capital can be directly invested into the equity of unlisted enterprises, provided that such investment shall be limited to the equity of enterprises engaging in finance, aged care services, healthcare, energy, resources, automobile services or modern agriculture.

The Implementing Rules also stipulate the requirements for overseas funds investable with insurance capital (including but not limited to securities investment funds, private equity funds, and real estate investment trusts). In regards to private equity funds (the "**PE**") to be invested, the Implementing Rules not only specify the requirements on the size, personnel, governing structure, stability, and risk control of the PE itself, but also regulate the size of and assets managed by the

equity investment institution initiating and managing the PE. Furthermore, insurance capital is prohibited to be invested in an overseas PE where a financial institution directly or indirectly holds de facto control over its management and operation or hold a general partnership interest therein. With the introduction of the Implementing Rules, domestic insurance institutions will become represent a large group of potential institutional investors for overseas PEs (including competent fund of funds), in addition to those few existing large Chinese institutional investors like China Development Bank and China Investment Corporation. As a result, the introduction of the Implementing Rules will make a new source of capital available to global PE markets.

Risk Control

In view of the special nature of insurance capital as life insurance money to policyholders, the safety of the operation of such capital is critical. Therefore, risk control is of great importance when opening overseas investments with insurance capital. Based on the Interim Measures, the Implementing Rules further emphasize the use of risk control in overseas investments with insurance capital from the following aspects, including but not limited to:

1) Higher Requirements for the Qualifications of the Parties

In regards to the qualifications of the parties in an overseas investment with insurance capital set forth in the Interim Measures, the Implementing Rules specify the requirements regarding professional experience in investment or management, proprietary assets or assets under custody. The following represents a selection from the requirements:

(1) a trustor's solvency adequacy ratio is not lower than 120% at the end of the quarter before an investment is made;

(2) the total amount of assets entrusted to a domestic trustee's management in the most recent fiscal year is not less than RMB10 billion and the insurance capital entrusted to the management of a domestic trustee may only be invested in the Hong Kong market;

(3) the average amount of assets under an overseas trustee's management is not less than USD30 billion or an equivalent amount in other freely convertible currencies in the most recent year, and the total amount of assets of non-affiliated parties under its management is not less than 50% of the total amount of assets under its management or not less than USD30 billion or an equivalent amount in other freely convertible currencies;

(4) a custodian's paid-in capital or net capital in the most recent fiscal year is not less than RMB30 billion and total amount of assets under its custody is not less than RMB200 billion.

The Implementing Rules further provide that a custodian or a custodian's agent shall not have any of the following relationships with a trustor:

(1) where one party directly or indirectly holds over 10% equity interest in the other party;

(2) where a third party directly or indirectly holds over 10% equity interest in both parties; or

(3) other affiliation relationships determined by the CIRC.

If a custodian or a custodian's agent has any of the above-mentioned relationships with its trustor, an effective risk insulation mechanism will be established and insider trading or interest transfer shall be prohibited.

2) Limited Overseas Investment Ratios

The Implementing Rules, following the limits on the investment ratios set forth in the Interim Measures, provide that the balance of the overseas investments of an insurance institution may not exceed 15% of its total assets at the end of the preceding year and the balance of its investments in emerging markets may not exceed 10% of its total assets at the end of the preceding year. As to a single investment of an insurance institution, the ratios of its investments of various types domestic and overseas shall be calculated on a consolidated basis and subject to any ratio restriction on domestic investments of the same type. Moreover, the Implementing Rules stipulate limits on the amount and term of the short-term lending or borrowing of funds in overseas investments with insurance capital.

3) Prohibited Investments

The Implementing Rules stipulate that overseas investments with insurance capital shall not be involved in the following activities:

(1) investing in physical commodities, precious metals or certificates representing precious metals or commodity derivatives;

(2) raising funds through securities institutions, buying securities or participating in short sales without holding the underlying assets; or

(3) borrowing funds in any form except for the purpose of settlement of transactions.

4) Risk Control in Derivatives Transactions

The Implementing Rules permit the use of financial derivatives for investment risk hedging, provided that the total value of the subject matters of the derivative contracts, the total amount of charges, option fees and margins for the operation of financial derivatives, the total mark-to-market exposure of any counterparty to over-the-counter trading in each working day, and the qualifications of a counterparty in over-the-counter trading are subject to certain requirements and restrictions set forth therein.

5) Regular Reporting Obligations

In order to further the disclosure and reporting system of material and/or specific events set forth in the Interim Measures, the Implementing Rules establish a regular reporting obligation for trustors and trustees, which ensures the timely and efficient supervision and management of the CIRC on overseas investments with insurance capital.

6) Standard Agreements

Whereas the Interim Measures require that trustors shall enter into written agreements with their trustees and custodians, the Implementing Rules specify that specialized lawyers who have at least three years' relevant practice experience shall be engaged in expressing legal opinions on such agreements, which represents a higher requirement for the normalization and authenticity of relevant agreements.

Conclusion

Data from the CIRC indicates that by the end of 2011, the total assets of the insurance industry in the PRC reached RMB6.01 trillion. This was calculated under the criteria that the balance of overseas investments of an insurance institution may not exceed 15% of its total assets at the end of the preceding year as provided under the Implementing Rules. Currently, insurance capital in the PRC available for overseas investment amounts to RMB900 billion (among which RMB600 billion are available to be invested in emerging markets). As more insurance institutions start to engage in overseas investments, these institutions will certainly come to play an important role as a new group of investors in overseas private equity funds.

3. CSRC Issued Decision on Amending the Rules for the Establishment of Foreign-Invested Securities Companies (Authors: Kelvin GAO, David LI, and Joe ZHANG)

The China Securities Regulatory Commission (the "**CSRC**") promulgated the Decision on Amending the Rules for the Establishment of Foreign-Invested Securities Companies (the "**Decision**") on October 11, 2012. This Decision comes after the Fourth Round of China-U.S. Strategic and Economic Dialogue, which further opens the door for foreign investors in the securities sector. The Decision came into effect as of the date of promulgation.

Specifically, there are three amendments to the Rules for the Establishment of Foreign-Invested Securities Companies (the "**Rules**") under the Decision (i.e., Article 10, the first paragraph of Article 25 and Article 27 of the Rules.) Details of the amendments are as follows:

Raising the Maximum Shareholding Ratio of Foreign Shareholders in Foreign-Invested Securities Companies

The first paragraph of Article 10 of the Rules was amended under the Decision as:

The shareholding ratios of foreign shareholders or the equity interest ratios owned by such foreign shareholders (including those held directly and controlled indirectly) in a foreign-invested securities company shall not exceed 49% in aggregate.

The amendment raises the maximum shareholding ratio of foreign shareholders in a foreign-invested securities company from 1/3 to 49%, which will further bring more security business opportunities to foreign investors. The amendment enables foreign investors to further enjoy the development of the foreign-invested securities companies in which they invested, and increases their decision-making power in the corporate governance of the companies with respect to material operation matters.

In connection with the above amendment, the second and third paragraph of Article 10 and Article 25 of the Rules were amended accordingly.

1) The second and third paragraph of Article 10 of the Rules were amended as:

There shall be at least one domestically-funded securities company, among the domestic shareholders of a foreign-invested securities company, holding not less than 49% of shares or equity interests in such foreign-invested securities company.

After a domestically-funded securities company is converted into a foreign-invested securities company, there shall be at least one domestic shareholder holding not less than 49% of shares in the foreign-invested securities company.

2) The first paragraph of Article 25 of the Rules was amended as:

A foreign investor may hold the shares of a listed domestically-funded securities company either through securities trading at a stock exchange, or by establishing strategic cooperation relationship with such listed domestically-funded securities company, subject to the approval of the CSRC, without changing the approved business scope of the listed domestically-funded securities company. The listed domestically-funded securities company shall not be subject to the restriction that at least one domestic shareholder shall hold not less than 49% of shares or equity interests in a foreign-invested securities company, provided that the controlling shareholder is a domestic shareholder.

Special Provision for Investors from Hong Kong, Macau and Taiwan

In order to be in line with openness of securities companies to the investors from Hong Kong, Macau and Taiwan actively and steadily in the framework of the Mainland and Hong Kong Closer Economic Partnership Arrangement (the "**CEPA**") and the Cross-strait Economic Cooperation Framework Agreement (the "**ECFA**"), Article 27 of the Rules was amended under the Decision as:

With regard to the equity participation in securities companies by investors from Hong Kong Special Administrative Region, Macau Special Administrative Region and the Taiwan region, these Rules shall apply as a reference. Where the State stipulates otherwise, those provisions shall prevail.

Therefore, as to the investors from Hong Kong, Macau and Taiwan, the provisions under the CEPA and the ECFA specifically regulating foreign-invested securities companies shall prevail.

4. New Individual Income Tax Policy on Dividends and Bonuses from Listed Companies （Authors: Yang CHEN, Bing XUE, and Fang JI）

On November 16, 2012, the Ministry of Finance (the "**MOF**"), the State Administration of Taxation (the "**SAT**"), and the China Securities Regulatory Commission jointly issued the *Notice on the Implementation of the Differentiated Individual Income Tax Policy on Dividends and Bonuses Received from Listed Companies* (Caishui [2012] No. 85, hereinafter referred to as the "**Notice**"). The Notice provides that the individual income tax ("**IIT**") on dividends and bonuses received from listed companies will be levied differently based on the relevant stock-holding periods. For stocks with a holding period of no more than one month, all the dividends and bonuses shall be subject to the IIT. For stocks with a holding period above one month but not exceeding one year, 50% of the income shall be subject to the IIT. For stocks with a holding period of more than one year, 25% of the income shall be subject to the IIT, and the applicable IIT rate will remain at 20% as stated in the Individual Income Tax Law (the "**New Tax Policy**"). The Notice will take effect on January 1, 2013.

Current Individual Income Tax Policy on Dividends and Bonuses

The IIT Law stipulates that the dividends and bonuses income shall be taxable in full at the rate of 20%. In 2005, the MOF and the SAT issued the *Notice on the Individual Income Tax Policy on Dividends and Bonuses* (Caishui [2005] No. 102) and the *Supplementary Notice on the Individual Income Tax Policy on Dividends and Bonuses* (Caishui [2005] No. 107) (together the "**Current Policy**"), which state that as of June 13, 2005, only 50% of the dividends and bonuses actually received by individuals from listed companies should be subject to IIT. Listed companies as stated in the Current Policy refer to those that are listed on the Shanghai and Shenzhen Stock Exchanges. Therefore, the effective IIT rate on the dividends and bonuses received from listed companies is currently 10%.

New Tax Policy of Differentiated IIT Treatment on the Dividends and Bonuses Received from Listed Companies Based on the Stock-holding Period

The Notice changes the Current Policy that imposes a 10% effective IIT rate on the dividends and bonuses distributed by listed companies irrespective of the stock-holding period. In contrast, the Notice provides differentiated IIT treatment based on the relevant stock-holding period in order to promote long-term investment. The comparison table below illustrates the impact of the New Tax Policy on stocks with different stock-holding periods:

Stock-holding Period ("SHP")	Current Policy Effective Tax Rate	New Tax Policy Effective Tax Rate	Change in Effective Tax Rate
SHP ≤ 1 Month	10%	20%	Increased by 100%
1 Month <SHP≤ 1 Year	10%	10%	Unchanged
SHP > 1 Year	10%	5%	Reduced by 50%

In addition to the changes in effective tax rates, attention should also be drawn to the following points in the New Tax Policy.

1) Scope of Listed Companies

Same as the Current Policy, listed companies as stipulated in the Notice refer to those that are listed in the Shanghai and Shenzhen Stock Exchanges. As such, for the dividends and bonuses received by individuals from unlisted or overseas listed companies, IIT should be levied at a rate of 20% on the total income.

2) Stock-holding Period

As the stock-holding period affects IIT treatment on dividends and bonuses, the calculation thereof is of great importance. Pursuant to the Notice, a stock-holding period is the holding period from the time when an individual acquires the stocks of a listed company from public issuance and transfer market to the day immediately before the day of transfer. This period is counted on the basis of calendar year and calendar month. A stock-holding period of one-year is the continuous holding of stock from a certain day in a certain month of the preceding year to the day immediately before the same day in the same month of the current year. A stock-holding period of one month is the continuous holding of stock from a certain day of the preceding month to the day immediately before the same day in the current month. When the stocks are transferred, the stock-holding period is calculated on a first-in, first-out basis. For example, the stocks acquired earlier in one's stock account are deemed to be transferred earlier.

3) Withholding of Individual Income Tax

Both the Current Policy and the New Tax Policy require listed companies to act as IIT withholding agents regarding dividends and bonuses distributed. Since the New Tax Policy brings about differentiated tax treatments based on the relevant stock-holding period, special IIT withholding arrangements are listed below:

(1) For stocks with a holding period of more than one year as of the record date: the listed companies shall withhold the IIT at the effective tax rate of 5%;

(2) For stocks with a holding period of up to one year as of the record date that have not yet been transferred: a two-step approach shall be undertaken as follows:

- The listed companies shall first withhold the IIT at the effective tax rate of 5% upon the distribution of the dividends and bonuses;
- Upon the transfer of the stocks, the securities depository and clearing corporation shall calculate the taxable income based on the actual stock-holding period. As for the part in excess of the tax already withheld, the securities company may deduct the amount from the individual's monetary account and remit the same to the securities depository and clearing corporation. This will in turn remit the withheld IIT to the distributing listed companies within 5 working days of the following month. The listed companies will be responsible for the filing and payment of the withheld IIT to the competent local tax authorities within the statutory filing period in the month when the withheld IIT is received. If the balance in the individual monetary account is insufficient, the securities companies will notify the relevant individual to put up enough funds.

4) Dividends and Bonuses on Restricted Stocks

Before the release of restrictions on the restricted stocks, dividends and bonuses received shall be subject to the IIT at the 10% effective tax rate. After the release of restrictions on the restricted stocks, the IIT shall be levied in accordance with the New Tax Policy and the stock-holding period shall be calculated from the date of release.

5) Dividends and Bonuses Received by Securities Investment Funds

Pursuant to the current tax collection and administration policies,[6] listed companies shall withhold the IIT when distributing dividends and bonuses to securities investment funds. Securities investment funds shall not withhold the IIT when distributing the dividends and bonuses to individual investors. , In accordance with the above stipulations, listed companies shall also withhold the IIT when distributing dividends and bonuses to securities investment funds based on the stock-holding periods of the funds.

6) Possible Situations of the Acquisition and Transfer of Stocks

The Notice also lists the possible situations of the acquisition and transfer of stocks. In addition to the acquisition or transfer of stocks through stock exchanges, based on agreements, by court order or by legal inheritance/partition of family property, stocks can also be obtained through the following: acquisitions, exercise of stock warrants, conversion of convertible debts, issuance of stocks, allotment of stocks, stock dividends or using reserve funds to increase capital, holding stocks transferred from an agency share transfer system to the Main Board (or the SME or GEM Board),

[6] *Circular of the Ministry of Finance and the State Taxation Administration on the Tax Issues Related to Securities Investment Funds* (Caishuizi [1998] No 55) and *Circular of the Ministry of Finance and the State Taxation Administration on the Relevant Issues concerning the Taxation of the Open-end Securities Investment Funds* (Caishui [2002] No. 128).

stocks received as a result of the merger or spin-off of listed companies, and other means of stock acquisition from public issuance and transfer markets. Stocks can also be transferred by way of transferring stocks in acceptance of a tender offer, exercising cash options and transferring stocks to the third party that offers the cash option, subscription to ETF shares by stocks, and any other situations that are stock transfers in substance.

7) Effective Date of the Notice

The Notice will take effect on January 1, 2013. More specifically, the differentiated IIT treatment applies to dividends and bonuses distributed by listed companies with a record date on or after January 1, 2013. For stocks that are held by individuals prior to the effective date of the Notice, the stock-holding period shall be calculated from the date of actual acquisition of the stocks.

Impacts of the New Tax Policy on Investments in the Stocks of Listed Companies

It is apparent that the New Tax Policy aims to encourage long-term investment in the stocks of listed companies. The New Tax Policy also intends to direct investment from short-term speculation to blue-chip companies that have a relatively low stock price but distribute more dividends. In addition, the New Tax Policy will promote the development of securities investment funds since it applies to dividends and bonuses received by those types of funds from listed companies, and securities investment funds usually hold stocks for a longer period of time, which is more likely to benefit from the reduced 5% effective tax rate.

However, the effect of the New Tax Policy on individual investors may be rather limited. Many individual investors derive most of their income via the capital gains arising from the disposition of stocks, and they may hardly benefit from the New Tax Policy. In the event of a possible market downturn, the investment risk associated with the long-term holding of stocks may far exceed the tax benefit brought about by the New Tax Policy. Furthermore, the tax impact of the New Tax Policy is limited to dividend and bonus income, while the IIT is still exempt from the transfer of stocks. As a result of the difference in tax burden, individual investors may still prefer to invest in companies that seldom distribute dividends and bonuses but have a high stock price. In addition , companies that choose not to distribute dividends and bonuses may be able to use their profits for potential investment projects that may benefit their respective companies and increase their stock prices. Therefore, investors may more inclined to invest in these companies due to their high stock prices.

All things considered, investors should be made aware of the New Tax Policy, and take all factors, including the profitability, development prospects, and dividends policy of the listed companies into consideration when making prudent investment decisions.

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.

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

Wenyu JIN Attorney-at-law
Tel.: +86-10-8525 5557
Email: wenyu.jin@hankunlaw.com

Shanghai Office
Tel.: +86-21-6080 0909
Suite 5709, Tower 1, Plaza 66, 1266 Nanjing West Road,
Shanghai 200040, P. R. China

Yinshi CAO Attorney-at-law
Tel.: +86-21-6080 0980
Email: yinshi.cao@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

Copyright © 2004-2012 Han Kun Law Offices All Rights Reserved