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CHANGES TO HOLDING COMPANY LAW EASE SOME RESTRICTIONS

Key Points:

- **Business extended to foreign trade and domestic commerce**
- **Establishment criteria relaxed**
- **Role of regional headquarters recognized and scope of operation expanded**

On November 17, 2004 the PRC Ministry of Commerce (“MOFCOM”) issued a revised Regulation on Foreign Investment in Holding Companies, which took effect 30 days later. This Regulation not only extends the scope of business of foreign-invested holding companies to provide for foreign trade and domestic distribution, but also relaxes some of the criteria for the establishment of a holding company and for the designation of a holding company as a regional headquarters.

The new regulation can be seen as a follow-up to the recent amendments to the *Foreign Trade Law* and

the *Administration of Foreign Investment in the Commercial Sector Procedures* (“Commercial Procedures”) promulgated in April 2004 (both of which were reviewed in prior editions of our *China Update*). The amendments to the Trade Law provide that foreign-invested entities need only register with the relevant authorities to engage in import and export activities. The Commercial Procedures allow foreign-invested entities to engage in retail, wholesale, and franchising activities and also operate commission agencies.

Accordingly, the latest holding company regulation clarifies that holding companies may engage in foreign trade and commerce on the same terms as other foreign-invested entities. Specifically, to engage in foreign trade, a holding company must comply with the *Filing and Registration Measures on Foreign Trade Operators*. To engage in retail, wholesale, franchising, or commission activities, a

holding company must comply with the relevant provisions of the Commercial Procedures.

Further, the criteria for establishing a holding company have been eased. The new regulation abolishes a requirement on the minimum amount of the proposed investment projects and eliminates the "Project Proposal" from the list of application documents.

In addition, the requirements in the prior regulation regarding the amount and nature of R&D institutions have been abolished. A holding company that operates only one R&D center may be recognized as a regional headquarters. Holding companies that have been recognized as regional headquarters now may entrust the domestic enterprise to produce or process products of its own or of its parent company and then sell them either in China or abroad.

Through this revision, the legal environment for the foreign-invested entities has been further integrated with other legislation and with China's WTO commitments. – *Zhang Wei*

MOFCOM PROMULGATES NEW REGULATION ON FRANCHISING

Key Points:

- *Replaces prior regulation*
- *Includes a section on foreign invested enterprises that is consistent with China's WTO commitments*

The Ministry of Commerce ("MOFCOM") issued on December 30, 2004 the *Administrative Measures on Commercial Franchise Operations*, replacing a prior "tentative" regulation promulgated by the former Ministry of Domestic Trade in 1997. The new

regulation will take effect on February 1, 2005.

Compared with the 1997 regulation, the new 9-chapter, 42-article regulation provides considerably more detail, and adds certain additional requirements. For example, the new regulation requires the franchisor to own and operate at least two outlets by itself within Chinese territory.

Chapter 7 of the new regulation is dedicated to foreign invested enterprises ("FIEs"). MOFCOM published a draft regulation on franchise operations by FIEs in late November and invited public comment. It appears this draft regulation on FIEs has now been assimilated into the new regulation and forms a separate chapter, and that there will not be a separate franchising regulation for FIEs.

Under the new regulation, the key requirement for FIEs that does not apply to purely domestic enterprises in the conduct of franchising operations is that the approval of MOFCOM or its local counterpart is required. This is consistent with the current approval system for other FIEs and, therefore, is not a surprise. – *Zhao Yong*

CHINA ALLOWS FUND TRANSFERS BETWEEN MNC SUBSIDIARIES

Key Points:

- *Allows internal transfers of foreign exchange funds by MNCs*
- *Specifies details on qualifications, application procedures, and supervision measures*

On October 18, 2004, the State Administration of Foreign Exchange ("SAFE") released the *Notice on Internal Transfers of Foreign Exchange Funds by*

Multinational Companies (“Notice on Internal Transfers”), effective from November 1, 2004. Under the Notice on Internal Transfers, a multinational company may carry out foreign exchange lending and borrowing between its domestic affiliates in China, or between a domestic affiliate and a foreign affiliate.

“Multinational company” is defined as a company that possesses affiliates both in China and overseas at the same time that also has an affiliate in China responsible for the company’s global or regional investment management. Finance companies, however, are excluded from the application of the Notice on Internal Transfers.

The allowed foreign exchange lending and borrowing may be carried out by establishing a finance company in China, or extending an entrusted loan through a designated foreign exchange bank in China. An affiliate in China may also directly extend foreign exchange loans to a foreign affiliate.

The interest rate on such foreign exchange lending must be based on the rate of international commercial loans for the same period. There is also a requirement that all such foreign exchange lending must be done with the readily available funds in the foreign exchange capital or current account of the affiliates in China.

When a domestic affiliate is obtaining foreign exchange funds from a foreign affiliate, the relevant laws regarding foreign debt apply. In addition, foreign exchange funds extended through entrusted loans to a domestic affiliate may not be converted into Renminbi, or be pledged to secure loans

denominated in Renminbi.

When a domestic affiliate is transferring foreign exchange funds to a foreign affiliate, the balance of foreign exchange funds transferred out of China may not exceed the sum of the foreign investor’s repatriated profit distribution for the prior year and the undistributed profits to which the foreign investor is entitled based on its proportion of investment. Furthermore, before a domestic affiliate may transfer foreign exchange funds to a foreign affiliate, the principal and proceeds of the foreign exchange funds transferred by such domestic affiliate out of China during the last transaction must be returned before the relevant stipulated deadline. The maximum period of time during which a domestic affiliate may transfer foreign exchange funds out of China is two years, upon the expiration of which such funds must be returned to the foreign exchange capital and current (if applicable) account of the domestic affiliate.

The Notice on Internal Transfers also specifies detailed qualification requirements, application and operation procedures, as well as establishing measures for supervision by SAFE. – *Shawn Tai*

NEW CHINESE RULES PROTECT INTERESTS OF LABORERS

Key Points:

- **Details on sanctions for infringing employees’ rights**
- **Stronger protection of rights of women and children**

The State Council recently issued the *Labor Protection Supervision Regulations* (the

“Regulations”) to protect the rights and interests of laborers. The Regulations came into effect as of December 1, 2004.

The Regulations allow the relevant labor and social security authorities to sanction employers by ordering them to correct their infringements of the rights and interests of their employees. Specifically, the labor and social security authorities now have the right to order employers to pay employees any difference between their wages and the minimum standard wage, as well as economic compensation for termination of a labor contract. Where an employer breaches its wage obligation to an employee, the employer, in addition to paying the wages in full, may be required to pay compensation in an amount not less than 50% but not more than 100% of the wage of the employee whose rights were infringed. The employer may also be fined up to RMB 20,000 (approx. US\$2,415) in a case involving unreasonable refusal or impediment of labor protection supervision. If an employer commits fraud in reporting the amount of wage or the number of employees, a fine of up to three times the total wage will be imposed.

These Regulations apply to all enterprises and industrial and commercial households, all employment agencies, career training service centers and occupation appraisal organizations, and all government institutions and authorities.

The Regulations also forbid assigning women to hazardous posts, such as working in mine shafts and working in high places during their menstrual period, and assigning night shift to women who are more than seven months pregnant.

The Regulations further forbid employers from obstructing the establishment and normal operation of trade unions.

Employers will be required to maintain records showing compliance with the Regulations.

The Regulations encourage reporting of violations of labor rights and interests to departments of labor and social security, noting that informers in major cases will be rewarded. – *Maureen Meng*

TAX INCENTIVE ANNOUNCED FOR CHINA'S NORTHEAST REGION

Key Points:

- *Value added tax refund on fixed assets*
- *Preferential enterprise income tax policy*
- *Reduced resource tax on oil fields*

The Ministry of Finance and the State Tax Bureau have jointly promulgated a series of regulations in order to revive the Northeast Region of China. New tax incentives include input tax credits or refund on value added tax (“VAT”), preferential enterprise income tax policy, and resources tax reduction on oil fields. Because the land usage fees are increasing and the supply of electricity in the Yangtze River Delta is insufficient, the new regulations aim to attract more investment to northeastern China (i.e., the provinces of Liaoning, Jilin, and Heilongjiang, and the city of Dalian).

Value Added Tax Refund on Fixed Assets

The *Regulations on Certain Issues on Expanding the Scope of VAT Credit in the Northeast Region* issued on September 14, 2004 provide that qualifying

enterprises are entitled to claim input tax credits or refund on VAT when any of the following occur:

1. Purchase of fixed assets (including fixed assets received as a donation or as an investment);
2. Purchase of goods or taxable services to produce, reconstruct, expand, or install fixed assets;
3. Fixed assets are acquired through finance leases, provided the lesser paid VAT on the assets; or
4. A transportation fee is paid for fixed assets.

According to the regulation, the purchased or self-developed real property is not included in the scope of fixed assets, and in recent practice, input VAT incurred through the purchase of fixed assets is not deductible.

This regulation applies to the general VAT taxpayer mainly engaging in the manufacturing of goods and equipment, petrochemicals, metallurgy, vessels and autos and the processing of agricultural products in the Northeast Region.

The amount of the deductible input VAT is limited to the increase in the VAT payable in the current year. If there is no increase in the VAT payable in the current year or the incremental amount is insufficient to recover the VAT credit, the unclaimed input VAT credit is deferred to the following year.

Although there have been complaints that there are too many restrictions and limitations on the VAT refund, many enterprises in the Northeast Region seem to benefit from the regulation. As of October

2004, more than 40,000 companies in Northeastern China had received RMB 284,000,000 in tax refunds. Further, tax reform in the Northeast Region indicates that China is attempting to transform the current manufacturing-based VAT system to a consumption-based one. VAT tax reform is regarded as one of the ways for China to adjust its industrial sector. The beneficiaries are the companies whose percentage of fixed asset investment is comparatively high, e.g., the large and medium-type state-owned companies and the high-tech companies. Some anticipate that this reform will be implemented on a nationwide basis in the future.

Preferential Enterprise Income Tax Policy

The *Notice on Implementing Preferential Enterprise Income Tax Policy in the Northeast Region* provides that manufacturing companies in the Northeast Region may improve their fixed asset (excluding houses and buildings) depreciation rate and shorten the intangible assets amortization period. In addition, the threshold for individual income tax is raised from RMB 800 to RMB 1,200 per month.

Reduced Resources Tax on Oil Fields

According to the *Notice on Adjusting the Resources Tax on Oil Fields in the Northeast Region*, the oil fields or mines with few exploitable mineral resources will enjoy an up to 30% reduction in resources tax when approved by the provincial government.

These regulations went into effect on July 1, 2004 and on December 24, 2004, the head of the State

Tax Bureau, Xuren Xie, highlighted the VAT refund reform in the Northeast Region at a National Tax

Conference. – *Carole Fan*

Other articles and publications

Please let us know if you would like copies of any of the following:

Zhao Yong, “Draft Anti-Monopoly Law Submitted to the State Council for Review,” *SSD Antitrust & Trade Regulation Update*

Zhao Yong, “Chinese SAIC Issues Report on Monopolistic Conducts of Multinational Corporations in China,” *SSD Antitrust & Trade Regulation Update*

Zhao Yong, “Regulation on Filing of Price Violations Complaints Revised,” *SSD Antitrust & Trade Regulation Update*

James Zimmerman, “China’s Homegrown Standards Bring Headaches to US Firms,” *Investor’s Business Daily*

James Zimmerman and Diarmuid O’Brien, “CIETAC Financial Dispute Arbitration Rules: Practice and Problems,” *Asian Dispute Review (November 2004)*

James Zimmerman, “China Customs Practices: Corporate Compliance Takes Priority,” *FindLaw LINKS (June 2004)*

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