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DISTRIBUTION RIGHTS UPDATE – MOFCOM CLARIFIES TAX BREAKS FOR MANUFACTURING FIEs

Key Points:

- **Must derive more than half of total revenue from manufacturing**
- **Follows rule of SAT 1994 Notice**

Officials at the PRC Ministry of Commerce (MOFCOM) recently confirmed that existing manufacturing foreign-invested enterprises (FIEs) that expand their business scope to include distribution will continue to enjoy manufacturing tax incentives as long as they derive more than 50 percent of their total revenue from manufacturing.

An FIE, if identified as a manufacturing enterprise, is entitled to a two-year exemption and a three-year 50% reduction in their income tax rate and other tax incentives with respect to reinvestment, export products and other matters. However, since a manufacturing FIE is also permitted to provide

technical, consulting and after-sale services that relate to its products, the State Administration of Taxation (SAT) issued a Notice in 1994 (“SAT 1994 Notice”) announcing that companies may enjoy the tax breaks as long as their manufacturing revenue is more than 50% of their total revenue within a given year in the tax holiday period. That means the income generated from non-manufacturing activities can also enjoy the preferential tax rate so long as the manufacturing revenue exceeds 50%.

Since the end of 2004 when FIEs were first permitted to engage in domestic distribution, many FIEs have applied for expansion of their business scope to include domestic distribution rights. Most of these have been manufacturing enterprises. To ensure that manufacturing FIEs will not, in fact, become trading companies, MOFCOM issued a Notice in April 2005 indicating that a manufacturing FIE would lose tax breaks if its distribution (i.e., “buy-sell”) revenue exceeds 30 percent of its total revenue after it incorporates distribution into its business. In September, however, MOFCOM’s *Practical Handbook for Foreign Investors Investing in the Commercial Sector* followed the 50% rule of the SAT

1994 Notice. Although MOFCOM failed to revise its April 2005 notice and did not clarify this change elsewhere in writing, MOFCOM officials as well as the State Administration of Taxation confirmed that the preferential tax treatment threshold of the SAT 1994 Notice still applies.

Therefore, manufacturing FIEs may continue to enjoy a tax holiday after engaging in the domestic distribution business so long as their manufacturing revenue is more than 50% of their total revenue. Companies whose non-manufacturing revenue, such as from trading and service, exceeds the 50% threshold in one tax holiday year may enjoy tax breaks in subsequent remaining years so long as their manufacturing revenue is more than 50% of total revenue during those years. – *Lindsay Zhu*

FOREIGN INVESTORS TO BE PERMITTED TO BUY “A” SHARES

Key Point:

- *Non-tradable shares to become tradable*
- *Encourages greater foreign participation in China’s capital market*

Foreign investors may be able to further expand their participation in China’s publicly traded companies by virtue of a recent government reform designed to do away with non-tradable stocks in listed companies.

Foreign investors have played a role in the Chinese capital market since 2002: Foreign financial institutions have been permitted to form joint venture mutual fund management companies and securities companies with Chinese counterparts; the QFII

system, which allows qualified financial institutional investors to trade in A shares, has been introduced; and China has clarified rules and policies regarding assignment of non-tradable state-owned shares and institution-owned shares to foreign investors.

Earlier this year, China launched a reform designed to gradually convert non-tradable shares into tradable shares. As some listed companies complete their non-tradable shares reform, non-tradable stocks held by foreign investors will become tradable pursuant to an individual reform plan. The plan includes a lock-up period no less than 12 months following implementation. This change has provided great opportunities for foreign strategic investors.

Further, as indicated in a recent circulation jointly issued by MOFCOM and China Securities Regulatory Commission (CSRC), listed companies that have completed their non-tradable shares reform may also introduce overseas strategic investors. Overseas strategic investors may trade in A shares of listed companies subject to a certain lock-up period. Forthcoming implementation rules, should answer the following questions: how to define such strategic investors, how to regulate such A shares held by strategic investors, and how to define the length of lock-up periods. – *Zijie Li*

NEW POLICY FOR VENTURE CAPITAL ANNOUNCED

Key Points:

- *Venture capital enterprise defined*
- *Three types of preferential policies*
- *Foreign-invested venture capital may enjoy preferential policies*

According to the "Opinion Notice on the Venture Capital System" issued by the General Office of State Council in 1999, the government will enact financial supporting policy for venture capital. The "Middle and Small Scale Enterprises Facilitation Law," which took effect on January 1, 2003, further states that the government shall encourage venture capital to invest in middle and small scale enterprises through tax and policy incentives.

Recently, 10 ministries – National Development and Reform Commission, Ministry of Science and Technology, Ministry of Finance, Ministry of Commerce, People's Bank of China, State Administration of Taxation, State Administration of Industry and Commerce, China Banking Regulatory Commission, China Securities Regulatory Commission and State Administration of Foreign Exchange – jointly issued a new circular, "Tentative Administration Measures on Venture Capital Enterprises." In this circular, a venture capital enterprise is defined as "an enterprise that engages in venture capital work with a registered office within the PRC." Here, "venture capital" refers to an investment method in which one invests in a target enterprise's equity interest with the aim of obtaining

capital increment proceeds by virtue of equity transfer after the target enterprise becomes mature or relatively mature.

Because of the high risk involved in the venture capital market, the government has enacted three kinds of preferential policies to enhance development of the venture capital industry. The circular states that the central and local government shall build the Venture Capital Guiding Fund and support the establishment and development of venture capital enterprises through equity investment, financing guarantees and other incentives. In addition, the government will enact tax incentives to encourage venture capital investment in middle or small scale enterprises especially high-tech companies. Details of these tax incentives are still under discussion. The final policy states that competent authorities shall build exit mechanisms for venture capital, such as IPOs, equity transfers and equity repurchases.

The circular also explains that foreign-invested venture capital enterprises are subject to "Administration Regulations on Foreign-invested Venture Capital Enterprise," which were promulgated in 2003. However, the government shall grant national treatment to such an enterprise if it complies with "related conditions." Some ambiguities remain as to the definition of "related conditions."

Although this circular functions merely as a guideline and further action remains to be implemented, it is regarded as a milestone in the development of China's venture capital industry. – *Carole Fan*

RESTRICTIONS ON LOW-EMISSION CARS TO BE CANCELED

Key Point:

- *Local prohibitions to be canceled*

China will issue policies to encourage low-emission economical cars, said a senior official with the National Development and Reform Commission in an international conference held Nov. 7- 8. This is an important move by the government to balance the booming car industry of the country with its soaring energy demand.

According to the official, new policies will be issued soon to cancel local restrictions on low-emission cars to encourage higher economic efficiency. The coming policy will stipulate a clear definition of

“economical cars,” as low-emission cars are not necessarily economical. Aside from having low emissions, an economical car should also meet some other requirements. Generally, it should be no more than 4 meters long, have below 1.4-litre emission and more advanced technologies, yet be within the purchasing power of ordinary people.

To date, small cars are still not permitted to run in more than 80 cities nationwide, despite Chinese Premier Jiaobao Wen's call this past summer for cancelling restrictions on cars with low emissions, low oil consumption and high fuel efficiency.

The official added that the new policies will also contain preferential taxes for producers and users of economical autos. – *Guojun Ye*

Articles and Publications

James Zimmerman, *China Law Deskbook, Second Edition (2005): A Legal Guide for Foreign-Invested Enterprises*. More information is available on ABA's Web site:

<http://www.abanet.org/abastore/index.cfm?section=main&fm=Product.AddToCart&pid=5210139>.

Amy L. Sommers, "Foreign Investment Verification: Reform, Status Quo, or Bafflement?," *China Business Review*, November-December 2005. Access to the article is available at:

http://www.ssd.com/publications/pub_detail.aspx?pubid=9426

"Cal Law 2005 Roundtable Series: Doing Business in China," GC California Magazine, November 2005. The article features Jerome J. Joondeph Jr., partner in Squire Sanders' Palo Alto office, on a panel discussing US companies and law firms setting up operations in China. Access to the article is available at:

http://www.ssd.com/resources/news_detail.aspx?newsid=12381

Presentations and Recent Events

Amy Sommers, national partner in Squire Sanders' Shanghai office, participated on a panel at the International Real Estate Trade Organization (IRETO) International Commercial Investors Day December 17, 2005 at CIHAF 2005, the 7th Annual China International Real Estate & Architectural Fair, in Shanghai. The panel was titled "Step-by Step: Understanding Chinese Real Estate Development and Investment from Planning, Legal Accounting, Social and Due Diligence Standpoints." Squire Sanders was a Gold Level Sponsor of IRETO International Commercial Investors Day.

Amy Sommers, **Dan Roules**, and **Charlie McElwee**, participated in a roundtable discussion on China and Government Procurement issues at a December 6 event at Shanghai Jiao Tong University co-sponsored with the United States Council of International Business (USCIB) and the Shanghai WTO Affairs Consultation Center.

Mark Dosker (San Francisco) presented a seminar on "Litigation in the U.S. Courts and Arbitration with U.S. Companies and other challenges for Chinese Companies" on December 12 in Beijing and December 14 in Shanghai.

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December 2005

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