



China Law Update



China Law Update begins 2009 with a look at five sets of rules and regulations that were enacted or took effect in late 2008 and might be of interest to foreign investors and foreign-invested companies doing business with and in China.

We first summarize an effort by the China Securities Regulatory Commission to facilitate the launch of margin trading on China's securities markets. The *Provisional Regulations for the Examination and Approval of the Business Scope of Securities Companies*, which took effect on December 1, 2008, build upon previous, tentative steps towards enabling margin trading and reflect the government's desire to stimulate China's plummeting securities markets by allowing investors to leverage capital. (See page 4.)

Next we follow up on a trio of reports from the December 2008 issue of *China Law Update* on changes by the State Council to China's tax laws. In mid-December, the Ministry of Finance issued three sets of implementing rules to carry out those tax reforms: the *Implementing Rules for the Provisional Regulations of the People's Republic of China on Value-Added Taxes* (see page 6); the *Implementing Rules for the Provisional Regulations of the People's Republic of China on Business Taxes* (page 9); and the *Implementing Rules for the Provisional Regulations of the People's Republic of China on Consumption Taxes* (page 11).

Our final summary looks at an attempt by China's Supreme People's Court and the Supreme People's Procuratorate to curtail corruption, and bribery in particular. Our summary of the *Opinions on Issues Concerning the Application of Law in the Handling of Criminal Cases of Commercial Bribery* begins on page 12.

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Provisional Regulations for the Examination and Approval of the Business Scope of Securities Companies

Issuing Body: China Securities Regulatory Commission

Issuing Date: October 30, 2008

Effective Date: December 1, 2008

The China Securities Regulatory Commission (CSRC) issued the *Provisional Regulations for the Examination and Approval of the Business Scope of Securities Companies* (Business Scope Regulations) on October the 30, 2008, paving way for the launch of margin trading and short selling of securities in China. The new rules, which have been anticipated for at least a couple of years, took effect on December 1, 2008.

The CSRC issued the Business Scope Regulations in the wake of sharp declines in China's securities markets over the previous months. On the last day of trading before the country's week-long National Day holiday last October, for example, the benchmark Shanghai Composite Index closed at roughly 2,294 points after plummeting 70 percent in mid-September 2008 from the record high of 6,124 points in October 2007. Because margin trading will amplify capital and securities demand as well as turnover, analysts regard this move as the latest incentive from Chinese regulators to vitalize China's markets. (At the end of 2008, the Shanghai index was down to 1820.81.)

The Chinese government has been planning to institute margin trading for at least several years. In 2006, for example, the CSRC formulated the *Measures for the Administration of Experimental Margin Lending and Short Selling Business of Securities Companies* (Experimental Margin Trading Measures), which were intended to begin margin trading on an experimental basis. That experiment, however, was not finally implemented. Likewise, on April 23, 2008, China's State Council promulgated the *Regulations on the Supervision and Administration of Securities Companies* (Securities Company Administrative Regulations), which established a basic framework for margin trading and were again intended to institute it on a trial basis. The Business Scope Regulations, which supplement the Securities Company Administrative Regulations, allow securities companies to request an expansion of their business and specify procedures for getting approval to conduct margin trading. The CSRC is expected initially to approve margin trading by a limited number of brokerage houses, to monitor the experiment closely, and then, if it's successful, to expand such trading gradually.

Business Thresholds

In order to be eligible to conduct margin trading, securities companies are generally required by the Business Scope Regulations and the Securities Company Administrative Regulations to have good and efficient corporate governance, net capital capacity, solvency and operation capability, financial status and audits in compliance, internal controls, risk controls, and management. Neither set of regulations, however, provides specific net capital or other thresholds, using only terms such as “good,” “sound” and “efficient.” As a result, the CSRC will certainly have to issue more detailed rules. In any event, the thresholds for participation in margin trading are certain to be high, and only limited to large security companies, even industry leaders. Though never carried out, the Experimental Margin Trading Measures, for example, require that the registered capital of a security company shall generally be at least RMB 500 million in order for it to engage in margin trading; that the company has been in the securities brokerage business for at least three years; and that it has a net capital above RMB 1.2 billion for the most recent six months.

Securities companies are allowed only to use their own capital and securities for margin trading in China. Purchasers are allowed to borrow 50 percent of the total purchase price for margin trading of eligible securities, or 50 percent of the selling price in a short sale. These measures allow financial leverage—the degree to which a business is utilizing borrowed money or securities to fund operation—only to be twice as much as equity. CSRC officials, who enacted these new rules even as countries around the world were placing new limits on margin trading, have said they believe such restrictions will keep the risks of the market controllable.

CSRC officials have further stated that experimental margin trading will be open to all kinds of securities firms across the country, and that the agency will clarify the qualifications and criteria later. The CSRC has also promised to bring in an expert panel to handle applications in an open and transparent manner.

Stringent Supervision and Administration

The Business Scope Regulations authorize the CSRC and its sub-agencies to supervise and monitor the margin trading activities of securities companies. If a securities company violates laws or regulations, its risk control indicators fail to comply with regulatory provisions, or another statutorily mandated circumstance arises, the CSRC may take actions against the violating company such as imposing restrictions on business activities, suspending part or all of the company’s business, or even revoking its business permit.

Although margin trading will expand the business and broaden the use of capital of and by securities firms, it will also, of course, multiply losses when an investment goes against expectations. Most securities firms in China have thus far taken a cautious attitude towards this experiment and are awaiting more detailed guidelines from regulators. If the experiment ultimately proves successful, margin trading would be normalized in all securities firms in China.

Implementing Rules for the Provisional Regulations of the People's Republic of China on Value-Added Taxes

Issuing Body: Ministry of Finance

Issuing Date: December 25, 1993

Amending Date: December 18, 2008

Effective Date: January 1, 2009

As we noted in the December 2008 issue of *China Law Update*, China's State Council adopted a number of fiscal measures in November 2008 designed to protect China from the worst effects of the global financial crisis. Among those measures were a series of reforms of China's tax system: coordinated regulations on value-added taxes (VAT), business taxes and consumption taxes. Those regulations were together designed to shift China's VAT system, and the tax system generally, towards a consumption-based tax regime. They took effect nationwide on January 1, 2009. (For a summary of the three regulations, please refer to the December 2008 issue of *China Law Update*.)

Now, following up on those three tax regulations, China's Ministry of Finance has revised the corresponding implementing rules.

Of those recent changes to China's tax system, the most important, particularly for foreign investors, were surely the *Provisional Regulations of the People's Republic of China on Value-Added Taxes* (Amended VAT Regulations). The *Implementing Rules for the Provisional Regulations of the People's Republic of China on Value-Added Taxes* (VAT Implementing Rules) align regulations to the changes contained in the Amended VAT Regulations. The rules also help distinguish when business and value-added taxes are to be assessed. A third key change focuses on small-scale taxpayers.

Deduction of Fixed Assets Costs

Under the Amended VAT Regulations, businesses are allowed to deduct value-added taxes assessed on newly purchased fixed assets, a major change that shifts the tax burden away from production and towards consumption.

Fixed assets are defined under the VAT Implementing Rules as machinery, mechanical apparatuses, means of transportation and other equipment, tools and instruments related to production or business operations, which are used for at least one year. The VAT Implementing Rules further clarify that the VAT paid as part of the cost of the above fixed assets may be deducted, except to the extent that such fixed assets are specially used for goods or services that are not subject to VAT, that are exempted from VAT, or that are for collective benefits or individual consumption.

Taxation on Mixed Sales Activities and Concurrent Business Activities

Another element of the VAT Implementing Rules is to distinguish taxation methods on mixed sales activities from concurrent business activities, reflecting the boundaries of value-added and business taxes.

Mixed Sales Activities

As provided by the VAT Implementing Rules, a mixed sales activity is a business activity that involves both the sale of goods subject to VAT and the provision of services, which are not subject to VAT, to the same customer. (An interior designer, for example, sells furniture and provides services. The former is subject to VAT, while the latter is not.) Services not subject to VAT are subject to business taxes within the transportation, architecture, finance, insurance, post, telecommunications, culture, sports, entertainment and service industries.

For enterprises, business units or individual business operators that principally engage in the production of goods, either wholesale or retail, their mixed sales activities are subject to value-added tax payments. The mixed sales activities of other entities or individuals are not subject to VAT.

The situation is different for a taxpayer that engages in mixed sales activities for the sale of self-produced goods and the provision of services in the architecture industry. In that situation, according to the VAT Implementing Rules, the taxpayer shall keep separate accountings of the sales amount of goods and the turnover of services, with only the sales amount of goods being subject to value-added taxes. Turnover of non-VAT-taxable services is, however, subject to business taxes. If no such separate calculation is conducted, the competent tax authority will evaluate the taxable sales amounts.

Concurrent Business Activities

Concurrent business activities are similar to, but somewhat different from, mixed sales activities. With concurrent business activities, the same individual or entity sells goods (such as furniture), which are subject to VAT, to one customer, and provides services (such as interior design), which are not subject to VAT, to another customer. Such taxpayers are also required to keep separate accountings of the amounts of VAT-taxable goods sold, taxable services, and the turnover of non-VAT-taxable services. If no such separate accounting is conducted, the competent tax authority will evaluate the taxable sales amounts. Previously, in such circumstances, value-added taxes would be levied on non-VAT-taxable services together with those on goods or taxable services.

This change helps distinguish when business and value-added taxes are to be assessed.

Particular Provisions on Small-Scale Taxpayers

Under the Amended VAT Regulations, the tax rate for “Small-Scale VAT Taxpayers” was reduced from 6 percent to 3 percent, a key change that will save small businesses a significant sum of money. The VAT Implementing Rules alter the definition of “Small-Scale VAT Taxpayers” that was contained in the Amended VAT Regulations. According to the VAT Implementing Rules, Small-Scale VAT Taxpayers are defined as follows:

1. VAT taxpayers that engage in the manufacturing of goods or the provision of taxable services, with the annual tax payable being less than RMB 500,000.
2. VAT taxpayers that engage principally in the manufacturing of goods or the provision of taxable services and also in the wholesale or retail sale of goods, with the annual tax payable being less than RMB 500,000. (“Principally” is defined as meaning the combined sales revenue from manufacturing of goods and the provision of taxable services is more than 50 percent of total revenue.)

3. Taxpayers other than those specified above, with the annual tax payable being less than RMB 800,000.

Those three thresholds for Small-Scale VAT Taxpayers were reduced from RMB 1,000,000, RMB 1,000,000, and RMB 1,800,000, respectively, under the VAT Implementing Rules.

In addition, any individual other than such Small-Scale VAT Taxpayers whose annual tax payable exceeds the criteria for Small-Scale VAT Taxpayers shall also be treated as a Small-Scale VAT Taxpayer. Also, any non-enterprise entity or any enterprise that does not conduct regular VAT-taxable activities may choose to pay taxes as a Small-Scale VAT Taxpayer (i.e., at the 3 percent rate).

Implementing Rules for the Provisional Regulations of the People's Republic of China on Business Taxes

Issuing Body: Ministry of Finance

Issuing Date: December 25, 1993

Amending Date: December 18, 2008

Effective Date: January 1, 2009

In addition to amending the country's value-added tax rules last November, China's State Council also passed the *Provisional Regulations of the People's Republic of China on Business Taxes* (Amended Business Tax Regulations). As with the amended VAT regulations summarized above, we summarized the Amended Business Tax Regulations in the December 2008 issue of *China Law Update*.

In December 2008, the Ministry of Finance likewise passed the *Implementing Rules for the Provisional Regulations of the People's Republic of China on Business Taxes* (Business Tax Implementing Rules), which are intended to integrate and streamline the country's tax regime in accordance with those reforms.

Taxation on Mixed Sales Activities and Concurrent Business Activities

Like the VAT Implementing Rules, the Business Tax Implementing Rules also make changes to distinguish taxation methods on mixed sales activities from concurrent business activities.

Taxation on Mixed Sales Activities

As stipulated in the Business Tax Implementing Rules, a mixed sales activity involves both services (subject to business tax) and goods (which require payment of value-added taxes).

For enterprises, business units or individual business operators that principally engage in the sale of goods, whether wholesale or retail, mixed sales activities are not subject to business taxes; the mixed sales activity of other entities and individuals, however, are subject to business tax.

The situation is different for taxpayers who engage in mixed sales activities such as the provision of architecture services and the sale of self-produced goods. In such cases, according to the Business Tax Implementing Rules, the taxpayer shall keep separate accountings of the sales amount of goods and the turnover of taxable services. Only the turnover of taxable services is subject to business taxes. If no such separate calculation is conducted, the competent tax authority will evaluate the revenue of taxable services.

Taxation on Concurrent Business Activities

Taxpayers that engage in different types of business with different customers—some of which is subject to business taxes and some that is not—are involved in concurrent business activities. Such taxpayers are also required to keep separate accountings of the turnover of taxable business services and the non-business-taxable sale of goods or services. If no such separate accounting is conducted, the competent tax authority will evaluate the taxable revenue. Previously, under such circumstances, value-added taxes, not business taxes, were levied on non-business-taxable services and goods together with taxable services.

Business Tax Payment Threshold for Individual Taxpayers

Individual taxpayers must pay business taxes only after their total turnover exceeds designated payment thresholds. Under the Business Tax Implementing Rules, the tax payment thresholds are as follows:

1. For business taxes payable on a periodic basis, the business tax threshold ranges from RMB 1,000 to RMB 5,000;
2. For business taxes paid on a transaction-by-transaction basis, the business tax threshold is RMB 100 per day.

Compared with previous business tax rules, the above ranges have been increased dramatically, so as to relieve the tax burden on small enterprises and individuals. The competent financial and taxation bureaus at the provincial level are authorized to determine locally applicable tax thresholds within the prescribed ranges.

Tax Payment Period

Banks, financial companies, trust and investment companies, credit unions and representative offices of foreign enterprises must now pay business taxes on a quarterly basis. This is a new requirement under the Business Tax Implementing Rules.

Implementing Rules for the Provisional Regulations of the People's Republic of China on Consumption Taxes

Issuing Body: Ministry of Finance

Issuing Date: December 25, 1993

Amending Date: December 18, 2008

Effective Date: January 1, 2009

In addition to amending the country's value-added and business tax rules in November, China's State Council also passed the *Provisional Regulations of the People's Republic of China on Consumption Taxes (Amended Consumption Tax Regulations)*. As with the amended VAT and business tax regulations summarized above, we summarized the Amended Consumption Tax Regulations in the December 2008 issue of *China Law Update*.

Similarly, China's Ministry of Finance issued the *Implementing Rules for the Provisional Regulations of the People's Republic of China on Consumption Taxes* (the Consumption Tax Implementing Rules) along with the implementing rules for value-added and business turnover taxes. Like the other new regulations, the Consumption Tax Implementing Rules took effect on January 1, 2009.

The main goal of the Consumption Tax Implementing Rules is to adapt China's consumption tax policies to conform with the Amended Consumption Tax Regulations and the other new tax rules that were adopted in November 2008. For example, the new rules include conversion standards for liquids to conform to changes in the Amended Consumption Tax Regulations. Other changes align the Consumption Tax Implementing Rules with the newly enacted VAT and business tax implementing rules. Such terms as "charges and fees," "conversion method for foreign exchange sales revenue" and "tax payment period" are slightly amended to conform to other new implementing rules.

Opinions on Issues Concerning the Application of Law in the Handling of Criminal Cases of Commercial Bribery

Issuing Body: Supreme People's Court and the Supreme People's Procuratorate

Issuing Date: November 20, 2008

Effective Date: November 20, 2008

Since 2006, China has reportedly cracked down on commercial bribery in numerous areas, including construction, land transfer, the purchase of medical and pharmaceutical products, bank loans, securities and commercial insurance. Partly as a result, an increasing number of multinational corporations have been directly or indirectly implicated in commercial bribery scandals, with officials being accused of providing payments or gifts in return for better business opportunities, lower costs and/or higher market rates. While to some extent this problem is rooted in culture and history—even newcomers to China learn that *guanxi* (relationships) is essential to business success—it is also thought to stem from a lack of coherent, systemic laws to punish misconduct.

The *Opinions on Issues Concerning the Application of Law in the Handling of Criminal Cases of Commercial Bribery* (Anti-Bribery Opinions) were jointly issued in November 2008 by China's Supreme People's Court and the Supreme People's Procuratorate (the prosecutorial arm of the national government). They are in accordance with the Criminal Law of the People's Republic of China (Criminal Law) and its two amendments issued in November 2005 and June 2006.

The Anti-Bribery Opinions streamline the legal system by explaining and clarifying a number of uncertainties regarding the crime of commercial bribery.

Subjects of Commercial Bribery

Under the Criminal Law, both individuals and various types of organizations can be convicted of the crime of bribery: (i) government officials and state company employees; (ii) employees of private companies, enterprises and other entities; and (iii) entities.

The Anti-Bribery Opinions clarify that the term "other entities" includes not only permanent organizations (such as public institutions, social groups, villagers' committees, urban residents' committees and villagers' teams) but also some temporary organizations, such as organizing committees, preparatory committees and project contracting teams, which are set up to organize sporting events, theatrical performances or other activities.

The Anti-Bribery Opinions identify certain types of individuals as being particularly susceptible to bribery (medical staff, teachers, members of bid evaluation committees, negotiating team members for competitive procurement, members of procurement committees, etc.). The opinions make it clear that they can be charged with criminal bribery if they receive money or other forms of reward in exchange for favors given through their work.

Types of Rewards in Commercial Bribery Cases

The Anti-Bribery Opinions further clarify that the forms of reward for which individuals and entities may be charged with commercial bribery include not only cash, property, and in-kind contributions, but also certain benefits, the value of which can finally be calculated in monetary terms, including without limitation the provision of housing, furniture, travel packages and shopping coupons. In the determination of whether a crime of commercial bribery has occurred, and if so what punishment should be imposed, the value the reward is calculated on the basis of the actual paid costs and expenses (for example, the amount the briber paid for a travel package).

If an individual accepts a bankcard, the total amount deposited on the card shall be deemed the amount of the bribery, regardless whether the individual who took the bribe actually withdrew any or all of the money from the deposit. For a person who overdraws a bankcard, if the provider of the bankcard assumes responsibility for repayment, the overdrawn amount shall also be deemed part of the amount of bribery.

Distinguishing Bribery from Gifts

In order to protect legitimate business transactions, the People's Court and People's Procuratorate have formulated a series of principles designed to distinguish commercial bribery from business gifts. When trying commercial bribery cases, comprehensive analysis and judgment shall be made in consideration of the following factors:

- (i) background of the transacted reward, such as whether the two parties are relatives or friends, as well as the status and extent of their previous relationships and contacts;
- (ii) the value of the reward given;
- (iii) the cause, timing and method of payment of the reward, and whether the provider of the reward made any requests for position-related favors from the recipient of the reward; and
- (iv) whether the recipient has taken advantage of his position to provide any benefit to the provider.

The issuance of the Anti-Bribery Opinions reflects a resolve on the part of the Chinese government to curtail commercial bribery. Not coincidentally, a number of large multinational companies have in recent years been implicated in commercial bribery scandals, some of them involving enormous amounts of money. Depending on how strictly and how well the new rules are enforced, many more would appear to be in line to face charges from the People's Procuratorate and its offices.

Faegre & Benson's Greater China Practice

Faegre & Benson LLP has extensive experience advising U.S., European and Asian clients on entering the China business environment, as well as on investment, trade and commercial matters throughout the Greater China region. From our offices in Shanghai and Minneapolis, lawyers in our China practice regularly provide international structuring, documentation and negotiation assistance for transactions both inbound to and outbound from Mainland China, Taiwan and Hong Kong.

The core of our team includes highly experienced legal professionals who have studied and practiced in both the U.S. and in China. In addition, we collaborate with an extensive informal network of local law firms, which possess expertise vital in an often ambiguous regulatory environment, where local customs and practice can vary.

Lawyers in our China practice represent clients ranging from privately held emerging companies to Fortune 50 multinationals in connection with their cross-border business dealings involving China. Our experience includes work in the industrial manufacturing, consumer products, telecommunications, hospitality, financial services, software, automotive, engineering, chemical products, pharmaceuticals, infrastructure, restaurant, and construction industries.

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