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# China News Alert Issue 93

## Headlines

### SAFE introduces measures to intensify scrutiny of red chips

The State Administration of Foreign Exchange (SAFE) has issued a *Circular on improving foreign exchange administration in acquisitions and mergers by foreign investors*. The *Circular* aims at increasing supervision of PRC private enterprises which go public by means of red chip listing.

Generally, the process of red chip listing for a private enterprise involves the following stages:

* the owners of a PRC private enterprise establish a shell company in an offshore jurisdiction, such as the Cayman Islands;
* the company's capital in the shell company is increased through domestic equity or asset injections;
* the offshore entity then acquires the domestic private enterprise;
* the domestic private enterprise, under the offshore entity's name, applies for listing on a foreign stock exchange (such as Hong Kong, Singapore or New York).

The *Circular* provides that domestic residents directly or indirectly establishing or controlling offshore enterprises are required to undergo the formalities of examination, approval and registration according to the provisions of the *Exchange Control Measures for Overseas Investment*. As a result, private businessmen will be subject to examination and approval by local foreign exchange bureaus where they seek to set up companies overseas. Previously, only legal entities (such as corporations or enterprises) registered in the Mainland were required to comply with the *Measures*, whereas individuals establishing overseas companies were outside the scope of the *Measures*.

Restructuring of overseas enterprises through the acquisition of assets or equity of domestic enterprises was previously subject to control by the Ministry of Commerce according to the *Interim Provisions on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors*, with SAFE retaining a record of the acquisition. Under the new provisions, domestic residents seeking to swap domestic assets and equity for rights of equity or other assets of offshore companies are required to obtain approval from the foreign exchange authorities. Without approval, domestic residents may not use domestic assets and equity as trade consideration to obtain rights of equity or other assets of offshore companies.

In addition, the *Circular* provides that when handling foreign exchange registration for a foreign-invested enterprise for the purpose of a merger and acquisition, the relevant foreign exchange authorities must determine whether or not the overseas enterprise is established or controlled by domestic residents and whether or not an offshore company and its acquisition target have the same management.

In relation to foreign-invested enterprises established by domestic residents through the use of an offshore entity to merge with or acquire a domestic enterprise, all foreign exchange bureaus and divisions of foreign exchange management must submit the relevant application for foreign exchange registration to SAFE.

Under the *Operating Procedures on Foreign Exchange Registration for Foreign-invested Enterprises Established by Foreign Capital through Mergers and Acquisitions*, domestic enterprises are required to include in their applications a statement to the following effect:

"The new foreign shareholders of the company have no direct or indirect equity or asset relations with the original Chinese shareholders transferring their equity or assets. [We] have conducted no insider transactions that would violate regulations pertaining to foreign exchange administration. The relevant payment and settlement arrangements of the transaction comply with the provisions of the *Interim Provisions on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors*. Our company is willing to assume the corresponding legal liability for any false statements made."

By January 2005, there were more than 80 red chip listings on the Main Board of Hong Kong Stock Exchange, compared with over 70 H-share listings. The growing popularity of red chip listings is partly attributable to the fact that since 2003, private enterprises (other than state-controlled private enterprises) have not required to obtain approval from the CSRC to be publicly listed abroad.

In addition, by contrast with "H share" listings, red chips are not subject to the scale threshold of "456", whereby overseas enterprises undergoing H share listings are required to have

1. net assets of not less than RMB400 million,
2. after-tax profits in the previous year of not less than RMB60 million and
3. market capitalization of no less than US$50 million, with stock price calculated according to a reasonable P/E ratio.

The *Circular* also aims to supervise enterprise which have already obtained a red chip listing, by requiring foreign exchange authorities to list details of foreign-invested enterprises (formed by merger with or acquisition by an offshore enterprise) relating to capital and certificate verification, foreign exchange registration for foreign exchange collected from equity transfer to foreign capital, shareholder's loan registration, profit remittance abroad, profit reinvestment and equity transfers.

### Circular on stock investments by insurance companies

The China Insurance Regulatory Commission (CIRC) has promulgated a *Circular Concerning Issues relating to Stock Investment of Insurance Funds*, which sets out the relevant stock investment proportions of insurance funds. At the same time, the CIRC and the China Banking Regulatory Commission (CBRC) have jointly promulgated the *Provisional Guidelines for Trusteeship of Stock Assets in Insurance Companies*.

The *Circular* sets out the following stock investment restrictions for insurance institutions:

* the remaining balance of stock investment held by investing insurance institutions must not exceed 5% of the previous year's gross assets less the assets of investment-linked insurance products and comprehensive insurance products (where traditional insurance products are calculated based on cost price);
* the stock investment proportion of investment-linked insurance products (calculated according to the cost price) may be up to a maximum of 100% of the book value of the assets of the product;
* the stock investment proportion of general life insurance products (calculated according to the cost price) may not exceed 80% of the book value of the assets of the product;
* where the institution invests in public companies with less than 0.1 billion of tradeable stock , the cost balance must not exceed 20% of the assets available for stock investment;
* if the investor invests in tradeable, the cost balance must not exceed 5% of the assets available for stock investment;
* the number of negotiable stocks of a listed company that an insurance institution may invest in may not exceed 10% of the tradeable stock of the listed company and may not exceed 5% of the total share capital of the listed company;
* if the insurance institution converts its convertible bonds into shares in a listed company, the value of the convertible bonds should be transferred to the stock investment account of the company, so that this consolidated figure may be used to calculate the proportion of stock investment.

The *Circular* provides that in the event that the market value of the stocks owned by an investor for insurance institutions fluctuates dramatically, where the loss exceeds 10% of the investor's stock investment capital, or the profit exceeds 20% of the cost, the company must submit within 3 days a *Stock Investment Risk Control Report* to the CIRC.

The *Provisional Guidelines* stipulate that commercial banks seeking to be stock asset trustees of an insurance company, must have paid-in capital of not less than RMB8 billion and have at least 2 years trustee experience. For branches of foreign banks, the paid-in capital is to be calculated according to that of the head office of the relevant bank.

A trustee has the following responsibilities:

* it must open a specialized deposit account and a stock account in accordance with the insurance company's agency mandate;
* it must process the clearance and settlement of invested stocks in a timely manner according to the investment instructions of the insurance company and the insurance asset management company;
* it must submit to the CIRC reports regarding stock assets investment performance and risk evaluation of insurance companies.

The *Provisional Guidelines* provide that where several insurance companies share one transaction seat, the insurance companies must appoint the same trustee. If a commercial bank or other specialized financial institution directly or indirectly holds more than 10% of the shares in an insurance company, the bank or the institution may not act as trustee of the insurance company. Similarly, if an insurance company directly or indirectly holds more than 10% of the shares of a commercial bank or other specialized financial institution, the bank or the institution may not be appointed as trustee. In the event that trustees are legally dissolved, terminated, adjudicated bankrupt or acquired, stock assets held by the trustee may not be included within the scope of the liquidated assets.

### Measures on foreign company leasing and financial leasing

The Ministry of Commerce has issued the *Measures Concerning Foreign Companies' Investment in the Leasing Industry*. The *Measures* apply to foreign-invested enterprises in the PRC (Sino-foreign joint ventures, Sino-foreign co-operation or wholly foreign-owned enterprises) engaged in the business of leasing and financial leasing.

The *Measures* provide that when investing in the leasing industry, foreign companies are to adopt the form of a limited liability company or a joint-stock limited company.

The Ministry of Commerce is the competent authority in charge of examination and approval of foreign companies' investment in the leasing industry.

Foreign-invested financial leasing companies may conduct business in the form of direct leasing, subleasing, leaseback leasing, leveraged leasing, consigned leasing and joint leasing. Leasing property includes

1. movable property such as production equipment, communication equipment, medical equipment, scientific research equipment, testing equipment, engineering machinery equipment and office equipment;
2. transportation facilities such as airplanes, automobiles and ships, and
3. intangible assets such as software and techniques attached to movable properties and transportation facilities (provided that the value of attached intangible assets does not exceed one half of the value of the leased property).

The *Measures* provide that the total assets of foreign investors in foreign-invested leasing companies and financial leasing companies must be at least US$5 million.

Foreign-invested leasing companies must meet the following conditions:

* their registered capital must comply with the relevant provisions of the *Company Law*, as well as any related provisions relating to registered capital and total investment of foreign-invested enterprises;
* in the case of foreign-invested leasing companies established as limited liability corporations, the term of operation of such companies generally may not exceed 30 years.

Foreign-invested financial leasing companies must meet the following conditions:

* their registered capital must be at least US$10 million;
* in the case of foreign-invested financial leasing companies established as limited liability corporations, the term of operation of such companies generally may not exceed 30 years.
* professionals and senior managers of must possess corresponding professional qualifications and at least three years work experience.

The *Measures* also set out the incorporation procedures and documentation that must be submitted to the competent authorities when establishing foreign-invested leasing and financial leasing companies, and the scope of businesses run by those companies.

## Capital Markets

### Latest China stock market statistics

According to the latest data released by the China Securities Regulatory Commission (CSRC), there were 1,377 companies listed on China's domestic stock markets as at the end of 2004 (A and B shares), with a market value of RMB3,705.5 billion, and a tradeable market value of RMB1,168.9 billion. The total equity of listed companies amounted to 714.9 billion shares. The number of investors' accounts totaled over 72 million.

There were 4 Sino-foreign joint venture securities companies and 13 joint venture fund management companies as at the end of 2004. 15 new institutions were granted Qualified Foreign Institutional Investor (QFII) status qualifications, raising the total number of QFIIs to 27.

## Taxation

### MOF and SAT issue Circular on asset depreciation and amortization in the Northeast industrial base

The Ministry of Finance (MOF) and the State Administration of Taxation (SAT) have issued a *Circular* relating to the reduction in fixed asset depreciation and intangible asset amortization terms for industrial enterprises in the Northeast industrial base.

With respect to fixed assets (with the exception of houses and buildings) purchased by enterprises before July 1, 2004, on the basis of the term having not depreciated, their depreciation term must be reduced by the ratio of at most 40% from July 1, 2004. Amortization of enterprises' intangible assets shall be carried out by reference to the above provision.

Enterprises that have already applied the fixed asset depreciation balance decrement or sum-of-years-digits depreciation methods as prescribed in the *Circular Concerning Delegated Subsequent Management on Approved Fixed Assets Accelerated Depreciation Projects*, are not required to adopt methods of reducing the term of depreciation.

The *Circular* further specifies that for fixed assets purchased after July 1, 2004, enterprises may choose either of the declining balance or sum-of-years-digits methods, but may not adopt both methods simultaneously. The selected method may not subsequently be adjusted.

Enterprises may choose the proportion of shortening fixed asset depreciation term up to 40%. The selected defined proportion may not subsequently be adjusted. Enterprises may choose to apply accelerated depreciation to a portion of their fixed assets in accordance with production and operational requirements. However, the defined scope may not subsequently be adjusted.

### SAT Releases Key Items Related to Special Examination on Taxation in 2005

SAT has released the *Circular of the State Administration of Taxation on Implementing Specific Taxation Collection Examination in 2005*.

SAT has formulated a guidance plan of taxation examination and collection in 2005, which will focus on areas such as waste recycling, real estate and individual income taxes.

The nine priority sectors for special taxation examination as set out in the SAT guidance plan are as follows:

* steel manufacturers;
* concrete manufactures;
* coal manufacturers, transporters and distributors;
* motorcycle manufacturers and distributors;
* waste material recycling business and reprocessing enterprises;
* enterprise mainly engaged in manufacturing and processing of agricultural and sideline products;
* real estate industry
* manufacturers' tax exemptions, set-off and refunds on exports;
* individual income tax.

### SAT response on refunding of individual income taxes in stock transfers

The SAT has replied to a query relating to the refunding of individual income taxes in the case of stock transfers, which was submitted by the Sichuan Tax Bureau. The SAT made the following points:

* in accordance with the *Individual Income Tax Law* and its implementing regulations, as well as the Tax Collection and Management Law, if a contract on stock right transfer has been successfully performed, changes in the stock right have been registered and income from the stock right transfer realized, the transferor receiving the income shall pay individual income tax according to the relevant laws;
* in the case where the stock right transfer is subsequently reversed (by a second agreement), the SAT considers that, due to the fact that the execution and performance of the agreement is an independent action relating to the stock right transfer, the individual income tax collected for the previous stock right transfer will not be refunded;
* where the contract on stock right transfer has not been successfully performed (due to the appropriate arbitration committee's judgment on rescinding the contract), and the contract is terminated and the transferred stock right reclaimed at the original price, the SAT considers that the fact that the stock right transfer has not been successfully completed and the resulting income not been fully realized, and the income from the stock right will no longer exist as dissolution of the stock right transfer, the relevant party will not be required to pay individual income tax.

### SAT release Circular on tax deductions for administrative expenses

The SAT has released a *Circular Concerning Further Strengthening Supervision of Examination and Approval of Pre-tax Deduction of Administrative Expenses by Head Offices*. The *Circular* provides that pre-tax deducted administrative expenses withdrawn from a head office must be distributed pro rata (based on percentage of the total income) to all subordinate enterprises (including enterprises run at a narrow profit margin, loss-incurring enterprises and enterprises enjoying reduction or remission of taxes). The allocated proportion and amount related to the pre-tax deduction may not be adjusted among the abovementioned enterprises.

The *Circular* stipulates that operating and non-operating revenues, including revenues from the leasing of properties, income from interest accrued on government bonds and deposits, return on external investments (including investments made to subordinate enterprises) must be deducted from pre-tax administrative expenses collected by head offices.

Wages and bonuses of employees and other expenses paid by head offices on behalf of their subordinate enterprises shall be calculated in the costs of subordinate enterprises and may not be calculated as administrative expenses.

The *Circular* specifies that examination and verification of materials submitted by head offices will focus on the following matters:

* whether head offices comply with expense collection requirements;
* whether head offices provide name lists and relevant information of all subordinate enterprises (including enterprises run at narrow margin of profit, loss-making enterprises and enterprises enjoying reduction or remission of taxes);
* whether enterprises to which adminstrative expenses are allocated meet the relevant requirements applicable to wholly-owned enterprises;
* whether the expenditure scope and standard of administrative expenses comply with the relevant provisions;
* projects with large amounts of expenditure and changes in administrative expenses;
* whether the collection ratio, allocation amount and increasing degree of administrative expenses comply with the relevant provisions;
* whether the tax declaration of the last year separately reflects revenues related to administrative expenses.

### SAT and SAFE issue Circular on tax payment certificates on transfers of personal property

SAT and SAFE have jointly issued a *Circular on Tax Payment Certificate and Receipt Submitted for Transferring Personal Property*, which implements certain provisions of the *Provisional Rules for Administration of Sales and Payments in Foreign Exchange for Transferring Individual Property*.

The *Circular* provides that taxation authorities must provide evidence proving tax payment by applicants. Tax payment certificates for applicants will be separately issued according to category and source of income and property by the SAT and local taxation bureaus.

Applicants planning to transfer property, which has acquired the relevant tax payment certificate, may directly provide the tax payment certificate for foreign exchange administration purposes and will not be required to apply to taxation authorities for additional tax payment certificates.

Applicants planning to transfer property of less than RMB150,000 in value are not required to apply to taxation authorities for additional tax payment certificates.

The *Circular* also sets out application procedures for receiving tax payment certificates and documents which are to be submitted to taxation authorities for applying for tax payment certificates.

## Corporate & Commercial

### Proposed amendments to companies' registered capital requirements

The system of enterprise registered capital will be significantly modified under proposed amendments to the *Company Law*, so that the registered capital of both domestic and foreign-invested enterprises may be paid in installments. Under the current *Company Law*, domestic enterprises must pay all of their registered capital in one lump sum. The proposed amended *Company Law* will also reduce the minimum required amount of registered capital.

By allowing companies to pay registered capital in installments, the situation is avoided whereby companies fail to make us of capital after paying it, causing a portion of the capital to remain idle or to be used for non-operational activities.

In relation to the prescribed minimum registered capital thresholds, the proposed amendments to the *Company Law* are as follows:

* the minimum registered capital of limited liability companies will be reduced from RMB80,000 to RMB50,000 (or possibly lower);
* the capitalisation threshold for stock company seeking listing will be reduced from RMB50 million to RMB30 million;
* in the case of a company with capitalization exceeding RMB400 million, the required percentage of shares issued to the public will be reduced from 15% to 10%.

### Regulation on bidding for construction project materials released

The National Development and Reform Commission (NDRC), together with several Government Ministries (including the Ministry of Construction), has released the *Measures on Bidding and Tendering for Goods of Construction Projects*, which came into force on March 1, 2005.

Since the release and implementation of the *Tendering and Bidding Law*, the NDRC has issued a range of supplementary regulations, setting out details on the scope of bidding and standards of construction projects, and bidding for the design of construction and restoration works. The new *Measures* set out the basic operational rules for the bidding and tendering of goods for construction projects.

The *Measures* only apply to key equipment and materials used in construction projects. The purchase of goods unrelated to construction projects (such as, for example, articles and vehicles solely for office use) is regulated by the *Government Procurement Law* and its supplementary regulations.

The main provisions of the *Measures* relate to the following:

* bidding for goods within the context of the main contractor's tender;
* the necessary conditions which the bidding process for goods must satisfy;
* approval for the contents of the bidding;
* pre- and post-review of the qualifications of bidders;
* restrictions on simultaneous bidding by bidders;
* two-stage bidding.

### Regulation on power generation accidents

The *Provisional Regulations on Power Generation Accidents Investigation* came into force on March 1, 2005. The main aspects of the Regulations are as follows:

* adaptation of the current requirements of power system reform under relevant laws and administrative regulations;
* establishment of regulations at the national level governing power generation accidents;
* maintenance of consistency in safety standards;
* attribution of accident liability as found by an accident investigation panel.

### CNCA releases Measures on product certification inspectors

The Certification and Accreditation Administration of the PRC (CNCA) has recently released the *Measures Governing Compulsory Product Certification Inspectors*, which came into force on March 1, 2005. The *Measures* aim at establishing a consistent qualification registration system for compulsory product certification inspectors, to ensure the professional competence of 3C certification factory inspectors, and to promote the effective enforcement of the 3C certification.

The *Measures* provide that 3C certification inspectors applicants must possess basic theoretical knowledge and practical experience relating to the professional technical areas, master laws and regulations, and technical codes governing 3C certification. Applicants must also be familiar with the relevant product standards, testing methods and standards, product design, production, repair and servicing processes, and command key processes for product quality control. Inspectors who engage in inspections of foreign production enterprises should possess the necessary language skills.

## Other

### Enhanced protection of trademark rights

According to State Administration for Industry and Commerce (SAIC), the *Interpretation of Legal Issues Relating to the Processing of Criminal Cases for the Infringement of Intellectual Property Rights*, which was jointly released by the Supreme Court and the Supreme People's Procuratorate of China in 2004, has resulted in a significant reduction in the prosecution standard for conviction for trademark infringement offences.

The *Interpretation* largely relaxes the standard and defines 10 terms relating to trademark crimes in the *Criminal Law*. The *Interpretation* also adjusts the division between criminal and civil offences relating to trademark infringements.

It is understood that the release of the *Interpretation* has had a significant effect on enhancing protection of trademark rights, as well as strengthening the *Criminal Law's* deterrence against trademark infringements.

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