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FOREIGN INVESTMENT LAW OF THE PEOPLE'S REPUBLIC OF CHINA (DRAFT FOR COMMENTS) (THE "DRAFT FIL") （《中华人民共和国外国投资法（草案征求意见稿）》）, **ISSUED BY THE MINISTRY OF COMMERCE (THE "MOFCOM")**

China's current legal framework on foreign investment mainly includes laws governing the three basic forms of foreign-invested enterprises ("FIE"): wholly foreign-owned enterprises ("WFOE"), equity joint ventures ("EJV") and cooperative joint ventures ("CJV"), and their implementation measures, ancillary regulations and other stipulations found in different laws.

Due to China's rapid growth in recent decades, the Draft FIL aims to accommodate the ongoing development of China's investment environment, which has long been considered over-regulated. MOFCOM is now requesting public comments on the Draft FIL, and when the draft is officially enacted, it will become China's first integrated legislation relating to foreign investment.

The Draft FIL significantly restructures the current regulatory framework of foreign investment in China, as follows:

1. Definition of foreign investors and foreign investment

The Draft FIL states that domestic enterprises controlled by foreign individuals, foreign enterprises, foreign governments or international organizations investing in Mainland China must be identified as foreign investors and fall within the scope of the Draft FIL.

The Draft FIL broadens the definition of foreign investment to include (1) establishing domestic companies; (2) carrying out various forms of mergers and acquisitions; (3) providing financing to domestic companies with terms exceeding one year; (4) investing in real property; (5) obtaining concessions to explore or exploit natural resources, and carry out construction projects or operate infrastructure; and (6) controlling domestic companies, directly or through contracts, trusts or in other ways.

2. Definition of "control" and "actual controller"

To avoid uncertainties when determining whether domestic enterprises are controlled by foreign entities and thus identified as foreign investors, the Draft FIL defines "control" comprehensively, specifying the circumstances under which a party would be considered to have control over an enterprise:

1) A party directly or indirectly holds at least 50% of the shares, equity, property shares, voting rights or similar rights and interests in the enterprise.

2) A party directly or indirectly holds less than 50% of the shares, equity, property shares, voting rights or similar rights and interests in the enterprise, but:

    i. is entitled directly or indirectly to appoint at least half of the members of the enterprise's board of directors or similar decision-making body;

    ii. can ensure that its nominated people can obtain at least half of the seats on the enterprise's board of directors or similar decision-making body; or

    iii. the party's voting rights are enough to have a material impact on the resolutions of the enterprise's shareholders meetings, general meetings, board of directors or similar decision-making bodies.

3) A party can have a decisive influence on the enterprise's transactions, finance, personnel and technology, through contracts, trust or in other ways.

The Draft FIL also introduces the concept of "actual controller" for the first time in terms of foreign investment, relating to individuals or enterprises directly or indirectly controlling foreign investors or FIEs.

The new definition may significantly affect the validity of variable interest entity structures, designed to avoid the legal restrictions on the entry of foreign investment in some restricted sectors.

3. Administration of market entry

To grant national treatment to foreign investors, the Draft FIL adopts a negative list regime to manage market entry of foreign investment.

Under this regime, used on a pilot basis by the Shanghai Free Trade Zone since September of 2013, foreign investment is no longer subject to restrictive and case-by-case approval requirements, unless it affects sectors on the negative list.

Under the Draft FIL, all foreign investment projects not specified on the negative list must to go through record-filing procedures and submit information reports to the relevant authorities through a centralized information reporting system for foreign investment.

The negative list, which the State Council has not yet published, will be divided into two catalogues: prohibited sectors and restricted sectors, depending on the scale of investment and the invested industries. When the negative list is enacted officially, it will replace the *Industry Catalogue Guidance for Foreign Investments*, one of the most important legal documents in the current approval regime for foreign investment entering the market.

4. National security review system

The Draft FIL, also for the first time, codifies the national security review system, applying it to any foreign investment that harms or is likely to endanger national security. An inter-ministerial joint conference will be established to carry out security reviews based on the standards and procedures in the Draft FIL.

These standards and procedures will include scrutinizing the investment's impact on the nation's defense security, the research and development capacity of national security's key technology, the nation's leadership in national security technology, the nation's information and network security, and whether the investment is controlled by foreign governments.

The Draft FIL exempts national security review from administration reconsideration or litigation. Therefore, although it relaxes market entry administration, the inter-ministerial joint conference discretion in this process may lead to a lack of transparency. It is expected that detailed interpretation or standards will be published soon.

5. Information reporting mechanism

The new information reporting mechanism requires foreign investors to report the completion of and any change to foreign investment projects within specific periods and to report certain information on existing foreign investment regularly.

Although the Draft FIL significantly relaxes market entry administration for foreign investment, it establishes more restrictive information reporting obligations and consequences for non-compliance. Under the new information reporting mechanism, the actual controller's identity and the source of investment funds must be disclosed and failure to disclose this could result in a penalty of up to 5% of the investment amount, depending on the circumstances.

The information reporting platform is yet to be launched and implementing measures are expected after the Draft FIL takes effect.

The Draft FIL also regulates investment promotion, investment protection and measures for handling FIE-related complaints.

Date of issue: January 19, 2015. Deadline for public comments: February 17, 2015.

SUPREME PEOPLE'S COURT CONFIRMS SHANGHAI INTERNATIONAL ARBITRATION CENTER'S JURISDICTION OVER DISPUTE WITH ARBITRATION CLAUSE REFERRED TO CHINA'S INTERNATIONAL ECONOMIC AND TRADE ARBITRATION COMMISSION SHANGHAI SUB-COMMISSION

Shanghai No.2 Intermediate People's Court (the "Court") issued a civil ruling (the "Civil Ruling") on December 31, 2014, affirming, for the first time, that the Shanghai International Arbitration Center ("SHIAC") has jurisdiction over disputes applying arbitration clauses that designate the Shanghai Sub-Commission of China's International Economic and Trade Arbitration Commission ("CIETAC").

The Civil Ruling follows the Supreme People's Court's Notice on Properly Hearing the Relative Issues in Judicial Reviews on Arbitration, issued on September 4, 2013, under which the Supreme People's Court (the "SPC") required all lower courts hearing disputes over the jurisdiction of CIETAC or its former Shanghai and Shenzhen sub-commissions to refer these cases to the SPC for its internal review and decision.

The lawsuit was brought to confirm the validity of the arbitration clause in a share purchase agreement ("SPA"). The parties had designated CIETAC's Shanghai Sub-Commission to arbitrate any dispute arising from the SPA. When the dispute occurred, the claimant started arbitration procedures against the defendant before the CIETAC in Beijing. The defendant then started civil proceedings before the Court to challenge the validity of the arbitration clause, on the grounds that, following CIETAC's split, the arbitration commission designated by the parties under the SPA was now the SHIAC. The arbitration proceeding was suspended while the Court reached a decision.

In the Civil Ruling, the Court stated the following:

1. CIETAC Shanghai Sub-Commission was established in 1988 through a formal procedure. It was registered with the Bureau of Justice of Shanghai Municipality and obtained the PRC Arbitration Commission's Registration Certificate, issued by the Justice Bureau of Shanghai Municipality.

2. CIETAC Shanghai Sub-Commission was officially renamed SHIAC, after receiving the necessary approvals from the Shanghai local authorities.

3. The agreed arbitral institution, CIETAC Shanghai Sub-Commission (now SHIAC), is legally established and has the power to arbitrate and make arbitral awards based on arbitration clauses agreed by parties.

The Civil Ruling reflects the SPC's view that SHIAC, instead of CIETAC, has jurisdiction under arbitration clauses referring to CIETAC Shanghai Sub-Commission. However, as case law is not binding under the PRC legal system, this judicial decision could be challenged and overturned in the future.

NOTICE OF MINISTRY OF FINANCE AND STATE ADMINISTRATION OF TAXATION CONCERNING ENTERPRISE INCOME TAX TREATMENTS FOR PROMOTING CORPORATE RESTRUCTURING (CAISHUI [2014] NO.109) (财政部、国家税务总局关于促进企业重组有关企业所得税处理问题的通知)

On March 7, 2014, the State Council released its Opinion on Further Optimizing the Market Environment for Corporate Merger and Restructuring (Guo Fa [2014] No. 14, "Circular 14"), to improve the institutional mechanisms and policies that encourage corporate mergers and restructuring. Circular 14 gives overall guidance on special treatments for merger and corporate restructuring transactions with regard to enterprise income tax ("EIT"), land value-added tax, value-added tax and business tax.

In response to Circular 14, on December 25, 2014, the Ministry of Finance ("MoF") and the State Administration of Taxation ("SAT") jointly released Caishui [2014] No. 109 ("Circular 109") to expand the scope of the EIT tax deferral treatment.

To date, the EIT tax deferral treatment for corporate restructuring transactions has been regulated under Caishui [2009] No.59 ("Circular 59"), which establishes the special conditions merger and corporate restructuring transactions must meet to qualify for it. Because of the difficulty of satisfying all the conditions, specifically the one related to having a 75% minimum percentage in the target company's equity (or assets), many corporate restructuring transactions did not benefit from the EIT tax deferral treatment.

Circular 109 relaxes EIT restructuring rules, lowering the 75% threshold and introducing a new type of qualified transaction. This is expected to result in a new surge of corporate restructuring in China.

Circular 109's main highlights are as follows:

- For equity acquisition transactions, the minimum equity acquisition percentage needed to benefit from the EIT tax deferral treatment is lowered from 75% to 50%. The other requirements and procedures established under Circular 59 still apply.

- For asset acquisition transactions, the minimum asset acquisition percentage needed to benefit from the EIT tax deferral treatment is lowered from 75% to 50%. The other requirements and procedures established under Circular 59 still apply.

- Circular 109 introduces transfer of equity or assets within a group as a new type of transaction eligible for the EIT tax deferral treatment, establishing the following requirements:

  (1) Eligible group transfers are those made (i) between resident enterprises, when one directly holds 100% of the other's shares, or (ii) between resident enterprises that are 100% directly owned by the same enterprise(s).

  (2) The transfer price must be equal to the net book value of the equity or assets transferred.

(3) The transfer has a reasonable business purpose and is not carried out to reduce, avoid or delay tax payments.

(4) The original business activities of the company whose equity or assets are transferred must not be changed in the 12-month period following the transfer.

(5) The transferor and the transferee must not recognize a profit or loss for accounting purposes.

The tax deferral treatment will mean:

(1) the transferor and the transferee do not recognize income for the transfer;

(2) the transferee recognizes the original net book value of the equity or assets as their tax basis; and

(3) the transferee uses the original net book value of the equity or assets to calculate their depreciation.

There are no other requirements, which gives a different treatment to fully domestic intergroup corporate restructuring transactions (to which other restrictions under Circular 59 do not apply).

Circular 109 became effective retroactively on January 1, 2014. Taxpayers may now reassess the completed or pending corporate restructuring transactions previously not eligible for the EIT tax deferral treatment that have not yet been settled.

Further developments in land value-added tax, value-added tax and business tax concerning corporate restructuring transactions are expected soon, implementing Circular 14.

Date of issue: December 25, 2014. Effective date: January 1, 2014.

NOTICE OF MINISTRY OF FINANCE AND STATE ADMINISTRATION OF TAXATION CONCERNING ENTERPRISE INCOME TAX POLICIES FOR NON-MONETARY ASSET INVESTMENTS (CAISHUI [2014] NO.116) (财政部、国家税务总局关于非货币性资产投资企业所得税政策问题的通知)

Through Circular 14, the State Council also called for improving EIT policies for non-monetary asset investments. In response, on December 31, 2014, the MoF and the SAT released Caishui [2014] No.116 ("Circular 116"), providing an EIT deferral treatment for non-monetary asset investments, which became effective retroactively on January 1, 2014.

Under the EIT deferral treatment, income derived from qualified contributions of non-monetary assets, calculated as the difference between the fair market values of the non-monetary assets in an independent valuation and their original tax basis may be subject to EIT through yearly installments for up to five years.

Resident investors must use the original tax basis of the invested non-monetary assets as the tax basis to recognize the equity investment, and make yearly adjustments to the tax basis by adding the deferred income installments; the invested company must recognize the fair market values of the non-monetary assets as its tax basis.

The conditions to qualify for the tax deferral regime are as follows:

(1) Investors must be resident enterprises.

(2) Non-monetary assets exclude assets like cash, bank deposits, receivables, note receivables, and held-to-maturity bond investments.

(3) The investment must aim to establish new resident enterprises or contribute to existing resident enterprises.

If the treatment is not applied to the non-monetary asset investment, the resident investors must recognize the income as taxable when the relevant investment agreement becomes effective and the equity registration procedures are completed. When the investment is disposed of, or liquidated, the tax deferral regime will no longer apply and any remaining installments must be paid immediately.

If a non-monetary asset investment qualifies for both the tax deferral treatment under Circular 59 and the tax deferral treatment under Circular 116, the invested company can choose which regime to apply. Also, taxpayers may now reassess the completed or pending non-monetary asset investments previously not eligible for the EIT tax deferral treatment that have not yet been settled.

Date of issue: December 31, 2014. Effective date: January 1, 2014.

DECISION OF THE STATE ADMINISTRATION OF TAXATION CONCERNING AMENDMENTS TO THE ADMINISTRATIVE MEASURES ON TAX REGISTRATION (SAT DECREE NO.36) (国家税务总局关于修改《税务登记管理办法》的决定)

On December 27, 2014, the SAT released the amended Administrative Measures on Tax Registration ("the amended Measures"), which will come into effect on March 1, 2015.

Under the amended Measures, taxpayers will be given a unified taxpayer identification number instead of the current tax registration code.

Under the amended Measures, if taxpayers submit complete and proper documents for tax registration purposes or amendments, the tax authorities must issue the tax registration certificate or make the amendments the same day they accept the documents (the former measures only established that tax registration and amendments should be done in due time after documents were accepted).

Date of issue: December 27, 2014. Effective date: March 1, 2015.

ANNOUNCEMENT OF THE STATE ADMINISTRATION OF TAXATION CONCERNING URBAN AND TOWNSHIP LAND USAGE TAX POLICIES FOR LAND OBTAINED THROUGH BIDDING, AUCTION AND LISTING (SAT ANNOUNCEMENT [2014] NO. 74) (国家税务总局关于通过招拍挂方式取得土地缴纳城镇土地使用税问题的公告)

Under the urban and township land usage tax ("UTLUT") regulations, UTLUT on newly expropriated farmlands accrues one year after the expropriation is approved.

Announcement [2014] No. 74 clarifies that lands obtained through bidding, auction and listing do not fall within the definition of newly expropriated farmlands, so they should not be taxed under the above rule. In these cases, taxpayers must follow article 2 of Caishui [2006] No. 186:

- if a specific land transfer date is agreed in the contract, UTLUT will accrue from the month following that date; or

- if a specific land transfer date is not agreed in the contract, UTLUT will accrue from the month following the date the contract is signed.

Date of issue: December 31, 2014. Effective date: December 31, 2014.

ANNOUNCEMENT OF THE STATE ADMINISTRATION OF TAXATION CONCERNING THE ISSUE OF ADMINISTRATIVE MEASURES ON CATEGORIZATION OF ENTERPRISES QUALIFIED FOR EXPORT TAX EXEMPTION AND REFUND (SAT ANNOUNCEMENT [2015] NO. 2) (国家税务总局关于发布《出口退（免）税企业分类管理办法》的公告)

On January 7, 2015, SAT issued the Administrative Measures on Categorization of Enterprises Qualified for Export Tax Exemption and Refund ("the Measures"), applicable to export enterprises registered with the export tax exemption and refund status ("export enterprises"). The Measures will come into effect on March 1, 2015.

The Measures classify export enterprises into four categories and establish the applicable criteria for categorization purposes (such as asset status, credit grades as taxpayers and internal risk control). After the export enterprises have been categorized, tax authorities will adopt differentiated administrative measures.

For example, Class One enterprises, which are those with the best tax compliance credit, will benefit from a more relaxed supervisory procedure. These enterprises can make the formal declaration when the electronic data on export tax exemption and refund passes the pre-review stage, and they will not need to submit original documents as long as they keep the documents at the company. The tax authorities will prioritize these companies' tax refunds, designating a green channel to deal with their export tax refund problems. Class Four enterprises will go through more extensive and in-depth approval procedures.

The categorization assessment will be made yearly, within one month after the enterprise tax credit rating assessment result is announced.

Date of issue: January 7, 2015. Effective date: March 1, 2015.

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