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LEGAL FLASH | SHANGHAI OFFICE

2016 - YEAR IN REVIEW

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LEGAL REGULATIONS: 2016 UPDATE

In 2016, Chinese legislation further liberalized foreign investment in certain sectors by replacing the examination and approval procedure for most projects with a simplified record filing, and by simplifying company registration and other procedures. However, it implemented stricter monitoring of other issues where administration had been more relaxed in practice. This update covers the most significant changes. Please see our monthly legal flash for more comprehensive information.

The main change last year to foreign investment administration was the **abolishment of approval and examination procedures**. These were replaced in October with record filings, excluding (i) investments listed on a negative list of restricted and prohibited categories under the 2015 Guidance Catalogue for Foreign Investment Industries, and investments in the encouraged category that are required to have a Chinese party/parties' shareholding or senior management; and (ii) foreign investors' M&A projects in domestic companies.

Different laws on foreign-invested enterprises ("FIEs") were also amended, applying record filing to all enterprises outside areas subject to special state administration.

Other amendments include the following:

- In April, the National Development and Reform Commission ("NDRC") and the Ministry of Commerce ("MOFCOM") jointly issued the **Draft Negative List for Market Access (Pilot Version)** (the "Negative List") listing 328 items (industries, sectors and businesses), prohibiting market access in 96 items and restricting access in 232 items. The Negative List affects both domestic enterprises and FIEs. It will be implemented first in Fujian, Guangdong, Shanghai and Tianjin as pilot areas until December 31, 2017, and then extended nationwide in 2018. FIEs in these areas will be subject to the Negative List, and also to the 2015 Guidance Catalogue for Foreign Investment Industries and the special administrative measures for foreign investment admission currently in effect in the pilot free trade zones ("FTZs") there.

- Stemming from the reform on examination and approval procedures of foreign investment and the Negative List, towards the end of 2016 a **Revised Guidance Catalogue for Foreign Investment Industries** was published for public comments. Compared to the 2015 edition, and based on experiences in the FTZs, it reduces the number of restricted items to 62, including industries with shareholding requirements, restricted industries and prohibited industries that together make up the Industries with Special Requirements to be entered by Foreign Investment, or Negative List, subject to an approval and examination procedure instead of the newly introduced record-filing procedure.

- On December 12, 2016, a new **Revised Catalogue of Investment Projects subject to Governmental Approval** took effect. Foreign-invested projects with total investment of USD 300 million or higher falling within the restricted industries under the Guidance Catalogue for Foreign Investment Industries are subject to the NDRC's approval, while approval of projects in restricted industries with total investment under this threshold is delegated to provincial governments. Projects in encouraged industries applying the requirements of having Chinese controlling shareholders are no longer subject to governmental approval, irrespective of the total investment amount, but are subject to MOFCOM's examination and approval, as they appear on the Negative List.

The establishment of **seven new pilot FTZs** was officially announced, bringing the total number to eleven FTZs in the People's Republic of China ("China," excluding Taiwan and the special administrative regions of Hong Kong and Macau). The FTZs are renowned for testing pilot reforms on the administration and liberalization of foreign investment, and are expected to implement more policies.

The following reforms were implemented nationwide:

- In April, the People's Bank of China extended nationwide the new **macroeconomic management regime on overseas financing** that had been applicable for some time in several FTZs. The new regime establishes a debt ceiling by referring to (i) the value of the enterprise's assets, as stated in the latest audited balance sheet; and (ii) the existing foreign debt, both adjusted by multiplier coefficients established by the authorities at a macroeconomic level, and eases procedural restraints, i.e. prior authorization from the State Administration of Foreign Exchange ("SAFE") to enter into an overseas loan is replaced by post monitoring. The new system is compulsory for domestic enterprises, while FIEs may choose whether to apply it, but are bound by their choice.

- The SAFE strengthened the **reform on capital account foreign exchange settlement** in April and June 2016, introducing a unified administration on foreign currency debt settlement for domestic-funded enterprises and FIEs, which enables all enterprises to settle their foreign currency debt (and the registered capital contribution account for FIEs) at their discretion and based on their need. However, certain purposes are still not allowed, e.g., expenditure beyond business scope, security investment, loans to non-affiliated enterprises, and construction or purchase of real estate other than for self-use. In addition, the threshold for a cumulative monthly payment of imprest cash was set at USD 200,000.

- On October 1, 2016, company registration reforms were extended to include "**five-certificates-in-one, one-license-one-code,**" meaning newly established and existing enterprises no longer need to apply for social security certificates and statistic certificates separately from their business licenses. Currently, only customs, foreign exchange and foreign trade operation registrations have to be carried out separately.

- The State Administration for Industry and Commerce ("AIC") called for the **company name database** to be opened to the public, to enable applicants to check whether an enterprise name is available before applying for pre-approval. This is an attempt to reduce the time needed for foreign investors to become established. District AIC branches should have opened by December 1, 2016, while there is no specific timeframe for provincial AIC branches.

- The AIC removed approval procedures for FIES to register **share pledges**. They now only need to register share pledges with the AIC, and they are subject to the same requirements as domestic enterprises.

- **Simplified deregistration of enterprises** will be implemented nationwide and include FIEs by March 2017. The previous pilot reforms in FTZs did not allow FIEs or enterprises that had been established for over three years to benefit from this. Enterprises on the Negative List are excluded, as well as companies limited by shares and under other specific circumstances.

The **Law on the Administration of Activities carried out by Foreign Non-Governmental Organizations** (NGOs) was passed in April and became effective January 1, 2017. It tightens the previous more relaxed administration and registration requirements for foreign NGOs in China, after the establishment of representative offices having been suspended for over a year.

In September 2016, the State Administration of Foreign Experts Affairs launched a **pilot reform on foreign employee work permits administration** in several locations across China, to be rolled-out nationwide on April 1, 2017. The reform's main feature is to assign grades to foreign employees based on a scoring system, which each municipality must decide. The principles governing the reform are to (i) encourage high-end talent (Grade A), control general foreign employees (Grade B) and restrict low-end foreign workers (Grade C); and (ii) lessen the documentation burden and shorten procedures, especially for Grade A. At the same time, on September 26, 2016, Shanghai Municipality published its **New Opinions on Talent Development to Support Setting up a Science and Innovation Center in Shanghai,** clarifying and developing the measures introduced in July 2015 to attract and retain foreign talent by easing the immigration process.

Previously prohibited online ride-hailing services have been legally permitted to operate in China since November 2016. China is the first country in the world to allow this type of business to operate legally.

After a year and a half and three readings, the **Cybersecurity Law** was also passed in November, effective June 1, 2017. This law was controversial because key information infrastructures operators can only store personal information and important data in China, and transferring this data overseas is subject to a network security assessment. New standards and measures still need to be approved before the law comes into effect.

China's first **Anti-Terrorism Law**, which came into effect on January 1, 2016, also brought attention to telecommunications, information and related service providers, which are required to give technical support and assistance to state security agencies when preventing or investigating terrorist activities; to implement an information content monitoring system; to verify users' identities; and to censor terrorist or extremist content and report to the relevant authorities. One main concern is that access and extended handling may put data protection and privacy at risk.

Finally, although the NDRC released a revised draft on administration of outbound investment projects for public comments during the year, aimed at easing domestic investors' burden, **stricter administration of outbound investment** was announced in the last few hours of 2016.

The authenticity of outbound projects will be strictly and substantially reviewed to curb irrational investment tendencies and money laundering, and the purchase of foreign currency by individuals will be closely reviewed to enforce the ban on investing in real property, securities, life insurance and insurance with rebates in foreign countries, and on individuals lending or borrowing personal allowances.

TAX REGULATIONS: 2016 UPDATE

In 2016, China continued to modernize its tax system, fully expanding the value added tax ("VAT") reform, improving transfer pricing regulations following its involvement in the G20 and OECD's Base Erosion and Profit Shifting ("BEPS") Action Plan, and implementing the OECD's Multilateral Convention on Mutual Administrative Assistance in Tax Matters. Towards the end of 2016, the State Administration of Taxes ("SAT") and the SAFE agreed to establish a routine information exchange system to share data on tax administration and foreign exchange supervision, focused on risk monitoring, assessment and warning, confirming their resolution to combat tax refund fraud, protect China's tax sources and prevent illegal foreign exchange transfer. China also continued to use tax policies to drive an economic model based on domestic consumers, innovation and the growing service sector (which represented over 50% of last year's GDP). This update highlights the most significant tax updates in 2016. Please see our monthly legal flash for more comprehensive information.

The **full expansion of the VAT reform**, effective May 1, 2016, started a new era for China's indirect taxation system and put an end to business tax. VAT now applies to supplies of goods and supplies of services in all industries and activity sectors, including real estate, construction, finance and consumer services.

VAT migration, which started in 2012, aims to improve market efficiency and reduce the tax burden by granting tax neutrality throughout the business chain and limiting taxation to the value created for the final consumer (as opposed to business tax, which applied to the total transaction price at each stage of the business chain, with the corresponding cost increase and double taxation).

The new VAT regulations address crossborder services, which is a significant improvement. However, although changes will bring China closer to international indirect tax standards, there are still some differences with VAT systems in other jurisdictions.

For instance, China's VAT scope is broadly defined in terms of the location of the parties involved, regardless of the location of services (excluding services related to immovable property and natural resources). Overseas suppliers of services entirely occurring overseas are not subject to VAT in China. However, the wording used is vague and it does not clarify how to interpret it: whether it refers to where the services are used or where they are provided. In practice, not being subject to VAT is limited to crossborder services that are (i) physically performed at an identifiable place overseas, and (ii) used at the time and in the place they are physically performed.

As the last industries to be included in the reform were the most complex ones to migrate from business tax to VAT, causing a number of practical issues, a series of regulations were released throughout the year to support full implementation. It is expected that China will eventually release a new VAT Law to replace the current scattered regulations.

In the context of China's active participation in the OECD's BEPS Action Plan, the SAT has been working over the last two years on amending its **transfer pricing regulations**, releasing a first comprehensive draft regulation for public opinion in September 2015.

However, considering this was an ambitious project, and to avoid delaying the process of integrating BEPS Action Plan into China's domestic law, the draft was shelved and separate announcements were released instead to deal with the two amendments that required more urgent action:

- Announcement [2016] No. 42 focused on improving related-party transactions reporting and administration of transfer pricing documentation applicable to the 2016 financial year and onwards.

  It further clarified the concept of related party, added new categories of related-party transactions and approved the new reporting forms. Most significantly, it implemented a three-tier approach to transfer pricing documentation, including (i) a master file, which is newly introduced on meeting certain thresholds or if the group's ultimate parent entity has already prepared it; (ii) a local file, with increased thresholds and requiring more information than its former versions; and (iii) a special item file on cost sharing agreements and thin capitalization, not subject to any thresholds. It also adopted the country-by-country reporting.

  Only transactions under advanced pricing arrangements ("APAs") and resident companies carrying out only domestic related-party transactions are exempt from documentation obligations.

  Transfer pricing documentation must be kept available for 10 years and be submitted to the tax authorities within 30 days at their request.

- Announcement [2016] No. 64, effective December 1, 2016, focused on improving APAs by redefining application conditions, documentation requirements and procedures, offering better guidance for both the tax authorities and taxpayers.

  Applicants must have carried out related-party transactions of over RMB 40 million in the three years before submitting the application, and must not fall under any of the rejection situations (e.g., being under tax audit or not having filed transfer pricing documents in the past). APAs cover from 3 to 5 years, and can be used to assess and adjust up to 10 previous tax years.

There is no specific time frame for the tax authorities to process applications for APAs, but considering the increasing number of cases showing a significant trend of multinational companies moving towards bilateral APAs, the tax authorities can prioritize cases under stipulated conditions when applicants proactively cooperate.

New regulations on remaining transfer pricing related issues are still expected.

Other developments in the **international framework** include (i) the conclusion of new double taxation treaties ("DTTs") with Romania and Cambodia on July 4, 2016, and October 13, 2016, respectively; (ii) the conclusion of an agreement with Poland to mutually exempt from VAT international air transportation services on June 20, 2016; and (iii) the completion of domestic procedures to have the DTTs with Chile and Russia take effect on January 1, 2017.

Also, OECD's Multilateral Convention on Mutual Administrative Assistance in Tax Matters entered into force on February 1, 2016, and China will start to implement it on January 1, 2017. Under this convention, assistance is limited to exchange of information, not including recovery of tax claims or conservancy measures, and only applies to enterprise income tax, individual income tax, urban and township land use tax, real estate tax, land VAT, VAT, consumption tax, tobacco tax, vehicle purchase tax, vehicle and vessel tax, resource tax, city maintenance and construction tax, farmland occupation tax, stamp duty and deed tax.

Regarding **enterprise income tax** ("EIT"), further to the government's decision to support high-tech activities, China amended the administrative measures and guidelines on **certification and administration of high-and-new-technology enterprises** ("HNTEs") effective January 1, 2016. HNTEs benefit from a reduced EIT rate of 15% for three years from the year they are certified.

The new regulations introduced new application requirements and enhanced existing ones. They shift the focus to the underlying core technologies that innovate and develop the applicant's products or services, rather than the products or services themselves, and to the applicant's innovation capacity, with a much stricter scoring system based on the nature of the intellectual property rights and the capacity to innovate and generate steady high-value technology and sell its technological achievements.

Procedurally, the new regulations strengthened administration. Qualified HNTEs are subject to annual reporting obligations concerning the annual status of IP rights, scientific and technical staff, R&D expenses and operating income. A follow-up monitoring management mechanism is also established combining random checks and examination of key HNTEs. If a HNTE fails to meet certification requirements during the follow-up monitoring management, HNTE status will be reviewed and, if discontinued, the tax authorities will collect any underpaid taxes (plus interest and penalties depending on concurring circumstances).

The new regulations also clarify several issues relating to the **super-deduction policy for R&D expenses**, effective in tax year 2016, focusing on redefining the scope, and the accounting and documentation requirements. Subsidiary accounts for R&D expenses that qualify for super-deduction on a project-by-project basis must be available for the tax authorities' future review and, at the year end, enterprises must fill in a summary form of subsidiary accounts for R&D expenses and file it with the annual financial report and its notes.

Regarding **individual income tax** ("IIT"), policies on equity incentive plans were improved to help unlisted companies attract talent by introducing a new preferential tax treatment. By using a filing procedure, and subject to meeting certain requirements, share options, equity options, restricted shares and equity rewards that unlisted companies grant their employees or the employees of other companies in the same group are not taxed at the time they are purchased; instead, tax is deferred until the employee transfers them.

On transfer, the tax base is calculated as the transfer price minus the original purchase cost and the transaction's taxes and charges, and the 20% tax rate for property transfer income applies.

Before, only equity incentive plans of listed companies had access to preferential treatments, as well as specific unlisted companies in the high-technology field. This tax preferential treatment will significantly reduce the tax burden and solve cash flow insufficiency issues still caused by the preferential tax treatment applicable to listed companies.

New tax policies for **crossborder e-commerce retail imports** took effect on April 8, 2016. Crossborder business-to-consumer e-commerce has boomed in China in recent years, and the authorities are paying closer attention to these rapidly developing new business models to avoid loss of tax revenue.

Under these new tax policies, import taxes (customs duty ("CD"), import VAT and consumption tax ("CT")) are charged on the e-commerce import of retail items in the Commodity Catalogue of Crossborder E-Commerce Retail Imports, with the individual consumer as taxpayer, and the e-commerce enterprises, e-commerce trading platform enterprises and logistic enterprises as withholding agents. However, goods purchased below RMB 2,000 for single purchases and RMB 20,000 for accumulated annual purchases by the same individual benefit from a 0% CD rate and a 70% reduction of the tax base for VAT and CT.

Crossborder e-commerce retail imports not covered by the new tax policies will continue to be treated either as import of items for personal use or import of goods for commercial purposes.

Regarding CT, an additional 10% tax was introduced by year end on super luxury cars at the retail level to guide reasonable consumption, save energy and reduce emissions. CT on cosmetics was also slightly amended in September.

Finally, the **Environmental Protection Tax Law** was passed on December 25, 2016, a year and a half after the first draft was issued. It will take effect on January 1, 2018. This is one of the first steps taken to counter pollution problems in China, in terms of air pollutants, water pollutants, solid waste and noise directly discharged into the environment, arising from economic development in recent decades.

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