

# China Update

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## China's 2011 Foreign Investment Industrial Guidance Catalogue

In order to bring foreign investments into close alignment with China's policy goals, the Foreign Investment Industrial Guidance Catalogue ("**Catalogue**"), jointly issued by China's National Development and Reform Commission ("**NDRC**") and Ministry of Commerce ("**MOFCOM**"), was most recently amended on 24 December 2011.

Under the Catalogue, foreign direct investment in various business activities are classified as encouraged, restricted or prohibited. Foreign investors in encouraged industries are mostly permitted to establish wholly foreign-owned enterprises ("**WFOEs**"), and they are also generally eligible for investment incentive programs such as tax holidays and exemptions from some governmental fees. Restricted industries have certain restrictions, such as more rigorous requirements for approving the establishments of foreign investment entities. Industries in the prohibited category are closed to foreign investment. Industries not listed in the catalogue are generally open to foreign investment unless specifically barred in other PRC regulations.

The 2011 Catalogue will take effect on 30 January 2012. Compared to the last version from 2007 the main change is an increase in the number of industries in the encouraged, permitted and prohibited categories.

- *Encouraged categories* now include venture capital enterprises, construction and operation of vehicle charging stations and battery changing stations, production of

film battery conductive glass and solar energy collection light glass, construction and operation of water treatment plants, production of new types of materials in the aviation industry, and nine service industries including venture capital enterprises, intellectual property rights services, marine oil pollution clean-up technical services, and vocational skills training.

- *Permitted categories* now include the production of carbonated soft drinks, financial leasing companies, distribution and import of books, newspapers and journals, import of audiovisual products and e-journals.
- *Prohibited categories* now include foreign investments in the research and development of genetically modified organisms, domestic express parcel services and construction and operation of villas.

In addition, the 2007 version of the Catalogue contained multiple restrictions on the equity percentage foreign investors could hold in joint-ventures operating in certain sectors. Some of these restrictions have been eased in the 2011 version. For instance, pursuant to the 2007 Catalogue, the Chinese shareholder(s) of the joint venture distributing audiovisual products (other than movies) should be the controlling shareholder(s), but in the 2011 Catalogue this restriction has been removed.

These changes basically reflect changes in policy in, among others, China's 12th Five Year Plan issued in 2011 to encourage the transformation and upgrading of the manufacturing industry, cultivate strategic new industries and promote the development of service industries. The changes also reflect priorities established by the State Council in the Several Opinions on Further Utilizing Foreign Capital, which aims to steer foreign capital to high-end manufacturing, high-tech industries, new technology, service industries, alternative energy and environmentally friendly industries.

If you would like to receive the original Chinese version or an English translation of the 2011 Catalogue please send us an e-mail by clicking [here](#).

## **MOFCOM's Conditional Approval for Seagate/Samsung's Merger**

Companies engaged in M&A transactions involving the Chinese market will need to take into account that the Chinese anti-trust regulator MOFCOM is increasingly taking decisions that deviate from the positions taken by other anti-trust regulators. In the acquisition of Samsung Electronics' hard disk drive (HDD) business by US-based Seagate Technology, MOFCOM recently imposed extensive behavioral remedies in its clearance, contrary to the unconditional clearance given by EU and US anti-trust regulators.

MOFCOM and the European Commission (EC) both found the geographic market to be worldwide in scope. Nevertheless, MOFCOM and EC came to opposite conclusions. Where the EC concluded that the merger would not significantly impede effective competition, MOFCOM ruled that the merger would have a negative impact on the interests of Chinese consumers, as it considers that the elimination of one competitor increases the likelihood of

coordination between the remaining competitors.

To address its competition concern, MOFCOM imposed extensive behavioral remedies on Seagate:

- Seagate must adopt measures to keep Samsung's brand as a separate competitor post-transaction in terms of pricing and sales (by creating firewalls to avoid information exchange etc.), production and R&D
- Seagate must keep its promise to expand the Samsung production capacity within six months of the decision, and reasonably determine and report the production capacity and volumes of Samsung's products thereafter
- Seagate may not materially change its current business model to force customers to buy HDDs exclusively from Seagate or its controlled entities
- Seagate may not force TDK (China) Investment Co. to supply magnetic pickup heads for HDDs to Seagate or its controlled entities exclusively or restrict the quantity TDK sells to other HDD manufacturers
- Seagate must invest at least USD 800 million per year for three years in R&D and maintain the momentum of R&D investment of recent years
- Seagate must appoint a monitoring trustee to supervise the performance of the above remedies.

Seagate may apply to MOFCOM for a release from its obligations under remedies (i) and (ii) above after 12 months after the clearance decision. MOFCOM will then decide whether to approve such a release based on market conditions.

MOFCOM's review took seven months from the initial notification, a period of time similar to its conditional clearance of GE/Shenhua Coal to Liquid JV on 10 November 2011. The approval process by MOFCOM took two months more than the EC needed in this case.

If you would like to receive the original Chinese version or an English translation of MOFCOM decision please send us an e-mail by clicking [here](#).

## China launches RMB Qualified Foreign Institutional Investor Scheme

China recently took a further step to internationalise its currency. Qualified institutional investors will now be allowed to use the RMB funds raised in Hong Kong to invest in the domestic securities market in Mainland China. This new development will further enhance Hong Kong's role as the centre of offshore RMB, and also help to repatriate offshore RMB and support the Chinese domestic capital market.

Previously, the traditional Qualified Foreign Institutional Investor scheme was only limited to foreign currency investments. On 16 December 2011, the China Securities Regulatory Commission ("**CSRC**"), the People's Bank of China ("**PBOC**"), and the State Administration of Foreign Exchange ("**SAFE**") jointly promulgated pilot measures concerning the launching, on a trial basis, of the Renminbi Qualified Foreign Institutional Investor (**RMB QFII**) Scheme in China. The CSRC further issued its own rules on the same day to elaborate on how it would

implement the provisions of the pilot measures.

The pilot measures allow Hong Kong subsidiaries of Chinese qualified fund management companies and securities companies ("**HK Subsidiaries**") to raise RMB funds in Hong Kong, and invest such funds back into the securities market in Mainland China. CSRC is the approval and regulatory authority for qualification of RMB QFII. SAFE is responsible for approving the permitted quota for such Hong Kong Subsidiaries' inbound securities investments and also for supervising the inflow and outflow of funds. The PBOC as the central banking authority will supervise the custodian bank accounts in China opened by Hong Kong Subsidiaries for their portfolio investments in China.

The pilot measures require HK Subsidiaries to meet the following conditions to be an RMB QFII:

1. HK Subsidiaries must be qualified to carry out asset management and keep good operations
2. the Chinese parent companies must also be permitted by CSRC to engage in asset management within China and may not have been subject to disciplinary proceedings by authorities for any material non-compliant activities for at least the last 3 years.

According to the pilot measures, an RMB QFII can invest in shares, bonds, warrants listed on stock exchanges (currently the Shanghai Stock Exchange and Shenzhen Stock Exchange), securities investment funds and other financial instruments approved by the CSRC and/or PBOC. An RMB QFII can also subscribe for equities in an IPO, convertible bonds, a rights issue and allotment of shares. And unlike the traditional QFII, an RMB QFII may invest in the inter-bank bond market in accordance with the rules of PBOC (although the corresponding rule has not issued by PBOC yet).

However, there are certain limitations to the investment portfolio of an RMB QFII. It must be balanced and comply with a prescribed allocation ratio. Currently, no more than 20% of the RMB QFII's funds may be invested in equities or equities investment funds, and no less than 80% of the funds must be invested in fixed-return products including various kinds of bonds and fixed-return type of securities investment funds.

It's reported that the CSRC will initially permit RMB 200 billion to be invested back into the mainland under the pilot RMB QFII scheme. Although the initial total quota seems to be relatively small, the launch of the pilot measures is considered a big step forward in providing a fresh investment channel for RMB holders overseas and increasing the liquidity of the RMB in its cross-border use.

## **China's pilot programme for replacing business tax with VAT launched in Shanghai**

On 17 November 2011, the Ministry of Finance ("**MOF**") and the State Administration of Taxation ("**SAT**") introduced a pilot programme in Shanghai to replace Business Tax with

Value-added Tax ("**VAT**") commencing 1 January 2012. The pilot programme marks a major step forward for China in aligning its indirect tax system to the VAT systems of other countries. Although its application is limited to selected industries in Shanghai only, the pilot programme will have a far-reaching impact and is likely to serve as a roadmap on how the reform of indirect taxes will be ultimately implemented nationwide. On 29 December 2011, it was reported that the Beijing Municipal Government had filed an official application with MOF and SAT for launching the same pilot programme.

VAT and Business Tax are the two most important, but different, indirect taxes in China. Under the current Chinese rules VAT is levied at the statutory rate of 17% or reduced rates, on the sale of goods, provision of repairs, processing and replacement services, and importation of goods. A regular VAT taxpayer can deduct VAT paid on a purchase from its own VAT liability. As a result, VAT avoids the cascade effect of other indirect taxes by taxing only the value added at each stage of production.

Business Tax, on the other hand, is levied at 3% or 5% generally on assignment of intangible assets, transfer of immovable properties, and provision of services that are not subject to VAT. Business Tax differs from VAT in that it cannot be credited and will add up through the supply chain. This results in serious issues, such as double taxation and price distortions. China therefore is endeavouring to reform its indirect tax system to apply VAT across goods and service sectors.

Under the pilot programme, the transportation services industry and "modern services industry" (together "**selected industries**") in Shanghai, which are currently subject to Business Tax, will be subject to VAT as of 1 January 2012. The transportation service industry, including road transportation services, water transportation services, air transportation services and pipeline transportation services, will be subject to 11% VAT. Most of the selected modern services, including R&D and technology services, IT services, cultural and innovation services, logistics and auxiliary services, attestation and consulting services, will be subject to 6% VAT; the rate of VAT on tangible movable property leasing services will be 17%.

The pilot programme will mainly affect businesses in Shanghai, but may also affect businesses elsewhere, including foreign parties. The key elements in that respect are the following:

- Businesses registered in Shanghai and engaged in the selected industries ("**pilot VAT taxpayers**") will be the most affected as they will become eligible to register as regular VAT taxpayers and have to pay VAT, instead of Business Tax, on sales as of 1 January 2012. As a result, they will be able to claim input VAT credit charged on purchases of goods and services against their own VAT liability.
- Foreign parties that provide services that fall within the selected industries in Shanghai will be subject to VAT as well, rather than Business Tax.
- VAT taxpayers (both in Shanghai and elsewhere in China) that purchase services from pilot VAT taxpayers after 1 January 2012 will be able to claim input VAT credit on these purchases.
- The pilot programme provides that, in principle, export of services will be either zero-rated (i.e. VAT refunded) or VAT exempted.
  - Generally zero-rated are the supply of international transport services,

- design services (excluding design services in respect of immovable properties located in China) and R&D services to overseas parties;
- VAT exempt are the export of other services and the supply of some services actually performed outside China, such as exploration services, exhibition services and warehousing services, as well as providing leasing services relating to tangible movable properties which will be used outside China (unless in each case MOF and SAT provide that a zero rate is applicable).
- In addition, the relevant circulars provide detailed rules regarding the choice of simplified VAT reporting, transition and retention of Business Tax preferences, etc.

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