

# CHINA UPDATE



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## Supreme Court of China Issues Interpretations Governing Foreign-Related Civil Relationships

### Key Points

- Clarification of “foreign-related civil relations”.
- Choice of law by the parties involved in foreign-related civil relations.
- Scenarios when application of PRC law is mandatory.

### Background

On 28 December 2012, the Supreme People’s Court (“SPC”) of China announced the Interpretations on Several Issues Concerning the ‘Law of the People’s Republic of China on the Application of Laws to Foreign-Related Civil Relations (the “Law”), which came into effect on 7 January 2013 (the “Interpretations”).

### Highlights of the Regulations

#### Clarification of “Foreign-Related Civil Relations”

The Interpretations have supplemented the previous rules under SPC’s judicial interpretations on what may determine a civil relation as a “foreign-related civil relation”. A foreign-related civil relation can occur in any of the following instances:

- Where either party (or both parties) of a civil relationship is a foreign citizen, foreign legal person, or other organization or stateless person.
- Where the subject matter of the relation is located outside the territory of the People’s Republic of China.
- Where the legal facts that trigger, change or terminate the civil relation take place outside the territory of the PRC.
- Where the “regular residence” of either party (or both parties) is located outside the territory of the PRC.
- Other circumstances that may be determined as foreign-related civil relations.

“Regular residence” is further defined as a place where a party to the relationship has consecutively resided for more than one year, with that residence functioning as the center of the party’s living at the time the civil relation established, changed or terminated. Medical treatment, labor dispatch and business affairs are excluded from this definition.

#### Choice of Law by the Parties

Under the Interpretations, if the PRC law does not specifically allow parties to choose applicable law for foreign-related civil relations, and the parties choose the applicable laws themselves, these will be deemed invalid by a PRC court. Domestic parties (including foreign-invested enterprises) without a foreign element in their relations may not choose applicable laws. Further, if a party intentionally creates a foreign-related element in order to avoid application of mandatory PRC law, this will be deemed invalid.

The Interpretations also clarify the selection of neutral law not connected to civil relations in Article 7. Here, if a party claims that the choice of law is invalid on the grounds that the law chosen by the parties has no connection with the foreign-related civil relation in dispute, such claim will not be upheld by the court.

#### Scenarios Where Application of PRC Law is Mandatory

Under the Interpretations, PRC law must apply – regardless of the agreement between the parties – if the relation involves:

- labor protection
- food and public health safety
- environmental safety
- financial safety such as foreign exchange control
- anti-monopoly and anti-dumping

Other circumstances may also be governed by PRC mandatory provisions.

#### Other Changes Under the Regulations

In addition to the changes highlighted above, the Interpretations also cover the retrospective force of the Law, the relations between the Law and other relevant laws, when international treaties and practices apply, the timeline for the choice of law and proof of foreign law.

#### Conclusion

The Interpretations intend to clarify certain major questions raised by the implementation of the Law since it came into effect in late 2010. According to the SPC, the Interpretations only provide explanations to the general principles of the Law and further interpretation on special provisions will follow.



**Tingting Guo**  
 Consultant  
 E [tingting.guo@squiresanders.com](mailto:tingting.guo@squiresanders.com)  
 T +86 21 6103 6312

# Amendments to PRC Industry Guidelines Come into Force in May 2013

## Key Points

- The original Guideline is an important reference point for governmental departments and local governments when creating local industry policies, investment catalogues and tax policies.
- New Guideline introduced to amend certain sections of the original Guideline.
- New Guideline adds, revises or removes a number of clauses relating to encouraged, restricted and eliminated catalogues.

## Background

On 16 February 2013, the National Development and Reform Commission issued the Notice of Amendments to Industry Adjustment Guideline (2011 Version) (the "New Guideline"), effective as of 1 May 2013. The New Guideline amends, adds or revokes various clauses relating to the three catalogues, (encouraged, restricted and eliminated) established in the Industry Adjustment Guideline (the "Guideline").

## Summary

### Changes to the Catalogues

The additions under the **encouraged catalogue** are closely related to clean energy and public security.

Under "new energy", clauses have been added to the technical development and equipment manufacture of offshore wind turbine and offshore wind farm section.

For "nuclear energy", clauses have been added to cover technology and equipment for the emergency response/management of the nuclear power plant.

For "public security and emergency product", there are total of eight new additional clauses which cover multifunctional fire engine, high-tech firefighting equipment, fire proofing material, extinguishing material, sprinkler system, among others.

Under the **restricted catalogue**, a clause relating to thermal power units discharging cooling water directly to the river has been removed. Several traditional fire-proofing materials have also been added under the section relating to "firefighting".

Under the **eliminated catalogue**, the New Guideline removes the clause "PVC packaging product directly contacting the food" and the "disposable foamed plastic dishware."

The Guideline is a framework document intended to reflect the macro industry policies in China. The New Guideline supplements this and shows the following trends:

- Supporting the development of the clean energy by adding new terms under the encouraged catalogue.
- Attending to public security and supporting the development and usage of high-tech, multifunctional and green products and materials.
- Highlighting energy saving and environment protection. As mentioned above, the "thermal power unit discharging cooling water directly to the river" clause, now removed, previously caused many local governments to put a lot of resources on the secondary cooling system and led to additional energy consumption.
- Reflecting the development of the technology in the past two years.

## Conclusion

The Guideline is an important reference point for governmental departments and local governments when creating local industry policies, investment catalogues and tax policies. Depending on the effectiveness of the New Guideline, it is possible that we may see further adjustments of the various local industry and tax policies in the future.



**Carrie Bai**

Consultant

T +86 10 6589 3755

E [carrie.bai@squiresanders.com](mailto:carrie.bai@squiresanders.com)

# Corporate Income Tax for Trans-Regional Companies in China Subject to New Rules

## Key Points

- Bulletin No.57 provides information on how CIT liabilities are allocated among corporate headquarters and branches in different provinces.
- Details how CIT revenue will be split between central and local treasuries.
- New rules apply to all 2013 CIT filings but do not affect the final settlement for the tax year of 2012.

## Background

Since 1 January 2013, the new Corporate Income Tax rules ("Bulletin No. 57") have been in effect for trans-regional companies paying taxes on a consolidated basis, providing further implementation rules for Cai Yu [2012] No. 40 ("Circular 40").

## CIT Consolidated Filing Measure

According to Bulletin No. 57 and Circular 40, companies with headquarters and branches established in different provinces in China shall calculate the CIT on a consolidated basis, allocating the tax liabilities based on certain methods for both provisional filing and final settlement. In particular, they must adhere to the following:

- 1) Headquarters must calculate the taxable income and tax payable of the company (including all its branches) on combined basis.
- 2) Headquarters and branches will be allocated with CIT liability, and must file and make provisional CIT filings on a monthly or quarterly basis to the relevant tax authorities at the place of registration.
- 3) After the end of a tax year, the final settlement will be handled by the corporate headquarters upon unified computation of the annual taxable income and tax payable, while refund of excess CIT prepaid or retrospective payment of underpaid CIT will be made to or paid by the headquarters and its branches in their place of registration.

According to Bulletin No. 57, consolidated filing is applicable for company headquarters and any of its branches considered to perform substantial functions of production and operation in a different province. For financial and internal structure purposes a company may have several tiers of branches. However, for tax purposes, there may be lower level ("third tier") branches which should be regarded as part of its "upper level" branch, and will not be required to make any CIT local filings.

## Exceptions to the Rules

As clarification, Bulletin No. 57 and Circular 40 also set out rules where branches should not apply the consolidated filing measure. Branches are not covered by consolidated filing requirements where:

- 1) They have no independent production and business functions and only engage in the company's internal supporting activities such as after-sale service for products, internal R&D and warehousing, for example, therefore not paying turnover tax locally.
- 2) They are small-sized low-profit enterprises which qualified in the previous year. In this instance, both the headquarters and its branches will not be covered by the measures.
- 3) Branches are "newly set-up". They will be party to the requirements for the first year.
- 4) A branch has been closed. Closed branches are released from the consolidated filing measure from the time its tax deregistration is completed.
- 5) It is an overseas branch.

However, the consolidated filing measure will apply to branches that have

been acquired in M&A and recently set up under internal restructure within the company.

A department of the headquarters may be treated as a branch for CIT purposes if it separately carries out manufacturing or business operations and its operating revenue, employee remuneration and total assets are accounted independently from that of the department with administrative function. Such department shall apportion the CIT tax for payment locally. This highlights the importance of the "substantial business and operation" functions over other factors when deciding whether branches qualify for consolidated filing measures. Therefore, when a branch carries out tax registration, it is advisable to provide the relevant tax authority with information on its operation manner, internal management policies and additional factors, to facilitate the tax officer's review on its future tax filing status.

For companies with headquarters and branches located in the same province, the provincial tax authorities will decide whether a similar CIT mechanism should be followed or whether the headquarters are responsible for CIT filings.

## Calculation Under CIT Consolidated Filing Measure

The taxable income and CIT payable should be calculated based on the overall result of the headquarters and its branches. As mentioned above, headquarters and branches must make monthly or quarterly CIT filings locally and pay provisional CIT allocated to them to the local authorities.

For each provisional CIT filing, 50% of the CIT liability remains with the headquarters, with the remaining 50% to be allocated to the branch offices. The 50% of provisional CIT allocated to the branch offices is further allocated among the branches based on three factors: operating revenue, employee remuneration and total assets, and each factor is given certain weight (i.e. 35:35:30). See the example below for details:

CIT liability of the branch = 50% of the CIT liability \* Allocation Ratio of the branch

Allocation Ratio = (Operating Revenue of the branch / sum of Operating Revenue of all branches) \* 0.35 + (Employee Remuneration of the branch / sum of Employee Remuneration of all branches) \* 0.35 + (Total Assets of the branch / sum of Total Assets of all branches) \* 0.30

Bulletin No. 57 redefines the factors in determining a branch's allocating ratio to make them consistent with the accounting standard, meaning they should therefore refer to last year's accounting records. Once such ratio is decided, normally it will stay valid for the whole year.

For a company with headquarters and branches located in different areas where different CIT rates apply, the company's overall taxable income will first be allocated among branches with the same allocation ratio; with the respective local CIT rate, the company can have the sum of CIT liabilities of all branches as the overall CIT liability of the company. Using the same allocation ratio again, the overall CIT liability will be allocated among the headquarters and its branches for payment and settlement purposes.



**Victoria Li**

Consultant  
T +86 10 6589 3727  
E victoria.li@squiresanders.com

## Amendment to Employment Contract Law

### Key Points

- Limits the scope of positions for employee secondment.
- Sets higher market access threshold for secondment services company.
- Further emphasizes “same work, same pay” policy.
- Limits the employee secondment rate of total labor of the employing company.
- Provides new administrative sanctions for violations of laws.

### Background

On 28 December 2012, the 30th Meeting of the Standing Committee of the National People’s Congress adopted the Amendments to Labor Contract Law.

### Highlights of the Amendment

- Employees can only be seconded for temporary, auxiliary or substitute positions.
- The formation of a secondment service company requires a minimum registered capital of RMB2 million and approval from the labor bureau.
- The policy of “same work, same pay” must be specified in contracts.
- The employee secondment rate of total employees must be limited to certain proportion to be determined by labor authorities.
- Violation of these rules may result in fines, confiscation of illegal incomes and revoking of approval.

### Summary

Under the terms of the amendment, a secondment services company must:

- Only second employees to temporary, auxiliary or substitute positions.
- Have a registered capital of no less than RMB2 million and a sound labor secondment management system. It shall obtain approval from labor bureau before registration with AIC.

- Have the policy of “same work, same pay” specified in the contract between the secondment services company and the employee and the contract between the secondment service company and the employer.
- Not exceed the employee secondment to total employees proportion set forth by labor administrative authorities.

### Conclusion

The practice of outsourcing labor is strictly regulated now that the amendment is in force.

If a secondment services company carries out secondment business without approval from the labor bureau, it may be forced to cease business. In addition, all illegal incomes from this act will be confiscated. Fines up to RMB50,000 or five times the illegal incomes will also be imposed on the secondment service company.

In case of serious violation of employment contract law, a fine for each employee concerned (ranging from RMB5,000–RMB10,000 per employee) will be imposed on the secondment service company and the approval previously granted by labor bureau may be revoked.



**Sarah Xiong**

Consultant

T +86 10 6589 3722

E sarah.xiong@squiresanders.com

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