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CHINA UPDATE 2008

Squire, Sanders & Dempsey L.L.P.
November 2008

Inside

China's Experimental VAT Reforms for 2009 and Revisions to Export Tax Rebates

Key Points:

- ***VAT reforms to see tax reductions of more than US$17 billion***
- ***Increased export tax rebates for some labor intensive industries***

Given the global credit crunch and concerns regarding demand for China's exports, the government recently announced an RMB4 trillion (US$585 billion) domestic infrastructure spending package designed to stabilize China's economic growth rate. In parallel with this development, and in response to a global downturn in demand, the State Administration of Taxation has taken bold new steps to boost domestic demand through a series of experimental VAT reforms, or reduced taxation, scheduled to begin in early 2009. These VAT reforms are expected to result in tax reductions of more than US$17 billion. The additional liquidity available to companies as a result is expected to generate further investment in research and development and an increase in domestic consumption.

In addition, the State Administration of Taxation and the Ministry of Finance have released a Notice on Increasing the Export Tax Rebate Rates for Labor Intensive Products and Other Products Subject to Value-Added Tax, which increases export tax rebates for certain labor intensive industries, effective December 1, 2008. The rebate rate for certain rubber and forestry products will increase from 5% to 9%; for certain molds and glass products, the rate will increase from 5% to 11%, while the rate for fisheries products will jump massively, from 5% to 13%. Increases from 5% and 9% to 11% are also slated for bags, shoes, home products, lights and nonferrous processed materials. Rebates on certain machinery products will rise from between 9% and 13% to between 13% and 14%. All of this is good news for domestic manufacturers, especially in labor intensive industries, who face an uphill sales battle amid growing uncertainty in global markets.

The new adjustments represent the third time China has adjusted export tax rebates this year alone. On August 1, 2008 the rebate for certain textiles and garments was increased from 11% to 13%; this was followed by a further adjustment, effective November 1, 2008, that saw increased rebates for myriad products in the labor intensive production sector, particularly textiles, garments and toys, and also for certain high-tech products. The new year may also witness reductions in corporate income tax, leading to enhanced liquidity for many enterprises. The recent economic stimulus package, coupled with adjustments to export rebates and expected reductions in corporate income tax, should serve to soften the impact on China of the global sag in demand and a contracting US economy.

– Diarmuid S. O'Brien, China Update Coordinator

Proposal for Permitting Bond Issues by Local Governments Submitted to the State Council

Key Points:

- ***Local governments to be authorized to issue bonds primarily for infrastructure projects***
- ***State Council approval required***

Newspapers report that the PRC government is contemplating permitting local governments to issue bonds. A proposal relating to issuance of bonds by local governments has already been drafted by the Ministry of Finance and submitted to the State Council for approval. Meanwhile, the Ministry of Finance has set up a division responsible for the administration of local government debts.

Under the Budget Law of China, no local government may issue bonds except as permitted by law or the State Council. In recent years, local governments have attempted to avoid these restrictions by borrowing money in other ways. For example, for city infrastructure construction, some local governments have first established a legal entity, using that entity to issue enterprise bonds. For example, in 1999, the Shanghai government used a local company to issue enterprise bonds from which funds were raised and then used for the construction of Shanghai's metro system. Similarly, for the construction of a water supply system, the Jinan government of Shandong Province arranged for bonds to be issued by the Jinan Water Supply Company. Further, the debts of many local governments are "implicit debts," for which there seem to be no reliable statistics, though the amount is estimated to be more than RMB1,000 billion.

In China, taxes and land grant fees are the main sources of income for a local government. The state's macroeconomic control of the real estate market, complicated recently by the global economic crisis, has resulted in a decline in revenues from taxes and land grant fees, with consequent financing difficulties for local governments. The local government bond proposal will permit local governments to issue bonds to cope with these financial difficulties.

The key challenge of the proposal is how to control risk if the state allows local governments to issue bonds. At the trial stage, only provincial governments may be authorized to issue bonds. Also, the purpose for the funds raised by the bonds may be strictly limited to infrastructure investment or investment for public use. The state may also establish strict procedures for the issuance of municipal bonds – for example, by requiring preliminary approval by the local People's Congress, final approval from the State Council and a credit rating.

If the proposal is approved, it will mark a significant shift in the financing of local governments, and may make their focus more market-oriented.

– Meng-Jiang Yao (Daniel)

New Rules on Foreign Investment in Advertising Enterprises

Key Points:

- ***Ownership restrictions on foreign investment removed***
- ***Approval application procedures simplified***
- ***Minimum RMB20 million required for opening branch office***

China's newly revised administrative regulations on foreign investment in advertising enterprises came into effect on October 1, 2008. The new regulations, promulgated by the State Administration for Industry and Commerce ("SAIC") and Ministry of Commerce ("MOC"), were set to replace the former regulations issued by SAIC and MOC on March 2, 2004.

The new regulations remove ownership restrictions on foreign investment in advertising enterprises. Although the previous regulations (2004) had permitted the establishment of advertising enterprises in the form of wholly foreign-owned enterprises ("WFOEs") as of December 10, 2005, such enterprises had difficultly in actually obtaining approval of their applications. The new regulations should facilitate applications to establish a WFOE in China. Application procedures have been simplified, allowing foreign investors to file with the relevant department at the provincial level. The provincial AIC is free to make its own decisions and issue an *Opinion Upon the Examination and Approval of Foreign-Invested Advertising Enterprise Projects ("Opinion").* Following the Opinion of the provincial AIC, foreign-invested advertising enterprises may directly submit their contracts and articles of association to the appropriate provincial commerce department rather than the MOC for inspection and approval.

In addition, the new regulations reiterate the business scope and requirements relative to foreign-invested advertising enterprises.

Foreign-invested advertising enterprises may engage in design, production, publication and some other types of advertising work for both domestic and overseas clients after receiving official approval.

A Sino-foreign advertising joint venture can be established on the condition that all investing parties are the enterprises engaged in the advertising business and that they have been in operation for more than two years.

To establish a wholly foreign-owned advertising enterprise, an investor is required to be an enterprise with advertising as its main business and also to have been in operation for more than three years.

A foreign-invested advertising enterprise is qualified to apply for establishment of a branch in China only if it has invested the full amount of its registered capital and has a minimum annual operating turnover of RMB20 million.

The new regulations show that China's government intends to encourage more global advertising agencies to invest in China in the future, which is likely to generate increased competition in the local advertising market. – *Zhiying Zhan (Olivia)*

Shanghai Government Organizational Reformation

Key Points:

- ***Municipal Economic Commission and Shanghai COFCOM will combine to form a Municipal Commission of Commerce***
- ***Larger integrated departments designed to enhance efficiency***

In October, following the organizational reform of the State Council, the Shanghai government adopted a localized plan of organizational reform, to combine related government agencies into larger departments to enhance efficiency and avoid overlapping or uncovered functions.

The following four changes may be of interest to businesses:

- The Municipal Economic Commission, the approval authority for domestic investment, and the municipal Foreign Economic and Trade Commission/Municipal Foreign Investment Committee, also known as Shanghai COFCOM, will combine to form a Municipal Commission of Commerce to integrate the investment approval functions. This agency will handle all future approval of foreign investment projects in lieu of COFCOM.
- The Municipal Labor and Social Security Bureau will be renamed the Municipal

Human Resources and Social Security Bureau, and will be in charge of medical insurance and administration of civil servants.

- The Municipal Hygiene Bureau will take charge of the Municipal Food and Drug Administration.
- The Municipal City Planning Bureau and the Municipal Land Resources Bureau will be combined to form a Municipal City Planning and Land Resources Bureau. This combination is expected to simplify real estate issues and enhance efficiency.

– Zijie Li (Lesley)

Draft Amendment to China's Postal Law

Key Points:

- ***Market entry restrictions for express delivery business remain***
- ***Foreign companies prohibited from providing domestic mail delivery services***
- ***Public comments sought by November 30, 2008***

The draft amendment to China's Postal Law was posted on the official website of the PRC National People's Congress (NPC) on October 30, 2008 for public comment. Any individual or entity may contribute a suggestion before November 30, 2008.

The draft amendment covers a broad range of areas relating to the postal sector including postal facilities, postal services, service fees, compensation for lost mail and express services. Laws related to the market-entry system for express services and the strengthening of security administration have drawn the most attention.

I. Market-Entry System of Express Services

According to the draft amendment, strict requirements will be set for express delivery businesses wishing to enter the Chinese market. First, because of security concerns, foreign companies are prohibited from providing domestic mail delivery services. For purposes of the draft amendment, “domestic mail” refers to mail for which the entire delivery process takes place within China.

Second, the draft requires enterprises applying for express delivery licenses to have a minimum registered capital of RMB500,000 to operate their businesses within provinces, autonomous regions or municipalities. If they conduct business in districts covering multiple provinces, autonomous regions and/or municipalities, they are required to have a minimum registered capital of RMB1 million. Enterprises engaged in international express delivery service must have a minimum registered capital of RMB2 million. Authorities are required to make operation licensing decisions within 45 days following acceptance of application documentation.

Under the terms of the draft, enterprises that obtained an approval certificate and business license for engaging in international express delivery service before official promulgation of the new Postal Law may go directly to the national postal administration bureau to receive an international express service operation license without undergoing further examination.

II. Security Administration

Under the draft amendment, postal agencies are authorized to examine items prior to delivery for security reasons. They are required to open packages other than envelopes to examine the items to be delivered. They may open envelopes if necessary, but are not permitted to read their contents.

Postal administration authorities are also required to consider security factors when reviewing and approving applications for express delivery operation licenses.

State and public security bureaus and agencies may also examine and retain mail or delivery service packages connected to a criminal investigation. In addition, courier service providers are required to offer client information if security bureaus deem it necessary. Finally, no individual or entity is permitted to use the mails or a delivery service to distribute information that may threaten national security.

In summary, the draft urges postal bureaus at both the national and provincial levels to tighten monitoring and management measures over postal service in a just, fair and transparent manner. *– Changshun Chen (Ryan)*

Recent and Upcoming Events

Nicholas Chan, partner in our Hong Kong office, will participate as a guest speaker at a seminar, "Business Opportunities for Small and Medium-Sized Enterprises (SMEs) During a Financial Crisis," to be held at the Marco Polo Hong Kong Hotel on November 26, 2008. Organized by the *Economic Digest* and Squire Sanders, the seminar will focus on the enormous challenge facing SMEs amidst the current global economic turbulence. The organizers will note that enterprises can still seek support from government, private institutions and professionals to realize and create business opportunities. Ma Guirong of the Hong Kong General Chamber of Commerce, chair of the Small and Medium-Sized Enterprises Committee, will speak on "Challenges for Small and Medium-Sized Enterprises During a Financial Crisis and Strategy." Guan Enci, vice general-director of the Trade and Industry Department of Hong Kong, will deliver an "Introduction to the Support to Small and Medium-Sized Enterprises From the Government." Mr. Chan will speak on "Practical Tactics for Negotiating Contracts." For further information, email medmarketing@newmediagroup.com.hk, telephone +852.9685.9335 or fax +852.2960.5775.

Nicholas Chan will participate as one of several guest speakers at the IT Contracts Masterclass program to be held in Hong Kong (at Clifton Central) November 27-28, 2008. According to the organizers, LexisNexis Conferences, the program will focus on the fast development of Asia's IT sector, which has resulted in a greater need for valid and up-to-date agreements to deal with changes in technology features as well as changes in the responsibilities of both developers and users. An in-depth and practical understanding of technology licenses and contracts will ensure that an organization is protected against potential legal disputes and costly litigation. The program is designed to provide IT and legal professionals with a concise and thorough view of legal issues that often arise in procurement of technology, both large and small, as well as IT outsourcing matters. It focuses on intellectual property and other legal considerations crucial to safeguarding a company's business and ensuring maximum value. Information on open source and strategic licensing in technology-based commercial transactions is included to keep companies updated on recent developments in the technology sector. Mr. Chan will deliver the presentation "The Art of Issuing and Bidding in Request for Proposals (RFPs) for IT Projects," focusing on identifying and dealing with two general categories of RFPs; initial considerations when issuing or receiving an RFP; managing and evaluating a response to an RFP with or without partners, subcontractors or suppliers; and anticollusion, bid rigging and application of competition laws and compliance with the US Foreign Corrupt Practices Act and local laws. For further information, call Eunice at +852.2965.1421.

Squire Sanders is once again joining with China Centric Associates, LLC to offer our clients the third annual edition of our **China Business Immersion Trip** March 13-20, 2009. Business decision makers and line operations managers serious about exploring the China market within the next 24 months are invited to participate. More details and the complete agenda for the eight-day trip are available on the Squire Sanders website at http://www.ssd.com/resources/event_detail.aspx?eventid=12371.

Articles, Publications and Other Media

Nicholas Chan is author of an extensive article in a recent edition of *Economic Digest,* "Standard Contracts Provide Fundamental Protection to Enterprises," in which he guides companies of all sizes on how to realize opportunities and reduce risks in the current tough economic climate through the use of well-formulated standardized contract templates, explaining key contract law issues and revealing negotiation strategies.

Charles R. McElwee, counsel in our Shanghai office, was quoted in October by *China Law and Business* regarding the impact of China's more stringent environmental standards on companies doing business there.

Song Zhu, senior associate in our Palo Alto and San Francisco offices, and **Amy L. Sommers,** national partner in our Shanghai office, participated as panelists on "Asia and the Globalization of Technology Development: Intellectual Property Challenges and Solutions" at the US-Asia Technology Management Center

(US-ATMC) at Stanford University on November 13. Moderated by US-ATMC director Richard Dasher, the discussion focused on how companies have found ways to solve or at least mitigate the intellectual property challenges of global technology development. The topic was broadly defined to include issues such as employment contracts as well as patent protection and coping with multiple regulatory and legal systems.

Amy Sommers attended the signing ceremony for the Memorandum of Understanding between the Asian Art Museum and the Shanghai Art Museum relating to a major exhibition that will open in San Francisco in February of 2010, focusing on visual culture in Shanghai from 1850 to the present day. This event is tied to the World Exposition, which will be held in Shanghai in 2010. San Francisco recently announced that it is opening a representative office in Shanghai to support trade and commercial ties between the cities.

James M. Zimmerman, partner in our Beijing office, was quoted on November 15 in *The Wall Street Journal* in the article "Beijing Reveals Small Parts of Big Stimulus: Central Government to Fund a Quarter of $586 Billion Package, Rely on Local Authorities, Private Sector." The article reported on the direct funding by the PRC government of one quarter of its RMB4 trillion economic stimulus package and noted that other funds would be expected from local government and the private sector. The article quoted Mr. Zimmerman as stating, in his capacity as chairman of the American Chamber of Commerce in China, that he had sent a letter to US Treasury Secretary Henry Paulson asking him to encourage China's government to release more information on the projects the stimulus will fund. Without those details, Mr. Zimmerman wrote, it would be difficult for businesses to take advantage of the new spending. The article is available here:

http://online.wsj.com/article/SB122670803014529937.html. Mr. Zimmerman was quoted on November 6 on CRIENGLISH.com, the English language news website of China Radio International, about US-China relations in the new US administration. He was also quoted by the Associated Press on November 5 in an article that was published in *The Miami Herald,* and he was quoted on Sohu.com on November 5 regarding US-China ties under the new US administration. Mr. Zimmerman also published an opinion piece in *China Daily* on November 4 regarding US-China ties under President-elect Obama's administration. In "A Policy to Improve Sino-US Ties," he put forth the need for ". . . a clear-eyed, balanced view of China that provides a foundation for future policy." Mr. Zimmerman noted that "The next administration should acknowledge that China is going through an extended learning and maturing period that requires that the United States partner with China." The article is available here:

http://www.chinadaily.com.cn/opinion/2008-11/04/content_7171115.htm

James M. Zimmerman, *China Law Deskbook, Second Edition (2005): A Legal Guide for Foreign-Invested Enterprises.* More information on the *China Law Deskbook* is available on the ABA website:

http://www.abanet.org/abastore/index.cfm?section=main&fm=Product.AddToCart&pid=5210139

This newsletter provides free information on the influence of certain aspects of the Chinese legal environment and does not constitute legal advice.

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CHINA UPDATE NOVEMBER 2008

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