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Inside

The Application of Laws to Commercial Bribery Cases – New Opinions

Key Points:

- ***Clarification of parties subject to commercial bribery charges***
- ***Clarification of key factors when determining commercial bribery***

China's policy of becoming more open, celebrating its 30th anniversary, coupled with its phenomenal growth rates and record increases in trade and foreign direct investment, attracted the world's attention. However, in any country, such rapid economic expansion, with parallel commercial opportunities and wealth creation, can also create new opportunities for bribery and corruption. Over the past 20 years, China has introduced a series of laws and regulations to guide business operators and government officials in their day-to-day activities. In addition, the Communist Party has issued numerous internal rules governing the activities of government officials regarding gift giving, entertainment and foreign visits.

Nevertheless, the number of corruption cases in the courts continues to rise, with 120,000 cases brought before the Beijing courts between 2003 and 2008. Moreover, in recent years, many cases of corruption before China courts have involved high-profile government officials including the case against the former party chief in Shanghai, Chen Liangyu, that resulted in a lengthy prison sentence.

The PRC Criminal Law, the primary law on bribery and corruption in China, explains two types of bribery: official and commercial. Official bribery comprises various offenses involving state functionaries and government bodies or entities involving kickbacks, rebates, property and other gifts of value offered to government officials and bodies for the purpose of obtaining benefits. In contrast, commercial bribery relates to offenses by those in the private business sector.

On November 20, 2008 the Supreme People's Court ("SPC") and the Supreme People's Procuratorate issued Opinions on Several Issues Concerning the Application of Laws to Commercial Bribery Cases ("Opinions"), which are now effective. The Opinions set forth the various commercial bribery charges that may be brought against individuals and legal entities: accepting or offering bribes from or to nonstate employees; accepting or offering bribes; offering bribes by or to an organization; and introducing bribes..

The Opinions also specify the types of legal persons that can be charged with commercial bribery by elaborating on the PRC Criminal Law:

(i) "Other organizations" including institutions, social organizations, village committees, neighborhood committees, village groups,

and also temporary organizations such as sports organizing committees;

(ii) "Staff at companies, enterprises and other institutions" including nonstate-employed staff of state-owned enterprises (SOEs) and other state-owned units;

(iii) "Staff at medical institutions" including state- and nonstate-employed staff and all medical staff;

(iv) "Staff at educational institutions" including state- and nonstate-employed staff and all teaching staff; and

(v) "evaluation committees, negotiating teams" in competitive purchase negotiations and "inquiry teams" engaged in processing requests for quotations (including members representing SOEs and units).

The Opinions also describe some of the most common forms of commercial bribery, such as financial inducement, gifts and other valuable items, such as bank or membership cards.

The Opinions also detail a range of diverse factors that should be considered when authorities must determine whether the offense of commercial bribery has been committed. These include the circumstances under which the transaction took place; the value of the property involved; the purpose, timing and methodology of the transaction; and, most importantly, whether the transaction resulted in the recipient using his or her station to confer an illegitimate benefit on the party that offered or gave the property.

The Opinions are a welcome addition to China's laws and regulations and provide the public, investigating authorities and courts with an enhanced understanding of the law and the importance of ensuring a corruption-free and level playing field for all when conducting business.

– Diarmuid O'Brien, Update Coordinator

China Permits Some Commercial Banks to Offer M&A Loans

Key Points:

- ***M&A loans permitted***
- ***Risk evaluation and risk management highlighted***
- ***Uncertainty regarding whether a non-China buyer may apply for M&A loans***

On December 6, 2008 the China Banking Regulatory Commission ("CBRC") released the Guide for Risk Control of Mergers and Acquisitions ("M&A") Loans by Commercial Banks ("Guide"), which permits qualified commercial banks to offer M&A loans and which regulates their M&A loan business. This Guide abolished the provisions regarding loans in the General Principles Regarding Loans (1996), which prohibited commercial banks

from granting loans to a borrower for M&A transactions.

The Guide sets standards for commercial banks' M&A loans, encouraging banking institutions to explore innovative M&A financing to meet increased corporate borrowing needs. The main principle behind the Guide is requiring qualified commercial banks to balance market demand and risk.

This Guide consists of four chapters and 39 articles providing a definition of M&A and M&A loans, specifying requirements for M&A loans made by commercial banks. These include requirements such as that the buyer and the target corporation be similar in business and strategy, and that the proposed transaction enable the buyer to acquire research and development capacity; key technology; a brand or license; a supply and distribution network; or strategic resources that will increase its competitiveness. Other requirements cover risk management and control, with both general principles and quantitative regulatory standards detailed.

The Guide regulates considerations for risk evaluation and management for a commercial bank granting an M&A loan. In making M&A loans, a commercial bank must control the entire process and set up sound internal controls incorporating detailed and comprehensive risk assessment and control procedures. These must include information on conditions of acceptance, due diligence, the organization of an inspection, loan agreements, the conditions of draw-down, the internal auditing risk evaluation and more. If an M&A loan involves cross-border transactions, the commercial bank is required to analyze risks including country, foreign exchange and cross-border capital risks. The quantitative ratios on risk concentration and large-risk exposure, as well as leverage ratio, are specifically provided.

Obviously, this Guide will play an important role in stimulating M&A business. However, the Guide does not clearly stipulate whether a buyer outside China is permitted to apply for a loan from a China-based commercial bank if it intends to conduct M&A business in the PRC. At least one local CBRC counterpart and some banks in Shanghai, when asked this question, replied that they were unsure as to whether the Guide applies to foreign buyers.

On December 14, 2008 the General Office of the State Council of the PRC released Opinions Concerning Finance Promoting Development of Economy ("Opinions"), Article 17 of which stipulates that commercial banks are permitted to grant loans to both PRC-based and overseas enterprises. According to the Opinions, it appears that an investor outside China may have an opportunity to apply for an M&A loan; however, this issue still requires further clarification.

As a result of this Guide, many PRC-based enterprises will have the opportunity to acquire more funding for their domestic or overseas M&A activities. However, because the Guide encourages domestic enterprises to conduct overseas M&A transactions and requires commercial banks to conduct due diligence on the target company when granting a loan, law firms outside China with particular experience in M&A work can expect more due diligence work from PRC-based clients.

– Adam Li

New Requirements for Preliminary Examination of Land Used for Construction Projects

Key Points:

- ***Cover preliminary examination of land to be used for construction projects by foreign entities***
- ***Additional content requirements for applications***
- ***Geohazard evaluation and certification of mineral resources required***

The Measures for the Administration of Preliminary Examination of the Land Used for Construction Projects ("Measures") promulgated by the Ministry of Land and Resources on July 25, 2001 and revised and adopted on October 29, 2004 are now into their second revision. On November 29, 2008 the ministry adopted amended Measures, which took effect January 1, 2009, that reflect changes and new requirements related to examination and approval of construction projects started after 2004.

According to the State Council's Decision on Reforming the Investment System (Guo Fa [2004] No. 20) (2004.7.16), China's National Development and Reform Commission (NDRC) has divided projects with investments by entities from outside China into three categories. The first, which applies to government-funded corporate projects, requires examination and approval; the second, which applies to major projects and projects belonging to restricted categories, also requires approval; and the third, which does not require approval and applies to projects not falling in the previous categories, requires only the filing of a record with the NDRC.

These Measures stress that preliminary examination of land used for construction projects is a necessary condition for approval of construction projects by non-China entities. The main change they implement is in permitting that examination to take place after filing a record with the NDRC, rather than beforehand, in cases in which prior approval from the NDRC is not required. For projects needing to obtain examination and approval or ratification from the NDRC or its local counterparts, a preliminary land examination must be completed prior to filing with the NDRC.

Another change in the Measures is in documentation requirements. Application reports filed with the Ministry of Land and Resources regarding preliminary examination of land for construction projects must include information on (a) the basis for requiring the land; (b) detailed information on the applicable land, using indicators such as plot/investment ratio; and (c) details regarding the consideration being paid for the land use rights.

As of January 1, 2009 investors in construction projects are also required to conduct a geohazard evaluation and certification of mineral resources in the land on which a construction project is to be built before applying for formal land use approval.

Results obtained from preliminary examinations of land used for construction projects are still valid for two years after they are completed.

– Brenda Xu

New Circular Regarding Tax Clearances on Payment for Services Trade Items

Key Points:

- ***Revisions to forex payments procedures for trade services***
- ***Payments of more than US$3 million subject to tax clearance***

On November 25, 2008 the State General Tax Bureau ("SGTB") and the State Administration of Foreign Exchange ("SAFE") issued a Circular on Certain Questions about Submission of Tax Payment Certification Regarding Outside Payment for Services Trade Items ("New Circular"), which took effect on January 1, 2009. It marked the second time in 2008 that the PRC government completely changed procedures for outside payment under services trade items.

In March 2008, SGTB and SAFE issued a notice ("March Notice") stipulating that before making any payment in a services transaction, the payer did not need to pay any relevant tax, only register the information with the tax bureau. Prior to the March Notice, in order to submit services payments outside China, the payer was required to present a certification indicating all taxes had been paid on the services. Upon its issuance, the March Notice was regarded as a means of encouraging services trade and as a sign that China was relaxing foreign exchange controls on payments outside the country.

The New Circular, however, actually reverts the law to where it stood prior to issuance of the March Notice. Under the New Circular, any payment made outside of China for services valued at more than US$3 million may be made only by presenting a Tax Paid Certification – i.e., the payer must pay the tax on the services first, before paying for the services. The March Notice will be abolished when

the New Circular takes effect, ending the registration system in place for only 10 months.

The following types of services payments, however, are not subject to this rule, and no Tax Paid Certification needs to be presented for them:

(i) Payments under US$3 million;

(ii) Payments for certain expenses occurred outside of China by China-based entities, such as expenses related to meetings, accommodations, office management, commissions, insurance, damages and transportation;

(iii) Payments for individually used services.

Many commentators believe that, given the world financial crisis, the issuance of the New Circular shows that the PRC government's concerns regarding outflow of speculative capital, or "hot money," now exceed its concerns regarding inbound hot money. It is expected that the government may issue more policies to control the flow of foreign currency outside the PRC.

– Lindsay Zhu

New PRC Tax Treatment for Disposal of Offshore Intermediate Holding Companies

Key Point:

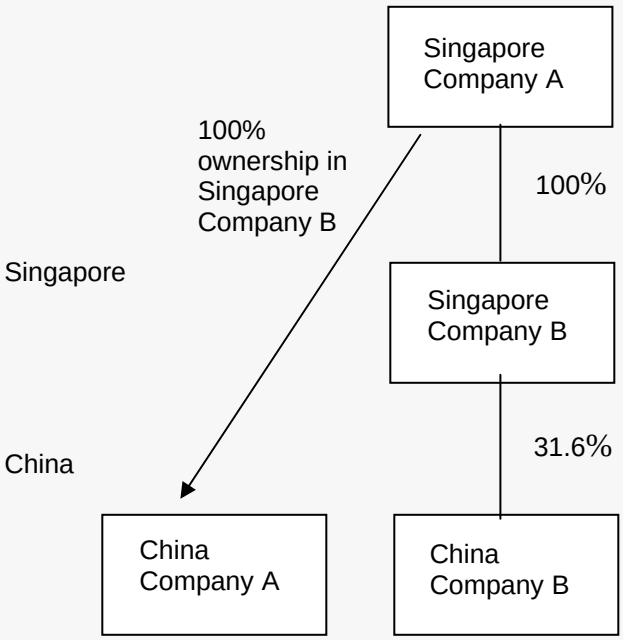
- ***Sales of offshore holding companies may now be subject to PRC tax***

Offshore holding companies have been widely used by investors from outside the PRC to structure their investments in China, especially if the investor intends to dispose of its China interests in the near future. Rather than selling its interest in a China-based company, which will normally attract a 10% PRC capital gains tax, the outside investor has in the past been able to avoid the PRC capital gains tax by disposing of its interest in the offshore company, which directly holds the interest in the China-based company. In such case, the capital gains derived are considered to be foreign-sourced income received by a non-China tax resident and thus not be subject to any PRC tax.

However, a recent ruling by Yuzhong District State Tax Bureau (a branch of the Chongqing State Tax Bureau) imposing PRC tax on an offshore equity transfer by an intermediate holding company may mean that using offshore holding companies to avoid PRC tax liability is no longer a viable tax planning structure for minimizing tax exposure.

In May 2008 Yuzhong District State Tax Bureau examined an equity transfer transaction between Singapore Company A and Chinese Company A

under which Singapore Company A transferred its 100% equity interest in Singapore Company B to China Company A. The transfer price was the equivalent of RMB63.38 million, representing a capital gain of about RMB9 million for Singapore Company A. Upon further investigation, the tax bureau discovered that the registered capital of Singapore Company B was only SGD100, and that it did not engage in any business activities other than holding a 31.6% interest in China Company B.



After consulting the Chongqing State Tax Bureau and the State Administration of Taxation, the Yuzhong State District State Tax Bureau concluded that (a) the transfer of equity in Singapore Company B constituted, in substance, a transfer of equity in Chinese Company B, and (b) the capital gain so derived should be considered China sourced income subject to a 10% withholding tax under the Sino-Singapore Tax Treaty.

This decision can be viewed as an application by the local tax bureau of a "commercial viability test" under the general anti-avoidance provisions in the new PRC Enterprise Income Tax Law. Under Article 47 of the Enterprise Income Tax Law, China's tax authorities may make tax adjustments when business transactions are considered to lack a *bona fide* business purpose. Indeed, Article 120 of the Enterprise Income Tax Law Implementation Rules defines such transactions as those whose primary purpose is to reduce, avoid or defer tax payments. Although details of the subject transaction have not been disclosed, the tax bureau determined that the transaction failed the commercial viability test and elected to redefine the transfer based on two major findings: (a) nominal registered capital (i.e., SGD100) and (b) the lack of commercial activities for the holding company.

Although not expressly noted in the above case, the transfer of an equity interest in an offshore holding company with a PRC subsidiary or investment may also be subject to PRC tax under the new PRC tax resident rule. According to this rule, a company established outside China, but with its effective management in China, is deemed to be PRC tax

resident and, therefore, subject to enterprise income tax on its worldwide income. A company is deemed to be effectively managed in China if its overall management and control, including management and control over production and business operations, employees, treasury and finance functions and property of the company, are in China.

Through unofficial channels we have learned that some tax authorities in Southern China have adopted the position taken by the Chongqing State Tax Bureau and begun imposing tax on capital gains derived from similar offshore equity transfers. This ruling, which was also recognized by the State Administration of Taxation, represents a major step by China's tax authorities in using the general anti-tax-avoidance principle against transactions deemed not to have a valid business tax purpose and structured only for tax avoidance purposes. Therefore, non-China investors relying on similar offshore holding structures should examine their current arrangements to analyze whether they can withstand potential challenges by China's tax authorities. In addition, offshore holding companies should avoid engaging in *de facto* management and control from China and thus being labeled as China tax residents.

Squire Sanders has extensive experience in cross-border business tax structuring and would be glad to discuss your China-oriented tax planning needs with you. Please contact Sharon Xu in our Beijing office if this could be useful to you or your firm.

– Sharon Xu

Reducing Work Force in China

Key Points:

- ***Large-scale reductions require trade union consultations***
- ***Severance payable***

Amidst the global financial crisis, many companies have considered reducing employee numbers. In China, reduction in staff numbers is now governed by the Labor Contract Law ("LCL"), effective January 1, 2008, which provides added protection for employees. Under the law, individual employees may be dismissed only on the basis of one or more specified events or circumstances expressly set forth in the law; in other words, one cannot dismiss an employee "at will." However, in instances in which, due to specified circumstances, an employer intends to reduce its workforce by 20 or more workers, or by fewer than 20 workers but by more than 10% of the existing work force, the employer must first refer and explain its intentions to the workers' trade union, or to all the workers at least 30 days in advance, and take their views into account (Art. 41 LCL). The employer is also required to file details of the plan with the local labor bureau.

The listed circumstances are as follows:

(i) Restructuring carried out pursuant to the provisions of the Enterprise Bankruptcy Law;

(ii) Serious difficulties in production or business operations;

(iii) When the enterprise switches production, introduces major technological innovations or adjusts its operational mode and, after modifying its labor contracts, still needs to reduce its work force;

or

(iv) When other major changes in the objective economic circumstances upon which the conclusion of the labor contracts was based render the labor contracts non-executable.

An employer is legally required to examine the opinions of the trade union and to notify the trade union in writing as to the outcome of its handling of the dismissals.

In the event of such a work force reduction, the employer must give priority to retaining the following personnel:

(i) Those who have concluded fixed-term labor contracts with the employer for relatively long periods;

(ii) Those who have concluded open-ended labor contracts with the employer; or

(iii) Those who are the only breadwinner in their families and whose families have a senior citizen or a minor as a dependent (Art. 41).

If the employer hires again within six months, it must notify the formerly dismissed personnel and give priority to them in hiring, provided the conditions are the same (Art. 41 LCL).

Under the LCL, severance payments must be paid on the basis of time served (Art. 47 LCL). However, if a labor contract existing on the implementation date of the LCL (January 1, 2008) is dissolved or terminated after that date, and economic compensation is payable, the number of years for which the economic compensation is payable will be counted from the implementation date of the law. This includes situations in which the employer dissolves the labor contract in accordance with Article 41 of the law[1]. Employees are paid financial compensation based upon the number of years worked for the employer, at the rate of one month's wages for each full year worked. Any period of not less than six months but not more than a year is counted as a year. The financial compensation payable to an employee for a period of less than six months is one-half of his or her monthly wage or salary. If the monthly wage or salary of an employee is higher than three times the average

[1] Beijing Labor Bureau confirms that if a nonfixed-term employment contract is terminated by the employer, the employer shall pay economic compensation on the basis of the full period of service by the employee.

monthly wage or salary of employees in the local area for the preceding year as published by the local people's government in the employer's location, the rate at which financial compensation is to be paid will be capped at three times the average monthly wages of employees in that city. Also, the maximum period of financial compensation cannot exceed 12 years (Art. 47 LCL). The term "monthly wage" refers to the employee's average monthly wage for the 12 months prior to the dissolution or termination of the labor contract. If the working time of the employee is less than 12 months, the average wages shall be calculated based on the actual work time.

If an employer dissolves or terminates a labor contract in violation of the provisions of the law, it is liable to pay damages to the employee at twice the rate of the financial compensation provided for in Article 47 of the law (Art. 87 LCL).

It is imperative that any employers contemplating work force reductions take heed of the strict provisions of the LCL and its implementing regulations.

– Diarmuid S. O'Brien, Update Coordinator

Recent and Upcoming Events/Articles, Publications and Other Media

James M. Zimmerman, partner in our Beijing office, was quoted on December 3 by *China Daily* regarding the ongoing Sino-US Strategic Economic Dialogue. He also appeared discussing the same topic on CCTV-9 on December 5, and was quoted the same day on ChinaDaily.com regarding Sino-US relations. He was also featured in a recent issue of *Top China,* a leading Chinese-language magazine, commenting on the global economy, investments in China and corporate social responsibility. Mr. Zimmerman gave his final major speech as chairman of AmCham China at the chamber's Annual Appreciation dinner held at Beijing's China World Hotel on December 5. The keynote guest speaker was Minister of Commerce Chen Deming.

Nicholas Chan, partner in our Hong Kong office, and **Joachim Heine,** partner in our Frankfurt office, gave the presentation "Mergers and Acquisitions in China" on December 9 at the Fairmont Le Montreux Palace in Switzerland. Mr. Chan was also one of a number of experts recently invited by the financial column of Hong Kong's prestigious *Mingpao* newspaper to provide advice to small and medium-sized enterprises regarding the prevention of risks in commercial contracts.

Alexander D. (Sandy) Calhoun, counsel in our San Francisco office, received one of three New Silk Road Awards made by the California-Asia Business Council on November 21. The awards honor work done to foster commercial ties between California and China. Mr. Calhoun was selected for his role in globalizing legal services to increase the ease of doing business across the Pacific.

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.

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

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Squire Sanders Contacts

BEIJING

Sungbo Shim
James M. Zimmerman
Diarmuid S. O'Brien (China Update Coordinator)

Squire, Sanders & Dempsey L.L.P.
25th Floor, North Tower, Suite 2501
Beijing Kerry Centre
1 Guanghua Road
Chaoyang District
Beijing 100020
People's Republic of China

+86.10.8529.6998

HONG KONG

James S. Tsang
Nicholas Chan
Francis Li

Squire, Sanders & Dempsey
24th Floor, Central Tower
28 Queen's Road Central
Central, Hong Kong
Hong Kong SAR, China

+852.2509.9977

SHANGHAI

Daniel F. Roules
Amy L. Sommers
Charles R. McElwee II

Squire, Sanders & Dempsey L.L.P.
Suite 1207, 12th Floor
Shanghai Kerry Centre
1515 Nanjing Road West
Shanghai 200040
People's Republic of China

+86.21.6103.6300

TOKYO

Ken Kurosu
Steven S. Doi

Squire Sanders
Gaikokuho Kyodo Jigyo Horitsu Jimusho
Ebisu Prime Square Tower, 16F
1-1-39 Hiroo
Shibuya-ku, Tokyo 150-0012
Japan

+81.3.5774.1800

NORTH AMERICA
Cincinnati
Cleveland
Columbus
Houston
Los Angeles
Miami
New York
Palo Alto
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