

The Brief

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Editorial – Between reflating and rebalancing

The strong contraction of the Chinese foreign trade is evidence that one of the growth engines of the past years has also been hit by the world financial crisis. In exporting regions, in particular Guangdong, scores of factories have closed. This crisis has accelerated the disappearance of companies selling cheaply on the world markets, unable to resist the successive effects of RMB appreciation with regard to the US dollar, the increase of wage costs and the collapse of global demand. It also affects other more stable companies, which led the Chinese government to launch a vast RMB 4 trillion stimulus plan whose effects were first felt at the beginning of this spring 2009.

The Chinese economy's relative recovery since the beginning of the year can be explained by the speed of transmission of public investment programs in the real economy, which has occurred more rapidly in China than in Europe. This recovery is also the result of reopening the credit valve, a very sensitive issue since the beginning of the year. Even if it is necessary to remain wary of the long-term effects of this stimulus (some experts do not exclude a new decline within a few months), the Chinese economy has not collapsed in spite of the importance of foreign trade in the calculation of its GDP. Indeed, Chinese imports decreased at an even faster rate than its exports, showing the considerable portion of work using imported components in Chinese sales, and the decline of capital goods purchases.

More generally, China is "taking advantage" of the crisis to assert its growing weight on the international stage. It could quite soon replace Japan as the world's second largest economic power, and was at the centre of attention during the G20 summit in London. Only a few days before this summit, the governor of the central bank did not hesitate to evoke the idea of replacement of the dollar as the international reference currency.

However, the question of rebalancing the Chinese economy remains.

Before the crisis, authorities had launched adjustment policies to encourage a more qualitative and green growth, rather than a quantitative and resource-hungry growth. These policies also encouraged a lessening of the gap between urban and rural standards of living, and the upgrade of the Chinese economy's focus to industrial activities and higher value-added services.

The crisis exposes a contradiction between this long-term transition policy and the needs of short-term reflating, i.e. the contradiction between creating new, productive investments and the risk of industrial overcapacity and balance sheet degradation of Chinese banks under the weight of new junk debts, etc.

This new economic balance creates a more stabilizing and steadier domestic consumption through the continued implementation of social protection policies, the improved functioning of the markets and a more uniform application of legal rules.

Thus, even during the global crisis, the Chinese economy continues to be very attractive for the development of foreign companies. In addition, Chinese companies are increasingly looking for opportunities to purchase or invest abroad.

Hubert Bazin



Overview of redundancy rules in PRC

After several years of uninterrupted growth and in the wake of the recent worldwide economic recession, many Chinese firms have been pushed to reduce their total payroll. Meanwhile, employee rights were reinforced by the new Employment Contract Law, effective as of January 1, 2008. Last but not least, the unionization campaign run by the All-China Federation of Trade Unions in foreign-invested companies, and the information made available to the employees have apprised them of the legal and regulatory environment.

As a natural consequence, labour litigations have increased, especially in the south of China. In this new environment, what are the main rules that apply to individual lay-offs? What are the legal rules governing economic layoffs? Above all, how is the termination of employment contracts carried out in China? The managers of foreign-invested companies must know the answers to these questions in order to make decisions in light of the new legal rules.

I. Individual layoffs

The Employment Contract Law, promulgated on June 29, 2007, and its implementing rules, effective as of January 1, 2008, expanded the rules applicable in the case of individual layoffs. However, practitioners agree that these texts have not solved everything. As local governments have enacted local implementing rules which sometimes contradict national law, it is useful to verify the application of specific local rules to various matters.

While planning any individual lay-offs, these are the main points an employer must keep in mind:

The termination of employment contracts must be justified. This principle applies to both the termination of the employment contract during the probation period and afterward. The law specifies certain situations which may lead to a termination of the contract by the employer. The employer will have to state the reasons of the termination in a letter addressed to the employee. Contractual indemnities imposed by authorized Chinese labour service companies (temp agencies) such as FESCO or CIIC will also have to be taken into account.

In the case of a fixed term contract, termination before term is admitted only if the employer pays the employee the salary that he should have received until the term of his contract. One must be aware of the employment contract policy applicable in case contracts are signed

with intermediaries such as FESCO. In spite of negotiating this point, such intermediaries usually impose fixed term contracts.

Economic difficulties are not directly considered as a motive for individual lay-offs. Termination due to an economic motive is permitted by the law only in the event of mass lay-offs. Employment contracts can be terminated by the employer if “the objective circumstances relied on at the time of the conclusion of the employment contract have materially changed, making performance thereof impossible”. So far, it must not be excluded that economic difficulties may enter into this frame. In that case, the law specifies that termination is permitted only if “the employer and worker fail to reach agreement on amending the employment contract after consultations”. Such negotiations must be conducted with respect to legal rules, in particular those stating that employees in the same category must receive the same salary.

Absence of motive is a frequent cause of labour litigations. Yet, in spite of justifications, laid-off employees will be entitled to cancel the decision of termination on the basis of procedural defect and claim for salaries due during the whole process of the litigation.

Layoffs without notice and severance pay are possible only in limited circumstances. The law distinguishes depending on whether the lay-off is followed by both the payment of a monetary compensation and a notice period. The law also provides a detailed list of situations in which the employer can layoff an employee without having to pay a severance pay or respect a notice period.

Furthermore, when layoffs are permitted, the employer must respect a 30-day notice period or give the employee one month’s wage in lieu of notice. In such a situation, the employer must also have to pay a severance pay.

Severance pay shall be granted to an employee based on his years of service with the employer at the rate, in principle, of one month’s wage for each full year of service.

This monthly wage refers to the employee’s average wage during the twelve months prior to the termination. However, in certain cases, the average wage must be aligned with the company’s average wage. If the employee has worked less than six months, the severance pay shall be calculated on the basis of half a month’s wage. It shall include all incomes received or



that shall have been received by the employee such as bonuses and overtime work compensation.

For the working period since 1 January 2008, severance pay shall be paid to the employee at the rate of three times the average monthly wage as published by the local government where the employer is located and for a maximum period of service not exceeding 12 years. For the working period prior to 1 January 2008, severance pay shall be computed according to the rules stated by the 1995 labour regulations. In principle, seniority of the employee before 1 January 2008 is taken into account without any cap, except in some localities (for instance, Shanghai) where it was already capped. Thus, in certain cases, computation of severance pay may involve two different caps, depending on whether the working period prior to or after 1 January 2008 is taken into account.

Some formalities must be realized after the layoff. When an employment contract is terminated, the employer shall issue a certificate of the termination of such employment contract and, within fifteen days, carry out the procedures for the transfer of the employee's file and social insurance. This certificate shall bear the term of the employment contract, the date when it is terminated, the position of the employee and the working time of the employee with the employer.

Case of expatriates and seconded personnel. The law makes no distinction as to whether the employees are foreigners, expatriates or governed by a local employment contract. The same rules apply to all employees. A Circular dated January 5, 1996, specifies that all litigations between an employer and a foreign employee must be solved in accordance with Chinese law. It is in the interest of both expatriates and employers to closely investigate the applicability of provisions defining the competent jurisdiction and the applicable law.

The Shanghai Labour Bureau, in an implementing regulation of this Circular dated December 1998, specifies that in the event a foreign employee is laid off, the employer shall return the foreign employee's work permit to the labour bureau or report such situation to the labour bureau if the work permit cannot be returned. However, in certain cases, the possession of a work license is a condition for the employee to bring an action before the Chinese court against the employer. Similarly, if the work permit is cancelled, the employee can also lose his residence permit in China. Execution of these procedures may thus have a significant impact on the expatriates' lives, but also in the event of potential labour

litigation outside China if an expatriation contract has been signed with a group of companies outside China.

Role of Labour Unions. According to the law, the employer shall notify the labour union beforehand of all decisions regarding individual layoffs, in order for the labour union to give an advisory opinion on the decision.

If the employer violates any law, administrative regulation or stipulations of the employment contract, the labour union has the power to require the employer to make a correction. According to the law, the employer shall consider the opinions of the labour union and notify the labour union in writing about the relevant result. If the conflict between the employer and the employee is not solved by mediation or arbitration, labour unions are invited to provide legal assistance to employees who bring an action before a national jurisdiction.

The employer must keep in mind those general principles if he aims to terminate an employment contract based on individual reasons. Those modifications, favourable to the protection of the employee rights, are intended to raise the human resources managers awareness on the implementing of layoff procedures, and are also one way to retain documents that can help justify adherence to the legal procedure and applicable rules. For practical purposes, it is preferable to sign an amicable agreement of termination with the employee providing that this latest agreement will not bring any judiciary action before national jurisdictions.

II. Mass layoffs

Mass layoffs involve at least 20 employees or, for small companies, less than 20 employees who comprise at least 10% of the enterprise's workforce. The procedure described in the new Employment Contract Law, as well as in the past law of 1995, has occasionally been expanded locally. There again, the rules are likely to evolve in the following months at the instigation of local authorities.

The new law has set forth the circumstances under which an employer may carry out a mass layoff. It can be conducted in the instance of a restructuring in accordance with the Enterprise Bankruptcy Law; if the employer is experiencing serious difficulties in its production and operations; if the enterprise is to switch production, undergo a material technological makeover or adjust its mode of operations and still needs to cut back personnel after amendment of employment contracts; or, finally, if another material change occurs in



the objective economic circumstances relied upon at the time of the conclusion of the employment contracts, making the performance thereof impossible. The lack of a legal definition of the economic criteria leads us to think that local authorities close to the market will be able to exercise a certain degree of discretion.

The main principles which apply to this procedure are the following:

Order of priority and protected employees. A list of laid off employees shall be established. In principle, some employees are considered as protected and cannot be laid off, mainly employees on sick leave, those who were injured during their working time and pregnant women, as well as employees who have worked for the same employer for more than 15 years and who are 5 years from retirement.

Some employees benefit from legal protection and shall be retained on a priority basis such as those who have concluded relatively long-term fixed-term employment contracts with the employer, those who have concluded open-ended employment contracts and, finally, those who do not have other employed persons in the household and support elderly persons or minors.

Informing employees. The employer must notify either the labour union or all employees of the conditions of the mass layoff and the circumstances leading to such a decision. A meeting followed by a written notice shall be organized. In our experience, organizing a meeting during which the employees can obtain answers on the personal procedure to be followed and be made aware of their rights, especially concerning social security or labour law issues, is, in principle, a valid way to mitigate social conflicts.

Consultation of the labour union or employees' representatives. Following the notification, the employer must obtain a written opinion of the employees' representative or labour union. Discussions are to focus on alternative solutions to the proposed layoff plan.

Filing of a report to the labour bureau. 30 days after employees are informed, the employer shall file a report to the competent labour bureau. The reporting done to the labour bureau is for registration and not for approval. However, the labour bureau may refuse to issue the written receipt of the report; thus, it may be possible to have a prior discussion with the employer before the written receipt is delivered. More specifically, some local regulations such as those implemented in the Shandong or Hubei provinces have reinforced the role of the labour bureau in case the planned mass layoff affects more than 40 to 50 employees.

Concerning the report, its content varies from one locality to another, as some of them have expanded its content in local notices, as in Shanghai in January 2009. In accordance with our experience, an employer which carries out a mass layoff shall provide the following information to the labour bureau:

- Written downsizing plan which specifies the reasons for the downsizing request, the number of staff to be laid off, proportion of laid-off staff, identification of the staff to be laid-off with the rules on priority applied;
- Explanations on whether the company will take remedial measures;
- Documents and explanations made by the enterprise to the labour union or staff;
- Main opinion of the labour union or staff representative on downsizing, as well as all information on the labour union of staff representative.

Once the report is registered by the labour bureau, the layoffs can be notified to the employees and the notice period will begin.

For practical purposes, it is obvious that local authorities, in particular labour bureaus or local governments, would encourage employers to avoid mass layoffs and settle negotiated walkouts of all concerned employees. Support from the local authorities is fundamental when labour unions, which do not always feel as though they represent the employees' interests, are resigning. Certainly, local authorities may refuse to take the place of the employees or employees' representatives, but informal messages that those authorities may then send to the employees, the local representative of the All-China Federation of Trade Unions (ACFTU), and especially the employees' representatives designated ad hoc, will clearly help to lead the necessary discussions to settle the conflicts by mutual consent.

To conclude, Chinese and foreign employers must be conscious of the existence of a new deal regarding human resources management. If adjustment of the working force for economic reasons is the only solution for the employers, early termination of employment contracts shall be realized with respect to the new rules, which suppose to train human resources departments on those new regulatory constraints and also to a new social practice in order not to frustrate employees. Moreover, one must keep in mind that local practices shall be taken into account, especially due to the recent guidelines from Beijing that encourage authorities to limit layoffs.



Law of the PRC on enterprise bankruptcy

The sudden announcement of the closure of thousands of factories in Guangdong Province just before the Chinese New Year revived interest in the Chinese bankruptcy law, promulgated in 2006, which has been relatively ignored since its entry into force on June 1, 2007.

As the crisis escalates, it becomes essential to set up monitoring measures to assess the financial situation of clients and suppliers in order to prevent potential bankruptcy.

Assessing the financial situation of Chinese partners

It is indeed of primary importance to assess the financial situations of prospective clients or suppliers before entering into contracts. During negotiations, some pre-contractual measures will enable a genuine image of their businesses to emerge. Thus, obtaining technical, financial or legal information may be a prior condition for the continuation of the discussions. A similar right of information for the duration of the contractual relationship may be added to the final contract.. Finally, information from the potential partners' bankers, suppliers and clients may help identify any past hardship.

The frequent monitoring of a partner's business and performance indicators enables a quick reaction in the event of bankruptcy proceedings. Usually, the court decision opening the insolvency procedure is published in the *Newsletter of the People's Court* and is also available on the internet or by telephone. However, information is not always updated and can be incomplete. Therefore, it is sometimes necessary to hire professionals (investigation or credit rating companies) to set up an efficient monitoring mechanism.

Where possible, guaranties should be negotiated with Chinese partners in order to secure the payment of receivables. However, currently no specific legal guaranty is provided by law to creditors of bankrupt companies. Guaranties offered by banks should be carefully reviewed: indeed, it is unusual for financial institutions in China to provide first demand guaranties. Finally, granting collateral for debts falling due during the year prior to the court's acceptance of a liquidation petition (suspect period) may be nullified by a court decision.

When a supplier or a client encounters difficulties, it is important to have identified in advance new sources of supply or new sales opportunities. Whilst entering into

discussion with potential suppliers or clients is not prohibited, caution should be observed regarding the existence of an exclusivity clause in the contract. If applicable, the scope of this obligation should be considered in order to prevent any limitation from entering into discussion with possible prospects or suppliers.

In the event of non-payment or repeated delays, several options may be considered: Chinese law enables the co-contracting party to unilaterally early terminate the agreement for breach of contract. Unlike French regulations, Chinese legislation does not require a court decision to be delivered in order to terminate an agreement. Another solution would lie in renegotiating the terms of the agreement if both parties so agree. However, it should be noted that contractual amendments made during the suspect period, such as advance payments, may always be nullified in the event of the opening of an insolvency procedure.

Measures to be taken in the event of insolvency proceedings in China

The company experiencing financial difficulties—and if the case may be, its creditors—may ask for the opening of one of the three insolvency proceedings provided by the Chinese bankruptcy law. Regardless of whether the continuation of the activities of the company is likely, the court having jurisdiction may order the opening of a reorganisation, settlement or liquidation procedure. The court shall notify its decision to the known creditors within 25 days. The creditors have to declare their rights and receivables between 30 days and 3 months from the court's acceptance of a liquidation petition. Should they fail to declare their receivables, the creditors would lose their rights.

Debts subscribed prior to the opening of the insolvency procedure are "frozen" until a continuation or liquidation plan is decided by the court. All payments or guaranties granted within the year prior to the court's acceptance of a liquidation petition may be nullified if made in violation of certain prohibitions as referred to in the law.

The law provides for the designation by the court of a receiver manager in charge of the procedure aiming at "fairly settling the credits and the debts and safeguarding the legitimate rights and interests of creditors and debtors". The receiver manager has the right to early terminate or to continue to perform the outstanding contracts. This choice is discretionary and cannot be appealed. Therefore, the receiver manager may be tempted to



renegotiate the terms of continuation before making a decision.

In the event the receiver manager decides on the continuation of an outstanding contract, the co-contracting party shall perform its obligations under said contract but has a right to claim for collaterals. Failing to grant satisfying guaranties, the contract will be automatically terminated. In the event of a breach by the receiver manager to perform the contract, the latter may be terminated early by the co-contracting party. No prior court decision is required.

Creditors of the defaulting company shall be paid by the receiver manager. The bankruptcy law innovates regarding the creditors' ranks: previous regulations aimed at protecting employees and employment. From now on, secured creditors are ranked just below the reimbursement of liquidation costs and debts incurred after the filing of bankruptcy. Then come employees, for the payment of their salary and social expenses, unpaid taxes, and finally, unsecured creditors and secured creditors for the remaining amount of their debts. Nevertheless, it has to be taken into account that the local government may try to exercise pressure regarding the payment of wages in order to preserve social peace.

Directors' personal liability in the event of the opening of insolvency proceedings in China

So far, directors of companies have been spared regarding their personal liability under the former law. On the contrary, the 2006 law on bankruptcy provides for a three-year prohibition from management positions for those directors who have caused the bankruptcy of a company, as well as the principle of their personal liability. Directors also have an obligation of loyalty and sincerity towards the court and creditors after the opening of the bankruptcy. Should they not comply with such obligations, they may be fined. The courts having jurisdiction may restrain directors from changing domiciles, in addition to deciding on the incarceration of the entrepreneurs.

Under the terms of a newly promulgated regulation dated 19 November 2008, the directors may be held jointly and severally liable for the debts of the defaulting company in the event the shareholders and/or the directors withdraw from China without initiating the insolvency proceedings and thus create a prejudice for the creditors. The law aims at improving discipline among the directors under insolvency proceedings and at preventing early departures in order to escape liability. In the context of social tension, sanctions have to be considered, as evidenced by the Jianglong case

(River Dragon) where the authorities have turned the directors of a textile factory located in Zhejiang Province into custody, after they absconded from their heavily indebted company and destroyed all records and accounting.

Another new aspect of the 2006 law is that foreign decisions are now taken into account. Previously, courts decisions delivered outside China regarding onshore assets of a debtor could not be enforced due to either a legal vacuum or local legislations. From now on, under certain conditions, decisions delivered in another jurisdiction regarding some assets held in China may be enforced.

Provisions of the law on bankruptcy have not yet been used in practice due to China's annual economic growth, and thus are little known by Chinese practitioners. Due to the current economic crisis, this situation should change. The legal environment should also evolve with regards to the recent law on labour contracts which strengthen employees' rights.

Bruno Grangier and Florian Brechon

Changes in PRC turnover taxation

Several changes relating to turnover taxation were introduced at the end of 2008 and took effect on January 1, 2009. The most important ones are the possibility to deduct input Value Added Tax (VAT) paid for purchase of fixed assets and a broader definition of service income subject to Business Tax (BT). These changes should have a significant tax impact – positive or negative – on almost all enterprises pursuing business activities in China.

Introduction

On November 10 and December 18, 2008, the State Council and the Ministry of Finance successively revised the provisional regulations and the implementing rules governing the three turnover taxes applicable in China, namely VAT, BT and Consumption Tax. In addition, several circulars were issued thereafter to further detail certain provisions.

This brochure focuses on the key changes regarding VAT and BT, while Consumption Tax is not addressed, as it applies only to a limited range of products (i.e. fourteen in total, including certain vehicles, alcohol, tobacco and fuel).



Key Changes for Value Added Tax

As a reminder, VAT is levied on the import of goods and on the turnover derived from the sales of goods, as well as repair, replacement and processing services. The standard VAT rate is 17%.

(i) *Deductibility of Input Tax on Fixed Asset Purchases*

Previously, the most striking aspect of the Chinese VAT system was that VAT paid for the purchase of fixed assets could not be offset against output VAT. Such input tax thus remained a cost for taxpayers, unless they enjoyed a special exemption or refund regime (see below).

This particularity has now been removed and input tax will become deductible for fixed assets purchased as of January 1, 2009 (i.e. for which the special VAT invoice has been or will be issued on or after January 1, 2009).

Nevertheless, there are a few exceptions where input VAT remains non-deductible: the purchase of fixed assets used exclusively for activities where VAT does not apply or is exempted; collective welfare activities; and the purchase of specific products for individual use and on which Consumption Tax applies, such as cars, motorcycles and yachts.

(ii) *Repeal of Preferential Tax Treatments*

As a consequence of this reform, various preferential tax treatments aimed at compensating the non-deductibility of VAT on fixed assets have been repealed as of January 1, 2009. Firstly, VAT exemption for import of equipment used for processing trade and R&D centers have been removed.

Secondly, the encouraged status – which entitles foreign-invested enterprises in certain industries to a VAT and customs duties exemption on imported equipment and to a VAT refund on domestic equipment – has been abolished, as far as VAT is concerned. However, the VAT exemption or refund continues to apply on a transitional basis for equipment imported/purchased before July 1, 2009 for projects which had been recognized as encouraged prior to November 10, 2008.

By contrast, the customs duties exemption on imported equipment has been maintained.

(iii) *General Taxpayer vs. Small-scale Taxpayer*

In order to be able to deduct input tax from output tax, enterprises need to qualify as VAT general taxpayers.

This mainly requires the generation of a minimum annual turnover taxable for VAT purposes, the amount of which has been reduced to RMB 0.5 million for production and service activities (against RMB 1 million previously) and to RMB 0.8 for trading activities (against RMB 1.8 million previously).

Taxpayers who do not qualify are regarded as small-scale taxpayers, who may not credit input tax against output tax, and are subject to a lower tax rate. Such lower rate has been reduced to a uniform 3% (against 4 or 6% previously).

(iv) *Used Fixed Assets*

Previously, sales of used fixed assets were exempted from VAT if the sales price did not exceed the original cost. In other cases, VAT was levied at a reduced rate of 2% and was not creditable.

Another consequence of the deductibility of input VAT on fixed assets is that sale of used fixed assets is now treated like any sale of goods, giving rise to VAT at the standard 17% rate for general taxpayers or the 3% reduced rate for small-scale taxpayers. As an exception, VAT is levied based on a 2% rate in case of the sale of used fixed assets purchased or self-produced before January 1, 2009, even when the sales price is not higher than the original cost.

(v) *Periodicity of Tax Filing*

The new possibility to make VAT declaration and payment on a quarterly basis has finally been limited to small-scale taxpayers only. Other taxpayers shall continue to make tax declaration and payment based on a maximum periodicity of one month.

Key Changes for Business Tax

As a reminder, BT is levied on the turnover derived from (i) provision of services (not falling under the scope of VAT), (ii) assignment and license of intellectual property rights, and (iii) sale or rent of real estate, provided that such activities are carried out within China. The standard BT rate is 5%.

(i) *Definition of Service Income Subject to Business Tax*

Previously, services were regarded as carried out within China, and the related income was taxable for BT purposes, to the extent the performance of the services occurred in China.



This definition has been radically changed and services carried out within China are now defined as services whose provider or recipient is located in China. This completely unexpected change results in a wide extension of the scope of application of BT on service income. For instance, a service fee will be entirely subject to BT as long as the client is located in China, even though the services are wholly performed outside China.

Nevertheless, it is said that up-coming tax circulars could provide for an exemption for service exports (i.e. services rendered by a Chinese provider to a client outside China). However, this remains to be confirmed.

(ii) Place and Periodicity of Tax Filing

Previously, declaration and payment of BT for service income was in principle made with the tax authorities of the place where services were performed. In practice, this resulted in frequent conflicts of jurisdiction between local tax bureaus, in particular when services were rendered in different provinces.

The revised regulations introduce a simplification by providing that tax declaration and payment shall be made with the tax authorities where the taxpayer has its business establishment or residence. Nevertheless, some exceptions have been formulated for construction services and real estate transactions, for which the tax filing shall be completed at the place of performance of services or the location of the property, respectively.

By contrast, the rules on the periodicity of tax declaration and payment were finally not modified, contrary to what could have been expected from the revised provisional regulations issued last November 10.

GLN Comments

While not constituting a full-scale reform of the PRC turnover taxation system, the revised regulations introduce changes which will have a significant tax impact – positive or negative – for almost all taxpayers.

On the positive side, the deductibility of input VAT on fixed assets was a long-awaited change, which puts China in line with most jurisdictions implementing VAT. This should benefit the majority of VAT general taxpayers, especially those engaging in manufacturing activities.

On the negative side, the consecutive repeal of preferential VAT treatment may have serious adverse tax effects in certain sectors, in particular in those where exemptions and refunds of fixed asset input VAT are no

longer available and which do not generate output VAT. The affected sectors include activities for which BT (rather than VAT) applies, such as construction and operation of transportation infrastructures (railway, ports, airports, etc.) or which enjoy a special VAT exemption regime on the sale of products or provision of VAT services, such as export-oriented activities, and notably processing trade.

In these sectors, the non-exempted/refundable input VAT on fixed assets constitutes a net cost increase, which may be especially harsh for new projects recognized as encouraged after November 10, and thus not eligible for the temporary prolongation of the VAT exemption/refund for equipment imported/purchased in the first semester of 2009.

Such adverse consequences may not have been fully intended by the authorities, particularly since they affect some industries traditionally encouraged under Chinese fiscal policy. In this context, some rectifications or adjustments could take place in the next weeks or months.

Moreover, the tax burden of service providers engaging in cross border transactions with China is likely to be amplified by the enlarged definition of service income subject to BT. In this respect, previous best practices will need to be reconsidered and new tax planning work undertaken.

In the mid-run (possibly within the next one to three years), a much larger reform of turnover taxation is expected to take place. It would consist of the replacement of BT by VAT on services and other items currently falling under the scope of BT.

Pierre Wiehn



The Chinese anti-monopoly regime: Decisive steps forward

In the previous issue of *The Brief* we addressed the notification thresholds set out by the *Provisions of the State Council on Thresholds of Notification for Business Operators*, as well as the requirements as to when a business operator to a concentration should file a notification to the Chinese anti-monopoly authority.

Although China has taken promising steps with its new Anti-Monopoly Law (“AML”), as with most new legislations, the AML and the new threshold provisions leave certain issues unresolved, while at the same time creating new uncertainties. As a result, the Ministry of Commerce (“MOFCOM”) has issued a series of guidelines and measures aiming to provide greater clarity to the current anti-monopoly regime, parts of which remain to be enacted.

Right to control or exert a decisive influence

Pursuant to the rules presently in force, an acquisition or merger qualifies as a concentration when a business operator acquires “control” or a “decisive influence” over another company. Nevertheless, these rules were unclear whether typical minority shareholder protection rights (such as veto rights over major decisions or board seats) could constitute an acquisition of control or decisive influence.

The *Draft Provisional Measures on the Notification of Concentrations between Undertakings*, circulated for comments are aiming to address this issue. If a business operator “acquires the power”, either through capital investment or any other contractual means, to decide “on the appointment of one or more members of the board” or management team, or on the budgeting, marketing, pricing or management of another business operator, this should be deemed as “acquisition of a controlling right in another business operator”. This could mean that only investors who become sleeping partners could potentially evade the Chinese definition of a concentration.

Moreover, the new measures also clarify that the establishment of a new company by two or more undertakings will fall under the definition of a concentration. This means that a newly established joint venture may have to be notified if its partners meet the notification thresholds.

Definition of turnover

Under the newly published measures, MOFCOM is aiming to adopt a position close to the European accounting standards for the definition of “turnover”.

Turnover is defined as the revenue generated during the previous financial year from the gross sale of products and provision of services, as computed before income tax. As such, for the purpose of determining China-sourced turnover, only goods sold and services provided in Mainland China (excluding Hong Kong, Macau and Taiwan) are relevant.

In a concentration of business operators, the turnover of the acquiring party’s (the surviving company or company gaining decisive influence) parent companies, affiliates and subsidiaries, as well as of any company under the common control of these companies, is to be taken into account when calculating turnover. A company shall be considered as a parent company, affiliate or subsidiary of the business operator if it is controlling, controlled or under common control, directly or indirectly, by or with such business operator. Nonetheless, the intra-group turnover figures among such affiliated business operators shall not be included in the calculation when determining whether the notification threshold is met. By contrast, when a concentration among undertakings includes the takeover of a company, in line with EU calculation methods, only the turnover of the target company itself will be taken under consideration.

Notification process

The AML imposes a standstill provision which prohibits the contemplated concentration from being carried out without prior approval from the Chinese anti-monopoly enforcement authority MOFCOM’s newly created anti-monopoly bureau (the “AMB”). The standstill period can only begin once AMB has been provided a complete notification containing all required information and materials; it is AMB’s sole discretion to decide when a notification is complete. After filing a complete notification, the AMB will provide a written decision within 30 days as to whether the concentration may be implemented. If deemed necessary, however, the AMB may, at its discretion, conduct a further examination for a period of 90 days, which is extendable by 60 days under specific circumstances. Since the AML is silent on what information and documents need to be provided to the AMB, extensive consultations with the AMB may be necessary.

To address this issue, the *Guiding Opinion on Documents and Information Required for Notification of Concentrations of Business Operators*, effective as of 7 January 2009 now



provide that notifying parties are required to hand in complete and accurate information on the business operators involved in the concentration, such as the nature, background and estimated date of implementation of the concentration, the impact of the concentration on the relevant market, as well as an analysis on market entry, existing cooperation agreements between business operators in the relevant market, and efficiencies which the concentration may generate.

For example, as to the definition of “relevant market”, the newly published opinion lacks detailed guidelines for the determination of the relevant market and only provides general guidance such as analysis of the price and use of the products, consumer demand and preference, and demand and supply substitutability may, among other criteria, be used to define the relevant product market, while the relevant geographic market definition depends on an analysis of, *inter alia*, the characteristics of the industry and nature and transportation of the products. Without a clear definition of the relevant market, it would be impossible to evaluate a concentration. As such, MOFCOM is aiming to provide some clarification of the relevant market in the *Draft Guidelines for Defining the Relevant Market*, now circulated for comments, which when enacted, will constitute more detailed guidelines on the criteria and demarcation of the relevant market.

Examination process and MOFCOM decision

As to the process of examination of concentrations, practical guidelines are expected and welcomed through the formal promulgation of the *Draft Provisional Measures on the Review of Concentrations between Undertakings*, circulated for comments. This draft document would clarify the investigative rights of the AMB and rules for hearing procedures, as well as possibly attaching restrictive conditions to a particular concentration.

On the latter issue, the formulation of restrictive conditions indicates how important the notifying party’s input on the concentration examination can be. Namely, if the AMB believes the concentration will have or is likely to have the effect of excluding or restricting competition, it may inform the business operator of its objections and set a time period for the business operator to provide counter-statements or even propose restrictive conditions to the concentration.

The draft describes two categories of restrictive conditions which might be imposed on a concentration:

- (i) structural conditions, such as the divestment of part of the assets or businesses of the business operators involved in the concentration; or
- (ii) behavioural conditions, aimed at forcing the involved undertakings to either open their networks or other infrastructures, or license key technologies.

Indeed, as seen with the recent InBev brewery acquisition of Anheuser-Busch, MOFCOM’s decision was subject to restrictive structural conditions. Clearance of the InBev/Anheuser-Busch concentration was made conditional upon the new entity not increasing its shareholding in two domestic breweries or acquiring any shareholding in two other strategically important Chinese breweries. However, in this context, regardless of the imposed conditions, it is worth stressing that should such increase and acquisition take place, the concentration would in any event be subject to merger control notification. Moreover, some commentators have pointed out that there is no basis in the AML or other legal provisions for the imposition of remedies governing the future conduct of a business operator.

In this regard, the investors’ concern that the AML could be applied discriminatorily against foreign companies or used to reinforce industrial policies aimed at promoting market domination by domestic market players was borne out with the recent Chinese authorities’ recent refusal to approve the acquisition of Huiyan Juice by Coke.

Despite the number of opinions, circulars and regulations so far promulgated and yet to be promulgated, the predictability of the regulator in adopting a more consistent position would be welcomed. That said, the new anti-monopoly regime is a promising step forward as it provides a clear indication of the general direction in which anti-monopoly law in China is going.

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Gide Loyrette Nouel first opened offices in China in 1987. It was one of the first international law firms to be granted a licence from the Chinese Ministry of Justice to practise law in China. Gide's China practice is handled by a team of more than 130 people, including 70 Chinese and western lawyers, assisted by a team of 15 translators, working out of four offices: Beijing, Shanghai, Hong Kong and Paris. Gide Loyrette Nouel's expertise in China spans all areas of business law.

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