

## Legal Updates & News

### Bulletins

---

#### China Law Bulletin

June 2007

#### China Law Bulletin -- May 2007



#### Feature Articles

- [New Property Right Law Enacted](#)
- [New Enterprise Income Tax Law Promulgated](#)
- [New Enterprise Income Tax Law Diminishes Tax Advantages of FIE Structures for Use by Private Equity and Venture Capital Investors](#)
- [Revised Partnership Law Increases Flexibility for Investors](#)
- [Special Tax Deduction for Venture Capital Investment in the PRC](#)
- [Sunshine Provisions to Take Effect in 2008](#)

#### Recent Developments

- [After 171: An Update on New Real Estate Regulations and Policies Since Issuance of Opinion 171](#)
- [Judicial Interpretation on Unfair Competition Cases](#)
- [China's New Individual Foreign Exchange Administrative Rules](#)
- [China Revises Franchising Regulations](#)
- [New Trial Measures on Disclosure of Environmental Information](#)
- [New Measures on Surveying and Mapping](#)

#### Ear to the Ground

- [Employment Promotion Law Under Consideration](#)
- [Lawsuit Against Baidu Dismissed](#)

#### Featured Articles

##### New Property Right Law Enacted

The National People's Congress passed the *Property Right Law* (中华人民共和国物权法) (the "Property Law") on March 16, 2007, which will come into effect on October 1. The Property Law is one of the most important pieces of legislation promulgated in the People's Republic of China ("PRC") in recent years. Key provisions of the Property Law address ownership rights, property ownership registration system, condominium rights, neighborhood rights, land-contracting rights, property management rights, construction and homestead land-use rights, easements, security interests, and mortgages. To read our legal update, please follow the link below to the Morrison & Foerster website.

<http://www.mofo.com/news/updates/files/12380.html>

## **New Enterprise Income Tax Law Promulgated**

The long-awaited new Enterprise Income Tax Law (中华人民共和国企业所得税法) was finally promulgated by the National People's Congress on March 16, 2007, and is scheduled to come into effect January 1, 2008. The New EIT Law will replace the two separate, existing laws on enterprise income tax that are applicable to domestically funded enterprises and foreign invested enterprises. To read our legal update, please follow the link below to the Morrison & Foerster website.

[http://www.mofo.com/international/CN\\_en/news/11082.html](http://www.mofo.com/international/CN_en/news/11082.html)

## **New Enterprise Income Tax Law Diminishes Tax Advantages Of FIE Structures for Use by Private Equity and Venture Capital Investors**

The regulatory environment for private equity and venture capital investors in China has witnessed a radical transformation over the past eighteen months, evidenced by far-reaching reforms of the laws and regulations applicable to foreign exchange, mergers and acquisitions, and Internet-related businesses. To read our legal update, please follow the link below to the Morrison & Foerster website.

[http://www.mofo.com/international/CN\\_en/news/11997.html](http://www.mofo.com/international/CN_en/news/11997.html)

## **Revised Partnership Law Increases Flexibility for Investors**

The recently revised Partnership Law (合伙企业法) that comes into effect on June 1, 2007, introduces two new forms of partnership in addition to general partnerships: the limited partnership ("LP") and special general partnership ("SGP"). It is widely anticipated that the ability to establish LPs will provide a boost to venture capital investment in high-tech enterprises, while SGPs will promote the development of professional service firms in China. To read the full legal update, please visit the Morrison & Foerster website.

## **Special Tax Deduction for Venture Capital Investment in the PRC**

The Ministry of Finance ("MOF") and the State Administration of Taxation ("SAT") jointly issued a new tax notice *Cai Shui [2007] No. 31* for promoting the development of venture capital ("VC") enterprises ("Notice 31"). Notice 31 provides a special tax deduction for certain venture capital investments in Chinese high-technology enterprises, and describes the procedures and requirements to claim the deduction. Notice 31 provides that the new provisions are retroactive to January 1, 2006.

As discussed more fully below, there is some question as to whether the special tax deduction is available to VC enterprises with foreign investors, although there are persuasive arguments supporting that position. It is not yet clear when the MOF and SAT will clarify this uncertainty.

According to Notice 31, if a VC enterprise makes and holds an equity investment in an unlisted small or medium-size high-technology enterprise for at least two years, the VC enterprise may claim a deduction of 70% of that investment against its taxable income. If the taxable income of the VC enterprise is not sufficient to fully utilize this tax deduction, the unused deduction can be carried forward to future tax years.

In order to claim the deduction, the following requirements must be met by the VC enterprise and the investee company:

- The VC local enterprise must submit a special application to the tax authorities, who will forward it to the relevant finance and tax authorities for approval. The MOF and SAT will publish a list of the VC enterprises recorded at the national level in order to facilitate the application process. Likewise, the provincial finance and tax authorities will publish lists of the VC enterprises recorded at the provincial level and file those lists with the MOF and SAT.
- The VC enterprise itself must be properly registered in China and be operating in compliance with the

*Provisional Measures on Administration of Venture Capital Enterprises* (“VC Measures”) issued in 2005.

These requirements cover issues such as business scope, name indicating its VC nature, and compliance with recordal procedures and verification by the recordal authority.

- The size of the investee is restricted to no more than 500 employees, and neither gross sales nor total assets can exceed RMB 200 million (about US\$25 million). Moreover, when the VC enterprise files the application for the special tax deduction, the investee must be certified as a “high-technology enterprise” in accordance with the relevant high-technology enterprise certification rules. These rules require that the investee’s annual high-technology R&D expenditures represent at least 5% of the investee’s gross annual sales, and that the aggregate income derived from technical services and sale of high-technology products represent at least 60% of the investee’s annual gross revenues.

Compliance with the VC Measures by an investee is crucial for a VC enterprise to obtain the special tax deduction under Notice 31. A key question, however, is raised since Notice 31 refers only to the VC Measures, without mentioning foreign-invested VC enterprises in the parallel *Administrative Measures on Establishment of Foreign-Invested Venture Capital Enterprises* (“Foreign VC Measures”) issued in 2003. Since Notice 31 does not directly mention foreign-invested VC enterprises, it raises the question whether the special tax deduction is available to foreign-invested VC enterprises.

Supporting the position that Notice 31 should apply to foreign-invested VC enterprises is the fact that Article 5 of the VC Measures provides that if foreign-invested VC enterprises are properly established and their investment and operations comply with the relevant requirements, they are eligible for the relevant incentives granted under the VC Measures. In addition, Article 31 of the newly issued unified Enterprise Income Tax Law provides that VC enterprises that invest in encouraged industries (such as high-technology) can claim a portion of their investment as a deduction. We understand that Notice 31 was promulgated to give effect to the incentives identified under the VC Measures and to implement the VC investment incentive provided under the new Enterprise Income Tax Law. Finally, this position would be further supported by China’s WTO commitment concerning national treatment of foreign-invested enterprises.

Due to the technical differences between the VC Measures and the Foreign VC Measures, we anticipate that it will be necessary for MOFCOM to coordinate with the MOF or SAT to issue rules clarifying how foreign-invested VC enterprises may apply for the special tax deduction in accordance with Notice 31. Nonetheless, the creation of this special tax deduction for VC investments is an encouraging development for the venture capital market in China.

### **Sunshine Provisions To Take Effect In 2008**

On April 5, 2007, the State Council promulgated the *Provisions on the Disclosure of Government Information* (中华人民共和国政府信息公开条例), which will come into effect on May 1, 2008. These Provisions are a key development in the Chinese government’s commitment to enhance regulatory transparency, and are a dramatic reversal of past government practices by mandating that all government information should be publicly disclosed unless there is a reason not to do so. The General Office of the State Council is responsible for supervising government information disclosure matters.

Under the Provisions, government agencies are required to actively undertake the disclosure of information, subject to requirements of confidentiality, national security, public security, economic security, or social stability, and not to disclose any information involving state secrets, commercial secrets, or individual privacy. Government agencies are required to disclose government information in a timely and accurate manner, and to correct any false or incomplete information. They are required to establish confidentiality review mechanisms that permit the timely release of information. The information is to be deposited at national archives and public libraries and made available to the public. Individuals may also submit specific information requests to government agencies for access to government information that has not yet been made publicly available.

The Provisions provide that several broad categories of government information should be disclosed, including information concerning the vital interests of citizens, legal persons, or other organizations; information that should be widely known by the general public or concerns the participation of the general public; and information reflecting the structural establishment, duties, procedures for handling affairs, and other situation of the government agency. These include information such as administrative regulations, rules, and normative documents; development plans; statistical information; budget reports; information on administrative fees; government procurement catalogs; and all information relevant to administrative licensing.

A government agency may, when providing government information as applied for, only collect the costs for retrieval, replication, and mailing, and may not charge any other fee. No government agency may provide government information in the form of a paid service through any other organization or individual.

Government agencies will be required to annually report their government information disclosure work, including the types of information disclosed, statistics on information requests fulfilled and refused, fees charged, and applications for administrative reconsideration or bringing administrative lawsuits for government information disclosure.

If someone believes that a government agency is not properly disclosing government information, he or she can bring an appeal to that government entity's superior or supervisory body or the General Office of the State Council. Moreover, if someone believes that a specific administrative act committed by a government agency has infringed upon their legal rights, they can seek administrative reconsideration or bring an administrative lawsuit.

The promulgation of the Provisions in conjunction with other recent regulatory developments such as China's new Property Right Law is a key development toward regulatory transparency aimed at protecting the rights of individuals and enterprises with the goal of ensuring economic and social stability.

## Recent Developments

### After 171: An Update On New Real Estate Regulations And Policies Since Issuance Of Opinion 171

In an Update circulated last July, we reported on the promulgation on July 12, 2006, of the *Opinions on Regulating the Entry into and the Administration of Foreign Investment in the Real Estate Market* (Opinion 171) by the Ministry of Construction, the Ministry of Commerce, the National Development and Reform Commission, The People's Bank of China, the State Administration of Industry and Commerce, and the State Administration of Foreign Exchange. Opinion 171 set out far-reaching new policies governing foreign investment in real estate in China. As a policy document, Opinion 171 was short on specifics, leaving to the relevant regulators the job of implementing and clarifying these policies through legislation.

To read our recent China Real Estate Update, please follow the link below to the Morrison & Foerster website.

<http://www.mofo.com/news/updates/files/8519.html>

### Judicial Interpretation On Unfair Competition Cases

China's Supreme People's Court adopted a judicial interpretation of unfair competition cases that defines key terms and clarifies how damages are calculated in infringement cases that involve patents and trademarks. It went into effect on February 1, 2007. The *Interpretation on the Application of Laws in Civil Unfair Competition Cases* (最高人民法院于审理不正当竞争民事案件应用法律若干问题的解释) (the "Interpretation") addresses three categories of issues that were left undefined in the Anti-Unfair Competition Law. It also clarifies procedural rules for handling unfair competition claims, to which lower trial courts must adhere.

The first broad category addressed by the Interpretation affects branding and advertising, including defining the term "well-known commodity," which describes a commodity that enjoys a certain degree of good reputation in China's domestic market and is well-known by the Chinese public. The Interpretation addresses trade dress protection and the use of corporate and natural person names for product advertisements.

The Interpretation further provides guidance on activities that qualify as "false publicity" and provides several tests that lower courts can apply in determining if an action constitutes false publicity.

The final category addressed by the Interpretation involves determining what constitutes improper use of confidential information, including classifying what information enjoys such protection, what actions can subject a party to liability for obtaining such information, and what methods should be used by lower courts in determining damages. For tort claims that involve commercial secrets, damages must be determined primarily in accordance with the secret's commercial value, which takes into account factors such as research and development expenses, profits, and expected benefits. Moreover, the interpretation states that the burden of proof in commercial secret cases falls on the plaintiff, which must prove the qualification, material similarity between its commercial secrets and the one in question, and illegal practices or acts performed by the defendant. A key provision in the Interpretation clarifies that "reverse engineering" does not constitute unfair competition. It also provides that an employee is not obligated to treat an ex-employer's customer information as confidential unless specifically provided in an agreement. The Interpretation also clarifies that a party which has licensed the rights to certain products or business secrets has the right to bring a suit for infringement of the rights under the license.

## China's New Individual Foreign Exchange Administrative Rules

On December 25, 2006, the People's Bank of China promulgated the *Administrative Rules on Individual Foreign Exchange* (个人外汇管理办法). The new rules, which took effect February 1, 2007, supersede the *Interim Provisions for Administration of Individual Foreign Exchange* (境内居民个人外汇管理暂行办法) along with 15 other related rules and regulations. At the same time the State Administration of Foreign Exchange ("SAFE") issued implementing rules that also took effect on the same date (collectively, the "Rules").

The Rules streamline the administration of personal foreign exchange transactions, simplify the regulatory procedures for individual foreign exchange settlement and purchase, provide guidance for capital account transactions for individuals, and strengthen the monitoring of foreign exchange transactions. Key changes in the Rules include:

- *Imposing Annual Quota on Foreign Exchange Settlements.* The Rules abolish the previous limit for each separate settlement transaction, replacing it with a \$50,000 annual quota on foreign exchange settlements for any individual. PRC domestic individuals are also subject to a \$50,000 annual quota on foreign exchange purchases. Within such annual quota, individuals can now directly deal with commercial banks by providing identification documents. This new policy can be seen as encouraging individuals to more easily enter the foreign exchange market and, to some extent, helping to diversify the holders of foreign exchange so as to rationalize China's foreign exchange system.
- *Clear Guidance for Capital Account Transactions for Individuals.* Formerly, guidance on capital account transactions for individuals was unclear and ambiguous. The Rules represent an important step in providing clear guidance for various capital account transactions of individuals. The transactions addressed by the Rules include, among others, employee stock option plans in overseas listed companies, individual overseas foreign direct investments, and individual investments in securities and other financial instruments through qualified domestic institutional investors. In China, these transactions are now booming or have significant potential for development.
- *Rationalizing the Monitoring of Foreign Exchange Transactions of Individuals.* While the Rules offer greater clarity on transactions, they also strengthen the monitoring of individual foreign exchange transactions. Previously, even though each foreign exchange transaction was subject to a limit, there was essentially no effective supervision or control over the aggregate amount of such transactions. People could execute a number of transactions within the previous limits and thereby obtain amounts in excess of \$50,000. However, under the Rules, once the cumulative annual transaction amount exceeds the annual quota, subsequent transactions will require verification. Such practice is intended to prevent the in-bound flow of illicit funds.

The Rules evidence a trend that, as China's market economy develops and its financial markets become more robust, China will gradually lift restrictions on capital account foreign exchange transactions. In the foreseeable future, it is anticipated that the government will increase efforts to crack down on money-laundering and other criminal activities to improve market efficiency.

## China Revises Franchising Regulations

The State Council's new *Regulations on the Administration of Commercial Franchises* (商业特许经营管理条例) (the "Regulations") came into effect on May 1, 2007, replacing MOFCOM's 2005 *Measures for the Administration of Commercial Franchises*. Along with the Regulations, MOFCOM also issued the *Administrative Measures for the Information Disclosure of Commercial Franchises* (商业特许经营信息披露管理办法) (the "Disclosure Measures") and the *Administrative Measures for Archival Filing of Commercial Franchises* (商业特许经营备案管理办法) (the "Filing Measures"), which went into effect on the same day. Key features of the Regulations and two Administrative Measures include:

- *Filing Rather than Approval Requirement.* Franchise agreements must be in writing and filed with the local bureau of MOFCOM within 15 days of execution, or with the provincial or central-level MOFCOM if the franchise covers two or more provinces. This is a filing "for the record" requirement, rather than an approval requirement. MOFCOM will post a publicly available summary of the filings on its website that will disclose (1) the franchisor's registered IPR, (2) the date of the filing, (3) the franchisor's contact information and name of legal representative, and (4) the location of the franchisees within China. If a franchisor fails to file within 15 days, it will be subject to a fine of no less than RMB 10,000 and ordered to make the filing. If it subsequently fails to complete the filing, it may be subject to additional fines of up to RMB 100,000.
- *Franchisor Requirements:* The Regulations establish several requirements for franchisors:
  - A franchisor must be an enterprise, and cannot be an individual or other entity;
  - It must have a mature business model and the ability to provide long-term business guidance,

- technical support, business training, and other services to the franchisee; and
- It must have at least two direct sales stores, and have been engaged in the business for more than a year.
- **Disclosure Requirements:** At least 30 days before the signing of the franchise agreement, the franchisor is required to disclose in writing relevant information relating to the franchise, including:
  - Name, domicile, capitalization, and legal representative
  - Information on the franchisor's trademarks, patents, and other IPR
  - Type, amount, and payment method of franchising fees
  - Budget for the franchise outlet
  - Quantity, distribution, and evaluation of current franchisees in China
  - Digests of the financial statements and audit reports for the last two years
  - Information on major lawsuits and arbitrations for the last five years, as well as whether the franchisor was ever prosecuted for illegal business activities or fined more than RMB 300,000
- **Franchise Agreement:** The franchise agreement must contain certain standard terms and conditions, including specifics on the franchise contents and terms, franchise fees, how support and training will be provided for operations, technical support and training, the franchise quality and standard requirements, advertising obligations of the parties, dispute resolution and liability provisions, as well as term and termination. The term of the franchise agreement cannot be less than three years unless the franchisee explicitly consents to it. Additionally, the franchisee may not assign the franchise, nor may it divulge or permit others to use the commercial secrets of the franchisor, without the written consent of the franchisor.

### **New Trial Measures on Disclosure of Environmental Information**

On April 11, 2007, the State Environmental Protection Administration ("SEPA") issued the *Measures for the Disclosure of Environmental Information (for Trial Implementation)* (环境信息公开办法(试行)), which will come into effect on May 1, 2008. These Measures, following on the promulgation by the State Council of the *Provisions on the Disclosure of Government Information*, impose disclosure requirements on both the government and private enterprises regarding environmental information. SEPA and local EPAs will be responsible for collecting local environmental information and making it publicly accessible. This will include applicable laws and regulations, environmental protection plans, statistics on environmental quality, emergency response plans, environmental impact statements, and documents related to administrative hearings. They will also be required to publish annual compilations of enterprises that discharge pollutants in excess of applicable pollution standards, as well as compilations of enterprises that have caused serious environmental pollution events.

### **New Measures on Surveying and Mapping**

The Ministry of Land and Resources ("MOLAR") issued the *Interim Measures for the Administration of the Surveying and Mapping Conducted by Foreign Organizations or Individuals in China* (外国的组织或者个人来华测绘管理暂行办法) which came into effect on March 1, 2007. The Measures apply to the surveying and mapping activities conducted by foreign organizations or individuals within the territory of China and the sea areas under its jurisdiction.

Surveying and mapping is tightly regulated, and it is prohibited to engage in geodesic surveying, aerial photography of surveying and mapping, administrative boundary surveying and mapping, marine surveying and mapping, compilation of topographic maps or general maps, and compilation of electronic maps for navigation. Foreign organizations or individuals are only permitted to conduct surveying and mapping activities within China in the form of a minority-owned joint venture or in cooperation with a Chinese entity, and after first obtaining a Certificate on Surveying and Mapping Qualification.

### **Ear to the Ground**

#### **China to Promote Employment Through Legislation**

On March 25, 2007, the National People's Congress (the "NPC") released a draft *Law on the Promotion of Employment* (中华人民共和国就业促进法(草案)) (the "Draft Law") for public comment. The Draft Law is intended to facilitate the promotion of employment through establishing anti-discrimination policies in recruitment, stipulating the preliminary responsibilities of the government, and standardizing the operation of recruitment service agencies. It is expected that many of the provisions in the Draft Law will be general statements rather than specific provisions, and that implementation will be dependent on implementing regulations. For example, the Draft Law includes a vague clause calling for "supportive policies" to promote employment. The Draft Law is not scheduled to be promulgated by the NPC during 2007.

The NPC website hosts a discussion of the Draft Law and the comments received from the public. The website indicates that many comments were focused on the Draft law's antidiscrimination clause, which prohibits discrimination based on ethnicity, race, sex, and other factors. Other comments argue that the Draft Law should include other factors for anti-discrimination, such as educational background, marital status, residence permit (hukou), and appearance, which employers would not be able to use as the basis for discriminating against employees. Numerous comments advocated that the Draft Law establish channels which workers could use to remedy unlawful discrimination, that quantifiable indicators be established as benchmarks for nondiscrimination, and that the government provide financial support to enterprises that employ a certain percentage of disabled and laid-off workers.

Even though an extremely large number of public comments were received on the Draft Law, of most significance has been the government's transparent handling of the process. As part of a move towards greater visibility into the legislative process, the government has been increasingly seeking public comment on proposed laws and incorporating such comments into the drafts. In conjunction with other legislative developments, such as promulgation of the Government Information Disclosure Law addressed above, the government is taking concrete steps to address public concerns on key social and economic issues such as employment.

### **Record Companies Lose Lawsuits Against Baidu**

In September 2005, the seven international record companies EMI, Sony BMG, Warner Music, Universal Music, Gold Label, Go East, and Cinepoly brought lawsuits in the First Intermediate People's Court in Beijing against Baidu.com, the largest Internet search engine in China, for alleged illegal downloading and sharing of their copyrighted music.

The Court rendered its decision in November 2006, holding that Baidu's service did not infringe the plaintiffs' rights. The decision was based on a close examination of technical aspects of Baidu's service, which searches all music file formats on the Internet, including ".mp3", and makes no distinction between copyrighted and pirated songs. The Court held that as a search engine, Baidu did not have the intention of infringing copyright owners' rights to disseminate the music on the Internet. It also noted that since the record companies had not notified Baidu of detailed information on web servers hosting pirated music, Baidu did not have the obligation to cut off the link to such web servers.

After hearing the decision, the music companies indicated that they would appeal to a higher court. In January 2007, EMI pulled out of the lawsuit and reached an agreement with Baidu to cooperate on an advertising-supported music website.