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1. Foreign Direct Investment

Chinese Court Guidance on FIE Disputes

最高人民法院关于审理外商投资企业纠纷案件若干问题的规定 (8/5/2010)

On August 5, 2010, China's Supreme Court published the *Provisions Regarding Hearing Cases of Disputes Involving Foreign-invested Enterprises (Part I)* (the "FIE Dispute Guidance"). The FIE Dispute Guidance clarify many important issues related to disputes involving foreign-invested enterprises (FIEs). Two key provisions of the FIE Dispute Guidance are summarized below.



Validity of Side Agreements

The FIE Dispute Guidance confirms that side agreements entered into by shareholders of an FIE but not approved by Chinese authorities are valid as long as such agreements do not make any "significant or material change" to the FIE contracts approved by Chinese authorities. "Significant or material change" is defined to include changes to the registered capital, corporate form, business scope, term of operation, subscribed capital contribution, for of contribution, merger, division and share transfer. The FIE Dispute Guidance marks the first time Chinese courts will recognize the validity of side agreements among FIE shareholders, which are usually entered into by shareholders to supplement joint venture contracts / articles of association, the latter but not the former are submitted Chinese authorities for approval. It is good news for private equity/venture capital firms that typically need to obtain special rights with respect to liquidation, share transfer, dividend and management, which may be challenged by the authorities if submitted for approval.

Nominee Shareholders

The FIE Dispute Guidance also confirms that an entrustment agreement entered into by an actual shareholder and a nominee shareholder is valid so long as such entrustment agreement does not involve any circumstance that gives rise to ground for invalidation pursuant to any law or administrative rule. Chinese courts will support an actual shareholder's claim to obtain the benefits received by the nominal shareholder from the FIEs even if the entrustment agreement does not include a benefits allocation clause. On the other hand, Chinese courts will also support the nominee shareholder's claim to receive compensation from the actual shareholder for serving as the nominee. Furthermore, according to the FIE Dispute Guidance, Chinese courts will not support the actual shareholder's claim for dividend

allocation directly from the FIE or appeal to the court to directly exercise shareholder rights.

Although the FIE Dispute Guidance is judicial interpretation and not legislation, they provide critical guidance and clarification for planning FIE arrangements and litigating FIE-related issues.

- *Provisions Regarding Hearing Cases of Disputes Involving Foreign-invested Enterprises (Part I)*
- 最高人民法院关于审理外商投资企业纠纷案件若干问题的规定（一）
- *Issuing Authority: the People's Supreme Court*
- *Date of Issuance: August 5, 2010 / Effective Date: August 16, 2010*



2. Foreign Exchange Control

China Relaxes Foreign Exchange Restrictions on Providing Overseas Security

国家外汇管理局关于境内机构对外担保管理问题的通知
(7/30/2010)

The State Administration of Foreign Exchange issued the *Circular of the State Administration of Foreign Exchange on the Administration of Overseas Security by Domestic Institutions* (the "Overseas Security Circular") at the end of July. The Overseas Security Circular simplifies the administrative procedures for obtaining overseas security, mitigates previous restrictions, and relaxes the restrictions on financing of

outbound projects.

While the Overseas Security Circular keeps in place the distinctive systems of quota balancing (applicable to banks) and case-by-case approval (applicable to non-bank institutions) for security provided to foreign parties, a new group of entities, i.e., certain qualified non-banking financial institutions and other enterprises, may also apply to SAFE for a quota for providing overseas security. Under the current regime:

- Quota balancing applies when domestic banks provide financing-type security (where the underlying principal contract is of financing nature, such as loan, bond issuance and lease) to foreign parties;
- No approval or quota balancing is required for domestic banks qualified to provide security to provide non-financing-type security (i.e., any security other than financing-type security, such as quality guarantee, tender bond and payment guarantee) to foreign parties;
- Case-by-case approval applies when domestic non-banking financial institutions and other enterprises provide security to foreign parties;
- Domestic non-banking financial institutions and other enterprises that frequently provide overseas security and have a sound internal management system in place may apply to SAFE for the granting of a quota for providing overseas security.

The Overseas Security Circular expands the universe of overseas debtors. The requirements debtors have to satisfy are summarized as follows:

- Where a bank provides overseas financing-type security, the debtor is not subject to any regulatory restrictions with respect to affiliation with domestic entities, ratio of net assets and profit performance, etc.;
- Where a bank provides overseas non-financing-type security, either the debtor or the beneficiary shall be a domestic PRC entity or a foreign entity established or directly or indirectly owned by a domestic PRC entity;
- Where non-banking financial institutions provides overseas security, the debtor shall be a domestic PRC entity or a foreign entity established or directly or indirectly owned by a domestic PRC entity;
- Where a non-financial-institution enterprise provides overseas security, the debtor shall be a domestic PRC entity or a foreign entity established or directly or indirectly owned by such enterprise;
- Where a non-banking financing institution or enterprise provides overseas security, the debtor shall have a positive net assets value and have been profitable for at least one (1) of the most recent three (3) years. Where the debtor is engaged in long-term projects such as resource development, it shall have been profitable for at least one (1) of the most recent five (5) years.

Last but not least, the Overseas Security Circular clarifies that WFOEs (wholly foreign owned enterprises) that are not otherwise qualified for quota-balancing administration shall be subject to case-by-case approval when providing overseas security.

- *Circular of the State Administration of Foreign Exchange on the Administration of Overseas Security by Domestic Institutions*

- 国家外汇管理局关于境内机构对外担保管理问题的通知

- *Issuing Authority: the State Administration of Foreign Exchange*

- *Date of Issuance: July 30, 2010 / Effective Date: July 30, 2010*

3. Private Capital Investment

China Encourages Private Capital Investment

国务院关于鼓励和引导民间投资健康发展的若干意见 (5/7/2010)



After foreign direct investment has been hit by the global economic slowdown, the PRC State Council issued the *Several Opinions on Encouraging and Guiding the Sound Development of Private Investment* (the "Private Investment Opinions") aimed at broadening the permissible investment scope of domestic private capital.

Private capital plays a critical role in the growth of the national economy. Although the State Council promulgated the *Several Opinions on Encouraging, Supporting and Guiding the Development of Individual and Private Economy and Other Non-Public Economy* in 2005, it failed to attract private capital out of their traditional industries such as manufacturing, trading, distribution, catering, and service.

Pursuant to the Private Investment Opinions, the government will encourage and guide private capital to invest in industries and industry sectors not prohibited by law, ranging from infrastructure development, public utilities, social undertakings, finance service, trade and distribution, to national defense technology and reform of state-owned enterprises.

The Private Investment Opinions require local governments to follow up with implementing rules to support the development of private capital.

- *Several Opinions on Encouraging and Guiding the Sound Development of Private Investment*
- 国务院关于鼓励和引导民间投资健康发展的若干意见
- *Issuing Authority: the State Council*
- *Date of Issuance: May 7, 2010 / Effective Date: May 7, 2010*

4. Tax

SAT Clarifies EIT Treatment in Enterprise Restructurings

企业重组业务企业所得税管理办法（7/26/2010）

The State Administration of Taxation (the “SAT”) promulgated the *Administrative Measures for Enterprise Income Tax Derived from Enterprise Restructurings* (the “Restructuring Measures”), which became effective retroactively as of January 1, 2010. The Restructuring Measures aim to clarify controversial issues and provide detailed guidance on the implementation of the *Notice on Several Issues of Enterprise Income Tax Treatment on Enterprise Restructuring Business* (the “Restructuring Notice”, CaiShui [2009] No. 59), promulgated by the Ministry of Finance and the SAT on April 30, 2009.

The Restructuring Measures clarify several important terms provided in the Restructuring Notice, such as parties to the restructuring, substantial operating assets, controlling enterprise, date of restructuring, assessment institution. For example, the parties in various restructuring business which are subject to enterprise income tax (“EIT”) treatment as follows:

- Debtor and creditor, in debt restructure transactions;
- Acquirer, assignor and target company, in stock acquisition transactions;
- Assignor and assignee, in asset acquisition transactions;
- Merging or consolidating enterprises, merged or consolidated enterprises and shareholders thereof, in merger or consolidation;
- Surviving enterprises, divided enterprises and shareholders thereof, in split-off.

All parties to the same restructuring transaction are required to adopt either ordinary tax treatment or special tax treatment (a type of tax-free reorganization) consistently.

The following enterprises applying general tax treatment should conduct liquidation according to the *Notice on Several Issues of Enterprise Income Tax Treatment on Enterprise Liquidation Business* (CaiShui [2009] No. 60):

- An entity qualified as a legal person is converted to sole proprietorships, partnership enterprises or other non-corporate organizations, or transfers its jurisdiction of organization outside of China (including Hong

- Kong, Macau and Taiwan);
- Enterprises that cease to exist in a merger or consolidation;
- Divided enterprises that cease to exist in a split-off.

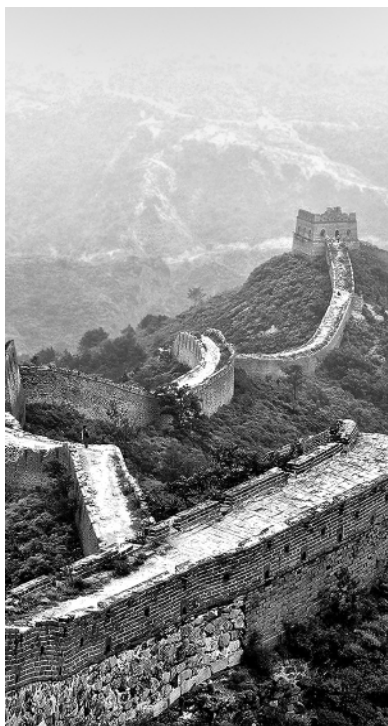
The Restructuring Measures also provide that parties to an enterprise restructuring eligible for and choose special tax treatment should file with relevant tax authorities when completing the annual EIT tax return of the current year. If the parties are uncertain about whether they are eligible for special tax treatment, the lead party (i.e., debtor in a debt restructuring, assignor in an equity acquisition or asset acquisition, proposed surviving party in merger, divided or surviving enterprise in a split-off) may submit an request to provincial tax authority for confirmation.

- *Administrative Measures for Enterprise Income Tax Derived from Enterprise Restructurings*
- 企业重组业务企业所得税管理办法
- *Issuing Authority: the State Administration of Taxation*
- *Date of Issuance: July 26, 2010 / Effective Date: January 1, 2010*

5. Tax

Guidelines for Tax Credit on Enterprise Income from Abroad

企业境外所得税收抵免操作指南(7/2/2010)



The State Administration of Taxation released the *Practical Guidelines for Tax Credit on Enterprise Income From Abroad* (the “Practical Guidelines”), effective retroactively as of January 1, 2010, to clarify certain provisions of the *Notice on Foreign Tax Credit with respect to Overseas Income Tax of Enterprises* (Caishui [2009] No. 125) (“Circular 125”) issued on December 25, 2009.

The Practical Guidelines cover the following topics:

(1) scope of application, (2) basic items in the calculation of tax credit on income from abroad, (3) calculation of taxable income from abroad, (4) verification of the income amount from abroad to be credited, (5) calculation of tax payment indirectly borne with respect to income from abroad, (6) calculation of equity ratio in the foreign company applicable to indirect tax credit, (7) verification of taxable amount applicable to tax spring credit, (8) calculation of tax credit ceiling, (9) calculation of the actual amount of tax credit, (10) simple method of credit calculation, (11) confirmation of the tax year corresponding to Chinese practice for overseas branch, (12) calculation of tax amount after tax credit, (13) definition of non-independent tax status, (14) treatment of income from Hong Kong, Macau and Taiwan, (15) application of priority under tax protocols, and (16) date of enforcement.

The Practical Guidelines provide that with respect to an overseas branch, the scope of reasonable expenses it incurs generally includes payroll, asset depreciation, interest, relevant tax payments, and management expense

allocated to such branch. Further, the Practical Guidelines distinguish losses incurred by an overseas branch as either actual loss or non-actual loss. Non-actual losses refer to losses incurred by an overseas branch that could not be made up with domestic or overseas gains of its parent entity due to restrictions on loss carry-forward imposed by Circular 125, and such losses can be carried forwarded for an unlimited time and can be made up with gains from projects in the same country/region.

- *Practical Guidelines for Tax Credit on Enterprise Income From Abroad*
- 企业境外所得税收抵免操作指南
- *Issuing Authority: the State Administration of Taxation*
- *Date of Issuance: July 2, 2010 / Effective Date: January 1, 2010*

6. Tax

SAT Clarifies Enterprise Income Tax Treatment of Losses Incurred in Equity Investments 关于企业股权投资损失所得税处理问题的公告 (7/28/2010)

The State Administration of Taxation released the *Announcement on Issues Concerning the Income Tax Treatment of Equity Investment Losses of Enterprises* (the "Investment Loss Announcement") late this July. The Investment Loss Announcement clarifies that losses incurred in equity investments by an enterprise shall be deducted once for all as losses of such enterprises in the year in which the confirmed losses occur. The Investment Loss Announcement became into effect as of January 1, 2010. Equity investment losses incurred by an enterprise prior to the promulgation of the Investment Loss Announcement and yet to be settled shall be deducted once for all in the year of 2010.

- *Announcement on Issues Concerning the Income Tax Treatment of Equity Investment Loss of Enterprises*
- 关于企业股权投资损失所得税处理问题的公告
- *Issuing Authority: State Administration of Taxation*
- *Date of Issuance: July 28, 2010 / Effective Date: January 1, 2010*

7. Tax

Duties and Import VAT Exempted for Major Science and Technology Special Project 关于科技重大专项进口税收政策的通知 (7/24/2010)

Five ministries and commissions under the State Council, including the Ministry of Finance and the State Administration of Taxation, jointly issued the *Circular on Tax Policies concerning Import under Major Science and Technology Special Project* (the "Import Tax Circular") on July 24, 2010.

According to the Import Tax Circular, key equipment (including software tools and technologies), parts and components, materials needed by projects that can not be produced domestically and that are imported with the financial allocation of the Central Government, local financial grant, self-raised funds or funds obtained through other channels by enterprises, colleges and universities, scientific research institutes and other public institutions that undertake major scientific and technological special projects (hereinafter referred to as project undertaking entities) under the *Outlines of the National Guideline on Medium-and Long-Term Planning for Science and Technology Development (2006-2020)* shall be exempt from import duties and import value-added taxes from July 15, 2010.

The major scientific and technological special projects mentioned above refer to major civilian scientific and technological special projects as listed in the *Outlines of the National Guideline on Medium-and Long-Term Planning for Scientific and Technological Development (2006-2020)*, including core electronic devices, high-end generic chips and basic software products, super large-scale integrated circuit manufacturing equipment and associated technologies, new-generation broadband wireless mobile communication network, high-end numerically controlled machine tools and basic manufacturing equipment, development of large oil-gas fields and coal-bed methane, large advanced pressurized water reactors and high temperature gas-coolant reactor nuclear power stations, water body contamination control and treatment, breeding of new genetically modified varieties, development of new significant drugs, prevention and treatment of major infectious diseases such as HIV/AIDS and viral hepatitis.

The equipment, parts and components, and materials with respect to which a project undertaking entity applies for tax-free import shall meet the following requirements:

1. They shall be directly used in scientific and technological research, technological development and application in connection with the project, and the imported quantity shall be within a reasonable range;
2. They can not be produced domestically or domestically produced substitutes cannot meet the technical specifications and are more costly to be produced domestically; and
3. The major technical specifications of such equipment shall generally be superior to those of the equipment listed in the *Catalog of Commodities Imported with no Tax Exemption for Domestic Investment Projects*.

- *Circular on Tax Policies concerning Import under Major Scientific and Technological Special Project*

- 关于科技重大专项进口税收政策的通知

- *Issuing Authority: the State Administration of Taxation, Ministry of Finance, Ministry of Science and Technology, General Administration of Customs, National Development and Reform Commission*

- *Date of Issuance: July 24, 2010 / Effective Date: July 15, 2010*

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