ISBN 978-92-64-05366-3
OECD Investment Policy Reviews: China 2008
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Executive Summary

China's regulatory framework for investment has been developed further since 2006

The OECD reviews the five landmark laws and sets of regulations promulgated since the publication of the 2006 *OECD Investment Policy Review of China*. It finds that these changes improve the tax and competition elements of the regulatory environment within which businesses, including foreign-owned enterprises (FIEs), operate in China, but tighten restrictions on inward direct investment, including cross-border mergers and acquisitions. The review also takes stock of developments in China's inward and outward FDI statistics methodology.

China's increasing outward investment is prompting calls for responsible behaviour

China has been rapidly becoming an important source of outward foreign direct investment (OFDI) in recent years. Government policy was initially the main determinant of OFDI, but it is now increasingly driven by commercial motivations. In the context of China's growing role as an investor in Africa in particular, concerns over China's investment behaviour are being raised and Chinese enterprises are under increasing pressure to be more responsible global players.

China is adopting policies to encourage responsible business conduct (RBC)

The OECD supports the Chinese government's efforts to promote high standards of corporate behaviour and develop further the framework conditions that enable responsible business conduct (RBC). The Chinese authorities are striving to ensure corporate compliance with laws relating to RBC and are also promoting RBC in overseas operations of Chinese enterprises. China has signed and ratified international agreements relevant to promoting RBC. Chinese companies are seeking to learn about RBC standards.

More can be done to encourage RBC

While the Chinese government has made efforts to encourage responsible business conduct, many Chinese enterprises are still largely unaware of what RBC entails and have not organised themselves to promote it. The lack of co-ordination of government agencies' approaches hinders communication of the government's expectations to Chinese companies. The OECD offers policy options to help implement at local level legislation and regulations establishing framework conditions for responsible business conduct.

China has made progress, but still faces challenges, in encouraging environmental RBC

China's rapid economic growth has been accompanied by negative environmental impacts. The Chinese government has accelerated its efforts to develop the legal framework and standards for environmental protection. The OECD offers policy options to meet the formidable challenges faced by the Chinese authorities in enforcing and implementing these.

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Chapter 1

Recent Developments in China's Investment Policies

This chapter assesses the extent to which China's legal and regulatory framework for investment has been improved since the the publication of the 2006 OECD Investment Policy Review of China, *including new cross-border mergers and acquisitions regulations, the Enterprise Income Tax Law, the Property Rights Law, the Anti-Monopoly Law and the latest revision of the Catalogue for Guiding Foreign Investment Industries.*

Overview

Five landmark laws and sets of regulations have been promulgated since the publication of the 2006 *OECD Investment Policy Review of China*: expanded regulations on cross-border mergers and acquisitions; an Enterprise Income Tax Law that sets a single tax rate for domestic and foreign-owned enterprises; a Property Law giving equal protection to private and public property; the People's Republic of China's first Anti-Monopoly Law; and a third revision of the Catalogues for Guiding Foreign Investment Industries.

The overall effect of these measures is to add essential building blocks to the regulatory structure within which businesses, including foreign-owned enterprises (FIEs) operate in China, especially the new laws on property and competition. The unification of business tax rates is positive in that it increases incrementally the transparency of the tax regime for domestic and foreign investors, as, in some ways, do the new cross-border M&A regulations. Similarly, the Anti-Monopoly law fills a major gap in China's competition legislation; it does not discriminate between domestic and foreign-invested enterprises except insofar as it allows for a national security review to be applied to the latter. On the other hand, an opportunity appears to have been missed in regard to the Foreign Investment Catalogues, which remain less than wholly transparent. The revised M&A regulations, which in other respects provide the potential for increased transparency, also introduce an extra and opaque screening barrier to cross-border acquisitions.

1. Current trend of FDI inflows

China's policies towards FDI are developing as a response to the new situation in which the country finds itself after nearly three decades of openness towards foreign investment and trade. China remains the largest recipient of FDI among developing countries (see Table 1.A2.1), a position it attained in the 1990s. The challenge perceived by the Chinese government is no longer one of simply attracting FDI, but rather one of meeting the needs of a rapidly developing economy. The result is a more selective approach, as is evident in the revised Catalogues for Guiding Foreign Investment Projects. This selectivity is made more affordable now that the economy has become less dependent on FDI as economic growth, largely driven by domestic investment, has accelerated. This decreased dependence on FDI has also allowed a further move toward full national treatment with the ending of the

special tax regime for foreign investment. As the trend in FIEs away from Sino-foreign joint ventures towards wholly-foreign-owned enterprises has continued, and as FIEs have maintained their dominance of China's export trade, fears of foreign investment have been voiced on behalf of domestic business in recent years. In response to such fears, and to perceived negative reactions abroad to China's own overseas investments, broadly-defined national security concerns are being included in new legislation.

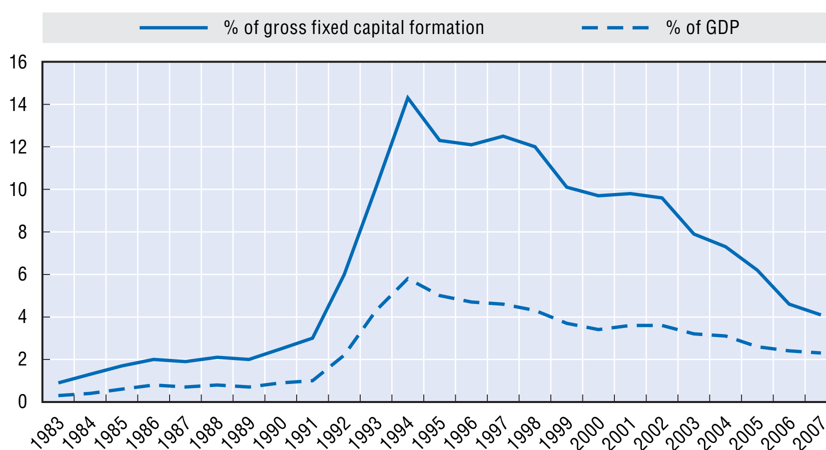
1.1. FDI inflows continued to increase in 2006 and 2007

Total FDI inflow rose from USD 60.3 billion in 2005 to USD 69.5 billion in 2006 and USD 82.7 billion in 2007, measured in terms of value of actually utilised investment (Table 1.A2.2). Non-financial FDI reached USD 65.8 billion in 2006 and USD 74.8 billion in 2007 (figures for financial and non-financial FDI were not published in earlier years).

1.2. FDI inflows are a declining proportion of fixed investment and GDP

Economic growth has been more rapid than FDI inflow growth, so the shares of FDI in gross fixed capital formation and GDP have fallen to 4.1% and 2.3% respectively after peaking in 1994 at 14.3% and 5.8% (Table 1.A2.3). FDI has always accounted for a minority of capital formation in China (Figure 1.1). As noted in earlier reviews, China has throughout the period of economic reform enjoyed a high saving rate which has enabled it to finance fixed investment from domestic resources.

Figure 1.1. **FDI inflow as % of capital formation and GDP**

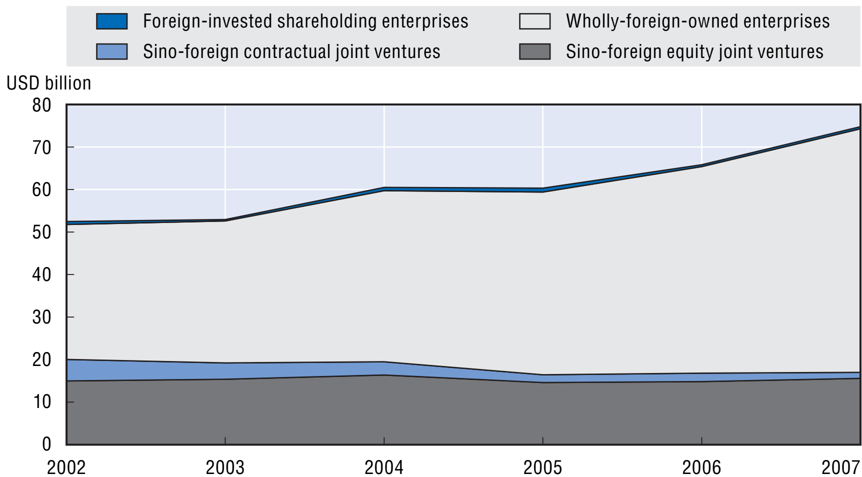


Source: OECD calculations from National Bureau of Statistics GDP data and MOFCOM FDI statistics.

Wholly-foreign-owned enterprises have continued to increase their dominance in non-financial FDI, rising from 60% of inflow value in 2002 to 76% in 2007. The share of joint ventures, both equity and contractual, which predominated in the 1980s and 1990s, continued to contract, respectively from 29% to 21% and from 10% to 2% in 2002-07 (see Figure 1.2). With improvement and maturing of the business environment, foreign investors, many of whom now have long experience of operating in China, have become less dependent on local partners.

Figure 1.2. **FDI inflow by type**

Non-financial FDI only



Source: MOFCOM yearbooks and FDI website *www.fdi.gov.cn*.

The largest source of China's FDI remains Hong Kong, China (Table 1.A2.5), although it remains uncertain how much of these inflows originates in Hong Kong, China itself, how much is pass-through FDI from other sources such as OECD countries using the territory as a convenient base for operations in China, and how much is "round tripping" capital from China taking advantage of tax incentives available there because Hong Kong, China is treated as a separate customs territory from the rest of China. The removal of these incentives is dealt with below in the section on the unified business tax. The proportion of FDI recorded as emanating from Hong Kong, China has been in secular decline since the 1980s, when it ranged between two-thirds and three-quarters of the total, but is now stable at around one-third and in 2007 the proportion rose to 37.1% of actually utilised FDI from 32.4% in 2006 as FDI from other major providers, including the EU, Japan, Korea, and the United States, fell in absolute as well as relative terms.

A major difficulty in calculating inflows from major sources remains the high proportion of FDI routed through tax havens. In 2007, there was a sharp increase in such inflows coming through Mauritius, the Cayman Islands, the British Virgin Islands and Samoa, which together accounted for 29.2% of the global total. The British Virgin Islands alone contributed 22.1%, more than combined recorded FDI inflows to China from Europe, North America and Japan. Recent co-operation between the OECD and China on improving the international comparability of China's FDI statistics is dealt with in the next chapter.

2. Regulations on the acquisition of domestic enterprises by foreign investors effective from 2006[1]

The OECD's 2003 and 2006 *Investment Policy Reviews of China* recommended more open policies towards cross-border mergers and acquisitions (M&As). The 2006 *Review* analysed *inter alia* the *2003 Interim Provisions on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors*, hitherto the most comprehensive set of regulations on cross-border M&A. It welcomed the additional transparency they brought and proposed further measures to liberalise cross-border M&A regulations, including: further relaxation of foreign ownership restrictions; increased regulatory transparency; adopting internationally-standard and transparent merger notification procedures; further improving corporate governance; and fully opening capital markets to foreign investor participation.

On 8 August 2006, the Ministry of Commerce (MOFCOM) announced a new set of *Regulations on the Acquisition of Domestic Enterprises by Foreign Investors* (hereafter the 2006 *Regulations*), to take effect on 8 September 2006.

The new policy towards cross-border mergers and acquisitions is explained in the 11th five-year plan for utilising foreign investment, announced by the National Development and Reform Commission (NDRC) on 9 November 2006.[2] This states that priority will be given to quality rather than quantity of foreign investments, that emerging monopolies by foreign-invested enterprises are posing a potential threat to China's economic security and that foreign businesses are harming Chinese enterprises' capacity for independent innovation. The plan sets forth a clear industrial policy prioritising geographical areas, industrial sectors, levels of technology, environmental protection and efficient use of natural resources. In response to perceived rising concern over foreign acquisitions of leading Chinese firms in critical sectors (so-called "dragon head" enterprises), the plan provides for increased supervision of sensitive acquisitions to ensure that what are termed "critical industries and enterprises" remain under Chinese control and to prevent the "abuse of intellectual property".

2.1. Foreign investors may use shares to pay for Chinese companies

The 2006 *Regulations* represent a further opening toward cross-border mergers and acquisitions (M&As) in line with standard international practice in that they allow for the first time the acquisition of equity interests held by shareholders of a Chinese domestic company by payment of equity interests held by shareholders of an overseas company or new shares issued by an overseas company.

The 2006 *Regulations* increase corporate transparency by requiring parties to a cross-border acquisition to disclose whether or not they are affiliated with each other and, if they are under the common control of the same entity, to provide additional information regarding the purpose of the acquisition and whether the appraisal results conform to fair market value. They also make specific and detailed provision for the use of special-purpose entities overseas by Chinese domestic firms making acquisitions in China – an important addition in view of the generally unrecorded but widespread practice of "round-tripping" by Chinese companies seeking to benefit from incentives offered to foreign investors.

2.2. The Regulations add a new screening requirement for cross-border M&A transactions

On the other hand, the 2006 *Regulations* add a new screening requirement on cross-border M&A transactions in which the foreign investor obtains controlling rights of a domestic enterprise if the acquisition: involves a major industry; has or may have an impact on national economic security; or may result in the transfer of famous trademarks or traditional Chinese brands.

The lack of definition of terms including "major industry", "impact" on "national economic security", "famous" trademarks and "traditional" Chinese brands appears to render the new screening requirement less than wholly transparent. Foreign investors seeking to merge with or acquire domestic Chinese enterprises, the domestic enterprises targeted for merger or acquisition, and the Chinese government agencies charged with implementing the new regulations may not have enough information to be able to apply these terms to an actual transaction. Pending the publication of detailed implementing regulations, if any, the new screening process may have a serious unintended discouraging effect on investments.

The new screening measures covering cross-border acquisitions which have or may have an impact on "national economic security" appear to go beyond measures to safeguard essential security interests.[3] This also raises an issue of compatibility with international commitments.

Since the extra layer of screening is added after the merger or acquisition, it amounts to an *ex post* restriction which can substantially impede the stability of cross-border merger or acquisition transactions.

"Famous trademarks" can be certified by a People's Court and also by Chinese administrative agencies, including the Trademark Office of the State Administration for Industry and Commerce (SAIC). Since People's Court certifications are not listed publicly, it is difficult for foreign investors to see whether a trademark falls into the category of "famous trademarks". It is not usual for developed countries to restrict cross-border mergers or acquisition by reason of "famous" trademark or "traditional" brands.

The creation of a new layer of screening is in addition to the examination and approval process based on the *Catalogues for Guidance of Foreign Investment Industries,* which the Chinese authorities have been invited in both the 2003 and 2006 OECD *Reviews* to make more transparent and eventually replace with a closed list. It does not appear consistent with the repeatedly expressed intention of the Chinese authorities to streamline foreign investment approval procedures.

The law concerning the control of strategic investment in listed companies by foreign investors was promulgated on 31 December 2005 and came into force on 30 January 2006. This law provides the relevant procedures for merger and acquisition of domestic listed companies by foreign investors. However, the relationship between the 2006 *Regulations* and this law is unclear, and therefore it remains uncertain whether the 2006 *Regulations* should be applied to a foreign investor merging with or acquiring a Chinese listed company.

2.3. Merger notification discrimination against foreign investors has been retained

The OECD's 2006 *Review* also noted that "the 2003 *Interim Provisions* contain regulations on premerger notification that appear to discriminate against foreign investors and others that are based on unquantifiable pre-merger notification thresholds". The *Review* welcomed the Chinese government's intention to promulgate a non-discriminatory anti-monopoly law and meanwhile recommended changes to the merger notification procedures in the 2003 *Interim Provisions* to increase their transparency. It was understood informally from the Chinese authorities that they intended to replace the discriminatory merger notification procedures in the 2003 *Interim Provisions* with a merger notification procedure in the anti-monopoly law that did not distinguish between domestic enterprises and foreign investors. This reassurance was needed in view of recent calls from some officials for the new anti-monopoly law to block undesirable cross-border acquisitions, following a

report by the State Administration for Industry and Commerce (SAIC) in 2004 that foreign companies were building monopolies in China (an allegation that MOFCOM has since publicly refuted).[4] The merger notification procedures in the 2006 *Regulations* do not reflect the OECD's recommendations and are essentially the same as those in the 2003 *Interim Provisions*. The new Anti-Monopoly Law does not in general discriminate against foreign-invested enterprises (see Section 3 on the law below), so it remains to be determined to what extent the provisions of the 2006 *Regulations* on merger notification procedure still apply and whether or not they will be rescinded.

Drawing on practices which OECD members have also encouraged each other to adopt, policy options for consideration include:

- Clarifying the conditions of application of the new screening procedures, in particular by listing sectors qualifying as "major industry", defining "national economic security" and "impact", and explaining the criteria for identifying "famous" trademarks and "traditional" Chinese brands.
- Reducing the number of stages required in examination and approval procedures. The 2006 *Regulations* appear to introduce new complexities to the examination and approval process for cross-border M&As. Any implementing regulations adopted to clarify the 2006 *Regulations* would be more encouraging to investment in China if they moved in the direction of greater transparency, clarity and simplicity.
- Using existing remedies which may be less restrictive than the additional procedures in the 2006 *Regulations* while still achieving the legitimate objectives which may underpin the introduction of the new screening process.
- Reconsidering the merger notification procedures in the 2006 *Regulations* in the light of the 2006 *OECD Investment Policy Review*, including the possibility of rescinding them to ensure consistency with the new Anti-Monopoly Law.

2.4. SASAC December 2006 Directive on "strategic" industries

The State Assets Supervision and Administration Commission (SASAC) in December 2006 issued a *Guiding Opinion Concerning the Advancement of Adjustments of State Capital and the Restructuring of State-Owned Enterprises*.[5] The Opinion recommended that state-owned capital be concentrated in "major industries and key areas", defined to include "industries involving national security, significant basic infrastructure and major mineral resources, industries supplying important public goods and services, and major backbone enterprises in 'pillar' industries and high and new technology industries". The industries referred to are not further defined in the *Opinion*, which makes reference to generalised national security concerns, but in presenting it to the media, SASAC Director Li Rongrong said that central state-owned enterprises (SOEs) in electrical power and distribution, oil and

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chemicals, telecommunications and armaments should either be solely owned by the state or else the state should have a majority shareholding, while the state must always have a controlling stake in coal, aviation and shipping SOEs. At the same time, he said, central SOEs in the downstream oil and chemical sector and in value-added telecommunications services could continue to bring in private or foreign capital.[6] Mr. Li also proposed that central SOEs should become dominant in other sectors, including machinery, automobiles, information technology, construction, iron and steel, and non-ferrous metals.[7]

2.5. Implicit restrictions on FDI in industrial equipment manufacturing

In January 2007, the Chinese government responded to the State Council's earlier *Opinions on Revitalisation of Industrial Machinery Manufacturing Industry* (which proposes encouragement of an increase in the market share of domestic enterprises in 16 sectors) by announcing preferential import tax incentives to "raise the core competitiveness and capacity for independent innovation of domestic industries". These incentives include refunds of previously levied import tariffs and value-added taxes for key parts and accessories imported for development and manufacture of such equipment. The refunded money is to be used as "national investment in research and development of new products and the cultivation of capacity for independent innovation". The Ministry of Finance is charged with deciding which enterprises meet the conditions for such refunds. The refunded money is to be transferred to "national capital", *e.g.* SOEs take the refund as registered capital, while enterprises without state-owned shares shall have the state-owned assets operation company authorised by local government hold the shares.[8]

3. Enterprise Income Tax Law effective from 1 January 2008[9]

On 16 March 2007, the National People's Congress promulgated an Enterprise Income Tax Law[10] which for the first time applies to all enterprises established in China, regardless of whether they are domestic or foreign-owned. This law replaces the Foreign-Invested Enterprise Income Tax Law[11] and the Interim Enterprise Income Tax Regulations[12] that applied to domestic enterprises.[13]

Enterprises are divided in the new law into resident and non-resident enterprises. Resident enterprises are those established in China, or established in accordance with the law of a foreign country (region) but having their actual administrative institutions in China. Non-resident enterprises are those established outside China but with organisations or establishments in China, or else having organisations or establishments outside China that

derive income from China. Resident enterprises are taxed on their worldwide income, non-resident enterprises only on their income from within China.

The Enterprise Income Tax Law, by setting a single 25% tax rate for all resident enterprises without distinguishing between domestic and foreign ownership,[14] ends the uncertainty that has surrounded this policy since China's accession to the WTO at the end of 2001 and establishes a level playing field for all enterprises in regard to taxation of income.

Up to end-2006, foreign-invested enterprises (FIEs) paid an average of 15% of their income in enterprise income tax, while domestic enterprises paid on average 25%. The standard concessions for an FIE included top income tax rates of 15% and 24% (depending on factors such as location) which only came into effect in a company's sixth full year of profit-making after a two-year tax holiday and three years at half-rate tax. Further concessions were available in certain sectors and locations. Domestic companies were subject to a standard enterprise tax rate of 33%, mitigated by sectoral and regional incentives. Domestic low-profit enterprises were levied tax at rates of 27% and 18%.[15]

The new law sets a standard rate of enterprise income tax of 25%,[16] regardless of whether the enterprise is Chinese or foreign-owned. The statutory tax rate has therefore been reduced by eight percentage points for domestic enterprises and increased by ten or two percentage points for FIEs. The effective tax rate for domestic enterprises will also fall significantly with the lifting of the previous restriction on the tax deduction for wage expenses. The Chinese authorities calculate that the result will be CNY 41 billion more paid in enterprise income tax by FIEs in 2008, after the law has come into force, while domestic companies will pay CNY 134 billion less, so total revenue from enterprise income tax is expected to be CNY 93 billion lower than if the law had not been enacted.

The new law is in line with the recommendation of the OECD's Investment Committee and Committee on Fiscal Affairs that China attract FDI by enhancing the regulatory framework for investment rather than by offering fiscal and other preferential incentives to foreign investors. The OECD's *2003 Investment Policy Review of China: Progress and Reform Challenges* cautioned against excessive reliance on special incentives to attract FDI as a substitute for establishing a broad enabling environment for investment characterised by openness, non-discrimination, transparency and effective rule of law.

The 2003 *Review* also stressed that the main concern of FIEs is to ensure that concessions already extended will not be revoked retroactively, but protected by grandfather clauses. The 2007 Enterprise Income Tax Law addresses this concern expressed in the Review by not including any retroactive rate change and phasing the increase to 25% for existing FIEs over a five-year transition period,[17] so that they can adapt gradually to the new rate.

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As pointed out in the preceding section, the August 2006 Regulations on the Acquisition of Domestic Enterprises by Foreign Investors make provision for checking on the use of special-purpose entities overseas by Chinese domestic firms making acquisitions in China. This as an important addition in view of the generally unrecorded but widespread practice of "round-tripping" by Chinese companies seeking to benefit from incentives offered to foreign investors.

By eliminating incentives for foreign investors in the Enterprise Income Tax Law, the Chinese government has now removed the motivation for round-tripping, which can be expected to dwindle rapidly. As a result, China's FDI statistics are likely to become more accurate, since they will no longer include an unknown proportion of investment that is really domestic investment disguised as foreign investment. Another beneficial outcome will be increased tax revenue resulting from the closing of this tax evasion loophole.

The removal of fiscal incentives for foreign investors will not remove incentives offered to investors in less-developed regions such as Western China and the Special Economic Zones and into sectors the government wishes to promote, such as environmental protection and renewable energy. As these incentives are non-discriminatory between foreign and domestic investors, they do not detract from the level playing field which the Chinese government is promoting by unifying the general enterprise income tax rate. For example, enterprise income tax for small-scale enterprises that meet certain conditions is 20%, and 15% for state-encouraged high-technology and new technology enterprises.[18]

The new law also increases the transparency of China's tax regime by bringing all enterprises within the scope of a single law.[19] Previously, FIEs were governed by the 1991 Income Tax Law of the People's Republic of China for Enterprises with Foreign Investment and Foreign Enterprises while domestic enterprises were governed by the 1993 Provisional Regulations of the People's Republic of China on Enterprise Income Tax. The Enterprise Income Tax Law is a step towards simplification of the plethora of tax legislation affecting FIEs in China. The promised further standardisation of non-discriminatory regional and sectoral tax incentives will also contribute to fulfilment of this objective.

Stronger measures in the new law to deal with tax avoidance, including provisions relating to transfer pricing, are broadly in line with OECD norms.[20] FIEs currently reportedly have a higher tax compliance rate than domestic Chinese enterprises, and multinational corporations operating in China which are based in OECD member countries are encouraged to comply with the *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* and with the *OECD Guidelines for Multinational Enterprises*.

According to official figures, FIEs have paid more than USD 200 billion in tax since the 1990s and now account for 4.1% of total tax revenue. In encouraging increased tax compliance by domestic enterprises, these measures will therefore contribute to a more level playing field.

The Enterprise Income Tax Law is likely to stimulate longer-term investments by large multinational enterprises. The prior tax incentive regime encouraged the establishment of short-term investment projects that could be shut down at the end of the tax holiday and replaced by similar short-term investments. The limited evidence available suggests that small and medium-sized foreign investors were more likely to be attracted by tax incentives than large multinationals.[21] The new law is therefore likely to lead to more stable inward direct investment.

Exemptions or deductions are available for income from: projects in agriculture, forestry, animal husbandry and fishery; major public infrastructure investment projects supported by the state; environmental protection, and energy and water conservation, projects; transfer of technology. Qualifying small-scale enterprises enjoy a reduced rate of 20% and state-encouraged high and new technology enterprises 15%. Governments in minority regions may reduce or exempt taxes for local enterprises.

Deductions are available to encourage R&D; employment of disabled workers; venture capital investment; technological upgrading; comprehensive resource utilisation; and the manufacture of specialised equipment for environmental protection, energy and water conservation, or production safety. The new Law gives the State Council powers to formulate special enterprise income tax incentives if "national economic and social development needs so require" or if an emergency seriously affects the business operations of enterprises. The granting of significant discretionary authority in the granting of tax incentives raises concerns over the provision of rent-seeking opportunities.

The Enterprise Income Tax law contains provisions to prevent or compensate for tax loss resulting from violation of transfer pricing norms. The tax authority may make adjustments based on reasonable methods for business transactions between an enterprise and its affiliates that are not in conformity with the arm's length principle and thus result in reduced taxable revenue or income for the enterprise or its affiliates. When an enterprise files its annual income tax returns with the tax authority, it must enclose an annual report on related party transactions, and it must provide relevant information to an investigation of related party transactions by the tax authorities.

Chinese officials appear to be concerned about the possibility that some foreign investment may be discouraged by the removal of tax incentives, and that consequently there is a need to improve the business environment

further to attract continued FDI inflows. Proposed measures include strengthening the rule of law, reinforcing infrastructure, investing in human capital and better protecting intellectual property rights.[22]

On 27 February 2008, the State Administration of Taxation (SAT) issued a circular on How to Deal with Related Issues after Cancellation of Several Previous Tax Preferential Policies on Foreign-Invested Enterprises and Foreign Enterprises.[23] The circular allows a foreign investor to apply for a tax refund on direct re-investment of post-tax profit to increase registered capital or set up another foreign-invested enterprise, provided the investment was completed before the end of 2007 and was not made with profit earmarked for distribution. It also allows income tax exemption on income obtained by a foreign enterprise from transfer of know-how or allowance of credit to China if the contract was signed before the end of 2007. Finally, the circular specifies that a foreign-invested enterprise enjoying tax reductions or exemptions for a set period will have to refund the tax exempted or reduced if the nature of its production or the length of its business operation changes after 2008, if, as a result of such change, it no longer meets the original legal conditions for preferential treatment.

4. Property Rights Law effective from 1 October 2007[24]

The Property Rights Law of the People's Republic of China was promulgated on 16 March 2007 and became effective on 1 October 2007 (Article 247). It enshrines in law, and elaborates in detail, the landmark change to China's state constitution in 2004 to include protection of private property. This is a welcome step forward in establishing a firm basis for the protection of investors, both domestic and foreign.

The Property Rights Law for the first time since the establishment of the People's Republic of China establishes private property rights, which are granted equality with state and collective property rights. This major innovation was hard fought during the drafting stage by opponents who claimed that this would change the country's socialist system and by those who were concerned that it would legitimate previous seizures of state-owned property by officials. It opens the way to legal actions by private individuals and other non-state actors such as companies to protect their rights, which are enumerated in detail in the new law. However, to ensure that the law was passed, a number of areas – including modalities of legal redress – have been left vague. These lacunae remain to be filled by other regulations and perhaps by an amended version of the Property Law following a review of initial implementation experience.

As is to be expected in a law designed to fit the "primary stage of socialism", public ownership is assigned a "dominant role", with "diverse

forms of ownership" (code for private and other forms of non-public ownership) developing side by side with it. The law states that the State shall develop the public sector while at the same time encouraging, supporting and guiding the development of non-public sectors of the economy. This is interpreted to mean that the State must ensure "equal legal status and right for development of all market players", meaning that private property rights are as strong as public property rights (Article 3). The law states explicitly that the property rights of the State, collectives, individuals and others are protected by laws and may not be infringed (Article 4). At the same time, the attainment and exercise of property rights must accord with law and social morality and not harm the public interest or the legitimate rights and interests of others (Article 7).

Real property rights may only be exercised after registration (Article 9). Ownership is confirmed by first registration, regardless of who first signed the contract of sale. The Property Law states that registration must be done in the registration department of the place where the property is located and that there must be a unified registration system (Article 10). When this is implemented, it will simplify and clarify the existing system of multiple registration. Potential purchasers, for example, will only have to go to one land register to check ownership of a property.

To avoid multiple sales of the same property, notice must be filed of pending registration when agreement is reached on a transaction. Once this has been done, no other transaction may be completed without the consent of the original parties. Such notice lapses automatically after three months (Article 20).

An interested party may apply to correct a registry entry if he/she considers it to have been wrongly entered. If the other parties involved agree, or if there is evidence to prove that a mistake has been made, the entry is corrected in writing. If the other party does not agree, then the applicant may file a suit within 15 days of registering opposition to the register entry. If opposition registration is judged inappropriate, the person affected may claim damages from the applicant (Article 19). Any party providing false materials for registration bears responsibility for compensating anyone who is harmed as a result. The registration department itself is also liable to pay compensation for damage caused as a result of mistakes in registration (Article 21).

Infringement of property rights may be handled by pacification, mediation, arbitration or litigation (Article 32). Where property rights are found to have been infringed, the affected party may request that any encumbrance or hazard be removed (Article 35). Where real or movable property is damaged, the obligee may request repair or restoration (Article 36). Where the obligee suffers from infringement done to property rights, he or she

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may claim damages and request that the infringing party bear other civil liabilities (Article 37). Interested parties may request affirmation of property rights when disputes arise over ownership (Article 33). If people without ownership rights take possession of real or movable property, the obligee has the right to request that the property be returned (Article 34).

State ownership is inviolate: no institution or individual is allowed to obtain the ownership of property owned exclusively by the State (Article 41). Collectively-owned land, houses and other real property owned by institutions or individuals may be expropriated according to law for public interest purposes. Compensation appropriate to the category of ownership shall be paid; for example, when a residence is expropriated, the residential conditions of the expropriated person(s) shall be guaranteed. Compensation may not be withheld, misappropriated or embezzled (Article 42).

Special protection is accorded to agricultural land. The transfer of agricultural land to construction land is limited so as to control the quantity of construction land. No expropriation of collectively-owned land in violation of authority and legal procedures shall be allowed (Article 43).This clause addresses the widespread practice of illegal land seizure from the farmers by officials for purposes of constructing factories or housing.

Expropriation of property is allowable under the Property Law for purposes of emergency handling or disaster relief. In such cases, property shall be returned to the owner after such expropriation or, if the property is damaged or lost, compensation for it shall be made (Article 44).

The state owns mineral resources, land, natural resources (*e.g.* forests, mountains, grassland, unclaimed land and beaches) except for those that are specified as collectively-owned, water and sea areas, specified wild animals and plants, the radio spectrum, specified cultural relics, national defence resources, specified public facilities (*e.g.* railways, roads, electric power, communications and gas pipelines).[25]

Collectively-owned properties include lands, forests, mountains, grasslands, unclaimed land and beaches; collectively-owned buildings, production facilities, cultivated land and hydropower facilities; collectively-owned education, science, culture and health facilities (Article 58).

Individuals enjoy ownership of real and movable property such as legitimate income, houses, living goods, production tools and raw materials (Article 64). Their lawful savings, investments and returns are protected by law. Inheritance is also protected (Article 65).

The state, collectives and individuals may contribute to the establishment of a limited liability company, joint stock limited company or other enterprises (Article 67). The enterprise as a legal person has the right to possess, utilise, obtain benefit from and dispose of its real and movable

properties in accordance with laws, administrative regulations and its articles of association (Article 68).

The Property Law sets out in considerable detail the rights and responsibilities of owners and residents of shared residential accommodation (Articles 70-83) and of neighbours (Articles 84-92).

Now that housing reform has allowed residents of apartment blocks to own their own properties, it is important to specify rights and duties with regard to such matters as the maintenance of jointly-owned parts of buildings, the protection of building security, the ownership of public sites including roads and fields within apartment buildings and the apportionment of parking spaces.

The law also stipulates that users of property should respect the interests of neighbours in regard to such matters as water supply and drainage, electricity, heating and gas supply; the use of land for passage to the neighbour's property; ventilation, view and lighting. In particular, a user may not discharge pollutants, including not only air pollution, water pollution and solid waste, but also harmful noise, light or magnetic wave radiation (Articles 94-113). Since it is common practice for developers to carry out construction work with scant regard for side-effects, this clause is likely to be the basis for frequent litigation.

Where real or movable property is transferred to a transferee by a person without the power to do so, the rightful owner has the right to recover the property. The procedures to be followed in such cases are specified in detail (Articles 106-107), as are those for dealing with lost property (Articles 109-113).

Since all land and water are owned by the state, it is important to provide detailed specification of user rights so that those who have gained such rights lawfully may pursue their activities without hindrance. The Property Rights Law does this in Part III (Articles 117-169).

The Property Law guarantees the continuance of arrangements dating back to the beginning of the reform period in the early 1980s under which rural households lease land from collectives, explicitly stating the right of the contractor to possess, utilise and obtain profits from farmlands (for a renewable term of 30 years), forests (30-50 years) and grasslands (30-70 years), and to engage in crop farming, forestry and animal husbandry.

The right to use land for construction also includes possession, use and obtaining profits, as well as the right to build buildings and related facilities. The right to use of land for construction may be assigned or transferred, with strict regulation of transfer. Land used for industry, commerce, tourism or entertainment must be assigned by auction or invitation to bid. The purpose of land use may not be changed without official approval. The land use rights owner owns the buildings and related facilities, unless there is evidence to the

contrary. Land use rights for construction use may be used as a capital contribution.

Where land is used for building houses, the lease is automatically renewed upon expiry. Land use rights for other purposes may be renewed if the parties agree. The owner of land use rights for residential housing has the right to build houses on the land, except in the case of the destruction or loss of such land as a result of a natural disaster, in which case the authorities have to find new residential housing land to which to relocate residents.

Chapter XVI of the Property Rights Law covers the right to mortgage (Articles 179-207). Detailed provisions covering mortgage are important because of the large number of households buying their residences as a result of housing reform and because of the need for varied forms of finance needed to support the development of small businesses in a rapidly growing economy. The right of pledge, covered by Chapter XVII (Articles 208-240), is also important in an economy with a developing variety of credit requirements.

However, there may be cases in which investors have acquired land and/or other assets from local governments which the latter are now discovered to have acquired illegally, creating uncertainty for the continuing operation of the enterprises concerned.

5. Anti-Monopoly Law[26]

In the 2003 *OECD Investment Policy Review of China*, the OECD proposed that China's competition policy could be further enhanced by combining and developing the various fragmentary and dispersed policy initiatives of different ministries and departments into a coherent policy that provides a sound, transparent and non-discriminatory framework for competition. It also pointed out that such a policy might well be made concrete in specific laws, formulated in a transparent manner to ensure consultation of all stakeholders, including foreign investors.

The Anti-Monopoly Law of the People's Republic of China was adopted at the 29th session of the Standing Committee of the 10th National People's Congress on 30 August 2007,[27] coming into force on 1 August 2008 (Article 57). The drafting process was long, having begun in the mid-1990s. In the interim, several drafts were circulated for comment to bodies outside China, including some sent to the OECD. A number of comments from such bodies appear to have been incorporated into the law.

The Anti-Monopoly Law, the first full competition law[28] to be promulgated in China since the establishment of the People's Republic, is a major step forward in that it establishes a basic framework for dealing with monopolistic practices. A key feature is that, for the most part, its provisions apply to all relevant enterprises, applying no distinction between domestic

enterprises and foreign-owned enterprises (FIE). The exception is a clause applying a national security review to acquisitions of domestic Chinese enterprises by foreign investors.

The body responsible for overall anti-monopoly organisation, co-ordination and guidance is the Anti-Monopoly Commission to be established by the State Council. The Commission is charged with: studying and drafting competition policies; organising the investigation and assessment of the state of overall market competition, and issuing assessment reports; constituting and issuing anti-monopoly guidelines; and co-ordinating anti-monopoly administrative law enforcement. The composition of the Commission is not specified in the Law (Article 9).

Another new body, the Anti-Monopoly Authority, is to be set up by the State Council to enforce the Law. The composition of the Authority is also not specified. The Law allows the authority to delegate its enforcement powers to corresponding agencies at provincial level (Article 10). For the Authority to function effectively it will be necessary to ensure that such delegation does not result in capture by local governments intent on maintaining barriers to the entry of external market players such as enterprises based in other provinces.

Activities prohibited by the Anti-Monopoly Law include: monopoly agreements (in Chapter 2); abuse of market dominance (Chapter 3); concentration of business operators (Chapter 4); and the abuse of administrative powers to eliminate or restrict competition (Chapter 5).

Monopoly agreements between competitors that are prohibited by the Law include those which: fix or change prices of commodities; limit the output or sales volume of commodities; allocate sales markets or raw material purchasing markets; restrict the purchase of new technology or new equipment, or restrict the development of new technology or new products; jointly boycott transactions (Article 13). Undertakings are prohibited from reaching monopoly agreements with counter-parties that fix the resale price or minimum resale price of products with respect to third parties (Article 14).

Exemptions are available for monopoly agreements that: improve technology or result in R&D of new products; upgrade product quality, reduce cost and improve efficiency, unify product specifications or standards, or implement the division of labour based on specialisation; improve the operational efficiency of small and medium-sized enterprises and enhance their competitiveness; save energy, protect the environment, or provide disaster relief and other charitable assistance; mitigate a serious decrease in sales volumes or distinctive production oversupply during an economic depression; safeguard legitimate interests in foreign trade and economic co-operation (Article 15).

The provisions in the new law against the abuse of administrative powers to eliminate or restrict competition are important because, as pointed out in the OECD's *2003 Investment Policy Review of China*, it is not clear that the 2001 regulation prohibiting local protectionism has been wholly effective.[29]

The Law states that administrations may not: set discriminatory fees and charges, set discriminatory standards or fix discriminatory prices for products from other regions; impose on products from other regions technical requirements or inspection standards different on those for similar local products, or require repeated inspection and certification on products from elsewhere; apply licensing only to products from other regions; set up checkpoints to prevent products from other regions coming in or local products going out; stop undertakings from other regions bidding locally by prescribing discriminatory qualification requirements or assessment standards, or by not publishing information according to law; reject or restrict investment or the establishment of branches by undertakings from other regions; compel undertakings to engage in monopolistic conduct; make regulations to eliminate or restrict competition (Articles 32-37).

Enterprises holding a dominant market position may not abuse their dominant market position by: selling at unfairly high prices or buying at unfairly low prices; selling products below cost without justification; refusing to enter into transactions with counter-parties without justification; constraining their counter-parties to enter into transactions exclusively with them with no justification; implementing tie-in sales without justification or imposing other unreasonable transaction terms; applying discriminating treatment on prices or other transactions terms to counter-parties without justification (Article 17).

Determining whether or not an undertaking holds a dominant market position depends on: the market share of the undertaking and competitive conditions in the relevant market; the ability of the undertaking to control the sales market or raw materials purchasing market; the financial status and technical conditions of the undertaking; the extent of dependence on the undertaking by other undertakings in respect to transactions; and the level of difficulty for other undertakings to enter the relevant market (Article 18). Dominant market position may be presumed if the market share of the undertaking is one half, if the aggregate market share of two undertakings is two-thirds, or if the aggregate market share of three undertakings is three-quarters (Article 19).

Concentrations of undertakings are defined in the law to include: a merger among undertakings; acquisition by undertakings of control of other undertakings by acquiring shares or assets; or by contract or other means, an acquisition by an undertaking of the ability to impose decisive influence on other undertakings (Article 20).

Concentrations that meet notification thresholds must be filed with the Anti-Monopoly Enforcement Authority (unless one of the undertakings involved holds over 50% of the shares with voting rights or assets of the other participating undertakings or more than 50% of the shares are owned by a single undertaking not participating in the concentration), otherwise they may not take place (Articles 21-22).

Within 30 days from the receipt of the correct documents the Anti-Monopoly Enforcement Authority must conduct a preliminary review and notify the undertakings in writing whether or not it has decided to initiate a further review. If not, or if no notification is received, the concentration may take place (Article 25).

Any further review must be completed within 90 days of the decision to conduct it, and the undertakings must then be notified of the resulting decision in writing. If the decision is against the concentration, reasons must be given. Extensions for 60 days may be allowed in certain circumstances (Article 26).

The Anti-Monopoly Enforcement Authority may then decide, and publicly announce its decision (Articles 28-30):

- That the concentration has the effect of limiting competition, and prohibits it.
- That the positive effect on competition outweighs the negative effect, or that the concentration is in the public interest, and allows it.
- To allow the concentration to go ahead but to impose restrictive conditions on it to reduce anti-competitive effects.

As well as deciding on concentrations notified to it as above, the Anti-Monopoly Enforcement Authority has powers to investigate suspected monopolistic conduct, including the right of entry to business premises, to interview the people involved, inspect and copy relevant documents and materials, seize evidence and examine bank accounts, while however protecting any commercial secrets obtained (Articles 28-42).

If the Anti-Monopoly Enforcement Authority decides that monopolistic conduct has taken place it must publish its decision (Article 44). An investigation may be suspended if the undertaking being investigated agrees to take concrete measures to eliminate the consequences of such monopolistic conduct within the time limit accepted by the Authority. The commitments must be made explicit and the Authority must monitor their performance, if necessary resuming the investigation if the undertaking fails to honour them, if material changes occur in the facts on which the suspension decision was based, or if new evidence comes to light (Article 45).

The Anti-Monopoly Enforcement Authority has the power to order undertakings to cease a monopoly agreement that violates the Law, confiscate

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the illegal gains and impose fines of more than 1% and less than 10% of the previous year's turnover. Where the agreement has not yet been implemented the fines may not exceed CNY 500 000. Undertakings that confess to monopolistic conduct and provide important evidence may be exempt from or suffer mitigated punishment (Article 46).

As pointed out in the 2006 *Review*, under the 2003 Interim Provisions on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors included a procedure for reviewing cross-border mergers and acquisitions in China that depended on market-share thresholds. In the Review the OECD welcomed the intention of the Chinese government to establish a non-discriminatory framework for considering industrial concentration, as drafts of the Anti-Monopoly Law indicated that domestic and foreign enterprises would be treated alike in the new law.

The Anti-Monopoly Law has fulfilled this promise of non-discrimination in almost all respects. Under the law, reviews are conducted without regard to the nationality of ownership of the enterprises involved. The exception is Article 31, which states that if the acquisition of a domestic enterprise or the involvement through other means in a concentration of undertakings by foreign capital affects national security, such acquisition shall be subject to a national security review in addition to the concentration review. It remains to be determined whether or not this provision refers to an existing national security review process, such as the "national economic security" review in the 2006 Regulations described above, or whether a new procedure is to be established. This may become clearer at a later stage when, as is normal for all major Chinese laws, implementing regulations are adopted.[30]

Stakeholder consultations which may precede the publication of implementing regulations have already begun. On 27 March 2008, the Legislative Office of the State Council published draft *Provisions on Notification of the Concentration of Undertakings* for public consultation, inviting comments by 12 April 2008. The draft rules set out clear turnover and market share-based thresholds for notification of mergers, but suggest that the authorities will retain broad discretion in the way in which the rules are applied to particular transactions.[31]

Under Article 3 of the *Draft Provisions*, notification of a transaction will be required if the global turnover of all parties to a transaction in the preceding financial year exceeds CNY 9 billion and at least two parties' Chinese turnover in the preceding financial year exceeds CNY 300 million; the turnover of all parties to a transaction in China in the preceding financial year exceeds CNY 1.7 billion and the Chinese turnover of each of at least two parties in the preceding financial year exceeds CNY 300 million; or if the transaction will cause one party to gain a market share of more than 25% of the relevant market

in China. But under Article 4 the authorities can still require notification of a transaction if they consider that the transaction may have the effect of excluding or limiting competition, even if none of these criteria applies.[32]

The *Draft Provisions* further outline procedures to be followed, for example by listing details of the information that must be submitted with a notification (Article 9). However, the authorities retain substantial discretion, including the authority to reject incomplete notifications (Article 11). The Draft Provisions require the Chinese authorities to establish a fast track system (Article 14), which could reduce the time required to obtain clearance of notifiable transactions. Where a transaction will "obviously" not result in the elimination or restriction of competition, the authorities must take a formal decision not to conduct further examination of the transaction as soon as possible.[33]

Stakeholder consultation prior to the coming into force of the Anti-Monopoly Law may ensure that the Law is more workable and that it can be applied effectively from 1 August 2008. Key issues for the implementing regulations to clarify include the role of existing government agencies in implementing the law.

6. Revised catalogue for guiding foreign investment industries, effective from 1 December 2007

The National Development and Reform Commission (NDRC) and MOFCOM decreed on 31 October 2007 that the State Council (China's cabinet) had approved a revised version of the Catalogue for the Guidance of Foreign Investment Industries. The Catalogue was first published in 1997, then revised in 2002 and 2004. The new version came into force on 1 December 2007, replacing the 2004 revision. This is thus the third revision.

From its inception, the Catalogue has divided foreign investment projects into prohibited, restricted, permitted and encouraged categories. Lists of sectors included in each category were published, with the exception of the permitted category. Sectors not listed in the three published categories are presumed to be open to foreign investment, unless they are closed or limited by other regulations. Publishing a permitted list would be difficult because it would be impossible to include all sectors open to foreign investment, including industries that had not yet emerged.

The 2002 revision was promulgated in February 2002 and came into force in April that year. Following China's accession to the WTO in December 2001, this version contained amendments appropriately reflecting the liberalisation of China's investment regime embodied in the country's pre-accession agreements. The number of encouraged industries was increased from 186 to 262, while the number of restricted industries was cut from 112 to 75.[34]

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The second revision was announced by the NDRC and MOFCOM in November 2004 and came into force on 1 January 2005. Unlike the 2002 revision, this did not liberalise the foreign investment regime further. Nor did it impose major new restrictions on foreign investment. The long sectoral lists remained largely unaltered, with at least as many restrictions added as were removed. A detailed analysis of this revision is in the 2006 *OECD Investment Policy Review of China: Open Policies towards Mergers and Acquisitions*.[35]

6.1. The encouraged list contains many new sectors, reflecting the evolution of China's industrial policy

The most prominent change in the 2007 revision of the Catalogue is the addition of many new sectors to the encouraged list, reflecting China's evolving industrial structure, which is producing an expanding need for many specialised and sophisticated technologies that China does not yet possess. This list can be seen as a showcase for the government's industrial priorities.

Environmentally-friendly technologies

These priorities include a tremendously strengthened emphasis on technology that protects the environment, saves energy and promotes recycling (see the account of government policy in this area in Chapters 4 and 5). Examples of the many encouraged sectors that meet these criteria include projects in all major sectors of the economy:

- Mining: Utilisation of mining gas and comprehensive application of ecological-recovery technology.
- Textile industry: Processing of special natural fibres that meet ecological requirements; comprehensive resource utilisation and environmental protection; manufacture of fluorine resources recycled from phosphorus chemical processing and aluminium smelting; manufacture of new types of fibre materials using renewable resources and biomass engineering technology.
- Construction: Manufacturing of energy-saving and environmentally-friendly building materials.
- Automobile industry: Manufacture of light-weight, eco-friendly new materials for automobiles and motorcycles; gas-efficient, low-noise, low-emission diesel engines; sprayers that can recover unused liquid complementary to large-scale tractors.
- Agriculture: Manufacture of equipment to conserve fertilisers and pesticides; comprehensive management technology for grassland-livestock balance.

- Energy and power: Manufacture of equipment to produce solar-powered batteries; manufacture of equipment for production and storage of hydrogen energy; manufacture of solar-powered air conditioners, solar-powered heating systems and solar-powered drying devices; integrated coal gasification combined cycle (IGCC) technology, circulating fluidised bed technology, pressurised fluidised bed combustion; wave energy power stations; biomass energy development technology.
- Pollution prevention: Manufacture of equipment for urban waste treatment; manufacture of equipment for preventing air pollution; manufacture of equipment for preventing water pollution; manufacture of equipment for solid waste treatment and disposal; manufacture of new technical equipment and instruments for environmental detection; manufacture of biodegradable materials; manufacture of environmentally-friendly printing ink and aromatic hydrocarbon oil.
- Recycling: Comprehensive utilisation of rural organic waste; manufacture of equipment for management and renewable use of waste plastics, electronic equipment, rubber and for recycling batteries; manufacture of equipment for the comprehensive use of waste tyres and old tyres; development and application of enterprises' manufacturing emissions recycling technology; re-manufacture of machine tools, automobile parts and construction machinery.
- Water resource conservation: Manufacture of water level data collection, processing and analysis, and flood-prevention warning devices and equipment; field instruments for analysing water quality; utilisation of seawater (direct use of seawater, desalination) and industrialisation of industrial waste water treatment and recycling.

Energy and natural resource exploitation

The encouraged list also contains some new items stemming from the energy and natural resource needs of China's rapidly expanding economy. Examples include: the exploration and development of bituminous rock, oil sand, heavy oil, ultra heavy oil and other unconventional oil resources; the exploration and development of seabed methane ice; manufacture of equipment used for oil extraction on land and sea; the development and application of new technology to increase the yield of mining debris.

High-tech manufacturing

The vast majority of additional sectors in the encouraged list are in high-tech manufacturing. The industries covered include aerospace, automotive, chemicals and fertilisers, construction materials, electronics, food and drink, geological equipment, infrastructure construction, machine tools, metallurgy,

mining machinery, pharmaceuticals, printing, railway equipment, shipbuilding and textiles.

Safety

Another set of additions to the encouraged list comprises technology to help address safety concerns. Projects in the list for this reason include food quality inspection and monitoring equipment; anti-bacterial equipment for food powder; bacteria-free solid and semi-solid food packaging facilities; and bacteria-free packaging materials. A major sub-category of this list is the manufacture of production safety and environmental protection devices, technologies and equipment. Also encouraged are the development and manufacture of underground well monitoring and disaster prediction systems for coal mines and integrated management systems for examining coal mine safety.

6.2. Export performance requirement removed from the Catalogue

Earlier versions of the Catalogue contained a clause allotting "encouraged" status to foreign investment in items in the "permitted" list that are to be directly exported. Removal of this clause in the 2007 revision may reflect objections from WTO partners to whom China had promised before WTO accession not to impose performance requirements on foreign investment – including in the 2003 *OECD Investment Policy Review of China*[36] – and is also consistent with the lower priority now given by the Chinese government to promoting exports now that the country has accumulated a mountain of foreign exchange reserves through a succession of record trade surpluses.

6.3. Several new items have been added to the list of restricted sectors

Unlike the encouraged list, the restricted investment industries list has not been greatly enlarged. However, there are a number of new additions and also some deletions.

In the primary sector, the development of food and oil seed is no longer restricted, but the development and production of new types of agricultural goods are. The mining of non-ferrous metals including wolfram, tin, antimony, molybdenum and fluorite is no longer restricted; on the other hand, the restriction on survey and mining of barite remains, while exploration and mining of phosphorus ore and the mining of polymetallic manganese nodules and sea sand have been added to the restricted list.

The manufacture of compound sweeteners is no longer restricted. A new restriction has been placed on investment in the processing of edible lipids from soybean and rapeseed and deep-processing of corn. The manufacture of biofuels (ethanol and biodiesel) has been added to the restricted list. The manufacturing of carbonated beverages with foreign trademarks was already under restriction,

now all carbonated beverages are restricted. The former restriction on the processing and production of cigarettes and filter tips has been replaced by one on the processing and production of tobacco threshing and redrying.

In the preceding version of the Catalogue, the construction and operation of oil refineries was restricted. This restriction has now been lifted for refineries with annual production of 8 million tonnes or more. New restrictions have been added on the manufacture of fluorine compounds, artificial rubber and chlorine compounds, including polyvinyl chloride (PVC) obtained through the calcium carbide process, together with the manufacture of potassium permanganate through the Siemens-Martin process.

In medical and pharmaceutical products, investment in multi-vitamin and calcium tablets has been put under restriction along with type 1 psychoactive drugs. The manufacture of fibre and non-fibre polyester and urethane elastic fibre has been derestricted. In metallurgy, new restrictions have been placed on the smelting of: tungsten molybdenum, tin (except tin compounds), antimony (including antimony oxide and antimony trisulphide), electrolytic aluminium, copper, lead, zinc and other rare metals.

In the machinery industry, the pre-existing restriction on medium-sized and small bearings has been expanded to include manufacture of all types of bearings and parts and semi-finished models. The restriction on cranes of less than 50 tonnes has been altered to one on the manufacture of crawler and wheeled cranes of less than 300 tonnes. To the restriction in the previous catalogue on bulldozers has been added restrictions on hydraulic excavators, wheeled loading machines, graders, road rollers, fork-lift trucks, off-highway automatic dumpers, pavement milling machines, horticulture machines and cement mixers. The repair, design and manufacture of ordinary ships (including parts) has been added to the restricted list, with the proviso that the Chinese side must hold a controlling interest. Another addition is the manufacture of tax-controlled cash registers.

In the energy sector, coal-fired power plants with a single-machine capacity of 300 000 MW or less remain on the restricted list. This has been relaxed to a capacity limit of 100 MW in Tibet, Xinjiang and Hainan. The construction and operation of electricity grids has been added to the restricted list, with the proviso that the Chinese side must hold a controlling interest.

In the financial sector, financial leasing companies and foreign exchange brokerages have been removed from the restricted list, futures trading companies (which were formerly prohibited) and credit rating and evaluation services have been added. In real estate, the construction and management of theme parks has been removed, real estate secondary market exchanges, intermediaries and brokerages have been added.

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A new item in the scientific research, technology services and geological survey industries is photography services, including aerial photography and stunt photography services, but not aerial photography for surveying and drawing.

The construction and management of golf courses has been moved from the restricted to the prohibited list (see below). Performance agent companies and the operation of entertainment venues have been added to the restricted list.

6.4. *The list of prohibited foreign investment industries has expanded slightly*

A few new items have been added to the list of prohibited foreign investment industries, while there have been no significant deletions.

In the previous catalogue, foreign investment in the production and development of genetically modified seeds was prohibited. This prohibition now also extends to genetically modified livestock, aquatic seeds and seedlings.

A completely new prohibition has been put on foreign investment in the survey and mining of tungsten, molybdenum, tin, antimony and fluorite.

Prohibitions on foreign investment in the processing and preparation of traditional Chinese medicines have been refined to correspond to regulations protecting natural medicinal resources and rare and endangered plants and to specific methods of preparation.

Presumably in line with the government's environmental protection policies, foreign investment has been prohibited in open-cell (with discharge of acid mist) lead acid batteries, silver-oxide button batteries containing mercury, paste-type zinc-manganese batteries and nickel-cadmium batteries.

Smaller coal-fired power stations, with sizes below those specified in the restricted list (see above) have been added to the prohibited list.

Social research and surveys have been added to the list of activities in which foreigners may not invest, as have R&D and application of stem cell and genetic diagnosis and treatment technology, geodetic surveys, ocean mapping, aerial photographic surveys, plotting of borders of administrative districts, including topographical mapping, and the creation of digital navigation maps from ordinary maps.

The pre-existing prohibition against foreign investment in the construction and operation of national nature reserves has been extended to include internationally-recognised wetlands.

Compulsory education institutions (*i.e.* ordinary schools) have been subject to foreign investment prohibition in previous catalogues. Foreign

investment is also now banned in military, police, political, party and other educational institutions in special categories.

The prohibition on foreign investment in film distribution now also includes cinemas. As noted above, foreign investment in the construction and operation of golf courses, formerly restricted, is now prohibited.

6.5. Presumed rationale for the 2007 changes in the Catalogue

The revised 2007 Catalogue continues the tradition of regarding foreign capital as a tool to be used by the government to achieve its economic development objectives.

Foreign investors were first invited to China nearly three decades ago so that they could use China as an export manufacturing base to generate foreign exchange earnings, and the domestic market was initially closed to them. The situation has now changed radically: the Chinese government is keen to use foreign investment to fill gaps in its own industrial structure, and is therefore encouraging foreign investment targeting the domestic market. This is a policy change much hoped for by many companies attracted to China in earlier decades by the potential size of the China market.

There is also no longer a requirement to encourage exports, now that these have surged ahead of imports for several years, largely because of the activities of foreign-invested enterprises (FIEs). By March 2008, the share of FIEs in China's merchandise exports had reached 57.5%.[37] In 2007, China had a trade surplus of USD 262.2 billion, 47.7% higher than in 2006, and the surplus did not start to shrink until February 2008.[38] As a result, China's foreign-exchange reserves reached record highs of USD 1 528.2 billion at end-December 2007 and USD 1 905.6 billion at end-September 2008.[39]

The 2007 revision was welcomed in the official Chinese media as contributing to the implementation of policies on environmental protection, energy conservation and recycling, noting that the encouraged list promotes investment in these areas while high consumption and pollution industries, along with the exploitation of rare mineral resources, are closed to foreign capital.

When China first opened to foreign investment in the late 1970s, it attempted to attract high-tech FDI, but in practice welcomed in other sectors that were of greater interest to the limited range of (mainly Hong Kong, China based) foreign investors who were available at the time, such as hotels and textiles. Having developed a relatively comprehensive industrial base, the Chinese government now seeks to upgrade to a higher level of technology by bringing it in from abroad. Thus, the Catalogue is now more overweight than before in the list of encouraged investment sectors.

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6.6. The Catalogue is unwieldy and less than transparent

The *2003 OECD Investment Policy Review of China*, while welcoming the 2002 Catalogue as a major step forward in FDI regime liberalisation, encouraged the Chinese authorities in their efforts to achieve further liberalisation by removing more categories of project from the prohibited and restricted catalogues and also to consider replacing the catalogue regime with a simple closed list.[40] The 2006 *Review* reiterated that the *Catalogue* appears an unwieldy regulatory instrument whose purposes might better served by less restrictive and more transparent means. The current *Review* retains that judgment, based on careful consideration of the latest revision.

Some amendments are in line with OECD recommendations

The OECD welcomes amendments made by MOFCOM and the NDRC to the Catalogue in line with the recommendations in the 2003 *Review*.

The 2003 *Review* said that there appears to be no advantage to be gained from banning FDI from entering the financial futures sector that could not be more effectively obtained by imposing appropriate prudential regulation covering both domestic and foreign-owned enterprises; as noted above, this prohibition has been replaced by a restriction (see above).

Also, in the 2003 *Review* the OECD noted that "since the inclusion of a proposed foreign investment project in either the permitted or the restricted foreign investment list can determine whether or not it is approved, this stipulation may be regarded as effectively imposing an export performance requirement on such projects", and that China is committed to implementing the WTO Agreement on Trade-Related Investment Measures (TRIMs) in full from the date of accession. The OECD therefore welcomes the removal of the clause giving "encouraged" status to sectors in the "permitted" list dedicated to export manufacture.

Some inappropriate prohibitions remain

As noted in the 2003 *Review,*[41] the Catalogue contains prohibitions on foreign investment that are unnecessary because they relate to activities that are already illegal, such as pornography and gambling. Some other activities prohibited to foreign investors, like tiger bone and ivory carving, are illegal under international agreements and should not be indulged in by anyone, Chinese or foreign. The OECD has also suggested that preserving traditional industries, such as tea and Chinese medicine, might be done more effectively by less restrictive means, such as increased training, than by banning foreign investment in these sectors.

The OECD notes that the restriction on foreign investment in genetically modified seeds, which it questioned in the 2003 *Review,*[42] has not only been

retained, but has been expanded. The intention appears to be protectionist, as similar restrictions are not applied to domestic investors.

A similar objection applies to prohibitions and restrictions on foreign investment in areas deemed polluting or wasteful. Discrimination against foreign investment would appear to be a less effective way of implementing policy to protect the environment, save energy and promote recycling than non-discriminatory measures such as anti-pollution laws, enforced regardless of the nationality of the investor.

A serious problem with the Catalogue is that it is incomplete, and to that extent non-transparent. Some specific industry restrictions which have been announced in recent years are included in the Catalogue, some are not. For example, the Catalogue states that foreign investors may not enjoy majority ownership of enterprises making complete automobiles. On the other hand, as noted in the 2006 *Review*, a similar restriction in the iron and steel industry is not in the Catalogue.[43] Therefore the presumption that any sector not mentioned in any of the three published lists is automatically permitted is invalid. Investors (and perhaps also local officials who have to implement the policy) may not always be fully aware which sectors are permitted.

These shortcomings could be addressed by replacing the current "bottom-up" approach, which (as in many other developing countries) has developed as a result of the phased opening up of a formerly closed investment regime, with a "top-down" approach, which starts with a presumption that all sectors are open to foreign investment except those explicitly cited in a closed list. This list would typically consist of a few sectors closed to protect public order and national security and not much else. As indicated above, many of the objectives of the Catalogue could be achieved more effectively by means other than blocking capital inflows into sectors of the economy and imposing discriminatory ownership restrictions on foreign investors.

Notes

1. This section is based on a Supplement to the *2006 OECD Investment Policy Review of China – Recent Developments in China's Policies towards Cross-Border Mergers and Acquisitions (M&A),* published on the OECD's China investment website *www.oecd.org/daf/investment/china* on 11 December 2006.
2. China Economic Information Network, *Semi-monthly Business Review*, Issue No. 063, 28 November 2006.
3. This may reflect a perception by Chinese officials that the definition of "national security" has recently been broadened to one of "national economic security" elsewhere, particularly in the United States, where it is seen as having prevented acquisitions by Chinese enterprises. See, for example, the article *Mergers and Acquisitions by Foreign-Invested Enterprises and National Security* [*Waizi Binggou yu*

Guojia Anquan, 外资并购与国家安全] by Xing Houyuan published on 20 September 2007 on the MOFCOM Chinese-language FDI website: *www.fdi.gov.cn*.

4. For example, in the article *Mergers and Acquisitions by Foreign Capital and National Economic Security* [*Waizi Binggou yu Guojia Jingji Anquan*, 外资并购与国家经济安全] by Wang Zhile published on the MOFCOM Chinese-language FDI website: *www.fdi.gov.cn* on 2 July 2007, in which the author argues that "there is still not yet any single sector that is really monopolised by foreign-invested enterprises".
5. *Guiding Opinion Concerning the Advancement of Adjustments of State Capital and the Restructuring of State-Owned Enterprises* [*Guanyu Tuijin Guoyou Ziben Tiaozheng he Guoyou Qiye Zhongzu de Zhidao Yijian* 关于推进国有资本调整和国有企业重组的指导意见], 5 December 2006, SASAC website: *www.sasac.gov.cn*.
6. *China defines key national economic sectors*, Xinhua, 18 December 2006.
7. *China names key industries for absolute state control*, China Daily, 19 December 2006.
8. Circular of the Ministry of Finance, State Development and Reform Commission, General Administration of Customs and State Administration of Taxation on Import Taxation Policies to Implement the Opinions of the State Council of Invigorating Equipment Manufacturing, *Cai Guan Shui* [2007] No. 11.
9. This section is largely based on a Supplement to the 2006 OECD Investment Policy Review of China entitled *The OECD Welcomes Policy Advances at China's 2007 National People's Congress Session*, which was originally published on the OECD website on 27 March 2007.
10. The Chinese text of the law is available at the State Administration of Taxation website: *www.chinatax.gov.cn*. An unofficial English translation is available at: *www.kpmg.com.cn* and *www.lehmanlaw.com*.
11. Income Tax Law of the People's Republic of China on Foreign-Investment Enterprises and Foreign Enterprises, Chairman Order [1991], No. 45.
12. Interim Regulations on Enterprise Income Tax, State Council Order [1993], No. 137, a consolidation of regulations passed in the 1980s.
13. Both laws are repealed as of 1 January 2008.
14. Non-resident enterprises pay 20%.
15. OECD (2003b).
16. Enterprise Income Tax Law, Article 4.
17. Enterprise Income Tax Law, Article 57.
18. Enterprise Income Tax Law, Article 28.
19. Article 1 of the Enterprise Income Tax Law stipulates that all enterprises and other organisations that obtain income within the People's Republic of China shall be taxpayers of enterprise income tax and shall pay enterprise income tax in accordance with the Law.
20. *E.g.* Enterprise Income Tax Law, Articles 14 and 17.
21. Li Jinyan (2007).
22. *How to Attract Foreign Investment after Unifying the Two Tax Rates* [*Liang Shui Bing Hou Ruhe Xiyin Waizi*, 两税合并后如何吸引外资] by Xie Tongyin, published on the MOFCOM Chinese-language FDI website: *www.fdi.gov.cn* on 16 August 2007.
23. Guo Shui Fa (2008) No. 23, on *www.mofcom.gov.cn*.

24. This section is an expanded version – based on the full text of the law, which became available later – of initial comments in the Supplement to the *2006 OECD Investment Policy Review of China* entitled *The OECD Welcomes Policy Advances at China's 2007 National People's Congress Session*, which was originally published on the OECD website on 27 March 2007.
25. Property Rights Law, Articles 46-52.
26. This section draws in part on the analysis of the new Anti-Monopoly Law in an OECD report on *The Challenges of Transition for Competition Law and Policy in China* [DAF/COMP/GF(2008)2] presented to the 21-22 February 2008 OECD Global Forum on Competition.
27. The version of the law referred to in this section is the official translation published on the MOFCOM foreign investment website: *www.fdi.gov.cn*.
28. The 1980 Interim Provisions for the Promotion and Protection of Competition in the Socialist Economy (the "Ten Articles on Competition") an subsequent decisions and statements by government and Communist Party bodies in the 1980s did address key competition issues, but did not amount to a complete law.
29. OECD (2003b).
30. Yin Yanling of the Anti-Monopoly Office of the Department of Treaty and Law of MOFCOM confirmed in a presentation to the OECD's Competition Committee on 21 February 2008 that such implementing regulations will be adopted.
31. Clifford Chance Client Briefing, April 2008.
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37. MOFCOM foreign investment website: *www.fdi.gov.cn*.
38. MOFCOM website: *www.mofcom.gov.cn*.
39. State Administration of Foreign Exchange (SAFE) website: *www.safe.gov.cn*.
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ANNEX 1.A1

Differences between the 2003 Interim Provisions and the 2006 Regulations

The new regulations add to Article 6 requiring examination and approval a paragraph stipulating that if the enterprise being acquired is a domestic listed company, it shall also carry out relevant procedures with the securities regulatory authority of the State Council, *i.e.* the China Securities Regulatory Commission (CSRC), pursuant to the *Measures Governing Strategic Investment Made by Foreign Investors in Listed Companies*.

Two articles in the 2006 *Regulations* did not appear in the 2003 *Interim Provisions*. These make explicit the application of current tax and foreign exchange legislation to enterprises acquired by foreign investors and do not appear to add any extra legal obligation. Article 7 of the new regulations states that the parties involved in the enterprise being acquired by a foreign investor shall pay taxes in accordance with tax regulations of China and accept supervision of tax authorities. Article 8 states that the parties involved with the enterprise being acquired by a foreign investor shall handle procedures with the relevant authority in charge of administration of foreign exchange approval, registration, filing and amendment in a timely manner in compliance with Chinese foreign exchange laws and administrative regulations.

As in the 2003 *Interim Provisions*, the contribution made by foreign investors is expected to be at least 25% of the registered capital. If it is less, then the approval certificate for the new enterprise will be marked "foreign investment proportion less than 25%". The 2006 *Regulations* add that this phrase will also be added to the enterprise's business licence and foreign exchange certificate, and that the enterprise shall not enjoy treatment of a foreign-invested enterprise (FIE). Any foreign loans it may borrow shall be handled in accordance with the relevant regulations governing foreign loans

borrowed by non-FIEs, except as otherwise provided by laws and administrative regulations.

The 2006 *Regulations* include a new clause on the acquisition by a domestic company, enterprise or natural person of an affiliate of the domestic company in the name of an overseas company lawfully established or controlled outside China. This states that such an enterprise shall not enjoy FIE treatment unless the overseas company subscribes to any increased capital of the domestic company or contributes additional capital to the enterprise newly formed after acquisition and the amount of the increased capital exceeds 25% of the new enterprise's registered capital. Where the contribution made by any foreign investor other than the actual controlling party of the FIE to the registered capital of the enterprise is higher than 25%, the enterprise shall enjoy FIE treatment.

This is further elaborated by another new clause requiring application to MOFCOM for examination and approval of the acquisition of any company inside China affiliating to a domestic company, enterprise or natural person made in the name of an overseas company lawfully established or controlled by a domestic company, enterprise or natural person. The parties concerned shall not circumvent the above requirements by making domestic investment through an FIE or otherwise.

The examination and approval authority specified in the 2006 *Regulations* is the Ministry of Commerce (MOFCOM) at national and provincial level, unchanged from the 2003 *Interim Provisions*, except that the approval authority was the Ministry of Foreign Trade and Economic Co-operation (MOFTEC) prior to a restructuring of ministries later in 2003. The registration authority also remains the State Administration of Industry and Commerce (SAIC). The 2006 *Regulations* add that the foreign exchange control authority shall be the State Administration of Foreign Exchange (SAFE) and its local branches.

Article 12 of the 2006 *Regulations* adds a new requirement that application for examination and approval must also be made when a foreign investor obtains the actual controlling rights of a domestic enterprise if the acquisition involves any major industry, or has or may have an impact on national economy security, or may result in transfer of the actual controlling right of the domestic enterprise owning any famous trademarks or traditional Chinese brands. If the party concerned fails to make an application to MOFCOM and its acquisition causes or may cause a significant impact on national economy security, MOFCOM, together with the relevant authorities in charge, may demand that the party concerned ceases the transaction and that it transfers relevant equity interests and assets, and they may take any other effective action to eliminate the impact of the acquisition on national economic security.

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The requirement in the 2003 *Interim Provisions* that a domestic enterprise selling assets shall give notice to creditors and make a public announcement in a newspaper at provincial level or above within ten days of the adoption of the resolution to sell the assets has been altered in the 2006 *Regulations*. The enterprise must now carry out the same obligations fifteen days before the investor submits application documents to the examination and approval authority.

Article 15 of the 2006 *Regulations* adds a new clause on related party transactions. The parties to an acquisition must make it clear whether or not there is any relation of affiliation between them. If both are under the control of a single party, they must disclose this fact to the examination and approval authority and explain whether or not the acquisition purpose and appraisal results conform to fair market value. Neither party may circumvent these requirements by means of trusteeship, holding, through agency, or otherwise.

Article 9 of the 2003 *Interim Provisions* states that where an FIE established after an equity merger or acquisition increases its registered capital, investors shall publish a schedule for capital contribution in the contract and articles of association of the FIE. If the capital contribution is to be paid in a lump sum, this must be contributed within six months from the date of issue of the FIE business licence. If it is to be paid in instalments, the investors' first instalment shall be not less than 15% of their respective capital subscription and must be made within three months from the date of issue of the FIE business licence.

The 2006 *Regulations* include a slight alteration to the stipulation of the 2003 *Interim Provisions* in this regard. Article 16 states that where a foreign investor subscribes to any increased capital of a domestic company, the shareholder(s) of the limited liability company or the domestic shareholding company established by means of sponsorship shall contribute no less than 20% of the increased registered capital when the domestic company applies for its FIE business licence. The schedule for contributions to the rest of the enterprise's increased registered capital shall be in conformity with the Company Law, relevant laws and regulations on foreign investment and the provisions of the Regulations on Administration of Company Registration. Relevant stipulations of other laws and administrative regulations shall also be followed where necessary.

An entire new Chapter IV entitled *The Acquisition of a Domestic Company by a Foreign Investor through Payment of Equity Interests* has been added in the 2006 *Regulations*. This form of payment for acquisition is not covered in the 2003 *Interim Provisions*. The new regulations allow the acquisition of any equity interests held by shareholders of a Chinese domestic company through payment of equity interests held by shareholders of an overseas company or

additional stocks issued by the overseas company. The acquiring company must be lawfully established in a jurisdiction with a complete corporate legal system. No punishment must have been imposed on the company or its managers for the previous three years. Unless it is a special-purpose company, it must be listed in a place with a complete and mature system of securities exchange.

The equity interests contributed by the overseas company in payment for acquisition of a domestic company must be: lawfully held and transferable according to law; subject to no dispute of ownership or lien; lawfully listed for public trade on an overseas securities exchange market; in the form of shares whose trading price has been stable for the previous year.

To acquire a domestic company through payment of equity interests, the domestic company or its shareholders must hire an acquisition consultant to conduct due diligence and issue an acquisition consultant report on the application documents, the overseas company's financial status, and conformity with the 2006 *Regulations*. The acquisition consultant must have a good reputation, possess working experience within the industry, have no record of significant illegal acts, and be able to analyse the legal system of the jurisdiction where the company is registered and listed and the company's financial status.

The examination and approval process by which a foreign investor applies to MOFCOM to acquire a domestic Chinese company through payment of equity interests is similar to that for other forms of acquisition, except that an extra set of documents is required:

- A description of any major changes in regard to the equity interests and assets of the domestic company during the previous year.
- An acquisition consultant report.
- Certifications of incorporation of the domestic company and the overseas company involved in the acquisition or identification materials of their shareholders.
- A description of the status in regard to the equity shares held by shareholders of the overseas company and a name list of shareholders holding over 5% of the overseas company's shares.
- The articles of association of the overseas company and a description of any external security provided by the company.
- An audited financial report of the overseas company for the most recent year and a status report regarding the transactions of its stocks for the preceding six months.

MOFCOM shall examine the acquisition application within 30 days of receiving application documents. An approval certificate valid for six months from the date of issue of the business licence shall be issued if all

requirements are met. The domestic company being acquired must complete change formalities within 30 days of receiving the certificate. It will then receive an FIE business licence and an FIE foreign exchange certificate, both valid for eight months from the issue date. When handling the formalities of registration of changes with the relevant registration authority, and the domestic company must provide in advance documents signed by its legal representative for future restoration of its equity structure, if applicable, including but not limited to the letter of application for change of equity interests, amended articles of association and equity transfer agreement. Within six months of the issue of the business licence the domestic company or its shareholders shall apply to MOFCOM and SAFE for examination and approval and registration of making overseas investment and establishment of overseas enterprise, including in their submission the approval certificate and business licence. MOFCOM issues a new approval certificate for overseas investment by the Chinese enterprise and a new FIE approval certificate. The domestic company must then apply within thirty days for an ordinary business licence and foreign exchange certificate. If the domestic company and the overseas company fail to complete procedures for change of equity interest within six months of the issue of the original business licence, the certificates of approval become null and void and the registration authority shall examine and approve to change the registration to its pre-acquisition state in accordance with the relevant equity change documents submitted earlier. If additional stocks are not issued by the domestic company before the registration authority approves the change of registration then the domestic company shall reduce its registered capital accordingly and make a public announcement in the newspapers under the Company Law.

The domestic company may not distribute profit to shareholders, provide any guarantee to its affiliates or pay any amount incurred from the equity transfer, reduction of funds, liquidation or any other accounts of capital-related items before obtaining the first certificate of approval and foreign exchange certificate.

Chapter IV of the 2006 *Regulations* also includes provisions on special-purpose companies, which are defined as any overseas company controlled, directly or indirectly, by a domestic company or Chinese natural person inside China for overseas listing of its/his/her share interests. The section applies to acquisitions of equity interests held by shareholders of domestic companies or additional stocks issued by domestic companies through payment of equity interests by shareholders of special-purpose companies or additional stocks issued by special-purpose companies for purposes of overseas listing.

Transactions for purpose of overseas listing of special-purpose companies must be approved by the China Securities Regulatory Commission (CSRC). The county or region where overseas listing of a special-purpose

company is proposed must have complete legal and supervisory systems, and the local securities supervisory and administration authorities must have entered into memorandum of understanding on co-operation with the CSRC and co-operate effectively with it.

A domestic company providing its share interests for overseas listing must meet these requirements:

- The title to its property rights is clear without question and there is no dispute, existing or threatened, regarding its property rights.
- It has a complete system for business operation and is capable of maintaining constant operation.
- It possesses a healthy and complete company operation structure and internal management system.
- No record shows any commitment of any material violation of law by the company and its shareholders in the previous three years.

A domestic company wishing to establish a special-purpose company overseas must apply to MOFCOM for examination and approval, submitting the following documents in additional to those normally required for establishing an overseas investment:

- The identification certificate of the ultimate controlling person of the proposed special-purpose company.
- The business plan of the proposed special-purpose company for overseas listing.
- The evaluation report provided by the acquisition consultant regarding the issuing price of the special-purpose company's stocks to be listed overseas.

The total value of stock issuing price for overseas listing of the special-purpose company shall not be lower than the equity value of the acquired domestic company as appraised by the relevant Chinese assets evaluation organ.

For purpose of acquisition of a domestic company by its special-purpose company through payment of equity interests, the domestic company must also submit to MOFCOM:

- The relevant approval certificate and documents for making overseas investment and establishing overseas enterprise when the special-purpose company was set up.
- The overseas investment foreign exchange registration form of the special-purpose company.
- The identification certificate of the ultimate controlling person or the incorporation certificate and articles of association of the special-purpose company.

- The business plan of the special-purpose company for overseas listing.
- The evaluation report provided by the acquisition consultant regarding the issuing price of the special-purpose company's stocks to be listed overseas.

If a domestic company targets an overseas company holding any equity shares of a special-purpose company as the main body through which an overseas listing will be made, the domestic company must submit these application documents:

- The incorporation certificate and articles of association of the targeted overseas company.
- Detailed descriptions of the transaction arrangements and price conversion assessment made by and between the special-purpose company and the targeted overseas company regarding the equity interests of the acquired domestic company.

MOFCOM shall issue an official reply of approval in principle if it consents to these documents submitted. The Domestic Company shall submit listing application documents to the CSRC, which must decide whether or not to grant approval within 20 days. After approval is granted, the domestic company shall apply to obtain from MOFCOM the formal approval certificate, valid for one year from issue of the business licence. Any change in the equity interests of the special-purpose company due to acquisition must be registered with MOFCOM and the local SAFE office. Within 30 days of receiving the certificate of approval, the domestic company must register these with MOFCOM and SAFE, who then issue an FIE business licence and an FIE foreign exchange certificate to the domestic company, both valid for fourteen months from date of issue. It must also provide in advance documents signed by its legal representative for the purpose of future restoration of its equity structure, if applicable, including the letter of application for change of equity interests, amended articles of association and equity transfer agreement. Within 30 days of overseas listing by the domestic company or its affiliate, the domestic company must report to MOFCOM regarding the overseas listing and relevant financing revenue returning plan and must apply for issuance of a new FIE approval certificate. Simultaneously, within 30 days of completion of the overseas listing, the domestic company shall report it to the CSRC and submit a financing revenue returning plan to SAFE. Within 30 days of receiving the approval certificate the domestic company must apply to MOFCOM and SAFE for an FIE business licence. If the company fails to report to MOFCOM in time, its original approval certificate becomes null and void and its equity structure is restored to its status preceding the acquisition.

The overseas listing revenue of a special-purpose company shall be arranged for returning for use within China in accordance with the revenue returning plan submitted to SAFE by:

- Providing a business loan to the domestic company.
- Establishing a new FIE in China.
- Acquisition of the domestic company.

The profits, dividends and foreign exchange income obtained by capital variation received by the domestic company and natural person(s) from its special-purpose company shall be returned to China within six months of receipt. Profits and dividends can be deposited in a foreign exchange current account or provided for foreign exchange settlement. Subject to SAFE approval, the foreign exchange income from capital variation can be maintained in a special account of capital items or provided for settlement. If a domestic company fails to obtain its final approval certificate within one year from the issue date of the original business licence, its original approval certificate becomes invalid.

After the special-purpose company has completed its overseas listing and the domestic company has obtained its final approval certificate and business licence, any further acquisition of the domestic company through payment of equity interests of the special-purpose company must be done in accordance with the procedures outlined above for acquisition of domestic company by a foreign investor through payment of equity interests.

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ANNEX 1.A2

Statistical Tables

Table 1.A2.1. **FDI inflows to developing countries in 2006**

USD millions, balance of payments basis

China	78 095
Hong Kong, China	42 891
Singapore	24 191
Turkey	20 070
Mexico	19 222
Brazil	18 782
India	17 453
Thailand	10 750
Egypt	10 043
Chile	7 952
Colombia	6 463
Malaysia	6 064
Indonesia	5 580
Argentina	4 840
Philippines	2 086
Vietnam	1 954*

* 2005.

Source: IMF, *Financial Statistics*.

Table 1.A2.2. **FDI inflows, 1979-2007**

	Projects newly contracted	Contracted FDI inflows (USD million)	Realised FDI inflows (USD million)
1979-1982	920	4 958	1 769
1983	638	1 917	916
1984	2 166	2 875	1 419
1985	3 073	6 333	1 956
1986	1 498	3 330	2 244
1987	2 233	3 709	2 314
1988	5 945	5 297	3 194
1989	5 779	5 600	3 393
1990	7 273	6 596	3 487
1991	12 978	11 977	4 366
1992	48 764	58 124	11 008
1993	83 437	111 436	27 515
1994	47 549	82 680	33 767
1995	37 011	91 282	37 521
1996	24 556	73 276	41 726
1997	21 001	51 003	45 257
1998	19 799	52 102	45 463
1999	16 918	41 223	40 319
2000	22 347	62 380	40 715
2001	26 140	69 195	46 878
2002	34 171	82 768	52 743
2003	41 081	115 069	53 505
2004	43 664	153 479	60 630
2005	44 019	189 065	60 325
2006	41 485	*	69 468
2007	37 888	*	82 658

* MOFCOM stopped publishing contracted FDI figures in December 2005.

Source: MOFCOM website: *www.fdi.gov.cn*.

Table 1.A2.3. **FDI inflows as a proportion of gross fixed capital formation and GDP**

	% of gross fixed capital formation	% of GDP
1979-1982	0.5	0.2
1983	0.9	0.3
1984	1.3	0.4
1985	1.7	0.6
1986	2.0	0.8
1987	1.9	0.7
1988	2.1	0.8
1989	2.0	0.7
1990	2.5	0.9
1991	3.0	1.0
1992	6.0	2.2
1993	10.1	4.3
1994	14.3	5.8
1995	12.3	5.0
1996	12.1	4.7
1997	12.5	4.6
1998	12.0	4.3
1999	10.1	3.7
2000	9.7	3.4
2001	9.8	3.6
2002	9.6	3.6
2003	7.9	3.2
2004	7.3	3.1
2005	6.2	2.6
2006	4.6	2.4
2007	4.1	2.3

Calculated by OECD from non-financial FDI inflows, gross fixed capital formation and GDP at current prices, and annual average USD/CNY exchange rates.
Source: MOFCOM website: *www.fdi.gov.cn*; National Bureau of Statistics website: *www.stats.gov.cn*; Chinability website: *www.chinability.com*.

Table 1.A2.4. **China's inward FDI in 2007 by source, number of projects contracted**

Non-financial FDI only

	No. of projects		% change	Share in total		% change
	2007	2006		2007	2006	
Total	37 871	41 473	–8.7			
10 Asian countries and territories	27 363	28 863	–5.2	72.3	69.6	2.7
Hong Kong, China	16 208	15 496	4.6	42.8	37.4	5.4
Indonesia	68	115	–40.9	0.2	0.3	–0.1
Japan	1 974	2 590	–23.8	5.2	6.2	–1.0
Macau, China	856	868	–1.4	2.3	2.1	0.2
Malaysia	285	336	–15.2	0.8	0.8	–0.1
Philippines	83	147	–43.5	0.2	0.4	–0.1
Singapore	1 059	1 189	–10.9	2.8	2.9	–0.1
Korea	3 452	4 262	–19.0	9.1	10.3	–1.2
Thailand	79	108	–26.9	0.2	0.3	–0.1
Chinese Taipei	3 299	3 752	–12.1	8.7	9.0	–0.3
European Union	2 384	2 619	–9.0	6.3	6.3	0.0
Belgium	52	68	–23.5	0.1	0.2	0.0
Denmark	71	56	26.8	0.2	0.1	0.1
United Kingdom	475	462	2.8	1.3	1.1	0.1
Germany	548	576	–4.9	1.4	1.4	0.1
France	268	338	–20.7	0.7	0.8	–0.1
Ireland	30	16	87.5	0.1	0.0	0.0
Italy	348	409	–14.9	0.9	1.0	–0.1
Luxembourg	31	41	–24.4	0.1	0.1	0.0
Netherlands	182	262	–30.5	0.5	0.6	–0.2
Greece	16	11	45.5	0.0	0.0	0.0
Hungary	12	19	–36.8	0.0	0.0	0.0
Spain	193	167	15.6	0.5	0.4	0.1
Austria	57	67	–14.9	0.2	0.2	0.0
Finland	23	39	–41.0	0.1	0.1	0.0
Sweden	78	88	–11.4	0.2	0.2	0.0
North America	3 320	4 093	–18.9	8.8	9.9	–1.1
Canada	693	888	–22.0	1.8	2.1	–0.3
United States	2 627	3 205	–18.0	6.9	7.7	–0.8
Selected free ports	3 233	4 106	–21.3	8.5	9.9	–1.4
Mauritius	243	281	–13.5	0.6	0.7	0.0
Cayman Islands	342	414	–17.4	0.9	1.0	–0.1
British Virgin Islands	1 883	2 605	–27.7	5.0	6.3	–1.3
Samoa	765	806	–5.1	2.0	1.9	0.1
Other	2 314	2 670	–13.3	6.1	6.4	–0.3

Source: MOFCOM FDI website: *www.fdi.gov.cn.*

Table 1.A2.5. **China's inward FDI in 2007 by source, value of actually utilised investment (USD million)**

Non-financial FDI only

	Actually utilised investment		% change	Share in total		% change
	2007	2006		2007	2006	
Total	74 767.8	65 821.0	13.6			
10 Asian countries and territories	41 383.4	36 279.4	14.1	55.3	55.1	0.2
Hong Kong, China	27 703.4	21 307.2	30.0	37.1	32.4	4.7
Indonesia	134.4	106.9	25.8	0.2	0.2	0.0
Japan	3 589.2	4 759.4	–24.6	4.8	7.2	–2.4
Macau, China	637.0	677.7	–6.0	0.9	1.0	–0.2
Malaysia	397.3	451.2	–12.0	0.5	0.7	–0.2
Philippines	195.3	142.3	37.3	0.3	0.2	0.0
Singapore	3 184.6	2 463.0	29.3	4.3	3.7	0.5
Korea	3 678.3	3 993.2	–7.9	4.9	6.1	–1.1
Thailand	89.5	148.6	–39.8	0.1	0.2	–0.1
Chinese Taipei	1 774.4	2 229.9	–20.4	2.4	3.4	–1.0
European Union	3 838.4	5 439.5	–29.4	5.1	8.3	–3.1
Belgium	95.8	81.1	18.2	0.1	0.1	0.0
Denmark	125.1	196.2	–36.2	0.2	0.3	–0.1
United Kingdom	830.9	754.5	10.1	1.1	1.1	–0.0
Germany	734.0	2 003.0	–63.4	1.0	3.0	–2.1
France	456.0	395.3	15.3	0.6	0.6	0.0
Ireland	61.0	24.1	153.8	0.1	0.0	0.0
Italy	347.9	358.1	–2.8	0.5	0.5	–0.1
Luxembourg	82.5	94.9	–13.1	0.1	0.1	–0.0
Netherlands	616.7	864.6	–28.7	0.8	1.3	–0.5
Greece	2.4	0.2	1 019.0	0.0	0.0	0.0
Hungary	8.2	9.9	–16.9	0.0	0.0	–0.0
Spain	213.2	242.8	–12.2	0.3	0.4	–0.1
Austria	82.3	152.5	–46.0	0.1	0.2	–0.1
Finland	55.9	55.9	0.0	0.1	0.1	–0.0
Sweden	126.4	206.4	–38.8	0.2	0.3	–0.1
North America	3 012.8	3 441.7	–12.5	4.0	5.2	–1.2
Canada	396.6	441.8	–10.2	0.5	0.7	–0.1
United States	2 616.2	3 000.0	–12.8	3.5	4.6	–1.1
Selected free ports	22 625.6	16 534.3	36.8	30.3	25.1	5.1
Mauritius	1 332.5	1 105.5	20.5	1.8	1.7	0.1
Cayman Islands	2 570.8	2 131.8	20.6	3.4	3.2	0.2
British Virgin Islands	16 552.4	11 677.3	41.7	22.1	17.7	4.4
Samoa	2 169.9	1 619.8	34.0	2.9	2.5	0.4
Other	3 907.6	4 126.2	–5.3	5.2	6.3	–1.0

Source: MOFCOM FDI website: *www.fdi.gov.cn*.