

# CHINA INSIDER INTERNATIONAL

不怕慢,就怕站

Be not afraid of growing slowly, be afraid only of standing still

富很大程度取决于运气,  
很小程度取决于刻苦

Great fortune depends on luck, a small one on diligence.

千里之行始于足下

The journey of a thousand miles starts with a single step



## Editorial

The tax political measures of the Chinese government and the financial administration obviously reflect that China can no longer be considered as a low tax country. An essential part of the latest tax decrees and administrative directives has been passed in order to ensure that the tax base in China is preserved. Furthermore, they are supposed to counteract a shifting of potential earnings outside of China. These trends are emphasized by the topics addressed in this China Insider International.

The article „SAT Aims to Offshore Indirect Equity Transfer of Chinese Companies“, for example, illustrates the effort of the Chinese financial administration to work against arrangements that are set up in

order to achieve an avoidance of Chinese withholding tax on the disposal of shares by means of indirect transfers.

Further measures aimed at the preservation of the Chinese tax base are the new regulations on transfer pricing documentation and thin capitalization rules that will be addressed in this issue as well.

However, we want to catch up on the latest positive developments for international investors, such as the new treaty on the avoidance of double taxation signed between China and Belgium and the amendments passed regarding the Chinese Patent Law, as well.

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## INCOME TAX LAW

### SAT Aims to Offshore Indirect Equity Transfer of Chinese Companies

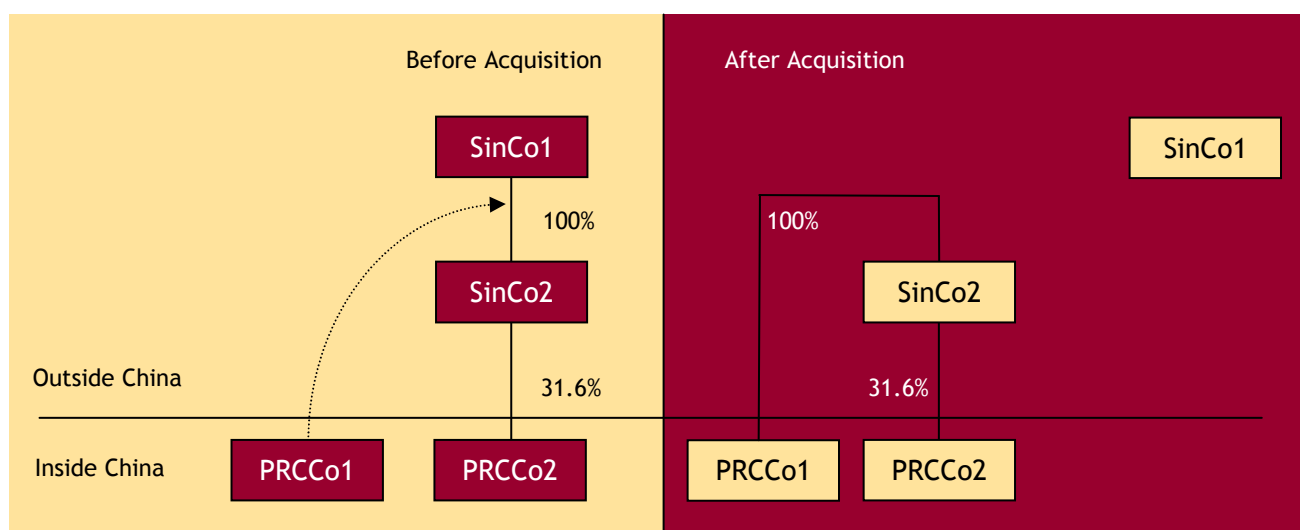
China's State Administration of Taxation (SAT) on December 10, 2009, issued Guoshuihan [2009] No. 698 (Circular 698), which clarifies enterprise income tax (EIT) treatment of capital gains derived by nonresident enterprises from the transfer of the shares (excluding publicly traded stocks) in Chinese resident enterprises.

#### Indirect Equity Transfers

Circular 698 says that a foreign investor (actual controller) who indirectly transfers the shares in a Chinese resident enterprise will be subject to disclosure of the documents designated in article 5 of Circular 698 (for example, the equity transfer agreement) to the Chinese competent tax authority in which the resident enterprise is situated within 30 days of the date the equity transfer agreement is signed, if the company (holding company), whose shares are directly transferred, is located in a tax jurisdiction that has an effective rate of less than 12.5 percent or does not levy income tax on its residents for foreign-source income.

Circular 698 states that if a foreign investor (actual controller) who indirectly transfers the shares in a Chinese resident enterprise through an arrangement lacking a reasonable commercial purpose (for example, abuse of corporate form) and avoids EIT obligations, then the competent tax authorities can, subject to review and confirmation from the SAT, disregard the overseas holding company and recharacterize the equity transfer transaction based on economic substance.

Below is a tax case of an indirect equity transfer of the shares in a Chinese company. In May 2008, a Chinese tax office in Chongqing, through an equity transfer agreement filing, noticed that a Chinese company (PRCCo1) purchased from a Singaporean company (SinCo1) 100 percent of the shares of a wholly-owned holding company (SinCo2) in Singapore that in turn owned 31.6 percent of the shares of a Chinese resident enterprise registered in Chongqing (PRCCo2), the Chongqing Municipal Office of the SAT reported. The sales price of this deal was CNY 63.38 million (about \$9.28 million) and the capital gains were about CNY 9 million (about \$1.32 million). The transaction is illustrated using the following chart.



In this tax case, it looked like China did not have taxation rights on the capital gains since SinCo2, whose shares were directly transferred, was located outside of China. That tax office, however, implemented investigations confirming that SinCo2 had a paid-in capital of only SGD 100 and did not have any other business operations except the stock holding activity. As a result, the tax office, after having obtained approval from the SAT, came to a conclusion that the disposition of 100 percent of the shares in SinCo2 was regarded as the sale of 31.6 percent of the shares in PRCCo 2 and that the capital gains were therefore sourced from China and subject to the EIT.

### EIT Calculation

The EIT on capital gains derived by a nonresident enterprise without an establishment in China from the alienation of the shares in a company located in China is calculated using the following formula:

$$\text{EIT} = (\text{sales price} - \text{investment cost}) \times 10 \text{ percent}$$

The sales price is the amount received by the transferor from the transfer of the shares in various forms such as cash, noncash assets, and equity. If the company, whose shares are transferred, has retained earnings and reserves in the owner's equity accounts, then the transferor of the shares cannot deduct the retained earnings and reserves from the sales price when calculating the EIT, according to Circular 698.

The investment cost is the amount of capital actually contributed by the transferor to the Chinese resident enterprise in the course of the investment or is the purchase price actually paid by the transferor to the original transferor in the course of the initial acquisition of the shares.

### Comments

Since Circular 698 has retroactive effect from January 1, 2008, a nonresident enterprise meeting the disclosure criteria regarding an indirect equity transfer arising on or after January 1, 2008 should submit the designated documents to the Chinese competent tax authority in a timely manner. Also, a nonresident enterprise triggering the EIT on capital gains on a direct equity transfer occurring on or after that effective date should accurately calculate and timely report the EIT in accordance with Circular 698.

◆ by Stone Yang, BDO in China

### SAT Clarifies Foreign Tax Credit Regime

The Chinese Ministry of Finance (MOF) and State Administration of Taxation (SAT) on December 25, 2009, issued Caishui [2009] No. 125 (Circular 125), providing new rules for foreign tax credits (FTCs). The new rules, which have retroactive effect from January 1, 2008, can be regarded as a clarification of the Chinese FTC regime.

Resident and nonresident enterprises can be entitled to claim an FTC for qualified taxes in accordance with the Enterprise Income Tax (EIT) Law and Circular 125. To qualify for an FTC, the particular enterprises must meet some stipulated conditions. For example, they are required to separately calculate the amount of Chinese-source taxable income and foreign-source taxable income on a country-by-country basis. The amount of creditable foreign taxes and FTCs will also be computed on a country-by-country basis. If an enterprise fails to calculate creditable foreign taxes on that basis, taxes paid to the corresponding foreign countries will not be allowed as an FTC in the current, or any future, year.

Circular 125 defines creditable foreign taxes as foreign taxes of an income tax character that are due and actually paid by an enterprise on foreign-source income in accordance with foreign tax laws and regulations. Circular 125, however, excludes some foreign taxes from the creditable foreign taxes, for example, those foreign income taxes that are incorrectly paid or unlawfully imposed according to foreign tax laws and regulations.

Circular 125 states that foreign-source taxable income derived by a foreign branch of a Chinese resident enterprise is total foreign-source income less reasonable costs and expenses relating to that income. Such income, costs, and expenses will be determined by the EIT Law and its implementation regulations. Also, the deductible costs and expenses must be relevant to the foreign-source income. Any income of a foreign branch of a Chinese resident enterprise will be included in the resident enterprise's foreign-source taxable income of the current tax year, whether or not the income is repatriated to China in that year. Net operating losses incurred by a foreign branch of a Chinese resident enterprise will also be calculated according to the EIT Law and its implementation regulations. The NOLs arising in a foreign country cannot be offset against any Chinese-source taxable income or foreign-source taxable income arising in another foreign country.

Regarding indirect FTCs, income taxes that are paid by a foreign enterprise but deemed to be borne by an immediate higher-tier enterprise are calculated using the following formula according to Circular 125:

$$\text{The taxes} = (\text{taxes actually paid by the foreign enterprise on its profits and dividend income} + \text{taxes indirectly borne by the foreign enterprise according to Circular 125}) \times \text{dividends distributed by the foreign enterprise to that higher-tier enterprise divided by after-tax profits of the foreign enterprise.}$$

For indirect FTC purposes, such a foreign enterprise in which a Chinese resident enterprise directly or indirectly holds more than 20 percent of the shares must fall within the first three tiers of the stock chain

immediately under that resident enterprise, unless otherwise stipulated by the finance and taxation departments of the State Council. Circular 125 sets different requirements for each tier foreign enterprises for indirect FTC purposes as follows:

- for the first tier, the Chinese resident enterprise must directly hold at least 20 percent of the shares in each first-tier foreign enterprise;
- for the second tier, each first-tier foreign enterprise must directly hold at least 20 percent of the shares in the second-tier foreign enterprises and the Chinese resident enterprise must directly or indirectly hold an aggregate of at least 20 percent of the shares in each second-tier foreign enterprise in cases where indirect shares are held through one or more qualified foreign enterprises; and
- for the third tier, each second-tier foreign enterprise must directly hold at least 20 percent of the shares in the third-tier foreign enterprises and the Chinese resident enterprise must directly or indirectly hold an aggregate of at least 20 percent of the shares in each third-tier foreign enterprise in cases where indirect shares are held through one or more qualified foreign enterprises.

Circular 125 also offers a tax sparing credit policy. Foreign taxes of a Chinese resident enterprise that are exempted or reduced according to the laws of the foreign jurisdiction can be treated as creditable foreign taxes, if those taxes are regarded as having already been paid based on the applicable tax treaty with that foreign treaty partner.

Circular 125 contains guidance for the calculation of FTC limitations. The FTC cap will be calculated separately for each country using an applicable formula set by the MOF and the SAT. Foreign taxes in excess of the FTC limitation may be carried forward to the following five tax years.

◆ by Shengshi Zhang, China Desk, BDO in Germany

### **SAT Clarifies Tax Treatment of Prior Years' Asset Losses**

China's State Administration of Taxation (SAT) on December 31, 2009, issued Guoshuihan [2009] No. 772 (Circular 772), clarifying that an enterprise's asset losses realized in a prior year (including any year preceding 2008) under the definition of asset losses in the enterprise income tax law valid at that time cannot be carried forward to following years but may be retroactively recognized in that prior year in accordance with China's EIT Law and Tax Collection and Administration Law. In other words, the tax year in which asset losses arise will not be changed regardless of whether the losses are claimed in a timely manner.

Circular 772 says that overpaid EIT resulting from missing a deduction of asset losses in a prior year may

be used to offset EIT due in the current year in which the tax authority approves a retroactive recognition of unclaimed losses. Any overpaid EIT in excess of the EIT due can be carried forward as a credit.

If the retroactive recognition of asset losses results in net operating losses for the prior year, the asset losses will still be recognized for that prior year and the NOLs will be carried forward by applying the NOL carryforward principle; overpaid EIT arising after that prior year because of the NOL carryforwards can be used to offset EIT due in the current year as specified above, according to Circular 772. Essentially, any unclaimed asset losses should be included in the prior year of occurrence as if they had been correctly claimed originally.

Failure to timely deduct asset losses and other costs and expenses from the taxable income of the current year could prevent a taxpayer from later receiving a refund of the overpaid EIT. A taxpayer can request a refund of overpaid tax plus interest if he realizes the overpaid tax within three years of the tax payment date, according to article 51 of the Tax Collection and Administration Law. The tax authority will refund the overpaid tax to the taxpayer after the overpayment has been verified. The tax authority may not approve the refund if the taxpayer misses the three-year deadline. NOLs can be carried forward a maximum of five years, and no carryback is allowed.

The tax administration recognizes two types of asset losses, according to Guoshuifa [2009] No. 88, issued by the SAT on May 4, 2009. For the first type of asset losses, taxpayers will calculate and deduct the losses in the year of occurrence and don't need to seek approval from the tax authority. Those losses include losses from the sale, transfer, and disposal of fixed assets, biological assets, and inventories in the ordinary course of business operations; losses from the trade of bonds, stock, funds, and financial derivatives in stock ex-changes and interbank markets; losses from the normal use of inventories, from the normal clearing of fixed assets on or after the depreciation expiration date, and from the normal death of biological assets on or after the normal useful date; and other losses that are permitted by the SAT.

The second type of asset losses covers all other asset losses – for example, bad debt losses and losses recorded when physically counting inventory and fixed assets. When taxpayers incur those losses, they will be required to submit documentation of them to the tax authority for approval in a timely manner in order to claim the deduction.

◆ by Glen Wei, China Desk, BDO in United States (this article was published in *Tax Notes International of Tax Analysts*)

## TRANSFER PRICING

### FIEs With NOLs Subject to Transfer Pricing Documentation, SAT Says

A foreign investment enterprise that had limited function and risk but had net operating losses in 2008 was required to complete transfer pricing documentation for that year by December 31, 2009, officials with China's State Administration of Taxation (SAT) confirmed in a January 28 online interview. This could affect, for example, single-function manufacturers, distributors, and research and development contractors.

Guoshuihan [2009] No. 363 (Circular 363), issued by the SAT on July 6, 2009, clarifies that if an FIE with limited function and risk generates NOLs for a current year, it must prepare contemporaneous documentation and other related documents for the loss-making year and submit them to the competent tax authority by June 20 following the end of that year (even if the FIE does not meet the minimum threshold for contemporaneous documentation). However, Circular 363 does not make clear whether such a taxpayer is subject to transfer pricing documentation requirements.

SAT officials said Circular 363 is a supplement to the transfer pricing rules (Implementation Rules for Special Tax Adjustments, Guoshuifa [2009] No. 2) that took effect on January 1, 2008. Such a 2008 loss-making taxpayer is therefore subject to contemporaneous documentation requirements as of June 20, 2009. The timing may be extended to December 31, 2009, under the transfer pricing rules, they added.

A taxpayer who fails to prepare contemporaneous documentation in accordance with the relevant provisions of the transfer pricing rules will be at higher risk of a transfer pricing investigation in accordance with article 29 of the transfer pricing rules. Therefore, taxpayers that meet the aforementioned 2008 documentation criteria and have not finished preparing the documentation should take measures to remedy the situation as soon as possible.

◆ by Glen Wei, China Desk, BDO in United States (this article was published in *Tax Notes International of Tax Analysts*)

### Circular Clarifies Thin Capitalization Rule for Interest Deduction

China's State Administration of Taxation on December 31, 2009, issued Guoshuihan [2009] No. 777 (Circular 777), which clarifies the application of the enterprise income tax deduction to interest paid by enterprises to individuals.

Circular 777 states that interest expenses paid by an enterprise to an individual shareholder or another individual who has a related-party relationship with the enterprise are subject to article 46 of the Enterprise Income Tax Law and to the criteria of Caishui [2008] No. 121 (Circular 121) when computing taxable income.

Those rules establish that an enterprise is allowed to deduct interest expenses actually paid to related parties up to the amount calculated based on the standard debt-equity ratio (5 to 1 for financial enterprises and 2 to 1 for other enterprises) and other limitations of the EIT Law and its implementation regulations, unless the enterprise satisfies conditions that exempt it from the debt-to-equity limitation. Interest expenses in excess of the limitation cannot be deductible in the current, or any future, year.

For interest paid by an enterprise to an unrelated individual (including an employee), Circular 777 states that the enterprise must sign a loan agreement with the individual and that the loan must be authentic, legitimate, and valid, and must not have the intent of illegal financing or violate other laws and regulations for deduction purposes.

The deductible interest is limited to the amount computed at the standard financial institution interest rate for the same type of loan with the same payment period. Also, the interest must have actually arisen and be reasonable and relevant to the taxpayer's income. In other words, if the interest has not actually arisen or is unreasonable or unrelated to the taxpayer's income, a deduction will not be allowed, even if it does not exceed the limitation.

◆ by Glen Wei, China Desk, BDO in United States (this article was published in *Tax Notes International of Tax Analysts*)

## TAX TREATIES

### China Clarifies Beneficial Owners' Status for Treaty Benefits

China's State Administration of Taxation on October 27 issued Guoshuihan [2009] No. 601 (Circular 601), which clarifies beneficial owners' status for treaty benefits such as income tax reductions or exemptions for dividends, royalties, and interest income.

#### Definition of Beneficial Owner

The circular states that a beneficial owner is a person who has the ownership and control rights of such income or of the rights or property arising from that income. According to Circular 601, a beneficial owner is an individual, a company, or any other organization; but it cannot be an agent or a conduit company. A conduit company is a company created generally for purposes of evading or reducing taxes or shifting or

sheltering profits. Such a company is registered in a given country as an organization formed under applicable laws but does not carry out manufacturing, purchases and sales, management, and other actual business activities.

Circular 601 states that in addition to domestic laws, treaty intent – avoidance of double taxation and prevention of tax evasion – and the substance-over-form principle must be used to determine the status of a beneficial owner on a case-by-case basis.

#### Substance Over Form

Circular 601 sets out the following examples that are unfavorable for applicants to establish the status of a beneficial owner:

- the applicant has the obligation to pay a third country or region’s resident all or most (such as 60 percent or more) of the income within a given period (such as 12 months from the date the income is received);
- in addition to the property or rights arising from the income, the applicant does not have or seldom has any other business operations;
- if it is an entity such as a company, the volume of the applicant’s assets, scale, and employees is small and obviously does not match the amount of the income;
- the applicant does not have or seldom has the rights to control or dispose of the income or of the property or rights arising from that income, and it does not bear or seldom bears relevant risks;
- the income is nontaxable, exempted, or taxed at a very low effective tax rate in the treaty partner country or region;
- besides the loan agreements for which the interest is derived and paid, the creditor has other loan or deposit agreements with a third party that are similar to these loan agreements in principal, loan rate, issuance date, and other respects; and
- in addition to the license agreements (such as copyright, patent, and technology agreements) for which the royalties are generated and paid, the applicant has other assignment agreements with a third party regarding the transfer of use rights or ownership in copyrights, patents, or technology.

#### Supporting Documents

Circular 601 requires a taxpayer to submit documents supporting its qualification as a beneficial owner when asking for tax treaty treatment. The candidate will not be recognized as the beneficial owner of the income if it does not meet the definition of beneficial owner on the basis of an analysis of the listed unfavorable factors.

#### Observations

When doing business in China, it is common for foreign companies to indirectly own their Chinese subsidiaries through a holding company established in Hong Kong

or Singapore for tax purposes. Such foreign companies should examine whether the holding company falls under the definition of conduit company and whether its business arrangements trigger the aforementioned unfavorable circumstances. When necessary, they should consider making proper business adjustments to avoid these adverse factors in order for the holding company to qualify as a beneficial owner and consequently qualify for the treaty rate of 5 percent on dividends derived from a Chinese source.

It is also common for foreign companies to offer a back-to-back loan to their Chinese companies via a holding company registered in Hong Kong for income tax purposes. They should carefully take the above unfavorable situations into consideration and make appropriate arrangements when making a back-to-back loan to their Chinese entities in the future. If the Hong Kong holding company is not identified as the beneficial owner of the interest income because of inappropriate arrangements, it will not be eligible for the treaty rate of 7 percent for the interest income arising from the loan.

A foreign company may also license a trademark, technology, or copyright to its Chinese company through a holding company located in Hong Kong so that the royalties paid by the Chinese company are taxed at only 7 percent for Chinese income tax purposes. Such a foreign company should also read the circular carefully before entering into future royalty arrangements.

◆ by Glen Wei, China Desk, BDO in United States (this article was published in *Worldwide Tax Daily of Tax Analysts*)

### Belgium, China Signs New Income Tax Treaty

On October 7, 2009, China and Belgium entered into a new Agreement between the Government of the People’s Republic of China and the Government of the Kingdom of Belgium for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income and a new protocol (new treaty). The new treaty will replace the Belgium-China tax treaty signed on April 18, 1985 as well as its protocols (old treaty) when it comes into effect, with the completion of required legal procedures. Compared with the old treaty, the new treaty contains more preferential treatment in the articles of permanent establishment, dividends, and royalties. Below are some differences between the new and old treaties.

#### Permanent Establishment

Under the new treaty, a building site, a construction, assembly, or installation project, or supervisory activities associated with the site or project will constitute a PE if the site, project, or activities last more than consecutive 12 months. As compared, the

old treaty provides for a six-month threshold for PE purposes and does not contain the words “a construction” and “installation project” in such a deemed construction PE clause.

The new treaty changes the threshold from 6 months to 183 days for purposes of determining whether a deemed service PE is created.

#### Dividends

According to the new treaty, a 5 percent rate applies if the beneficial owner of the dividends is a company (other than a partnership) that had ever a participation directly of at least 25 percent of the capital of the company paying the dividends during the 12-month period preceding the payment of the dividends, and a 10 percent rate applies in all other cases. In the old treaty, a 10 percent rate applies in all cases.

#### Royalties

The treaty rate for royalties derived by the beneficial owner of the royalties is 7 percent according to the new treaty. In the old treaty, the treaty rate for royalties is 10 percent; the taxable amount, however, accounts for only 60 percent of the gross amount of royalties if the royalties are paid for the use of, or the right to use, industrial, commercial, or scientific equipment.

#### Capital Gains on Equity Transfers

**Type 1 – Immovable Companies.** Gains derived by a resident of a contracting state (residence state) from the alienation of shares in a company whose property consists, directly or indirectly, principally of immovable property situated in the other contracting state (source state) may be taxed in the source state under the old and new treaties. The new treaty, however, clarifies the term “principally” as “more than 50 percent”.

**Type 2 – 25 Percent Shares in Other Companies or More.** Gains derived by a resident of a contracting state (residence state) from the alienation of shares, other than the shares referred to in Type 1, representing a participation of at least 25 percent in a resident company of the other contracting state (source state) may be taxed in the source state under the old treaties. As compared, the new treaty states that gains derived by a resident of a contracting state from the transfer of the shares in a resident of the other contracting state may be taxed in that other state if the firstmentioned resident owns directly or indirectly at least 25 percent of the shares in the other resident preceding the transfer, unless otherwise the shares are substantially and regularly traded on a recognized stock exchange and the total the shares traded in the fiscal year is 5 percent or less of the total publicly traded shares.

**Type 3 – Less Than 25 Percent Shares in Other Companies.** According to the old treaty, gains earned

by a resident of a contracting state (residence state) from the alienation of all other shares (other than the shares referred to in Type 1 and Type 2) in a resident company of the other contracting state (source state) may be taxed in the source state. However, such gains will be tax only in the residence state under the new treaty.

◆ by Stone Yang, BDO in China

## BUSINESS LAW

### China Tightens Administration of Representative Offices of Foreign Enterprises

The Chinese State Administration for Industry and Commerce and Ministry of Public Security on January 4 jointly issued Gong Shang Wai Qi Zi [2010] No. 4 (Circular 4), which provides new rules for the administration of representative offices (ROs) in respect of examination of registration documents, valid period of registration licenses, number of representatives, and on-site verification and inspection.

Circular 4 says that when applying for establishing an RO or amending the name of an RO, a certificate of incorporation of the foreign enterprise of the RO, which certifies that the foreign enterprise has been in existence for more than two years, must be submitted to the Chinese government department for industry and commerce. A credit certificate issued by a financial institution having business transactions with that foreign enterprise must also be provided. Prior to submission, these certificates must be notarized by a notary agency in the foreign country (region) where the foreign enterprise is located and verified by a Chinese consulate situated in that country (region).

Circular 4 also says that an RO is generally not allowed to have more than four representatives (including the chief representative) and that an RO that has already more than four representatives will not be permitted to increase the number of representatives but can reduce the number of representatives in principle.

Circular 4 requires local government departments for industry and commerce to set one year as the valid period of the registration license of an RO in accordance with relevant rules.

The local government departments for industry and commerce are also required to implement on-site inspection and verification regarding the registration information (such as registered address) within three months from the issuance date of the registration license of an RO, according to Circular 4.

An RO, whose legal system appears in the Provisional Regulations for Administration of Representative Offices of Foreign Enterprises issued by the State Council on October 30, 1980, is one of the oldest forms available for foreign enterprises to do business

in China. In general, activities available for ROs to perform in China cannot be direct business activities (profit-making business activities), but rather are usually limited to the following:

- establishment and maintenance of business relationship between the foreign enterprise and its potential business partners and customers;
- promotion of the foreign enterprise's products;
- execution of market surveys; and
- technical communications with regard to the business area of the foreign enterprise.

Some ROs, however, conducted profit-making business activities in recent years, which are outside of the abovementioned activities. Circular 4 is designed partly to remedy this situation.

The Legislative Affairs Office of the State Council on August 29, 2008, issued a draft of the Registration and Administration Regulations for Representative Offices of Foreign Enterprises, requesting comments from the public. The draft, which is supposed to reform the Chinese legislation regarding ROs, defines permitted activities of ROs and also sets out administrative sanctions on ROs in violation of related provisions. For example, the draft says that an RO performing profit-making activities because of violating the regulations could be subject to a maximum penalty of CNY 500,000 (about US\$ 73,000), an amount that represents 25 times the maximum penalty under the existing rules.

Under the draft, when the Chinese registration authorities suspect an RO's violation of the new regulations and therefore performs investigations on that RO, the authorities would have a series of rights, for example, examining accounting vouchers and books, searching and/or sealing suspect space, and requesting the appropriate authority to freeze bank accounts containing illegal money.

The draft also indicates that if the registration license of an RO is revoked as a result of violation of the new regulations, the foreign enterprise of that RO would not be eligible to open any new RO in China within five years of the date the license is revoked.

◆ by Gai-Mau Ma, China Desk BDO in Germany

### China Amends Implementation Regulations of Patent Law

The State Council on January 9 published an amendment to the Implementation Regulations of Patent Law of the People's Republic of China (Decree No. 569), which contains a wide range of modifications to the previous implementation regulations to the patent law. The amended implementation regulations took effect on February 1.

The January 9 modification conforms to the third amendment to the Patent Law of the People's

Republic of China, which was passed by the standing committee of the National People's Congress on December 27, 2008 and came into force on October 1 last year.

The new patent law regime covers, for example, the following provisions and changes:

- An absolute novelty standard, which replaced the "relative novelty standard", will be applied to assess the patentability of inventions and utility models. Prior art (existing technology), which is outside of the new patentability standard under the new patent law system, is defined as any technology that is publicly known anywhere in the world before the filing date.
- A foreign individual, enterprise, or other organization that does not have a habitual residence or a business establishment in China will be required to engage a patent agency established in accordance of laws to apply for patent registration in China in the course of the application. A patent application by such a foreign individual or entity will no longer be necessarily carried out by a patent agency appointed by the Chinese government department in charge of patents.
- A patent application for an invention or utility model created by any entity or individual in China can be filed directly outside of China but will be subject to a prior examination of confidentiality (security review) by the patent department of the State Council.
- A co-owner of a patent can individually exploit the patent or allow a third party through a general license (other than an exclusive license) to exploit that patent, unless otherwise stipulated by the co-owners. In that case, royalties arising from that license will be shared among those co-owners.
- The transfer of a patent application right or a patent by a Chinese entity or individual to a foreign individual, enterprise, or other organization will be subject to procedures prescribed by relevant laws and regulations. As compared, the old patent law stated that such a transfer was subject to approval from the related competent department of the State Council.
- A compulsory license of an invention or utility model patent may be granted by the patent department of the State Council to an entity or individual applicant who is capable of exploiting the patent if the owner of that patent has not exploited, or sufficiently exploited, the patent without any reasonable grounds within three years of the approval date of the patent and four years of the filing date of the patent. Such a compulsory license may also be triggered in case of a national emergency or extraordinary event or of public interests need.
- The protection period of an invention patent is 20 years of the filing date; the protection period of a

utility model patent or a design patent is 10 years of the filing date.

- A preliminary injunction (pre-suit injunction) may be available for qualifying infringement cases before filing an infringement suit. A court is required to make a decision within 48 hours after accepting a request for a preliminary injunction. The decision deadline may be extended by 48 hours for special circumstances. If the court makes a decision that requires stopping of an infringement act, that decision will be implemented immediately.
- The amount of compensation for patent infringement damages will be determined by one of the following four methods by the following order (for example, if the actual losses under the first method can be determined, the rest of the methods will not be applied; otherwise, the second method will be taken into consideration):
  1. The actual losses incurred by the patentee.
  2. The profits earned by the infringer from the patent infringement.
  3. A multiple of the reasonable royalties by reference to licensing of that patent.
  4. An amount ranging from CNY 10,000 to CNY 1,000,000 (about US\$150,000) that is determined by the court based on the type of patent, the character of infringement, and the degree of damage.
- A counterfeiting of patents may make the infringer liable for a maximum penalty at four times income from that counterfeiting. If no income is earned, the maximum penalty may be CNY 200,000 (about US\$30,000).

The Patent Law was passed by the standing committee of the National People's Congress on March 12, 1984 and took effect on April 1, 1985. The first and second amendments to the Patent Law were passed by that standing committee on September 4, 1992 and August 25, 2000, respectively.

◆ by Jing Wang, China Desk, BDO in Germany

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