



China Insights

A PUBLICATION OF BENESCH FRIEDLANDER COPLAN & ARONOFF LLP

China Goes Global: Examining China's Outbound Investment

China's overseas investment has rapidly increased over the last few years as Chinese companies expand into new markets seeking to develop advanced technology, brand names and natural resources. More and more Chinese enterprises are now investing abroad. From 2007 to 2008, China's overseas investment doubled from \$20 billion to \$52.2 billion. Over the last year, Chinese enterprises have invested in companies ranging from Addax Petroleum, a publicly traded Canadian oil and gas company, to the Cleveland Cavaliers basketball team.

While the global financial crisis has slowed the growth of Chinese outbound investment, it has also created investment opportunities for cash rich Chinese enterprises by lowering prices for targeted companies and assets. Despite the financial crisis, China's outbound investment is growing. China's National Development and Reform Commission (the NDRC), which guides many aspects of China's economic and social development, estimates that outbound investment will have increased by 13.2% in 2009.

As part of a campaign started in 2000, the Chinese government encourages Chinese companies to "zou chu qu" or "go out" or "go abroad." Recently, various Chinese government agencies have relaxed regulations to allow Chinese enterprises to secure favorable outbound investment deals during the current economic downturn. These changes will help more Chinese enterprises

invest abroad and thereby expand their distribution channels, enter new markets, and secure important strategic resources such as strong brand names, advanced technology and natural resources.

Why Chinese Enterprises Are Investing Abroad

One of the main reasons Chinese enterprises invest overseas is to secure the prestige that comes with acquiring an internationally known brand. The marketing appeal of an international brand motivates Chinese enterprises with established Chinese brands to expand into foreign markets. Additionally, the allure of creating the Chinese equivalent to Sony or Samsung appeals to a sense of national accomplishment among Chinese enterprises. As a result of the appeal of building a strong brand, Chinese companies looking to expand overseas are increasingly moving away from manufacturing OEM and intermediate products bearing other companies' brands in favor of expanding with their own branded products. In addition, a Chinese brand that becomes well-known abroad has increased allure in the ever-growing Chinese domestic market. Being able to say that a particular brand is well-known in a foreign market (i.e., "famous in the USA") can be very good for business in China.

A second reason Chinese enterprises look to invest overseas is to develop advanced technology or enhance their R&D capability. In its bid for GM's Opel unit, the Chinese car producer Beijing

Automotive Industry Holding Co. cited GM's engine technology as a "key driver" of its interest in acquiring the company. Setting up R&D centers in developed countries allows Chinese companies to take advantage of those countries' research and innovation capabilities. For example, the Chinese networking and telecommunications equipment producer Huawei Technologies set up a network of foreign R&D centers, many in developed countries, which helped it to become the largest applicant for international patents in 2008. Chinese enterprises are increasingly interested in designing and owning their own intellectual property, and this interest motivates these businesses to expand into innovation-friendly developed markets like the U.S.

Access to natural resources has also been a driving force in motivating Chinese enterprises to invest abroad. China is the world's largest metals consumer and is second only to the U.S. in oil consumption. As China's economy grows, it will continue to consume more natural resources. Recent Chinese international M&A deals, like Sinopec's \$7.2 billion offer for Addax Petroleum and Chinalco's attempt to acquire the Australian mining company Rio Tinto,

continued on page 2

IN THIS ISSUE:

China Goes Global: Examining China's Outbound Investment

High-Technology Enterprise Status

China Goes Global: Examining China's Outbound Investment

continued from page 1

reflect China's emphasis on natural resource development.

For some Chinese enterprises, investing in markets abroad can also provide relief from competition at home. Many Chinese companies see opportunities, especially in emerging markets, where

they can effectively compete using existing technology to produce "good enough" but less expensive products. For example, Russia, the Middle East and Southeast

Asia have become important markets for inexpensive Chinese-made small vehicles, as Chinese auto companies face increasingly stiff competition from multinational car companies in the Chinese domestic market. Chinese companies, including Chery Automobile Co., have established themselves in these markets and may further expand into other emerging markets like Brazil. Expanding into international markets can also help Chinese companies avoid other problems in the Chinese market, such as overcapacity. Consumer electronics manufacturer Lenovo and home appliance manufacturer Haier both began their expansion abroad in the face of domestic overcapacity in their respective industries.

External catalysts are also driving Chinese enterprises to invest overseas. The financial crisis has lowered the cost of acquiring many companies and assets, and cash rich Chinese companies are taking advantage of these opportunities. Chinese companies such as Geely Holding Group Co. and Tengzhong Heavy Industrial Machinery have found themselves in a position to possibly acquire famous brands such as Volvo and Hummer from Ford and GM as the two American companies struggle through the current economic downturn.

The Chinese government has identified the global financial crisis as an opportunity for Chinese enterprises and has been working to promote outbound investment by simplifying regulatory procedures as discussed below. Some officials, such as Chinese Premier Wen

Jiabao, have also recommended using China's massive foreign exchange reserves, which have climbed to over \$2 trillion, to help Chinese companies invest abroad.

"The Chinese government has identified the global financial crisis as an opportunity for Chinese enterprises..."

How Chinese Companies Are Investing Abroad

Many Chinese enterprises are making their first international investments in developing markets. Developing markets generally give Chinese enterprises an opportunity to compete without investing in new technology or changing their business to comply with strict regulatory standards. However, despite the initial appeal of emerging markets, many Chinese businesses see success in developed markets like Europe and the U.S. as their ultimate goal.

Many Chinese enterprises moving into international markets have signaled that they plan to emphasize M&A as a way to gain an international foothold more quickly than through organic growth. Korean and Japanese companies took decades to become successful global enterprises, but Chinese companies hope to use acquisitions as a way to catch up with more established multinational companies. The economic downturn has strengthened the incentive to take this approach by lowering the prices of potential acquisition targets.

Challenges Facing Outbound Investors

Despite the favorable economic and regulatory conditions for Chinese

outbound investment, Chinese enterprises can still face problems with their international investments and often struggle to make their investments profitable. Cultural differences make cross-border expansion difficult, especially in M&A situations. Chinese enterprises also often lack the management expertise needed to run an international business. After Chinese television manufacturer TCL formed a joint venture with the French television manufacturer Thomson Electronics in 2003, it failed to integrate and turn around Thomson's unprofitable European and American business and saw its own net profits fall by half in 2004, followed by losses in 2005 and 2006. TCL cited greater than expected difficulties with the venture as a drag on its profits.

Chinese enterprises sometimes have difficulty in foreign markets, because they do not understand the subtleties and regulatory environments of foreign markets as well as domestic enterprises. In some instances, Chinese enterprises complicate their situation by refusing to hire consultants and legal advisors, leaving themselves overly reliant on domestic partners such as distributors or customers for advice on how to adjust to local regulatory and business conditions.

Regulations Governing Outbound Investment

Investment abroad by Chinese companies is regulated by three governmental bodies: (1) the Ministry of Commerce (MOFCOM), (2) the State Administration of Foreign Exchange (SAFE) and (3) the NDRC. In recent years, these agencies have sought to make expanding abroad easier for Chinese companies.

MOFCOM Regulation

MOFCOM is the main regulatory body governing outbound investment. It is responsible for formulating regulations

regarding outbound investment and coordinates the activities of the commercial counselors in China's embassies in protecting and advancing the interests of Chinese companies.

In March 2009, MOFCOM released the Measures for the Administration of Outbound Investment (the Measures), which came into effect on May 1, 2009. The Measures replaced the previous (2004) MOFCOM regulation governing China's outbound investment.

The Measures ease and simplify requirements and procedures for outbound investment. The Measures also delegate greater authority to provincial officials, which is expected to significantly expedite the approval process. These changes reflect a policy decision to promote outbound investments generally, but the Measures also signal that MOFCOM is reducing the level of scrutiny applied to some outbound transactions in order to focus on issues arising from certain other, higher profile overseas investments that could affect bilateral relations, national economic security, international obligations or fair competition.

The Measures detail the level of review that various Chinese enterprises are subjected to in order to receive an Outbound Investment Approval Certificate. Chinese enterprises must receive an Outbound Investment Approval Certificate in order to complete foreign currency, banking and customs procedures with the relevant Chinese government agencies.

According to the Measures, the following kinds of outbound investment transactions require central-level MOFCOM review: (1) investing in a country that has not established diplomatic relationships with China, (2) investing in a specific country or region on a list to be determined by MOFCOM and the Ministry of Foreign Affairs as well as other relevant departments, (3) investing an amount greater than \$100 million, (4) making an

investment that involves the interests of multiple countries or regions or (5) setting up a special-purpose company overseas to enable a domestic company to gain the benefits of a foreign listing.

The following kinds of outbound investment transactions require provincial-level MOFCOM review: (1) overseas investment level of between \$10 million and \$100 million, (2) overseas investment in the fields of energy or minerals or (3) overseas investments that require capital to be raised from within China.

As a general rule, central- and provincial-level authorities will deny permission to make an overseas investment under three circumstances: (1) the transaction endangers the sovereignty, national security or public interests of China or violates a law or regulation of China, (2) the transaction will likely violate any international treaty concluded by China with a foreign party or (3) the transaction involves exporting any technology or goods prohibited by China.

The Measures call for central and provincial MOFCOM officials to consult the appropriate Chinese embassy or consulate where the investment will be made as to the security status of the target country and the probable effect of the proposed investment on bilateral economic, political and trade relations.

All other investment transactions by Chinese enterprises are not subject to central- or provincial-level MOFCOM approval, and the investor need only submit an Application Form for Overseas Investment and should receive approval within three days. The Measures mark a significant change from the previous approval procedures that subjected all investments to full review by central or provincial MOFCOM officials.

The Measures make it clear that MOFCOM will not conduct or review feasibility studies of proposed investments, providing, in relevant part, that "economic and technical feasibility

of an overseas investment shall be the sole responsibility of the enterprise."

The Measures streamline the approval process for Chinese outbound investment and make the process much more predictable. Indeed, many enterprises should be able to avoid the cumbersome process of obtaining MOFCOM approval, or at least central MOFCOM approval. This should enable potential foreign sellers and joint-venture participants to select their preferred investors based on accurate predictions of the time necessary for governmental review.

SAFE Regulation

SAFE is responsible for, among other things, handling China's significant foreign exchange reserves. In that capacity, SAFE drafts and implements the rules that determine the conditions under which Chinese companies can use foreign currency.

On June 9, 2009, SAFE issued the Notice on Certain Issues Relating to Foreign Exchange Administration on Offshore Lending by Domestic Enterprises (the Notice), which became effective as of August 1, 2009. The Notice makes it easier for Chinese enterprises to finance their operations abroad by reducing qualification requirements for offshore lending, expanding the sources of funds for lending, and simplifying verification and remittance procedures for lending.

The Notice allows Chinese enterprises to use their own foreign currency holdings as well as government foreign exchange reserves to make loans to their foreign subsidiaries. Thin capitalization rules limit the amount of any such loan to 30% of either the amount of the Chinese investor's equity in the subsidiary or the agreed investment amount of the Chinese enterprise.

The global financial crisis had made it more difficult for foreign subsidiaries of Chinese enterprises to obtain funding abroad. The Notice is intended to help

continued on page 4

China Goes Global: Examining China's Outbound Investment

continued from page 3

address this situation and should facilitate more Chinese companies investing in and through subsidiaries abroad.

NDRC Regulation

The NDRC oversees outbound investments to make sure they align with China's overall economic development policy. The Commission plays an active role in the approval of outbound investment, and its review includes the commercial and technical feasibility of proposed projects. It is particularly interested in investment transactions that relate to natural resource exploration and development as well as transactions that require a large amount of foreign currency reserves.

According to the Temporary Management Measure Regarding the Approval of Overseas Investment Project, which was issued by the NDRC in 2004, Chinese companies are required to obtain NDRC approval to make investments abroad under two conditions: (1) when the investment transaction relates to natural resource exploitation and the investment amount is in excess of \$30 million and (2) when the company requires a large amount of foreign currency to make the investment and the investment is above \$10 million. If investments meet either of the two following conditions they require both NDRC and State Council approval: (1) the investment relates to natural resource development and the investment amount is above \$200 million or (2) the Chinese company requires a large amount of foreign currency to make the investment and the investment amount is above \$50 million.

The NDRC released a notice in June of 2009 requiring Chinese companies

that intend to acquire overseas companies in transactions that are subject to NDRC approval to submit certain informational reports to the NDRC before they sign any legally binding contracts.

“... Chinese enterprises ... use their own foreign currency holdings as well as government foreign exchange reserves to make loans to their foreign subsidiaries.”

The NDRC can then identify “apparent significant adverse factors” and notify the company accordingly.

Companies notified in this way may expect to have difficulty obtaining final NDRC approval for their investments.

Banking Regulations

Another regulation supporting increased outbound investment by Chinese enterprises is the Guidelines on Risk Management of Loans Extended by Commercial Banks for Mergers and Acquisitions (the Guidelines), released by the China Banking Regulatory Commission on December 6, 2008. The Guidelines allow Chinese banks to lend money to enterprises for M&A purposes, a practice that was forbidden by a 1996 regulation. The Guidelines were promulgated in response to a call by the State Council to increase bank support for M&A transactions as part of a stimulus effort to combat the global financial crisis.

Under the Guidelines, banks incorporated in China (including locally incorporated subsidiaries of foreign banks) can lend to enterprises incorporated in China (including foreign invested enterprises) for a variety of M&A purposes, including purchases of existing equity interests, subscriptions for new capital, mergers, asset acquisitions, debt restructurings and other similar transactions, but excluding the purchase of non-controlling minority stakes.

The Guidelines include capital and other requirements that banks must

meet before lending for M&A transactions. Specifically, banks must have: (1) comprehensive risk management systems and effective internal control systems, (2) a loan loss special reserve ratio of 100% or above, (3) a capital adequacy ratio of 10% or above, (4) a general reserve balance of at least 1% of the loan balance over the same period and (5) professional management capable of performing credit due diligence and risk assessment.

In addition, the Guidelines place the following restrictions on M&A loans: (1) an M&A loan cannot exceed 50% of the total acquisition price, (2) a loan to a single borrower cannot exceed 5% of the bank's net core capital, (3) the term of an M&A loan cannot exceed five years and (4) the borrower must provide adequate security for the loan.

On top of these financial restrictions, the Guidelines require banks to perform due diligence regarding compliance, operational and commercial risks relating to the parties and the transaction. Banks must evaluate factors like potential synergies between the two enterprises. The Guidelines give examples of synergies that emphasize factors like acquiring intellectual property and advanced technology. In order to comply with these requirements, Chinese banks will have to devote resources to developing expertise not only in the financial aspects of M&A transactions, but in other aspects of M&A deals as well. This could be an obstacle to quick growth in M&A lending because many Chinese banks currently lack experience dealing with M&A transactions.

What These Regulations Mean to U.S. Companies

When a U.S. company is selling its stock or assets to a Chinese buyer, very often the purchase agreement is drafted by U.S. lawyers. If counsel for the U.S. seller is

not familiar with the requirements and procedures that a Chinese buyer needs to go through with its governmental authorities, the closing may not happen as or when the transaction documents contemplate. Practically speaking, the signing of the definitive agreement and the payment of the purchase price generally will not happen simultaneously, because the Chinese purchaser needs to show the government the signed agreement before wiring the purchase price to the U.S. seller. Therefore, being familiar with the Chinese outbound investment requirements and procedures will permit the parties to have more realistic expectations as to how, when and even whether a transaction will close. Caution needs to be exercised if the Chinese buyer seeks to make obtaining Chinese government approval a condition of closing, because if the

buyer reconsiders completing the transaction, it may not seek the governmental approval aggressively, resulting in the Chinese buyer having a free “out.” U.S. sellers and their counsel need to thoroughly understand how China’s “zou chu qu” regulations and procedures operate in order to negotiate and document the transaction in ways that will protect the seller.

Conclusion

Chinese investors are increasingly looking abroad for investment opportunities. Chinese enterprises are using their enhanced outbound investment powers to gain access to new markets, advanced technology and brand development. The Chinese government has supported Chinese enterprises investing abroad by simplifying regulatory requirements applicable

to outbound investment. Under these conditions, Chinese outbound investment has grown, even during the global financial crisis. While Chinese investors still face many problems when investing abroad, outbound investment from China will likely continue to be a growing source of capital for the rest of the world.

This article was written by Will Broer, a senior at Claremont McKenna College, who recently interned in Benesch’s Shanghai office.

For additional information on this topic, please contact Yanping Wang at ywang@beneschlaw.com or (86) 21-3222-0388, Allan Goldner at agoldner@beneschlaw.com or (216) 363-4623, or Peter Shelton at pshelton@beneschlaw.com or (216) 363-4169.

High-Technology Enterprise Status

Background

Much of the world still calls China the world’s workshop, and many recognize China as the world’s fastest growing market. While continuing to justify both of these views, China has also transcended them by identifying itself as, and preparing itself to become, the world’s innovation center.

During the 17th National Congress in October 2007, China President Hu Jintao pointed out that the core of China’s national development strategy is to enhance China’s capacity for independent innovation and make China an innovative country. The Ministry of Science and Technology of China (MOST) emphasizes innovation as the “soul of a nation” and is of the view that China will transform its economy from simple OEM assembly to higher, value-added manufacturing activities to achieve the goal of a transition from “imitation to creation.”

To this end, the Chinese government has enhanced its encouragement of domestic and foreign investment in advanced technologies, and has created a series of preferential tax and other policies to stimulate and promote the production of high-tech products, the provision of high-tech related services and technology transfers into and within China. For example, in November 2009, China launched venture capital funds totaling RMB9 billion (US\$1.32 billion) to support the country’s growing high-tech sector. Of this RMB9 billion, the central government contributed RMB1 billion and seven provincial-level governments (Beijing, Jilin, Shanghai, Anhui, Hunan, Chongqing and Shenzhen) contributed RMB1.2 billion, with the remainder coming from private investors. Investments will focus on the electronics and information industries, the biological and pharmaceutical sectors and environmental and energy-related projects.

The concepts of providing preferential tax policies to attract investment by foreign invested enterprises (FIEs) in manufacturing businesses, generally, and of conferring “high-tech” status on certain kinds of businesses in order to provide even greater tax benefits (and, therefore greater attraction for investment) in technology came into existence almost at the same time China opened its door to foreign investors. The competition to attract investment by FIEs became so intense at the provincial, district, city and special economic zone levels that the high-tech incentives often became blurred with the general manufacturing ones, with the result that governmental officials were sometimes conferring high-tech status on almost any kind of manufacturing business – whether or not it complied with published high-tech standards (which were sometimes unclear and frequently inconsistently applied). Effective January 1, 2008, China amended its corporate income tax law (see October/November 2007 and February/March 2008 issues of *China Insights* for more about China’s

continued on page 6

High-Technology Enterprise Status

continued from page 5

Enterprise Income Tax Law) to level the playing field between FIEs and domestic Chinese businesses by essentially eliminating the preferential tax policies applicable to manufacturing businesses, generally, and establishing a new regime of preferential policies targeting the high-tech sector and covering both domestic Chinese companies as well as FIEs.

On April 14, 2008, MOST, the Ministry of Finance (MOF) and the State Administration of Taxation (SAT) jointly promulgated the Measures for the Recognition and Administration of New and High-Tech Enterprises (the Measures), which clearly specify the requirements for the recognition and administration of new and high-tech enterprises. Further, on July 8, 2008, the MOF and the Ministry of Science released the Guidance for the Recognition and Administration of New and High-Tech Enterprises (the Guidance).

Benefits Available to High-Tech Enterprises

The preferential treatment for high-tech enterprises is one of the principal remaining incentives under China's new tax regime. The benefits that a high-tech enterprise may enjoy include the following:

1. Lower Corporate Income Tax Rate.

Enterprises that obtain high-technology status are entitled to a preferential corporate income tax rate of 15%, which is substantially lower than China's ordinary 25% corporate tax rate. Additional benefits may be granted to high-tech enterprises located in five special economic zones (Shenzhen, Zhuhai, Santou, Xiamen and Hainan, collectively, "Five Special Economic Zones") or Shanghai Pudong New Area. These additional benefits may include a two-year 100% corporate income tax exemption beginning with the first year in which the enterprise makes a

profit and a 50% exemption for the third, fourth and fifth years.

2. Access to Grants and Government Support.

In addition, high-tech enterprises are eligible to obtain financial support from China's special Technological Development Fund and to receive competitive commercial bank loans carrying subsidized levels of interest.

3. Certain Tax-Exempted Income.

High-tech enterprises' revenue from technology transfer transactions and consultation services may be exempted from income tax.

4. Super Deduction of Certain R&D Expenses.

Super deductions may be permitted for qualifying R&D expenses incurred by high-tech enterprises. Qualifying R&D expenses include: (1) salaries, social insurances and housing funds paid to or for the benefit of R&D staff, and service compensation for external staff providing R&D services, (2) depreciation on, and rental of, buildings used for R&D activities, (3) application and registration costs and agency fees for intellectual property rights (IPR), (4) costs incurred for equipment testing, acquisition cost of samples, prototypes and inspection charges and (5) other expenses related to R&D activities, provided such expenses are capped at 10% of the qualified R&D expenditures.

These are referred to as "super" deductions because if the expenses do not result in the creation of an intangible asset, the enterprise may nonetheless take a current deduction in an amount equal to 150% of the actual expense. If the expenses do result in the creation of an intangible assets the enterprise can amortize the capitalized assets based on 150% of the actual costs incurred.

Requirements to Qualify for High-Tech Status

To qualify as a high-tech enterprise, an enterprise must meet the following conditions:

1. The applicant must have been established and have been operating at least one year prior to application for new high-tech status.
2. The applicant must own the IPR on the core technology of its main products or services. The "core technology" refers to certain intellectual property (IP) that is registered by a Chinese enterprise, including inventions, new models, new designs that are not a mere change in pattern and shape, software copyrights, patents on integrated circuits and designs or new species of plants. The ownership of the core technology can be obtained by means of independent R&D, technology transfer, donation or by means of merger or acquisition within the prior three years, or it can be granted under an exclusive license of at least five years in duration. The exclusivity of the license means that neither the licensor nor any third party may use the technology. In addition, such license must be worldwide in geographic scope. This requirement precludes many companies owned by foreign parent companies which are reluctant to transfer their IP ownership or grant worldwide exclusive licenses to their Chinese subsidiaries.
3. The applicant's products/services must fall into the catalogue of the State-Supported New and High-Tech Area (the High-Tech Industry Catalogue). The High-Tech Industry Catalogue classifies the "high-tech" category into eight industries, including electronic information technology; biology and new medicine technology; aeronautics and astronautics technology; new material technology; high-tech service

industry; new energy and energy saving technology; resources and environmental technology; and high-technology used to innovate in a traditional industry.

4. Engineers and technicians with associate's degrees or above must account for at least 30% of the total staff of the applicant enterprise in the year of application. Researchers must account for at least 10% of the total staff.
5. The cumulative amount spent on R&D in the previous three years for acquiring new knowledge on science and technology; innovative practices or new knowledge on science and technology; and substantive improvement of technology, products or science must meet the following thresholds:
 - (i) If the last years' revenues were less than RMB50 million, the amount must be at least 6% of such revenues;
 - (ii) If the last years' revenues were RMB50 million or more, but less than RMB200 million, the amount must be at least 4% of such revenues; and
 - (iii) If the last years' revenues were RMB200 million or more, the amount must be at least 3% of such revenues.

For an FIE, if its R&D cost is shared with its overseas parent to qualify as a high-tech enterprise, the R&D cost allocated to the FIE must not be less than 60% of the total R&D costs. If the FIE has been established for less than three years, the ratio must be based upon the actual operation period.
6. The applicant's annual income generated from new and high-tech products or services must account for not less than 60% of its total annual revenue.

7. There must be compliance with a system scoring each applicant's IP management and capability to exploit its IP. The highly technical discussion of this scoring system is omitted from this article.

Procedure to Apply for High-Tech Status

To apply for high-tech status, an enterprise must first conduct a self-assessment. If it concludes that it meets the conditions set forth above, it can apply to register at www.innocom.gov.cn. After registering on this Web site, an enterprise must prepare application documents and submit them to the provincial level of MOST. The application documents include an application letter, supporting documents including evidence documenting ownership of the IP, revenue information, R&D expenditure information and other information in the form of a statement verified by an outside accounting firm. Upon receiving the application, a committee consisting of at least five experts, organized through random selection, will review the application and make its decision within 60 business days. If the approval authority determines that the applicant meets the conditions, it will publish this determination for 15 business days. If no objection is raised, then a "High-Tech Enterprise Certificate" will be issued and the results will be published on a prescribed Web site. Upon obtaining such a certificate, the enterprise can start to apply for preferential tax treatment and other benefits for which it may be eligible.

Renewal of High-Tech Status

The high-tech status of an approved enterprise will be valid for three years. When the term expires, the enterprise must reapply for high-tech status at least three months before the expiration date, otherwise its high-tech status will expire.

U.S. Concerns

Relatively few companies have successfully achieved this new, higher standard status. For example, only about

300 companies out of more than 2,000 prior high-tech enterprises were recognized as high-tech enterprises under the new high-tech system in 2008–2009. If U.S. parent companies are interested in qualifying their FIE subsidiaries as high-tech enterprises, they may need to consider the following:

1. **Review Current IP strategy and compliance with U.S. law.** In the past, the IP strategy of some U.S. parent companies has been to leave the best technology home, and only migrate lower to middle level technology to China. Such a strategy will likely fail the new high-tech test. However, before bringing their best IP to China, U.S. parent companies must continue to be mindful of the risks associated with China's less reliable (but improving) enforcement of IPR, and also carefully consider any technology transfer control that may be imposed on a company's more sophisticated technology under U.S. law that may or may not have been applicable to lower or middle levels of the same technology.
2. **Properly document the IP transfer arrangement.** U.S. parent companies frequently allow their Chinese FIE subsidiaries to use the U.S. parent companies' technology. However, some of such companies inadequately document such use (or do not document it at all). In addition to considering the documentation requirements associated with satisfying Chinese high-tech requirements, both U.S. parent companies and their FIE subsidiaries must also be mindful of the documentation and other requirements associated with both Chinese and U.S. transfer pricing laws and procedures.
3. **Review the License Agreement.** Very often, license agreements drafted by U.S. parent companies provide that improvements will be owned by the

continued on page 8

High-Technology Enterprise Status

continued from page 7

U.S. parent companies, as the licensor. License agreements with such a clause may not be approved by the Chinese government. Our experience has been that Chinese officials sometimes require that if the improvements will be owned by the licensor, the Chinese licensee should be granted the right to use such improvements without incurring any additional cost.

Conclusion

While qualifying for high-tech status, and thus enjoying preferential tax and additional benefits, may be highly desirable, meeting China's new high-tech requirements will be more challenging. U.S. parent companies and their Chinese subsidiaries need to revisit their IP strategies as well as their technology use methodologies, and be mindful of IP protection issues as well as U.S. and China technology transfer and transfer pricing laws and regulations, in order to avoid pitfalls.

For more information, please contact Yanping Wang at ywang@beneschlaw.com or (86) 21-3222-0388, Peter Shelton at pshelton@beneschlaw.com or (216) 363-4169, or Allan Goldner at agoldner@beneschlaw.com or (216) 363-4623.

How We Work With Clients

We help U.S. companies as they: (1) establish China-related strategic alliances and joint ventures for manufacturing and distribution; (2) establish wholly owned manufacturing or other business operations in China; (3) acquire the shares or assets of China-based companies; (4) deal with governmental and operationally related legal issues in China; (5) source components or products from China and deal with related logistics issues; and (6) develop U.S.-based solutions to competition from China.

We also help Chinese companies with respect to U.S. legal and business considerations as they: (1) establish U.S.-related strategic alliances and joint ventures for manufacturing and distribution; (2) establish subsidiaries and other business operations in the U.S.; and (3) acquire the shares or assets of U.S. companies.

We help clients as they structure, negotiate and document China-related transactions; and consult with clients with respect to capital structure, operating control, governance, due diligence and other issues.

In the area of intellectual property, we are experienced in working with our China-based colleagues and government officials to maximize the protection of our clients' valuable patents, trademarks, know-how, trade secrets and other intellectual property rights.

Our established network of highly competent, experienced and reliable U.S. and China-based service providers (including Chinese licensed lawyers with whom we work when our clients' needs require) enables us to help produce complete China business/legal solutions. Together we provide U.S., China and other international legal, tax, governmental relations, import/export, construction, operational and other solutions for our clients in a cost-effective manner.

Pass this copy of *China Insights* on to a colleague, or e-mail emellott@beneschlaw.com to add someone to the mailing list.

UNITED STATES TREASURY DEPARTMENT CIRCULAR 230 DISCLOSURE: TO ENSURE COMPLIANCE WITH REQUIREMENTS IMPOSED BY THE IRS, WE INFORM YOU THAT, UNLESS EXPRESSLY STATED OTHERWISE, ANY U.S. FEDERAL TAX ADVICE CONTAINED IN THIS COMMUNICATION (INCLUDING ANY ATTACHMENTS) IS NOT INTENDED OR WRITTEN TO BE USED, AND CANNOT BE USED, FOR THE PURPOSE OF (i) AVOIDING PENALTIES UNDER THE INTERNAL REVENUE CODE, OR (ii) PROMOTING, MARKETING OR RECOMMENDING TO ANOTHER PARTY ANY TRANSACTION OR MATTER ADDRESSED HEREIN.

The content of the Benesch, Friedlander, Coplan & Aronoff LLP *China Insights* newsletter is for general information purposes only. It does not constitute legal advice or create an attorney-client relationship. Any use of this newsletter is for personal use only. All other uses are prohibited. ©2010 Benesch, Friedlander, Coplan & Aronoff LLP. All rights reserved. To obtain permission to reprint articles contained within this newsletter, contact Ellen Mellott at (216) 363-4197.

For more information, contact any member of our China Group:

Allan Goldner, Co-Chair | (216) 363-4623

agoldner@beneschlaw.com

Peter K. Shelton, Co-Chair

(86) 139-1754-4251 | (216) 363-4169

pshelton@beneschlaw.com

Yanping Wang, Partner-in-Charge, Shanghai Office

(216) 363-4664 | (86) 139-1754-4176

ywang@beneschlaw.com

Steven M. Auvil | (216) 363-4686

sauvil@beneschlaw.com

Mariann E. Butch | (216) 363-4198

mbutch@beneschlaw.com

Joseph N. Gross | (216) 363-4163

jgross@beneschlaw.com

Douglas E. Haas | (216) 363-4602

dhaas@beneschlaw.com

William I. Kohn | (216) 363-4182

wkohn@beneschlaw.com

Robert A. Marchant | (216) 363-4489

rmarchant@beneschlaw.com

Megan L. Mehalko | (216) 363-4487

mmehalko@beneschlaw.com

Leo Pan | (86) 139-1754-4172

lpan@beneschlaw.com

Bradford J. Sandler | (302) 442-7007

bsandler@beneschlaw.com

Bryan A. Schwartz | (216) 363-4420

bschwartz@beneschlaw.com

Robert M. Spira | (216) 363-4413

rspira@beneschlaw.com

Thomas C. Washbush | (614) 223-9317

twashbush@beneschlaw.com

Kay Zhao | (86) 139-1708-2514

kzhao@beneschlaw.com

Cleveland

200 Public Square, Suite 2300

Cleveland, OH 44114-2378

Phone: (216) 363-4500

Fax: (216) 363-4588

Columbus

41 South High Street, Suite 2600

Columbus, OH 43215-6150

Phone: (614) 223-9300

Fax: (614) 223-9330

Philadelphia

One Liberty Place

1650 Market Street, 36th Floor

Philadelphia, PA 19103-7301

Phone: (267) 207-2947

Fax: (267) 207-2949

Shanghai

Kerry Centre, Suite 1802

1515 W. Nanjing Road

Shanghai, P.R. China 200040

Phone: (86) 21-3222-0388

Fax: (86) 21-5298-5955

Wilmington

222 Delaware Avenue, Suite 801

Wilmington, DE 19801-1611

Phone: (302) 442-7010

Fax: (302) 442-7012

www.beneschlaw.com