

# CHINA POLICY: DEVELOPMENTS IN FOREIGN INVESTMENT POLICY-MAKING BENEFITING CLEAN ENERGY COMPANIES BACKED BY FOREIGN INVESTORS

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*China's foreign investment policy-makers are in the process of updating the "Foreign Investment Industrial Guidance Catalogue" (the "Catalogue"), a catalogue of China's industrial sectors categorized by different foreign participation restrictions. The National Development and Reform Commission ("NDRC") publicized a draft of the Catalogue (the "2011 Catalogue") in April 2011 to solicit public comments. The 2011 Catalogue is expected to facilitate further opening-up of the new energy industry<sup>1</sup> to foreign investment. In this article, we provide some background about such developments, with a view to provide a context for the recent policy-making shift in the new energy sector that we anticipate to impact the business models of foreign-participated industry players.*

## **Background of the 2011 Catalogue**

The updating of the Catalogue is believed to be driven by two policy considerations:

As the first and foremost policy consideration, Chinese authorities have accelerated opening the high- and new-technology sectors across the board. In early 2010, China's State Council issued Several Opinions on Optimizing the Utilization of Foreign Investment (the "State Council Opinions") to set in

motion a chain of policy adjustments to encourage more foreign investments in the new energy and energy conservation sectors. In the meantime, the heyday of the "Two Highs and One Resource"<sup>2</sup> enterprises, i.e., the resource-dependent sectors, will become history because of various levels of policy modifications geared toward discouraging foreign investment in these sectors.

The Catalogue is a set of guidelines issued by NDRC and China's Ministry of Commerce ("MOFCOM") used in assessing the advisability of granting market entry of foreign investment to companies in various sectors. It breaks up industrial sectors into three general categories: Encouraged; Restricted and Prohibited.<sup>3</sup> The sectors not identified in the Catalogue are considered as "Permitted". The current version was updated in 2007. The 2011 Catalogue evidences the attempt to conform the existing intricate system restricting foreign investment into the market to the dynamically changing macro policy-making climates to permit or even promote foreign investment in some sectors.

To date, the updating of the Catalogue has consisted of responses to the phased opening of an increasing number of sectors to foreign investment.

Vertically, the Catalogue would be amended to “upgrade” certain industrial sectors from the prohibited/restricted category to the restricted/encouraged/permitted categories. For example, the 2007 Catalogue upgraded the power grids operators from the Prohibited to the Restricted Category, and the 2011 Catalogue upgraded the distribution and importation of books, newspapers and journals from the Restricted to the Permitted Category. Such upgrading processes tended to be in sync with China’s implementation of its WTO commitments. Horizontally, certain restrictions applicable to a restricted category would be relaxed quantitatively and/or qualitatively. Typically, this would be achieved through decentralization of the approval authority from the central authority to its local level counterparts or the lowering of the total investment threshold applicable to the sector. In the new energy area, the 2011 Catalogue in effect created a new updating model by creating certain subcategories under the Encouraged Category that had previously not been identified in the Catalogue. Examples of such new subcategories are: lightweight and environmental protective aerospace and aviation materials, water reclamation plants, heavy metal wastewater treatment equipment, specialized equipment for car batteries, “critical” parts and components of new energy cars, renewable water plants, vehicle charging stations, car battery replacement stations and new generation IPv6 internet system equipment and applications.

As a direct response to the State Council Opinions, in February 2011, MOFCOM, the China regulator having primary authority for approval of foreign-invested enterprises (“FIEs”), decentralized the authority to approve FIEs to MOFCOM’s provincial offices if the total investment of an FIE does not exceed U.S. \$300 million (previously, U.S. \$100 million). Usually, a decentralization of approval authority would bring about a faster, more flexible and more streamlined approval process. Hence, in the new energy projects which are included in the Encouraged Category, a less clogged approval channel is to be expected.

### **An Exception to the Deregulation Trend?**

**As a less pronounced but definitely not secondary policy consideration**, the authorities also strive to enhance the competitiveness of certain domestic sectors. As a result, the 2011 Catalogue establishes a foreign participation limit with respect to the subcategory of “critical parts and components of new energy cars” where foreign investors would be preempted from holding more than 50% of equity in any project. The foreign participation limit would be in place notwithstanding that this particular subcategory is a “high- and new-technology” sector. The policies underlying the seeming protectionism present in this subcategory would be perceived as discordant with the general trend of deregulating foreign investments in the new energy sector.

The “critical auto parts and components of new energy cars” sector would be a stand-alone subcategory in the 2011 Catalogue, under the “Encouraged Category— Transportation Equipment Manufacturing.” Although the qualifier “critical” is used, this subcategory literally runs the gamut of almost all the auto parts and components sectors that would make new energy cars technologically viable.

In addition to including some sectors which were not previously identified in the Catalogue, this subcategory integrated certain sectors previously found elsewhere in the 2007 Catalogue—Encouraged Category. As a result of their inclusion, certain encouraged subcategories would now be regrouped and subject to the restrictive 50% limit for the first time. Examples are certain types of traction batteries (previously only subject to the requirement of forming joint ventures with a Chinese party, i.e. up to 99% foreign investment permitted), anode battery materials (previously no limit), and automobile hydrogen storage systems (previously no limit).

The foreign participation limit of 50%, if implemented retroactively, would lead to the reshuffling of the ownership structures across FIEs in the new energy car industry.

In the past 10 years, to the restricted-sector categorization, an alternative investment structure known as the “VIE” structure (also known as the “Sina model” or “captive structure”) seemed to be a response. “VIE”, or variable interest entity, refers to the

use of a China-established special purpose vehicle, usually organized as a wholly foreign-owned enterprise (“WFOE”), to contractually control the portion of equity that cannot be directly owned by the foreign investor. Two issues that the VIE structure were intended to solve are inflow of foreign capital to the operating company and repatriation of operation proceeds overseas. Such cash flow must be backed by certain legally viable and arm’s length transactions. Auto companies are immensely capital-intensive, which would likely pose additional logistical and legal questions to the traditional solutions to the aforementioned issues.

### **New Ambiguity on Auto Industry**

The 2007 Catalogue set forth in the Encouraged Category a subcategory of “final assembly of automobiles” while imposing a 50% foreign participation limit. The 2011 Catalogue removed this sector entirely, raising questions about whether this subcategory would now be treated as a “Permitted” Category.<sup>4</sup> Thus, there is a question about whether the 50% foreign participation limit would be sustained, and whether this sector may benefit from the decentralization of approval authority of MOFCOM as now being enjoyed by the Encouraged Sector.

Lastly, below we would like to elaborate on some other significant areas, i.e., tax and exits. First, the policymaking for **industry-specific income tax incentives** has yet to see any momentum. In terms of creating more domestic **exits for foreign investors** from their new energy projects, there have been tangible developments.

### **State of Affairs with Other Industry-Specific Incentives**

#### **Enterprise Income Tax Holidays:**

China phased out the dual tracks on enterprise income taxes (EIT) beginning in 2008 when the new Enterprise Income Tax Law was issued. Since January 1, 2008, a unified enterprise income tax bracket of 25% became applicable to corporations across the board. Prior to 2008, foreign-invested “manufacturing enterprises” in the energy and transportation infrastructure sectors enjoyed a deducted enterprise income tax rate of 15%. Since January 1, 2008, such enterprises qualified for a transitional period where the 15% lower bracket would be phased out year by year, rather than immediately on January 1, 2008. Pursuant to the transitioning schedule, the tax bracket would become 24% in 2011 and 25% in 2012. Thus, starting in 2012, there would not be particular national-level industry-specific EIT tax holidays.<sup>5</sup>

#### **Exits on China Stock Exchanges:**

The China Securities Regulatory Commission (“CSRC”) issued Guidelines on Optimizing the Sponsoring of Companies for IPOs on ChiNext in March 2010. Pursuant to the Guidelines, the sponsors of listing companies should sponsor “with emphasis” the listing companies in the new energy, new materials, energy conservation, environmental protection and certain other high-tech sectors. The guidelines also provide that China domestic IPOs by qualified foreign-invested enterprises should be supported.<sup>6</sup> In fact, since ChiNext was launched in October 2009, we are aware of an increasing number of IPOs by FIEs

backed by non-Chinese private equity firms or corporate investors. The industrial sectors of the listing companies seemed to have made a difference in how their IPO applications are received by CSRC.

### **Conclusions**

The new EIT Law phased out the FIE tax holidays since 2008. In the meantime, since 2007 with the publication of the 2007 Catalogue, policy-makers have tightened approvals of resource-dependent companies. Thus, we expect to see a reduction of FIEs which were driven primarily by these strategies.

In the meantime, international private equity investors who are looking at China more as a source of deal flow and diversified way of exits (ChiNext) may enjoy the multiplication of investment opportunities brought about by the additions to the Encouraged-Category sectors. To them, an “Encouraged” categorization of the sectors they are interested in means there will be fewer impediments in their flexible investment structuring. Some investors may still consider what is known as the “offshore” structure to invest in China, which would allow them to set up an offshore holding company and convert the Chinese target to a wholly foreign-owned enterprise.<sup>7</sup> This structure would be viable with the Encouraged sectors where there is no foreign investment limit.

The 2011 Catalogue indicates the deepening of the policies in favor of the new energy sectors. In these sectors, we expect to see more private equity investment activity and opportunities with increased participation of international firms.

## Endnotes

- <sup>1</sup> There is no official definition of “new energy” in the government publications. China’s “Twelfth Five-Year Plan” covers under this concept all clean energy and alternative energy sectors covered under China’s Energy Law (Draft).
- <sup>2</sup> “Two Highs” refers to high-pollution and high-energy-consumption and “One Resource” stands for resource-dependency.
- <sup>3</sup> The Catalogue provides categorical guidelines to the approval authorities to make detailed policies about the foreign investment limits, approval procedures and other market entry thresholds as the different treatments between the Categories. In general, the Restricted Category is the one where foreign investors may expect to encounter more market entry restrictions, such as the requirement of setting up a joint venture with Chinese investors, a foreign investment percentage limit, the central versus provincial level of approval requirement, higher investment requirements, etc. In the enterprise income tax regime prior to 2008, companies in the Encouraged Category also enjoyed certain tax holidays not available to companies in other categories. There are also tariffs and import VAT tax holidays on imported equipment available to companies in the Encouraged Category.
- <sup>4</sup> As a general rule, any categories that are not explicitly included in either “Encouraged”, “Restricted” or “Prohibited” Category are considered to fall under the “Permitted” Category.
- <sup>5</sup> At the province and municipal levels, there may be EIT tax holidays provided by the local authorities to incentivize solar companies to be established in the local industrial development zones. Such tax holidays do not have the effect of amending the EIT Law which does not provide for such incentives, but are usually granted through EIT refunds or fiscal stipends by the local governments.
- <sup>6</sup> Currently, there are uncertainties about the China domestic IPOs by FIEs that are majority-owned by foreign investors, due to the lack of clear guidance in the laws.
- <sup>7</sup> We note that there may be other regulatory impediments against such flexible investment structures, such as MOFCOM’s Regulation on Foreign Acquisition of Domestic Enterprises, issued in late 2006. However, for a sector to be included in an encouraged category would still mean there is greater flexibility to structure the investments.