

What is the Future of Administrative Subsidies Granted by Local Government Under the Framework of the Newly Adopted Foreign Investment Law?



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In the past decades, China has pursued foreign investments while local governments competed with one another to attract such type of investments including by creating local incentives in various forms. In such context, greenfield foreign investors used to compare the incentives granted by each locality in order to choose the location of their registered office and/or manufacturing plant.

Uncertain legal environment for the local governments' practice of granting Administrative Subsidies

In the absence in the PRC laws and regulations of a clear definition of the range of incentives which can be proposed by the local governments ("Preferential Treatments"), such Preferential Treatments included in practice administrative subsidies such as direct payment of subsidies (in amounts effectively reducing the price of acquisition of the land use rights), reduction or partial return or waiver of taxes (such as VAT and Individual Income Tax) and fees and other kind of monetary support to the enterprises from the local government ("**Administrative Subsidies**").

Some of the Administrative Subsidies granted by localities were, at best, baseless if not simply prohibited by PRC laws and regulations.

In such context, since 2014, the State Council has been trying to regulate Administrative Subsidies and clean up the legally dubious Administrative Subsidies especially in cases where such Administrative Subsidies highlight the discrepancy in treatments between FIEs and domestic companies, and between the local and national standards. To this end, the State Council

promulgated five main notices¹ to adjust local practices granting Administrative Subsidies with focuses on ensuring fair competitions among the companies, and credibility of commitments made by the governments.

In particular, in November 2014, the State Council promulgated a notice ("**2014 Notice**") to prohibit local governments from illegally reducing, exempting or postponing the collection of administrative fees and government funds from enterprises or selling the land at preferential prices or for free and in May 2015, the State Council further promulgated a notice ("**2015 Notice**") to assure enterprises that local preferential policies for taxation and other aspects contained in contracts concluded would remain in force, and that for the part already fulfilled, it would not be revoked.

Judging from the series of adjustments by the State Council and based upon our analysis of cases, there

1. Notice of the State Council on Screening and Regulating Preferential Policies in Taxation and Other Aspects, promulgated by the State Council on November 27, 2014 and effective on the same day; (along with Notice of the Ministry of Finance on Several Matters Concerning the Implementation of the Decision and Arrangement of the State Council to Check up and Regulate Preferential Policies in Taxation and Other Aspect, promulgated by the Ministry of Finance on December 22, 2014 and effective on the same day.)

Notice of the State Council on Preferential Policies for Taxation and Other Aspects, promulgated by the State Council on May 10, 2015 and effective on the same day.

Opinions of the State Council on Establishing the Fair Competition Review System in the Development of Market System, July 1, 2016 and effective on the same day.

Opinions of the Central Committee and the State Council on Perfecting the Mechanism of Property Right Protection in Accordance with Laws, promulgated by the Central Committee and the State Council on November 14, 2016 and effective on the same day.

Notice of the State Council on Several Measures for Expansion of China's Opening up to the Outside World and Active Use of Foreign Capital, promulgated by the State Council on January 12, 2017 and effective on the same day.

are two bottom lines which seem to be followed by a majority of the local courts that: 1) the local governments shall not develop the policies for foreign investment promotion beyond its statutory authorities; and that 2) the local governments shall adhere to the agreements duly entered with the enterprises.

However, there have been cases regarding a reduction or a partial return of the grant fee of land use rights and/or the related taxes and fees where the courts ruled for the reimbursement by the company of relevant taxes and fees exempted in the past or for the absence of obligation of the local government to refund the company with the relevant taxes and fees promised to be exempted.

Nevertheless, when examining the reasoning of the courts in two case studies, one can hardly identify a consistent reasoning of the courts:

- In both studied cases, the courts of first instance argued that the bureau representing the local government which either agreed to bear some taxes or to grant tax exemptions was not competent to grant such Administrative Subsidies and as such, the contract or the provisions granting such subsidies were deemed invalid. Consequently, in the first case, the investor had to refund the taxes which were paid on its behalf by a third party related to the local government and in the second case, the local government did not have to refund the taxes paid by the investor.
- Then, in the first case, the appeal court (i.e. the



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Intermediate Court) confirmed the first trial ruling on the basis of a different reasoning which involved examining whether tax laws and/or administrative regulations were violated or not (in such case, we found that the Intermediate Court ruling lacks legal basis).

- In the second case, the High Court first confirmed the application of State Council 2015 Notice which provide that local preferential policies for taxation contained in contracts concluded would remain in force; and that for the part already fulfilled, it would not be revoked, but then confirmed the first trial ruling on the basis that the investor claimed for a refund of taxes paid while the contract provided for an exemption of taxes.

In light of the above, the validity of the Administrative Subsidies granted by local governments to attract foreign investments, especially regarding grant fee of land use rights and/or the related taxes and fees, is rather uncertain in many instances and judicial practice does not always rule in favor of the investors even though the general trend is for the courts to avoid creating an uncertain environment for foreign investments by generally adhering to the agreement entered into by the local government.

The New Law now gives legal grounds for local governments to grant Preferential Treatments as from the beginning of 2020

Now, most recently, on March 15, 2019, the latest draft of Foreign Investment Law of PRC ("New Law") was passed by the Second Session of the 13th National People's Congress ("NPC") after deliberation, and will take effect on January 1, 2020.

Article 14 of the New Law provides that "As required for national economic and social

development, the State encourages and guides foreign investors to invest in specific industries, fields and regions. Foreign investors and foreign-funded enterprises may enjoy preferential treatments according to laws, administrative regulations or provisions of the State Council," and hence gives legal grounds for the local government to grant Preferential Treatment (including Administrative Subsidies) to the foreign investors or FIEs provided that such measures are stipulated by the laws, administrative regulations or provisions of the State Council (the "Legal Basis").

In other words, local governments are now expressly prohibited from creating preferential treatments without legal basis as from January 1, 2020, such as by way of local decrees, rules or policies, as some of them did in the past.

In such context, contrary to the past opaque practice of the local governments, investors need to insist in obtaining clear references to the Legal Basis of the Administrative Subsidies promised by the local government in order to confirm their validity.

Further, now that the New Law specifically requires a Legal Basis for the granting of Preferential Treatments (including Administrative Subsidies), it is quite likely that local governments' commitments to grant direct or indirect reductions in tax, land use fee and other kinds of administrative benefits will be fewer as such Preferential Treatments are more clearly restricted and under increased scrutiny by the State Council.

Administrative Subsidies granted in the past should be audited to assess their validity and their continuity

Now, the question remains as to the future of the Administrative Subsidies which have been granted in the past once the New Law is in effect.

Considering that the New Law has no retroactive effect, the validity of the Administrative Subsidies granted in the past and hence their continuity will suffer from the same judicial uncertainties as in the past, even though in our opinion if an FIE has already entered into an agreement with the local government providing for Administrative Subsidies, it is still quite possible that such agreement would remain unchallenged.

In light of the New Law, FIEs operating in the PRC should conduct audits (especially prior to an M&A deal or a relocation project) to identify the existing Administrative Subsidies (and how significant they are), check their validity under the New Law, identify whether their continuity is at risk or if the FIE may have to return such subsidies and finally identify potential remedies or mitigations involving if needed discussions with the local governments.

As for the Administrative Subsidies to be negotiated starting from January 1, 2020, investors should be more vigilant by obtaining from the investment promotion bureau of the local government, the Legal Basis of the proposed Administrative Subsidies.



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