New China negative list for foreign investment modifies sectoral restrictions

Background

On 28 June 2017, the National Development and Reform Commission ("NDRC") and the Ministry of Commerce ("MOFCOM") jointly issued the Catalogue of Industries for Guiding Foreign Investment (2017 revisions) (the "new Catalogue"), effective from 28 July 2017. The new Catalogue is to replace the existing Catalogue issued in 2015 ("2015 Catalogue").

The issuance of this document follows on from an executive meeting of the State Council on 28 December 2016, chaired by Premier Li Keqiang, which approved new guidelines to further attract foreign investment. The conclusions of this meeting highlighted a need to:

(i) Amend the Catalogue to encourage foreign investment;
(ii) Encourage foreign enterprises to invest in high-end manufacturing industry and services;
(iii) Promote the "Negative List" system to regulate pre-approvals for foreign investment.

Subsequently, the State Council on January 2017 published a new policy on foreign investment (Guo Fa [2017] No. 5) setting out 20 measures. This clarified that the Catalogue would be amended to relax restrictions on foreign investment and operations in the Chinese service, manufacturing and mining sectors.

To implement these State Council policies, the NDRC and MOFCOM jointly revised the 2015 Catalogue. The new Catalogue is the 7th revision since the first publication of the Catalogue in 1995. The layout of the Catalogue has been realigned to confirm with the new "negative list" system. This allows for simple MOFCOM recordals to be made for investments in industries where foreign investment is encouraged or permitted, with pre-approvals limited to industries where investment is restricted. Details of the new Catalogue changes are set out below.

Regulations discussed in this issue:

- The Catalogue of Industries for Guiding Foreign Investment (2017 revisions) (NDRC MOFCOM Order No. 4), issued on 28 June 2017 by NDRC and MOFCOM, effective from 28 July 2017
- The Catalogue of Industries for Guiding Foreign Investment (2015) (NDRC MOFCOM Order No. 22), issued on 10 March 2015 by NDRC and MOFCOM, effective from 10 April 2015, abolished from 28 July 2017
- Central Committee of the Communist Party of China and State Council’s Opinions on Building New Open Economy System, issued on 5 May 2015
- Notice on the Special Administrative Measures (Negative list) for foreign investment access in the pilot Free Trade Zones (2017 edition) (Guo Ban Fa [2017] No. 51), issued on 5 June 2017 by the State Council, effective from 10 July 2017.
Contents of the New Catalogue

Prior versions of the Catalogue were divided into 3 parts:

(i) Industries where foreign investment is ‘encouraged’;
(ii) Industries where foreign investment is ‘restricted’;
(iii) Industries where foreign investment is ‘prohibited’.

For industries other than those listed, foreign investment is treated as ‘permitted’. It should be noted that while references are made in the Catalogue to ‘industries’, these would be better thought of as ‘industrial/economic (sub)sectors’, and the listing can be quite granular in detail.

- Foreign enterprises investing in encouraged industries are entitled to enjoy preferential treatments, including incentives granted by local governments to attract foreign investment. Following the move to the ‘Negative List’ system (details below) simple recordals with MOFCOM suffice for investment in industries where foreign investment is encouraged/allowed, including entity establishment, alteration, and transfer.

- Restricted industries are those for which foreign investment is subject to detailed review by MOFCOM and other government agencies, to see whether it is acceptable. Investment in such industries subject to MOFCOM pre-approval, and tailored conditions may be set on the manner in which the investment can be made. There is also a number of encouraged industries for which foreign investors are limited in terms of the percentage of equity they can hold in the Chinese investment entity, or in terms of a requirement for certain number of the senior executives of the invested entity to be Chinese citizens. These investments remain subject to detailed review by MOFCOM and other government agencies.

- Prohibited industries are industries for which foreign investment is not allowed.

The structure of the new Catalogue has been amended to consolidate previously separate lists into the Negative list. This covers the restricted and prohibited industries, as well as the encouraged industries for which special requirements exist (e.g. requirements for Chinese business partner equity participation in the invested enterprise, requirement for local Chinese senior executives). Details of the approach are set out below.

Key changes in the new Catalogue relative to 2015 include the following:

1. **Relax restrictions for services, manufacturing and mining investment**

The number of overall limitations have been cut. There were 93 restrictive measures in the 2015 Catalogue: 19 encouraged list sectors with Chinese business partner equity participation or senior executive requirements, 38 restricted list items, and 36 prohibited list items. These are cut to 63 in the new Catalogue. The consolidation process combines the 19 encouraged list items with special requirements into the existing restricted list. However, reductions in the existing items on the restricted list offsets these additions, and the restricted list is overall reduced to 35 items. The prohibited items list, which remains a separate part of the Negative List, is reduced to 28 items. In detail:
• Limitations on foreign investment (including both restrictions and prohibitions) in certain service sector activities are eliminated, including highway passenger transportation, cargo handling, creditworthiness investigation and rating services, accounting and auditing, construction and operation of agricultural wholesale markets, construction and operation of water control hubs.

• Limitations on foreign investment (including both restrictions and prohibitions) in certain manufacturing sector activities are eliminated, including manufacturing of railway transportation equipment, electric bus network equipment, batteries for new energy vehicles, motorcycles, manufacturing and repair of marine engineering equipment, manufacturing of diesel engines for vessels, design and manufacturing of satellites, edible oils, corn processing, fuel ethanol. In addition, the limitation on the number of joint venture (JV) enterprises which may be established by a foreign enterprise for the manufacture of electric cars has been eliminated (previously, a foreign enterprise could establish no more than two such JV enterprises).

• Limitations on foreign investment (including both restrictions and prohibitions) in certain mining sector activities are eliminated, including non-conventional oil and gas (fracking), precious metals, lithium ore and rare metals etc.

Few significant changes were made in the new Catalogue in relation to the encouraged industries. The policy is to continue encouraging foreign investment in high-end manufacturing, high technology, energy conservation and environmental protection, and modern services. As compared with the 2015 Catalogue, 6 encouraged industries are added while 7 industries are removed. The newly added encouraged list items include manufacturing of smart emergency medical rescue equipment, manufacturing of hydrological monitoring sensors, research and development (R&D) and manufacturing of virtual reality (VR) and augmented reality (AR) equipment, design and manufacturing of 3D printer equipment, construction and operation of hydrogenation stations, construction and operation of parking facilities. (See KPMG China Tax Weekly Update (Issue 2, January 2017) and China Tax Weekly Update (Issue 4, January 2017) for details).

2. New prohibited sectors for foreign investment

As compared with the 2015 Catalogue, new prohibitions on certain industrial sectors are now included in the new Catalogue. These prohibitions are mainly in the cultural sector, including land surveying activity, editing of books, newspapers, magazines, audio-visual products and electronic publications, radio and TV video on demand services, satellite broadcasting, internet-based news and information services, and internet information publication services.

In addition, where the limitations on sectoral investment have become the same for Chinese-owned and foreign-owned enterprises, these sectors are no longer listed in the new 2017 Catalogue. For instance, for the construction of large-scale theme parks, and construction of new golf courses and villas, both Chinese-owned and foreign-owned enterprises are subject to the same restrictions and prohibitions under the 2016 NDRC/MOF Market Access Negative List so these are no longer included in the Catalogue. In total, 12 sectors have been removed from the Catalogue on this basis.
KPMG Observations

Further opening up of the Chinese market

The new Catalogue continues to follow the approach of the 2015 Catalogue. It encourages foreign investors to invest in high-end manufacturing, high technology, energy conservation and environmental protection, modern services. To an extent, it also relaxes the limitations on foreign investment in the services, manufacturing and mining sectors. This reflects China’s revised external economic strategy which seeks to align both “going out” (outbound FDI) and “bringing in” (inbound FDI) strategies. In a bid to promote economic growth and cross-border trade and innovation, foreign investors are to be encouraged to invest in high-end manufacturing, intelligent machinery, green technology, industrial design, engineering consulting services, modern logistics, and inspection and certification services in China.

However, in the new Catalogue solely the general services and mining sectors have seen significant liberalization for foreign investment access. An earlier Circular - Central Committee of the Communist Party of China and State Council’s Opinions on Building New Open Economy System indicated that, “The service sectors, including finance, education, culture, medical treatment will incrementally be opened up, …… while ensuring the safeguarding national security, restrictions on foreign investments in infrastructure sectors (such as transportation, telecommunication) as well as mining fields will gradually be lessened.” Foreign investors, who wish to invest in these more sensitive sectors, will probably have to wait to see whether such sectors will be opened up to foreign investment.

In parallel with the liberalized national Catalogue, the State Council on 5 June 2017 released Guo Ban Fa [2017] No. 51 with an updated foreign investment negative list for the pilot free trade zones (FTZs) (“2017 negative list”). This is effective from 10 July 2017, replacing the old negative list issued in 2015 (see KPMG China Tax Weekly Update (Issue 25, June 2017) for details). As the FTZs are designated as pioneering pilot areas, the negative list for FTZs will definitely provide for greater investment openness than the Catalogue. China now has 11 FTZs, including Shanghai, Guangdong, Tianjin, Fujian, Liaoning, Zhejiang, Henan, Hubei, Chongqing, Sichuan and Shaanxi; the latter seven were approved for set up in March 2017. Given that the number of FTZs is steadily increasing, these provide an increasingly attractive platform for foreign investors who intend to invest in China.

Furthermore, in another investment access relevant development, MOFCOM on 28 June 2017 announced that Mainland China and Hong Kong had signed an Investment Agreement (IA) and an Agreement on Economic and Technical Cooperation under the framework of the Mainland and Hong Kong Closer Economic Partnership Arrangement (CEPA). The IA is the important component of the CEPA and will be implemented from 1 January 2018. The Mainland commits to providing national treatment to investments and investors, based in Hong Kong, for all non-service sectors (subject to 26 defined limitations). It adopts more preferential treatment for investment in the vessel and plane manufacturing, resources and energy exploration, and financial market investment vehicles areas. It also commits to sustain preferential treatment for Hong Kong investments into the future. The Mainland and Hong Kong CEPA, Mainland and Macau CEPA, as well as the Mainland and Taiwan Economic Cooperation Framework Agreement (ECFA), collectively provide extensive market access to investors from Hong Kong, Macau and Taiwan.
What is more, in order to support industry and foreign investment in central and western regions of China, the NDRC and MOFCOM in February 2017 jointly published the revised “Catalogue of Priority Industries for Foreign Investments in Central and Western China 2017” (the “revised central/western Catalogue”). This took effect from 20 March 2017 and replaces the 2013 catalogue (See KPMG China Tax Weekly Update (Issue 8, February 2017) for details). From 1 January 2011 to 31 December 2020, eligible FIEs established in the western region are entitled to a Corporate Income Tax (CIT) rate of 15%. In addition to this, FIEs will be granted preferential treatments on funds, lands, and income tax, provided they fall within encouraged industries.

One of the 20 measures set out by the State Council in January 2017 was to allow local governments to develop preferential policies to support foreign-invested projects that can facilitate employment, economic development and technology innovation in their localities. There had been, in 2014, an effort to limit local authorities’ discretions in creating tax incentives and to “cleanse” existing reliefs, which were not consistent with national tax law. Guo Fa [2014] No. 62 “Notice of the State Council on putting in order tax incentive policies”, issued in November 2014, required the State Council to sign off new incentives and requires all provincial governments to ensure that all reliefs inconsistent with national law are abolished. This campaign was “temporarily” suspended in the middle of 2015. However, with this new development, local governments now are again allowed to offer incentives to attract foreign investment as set out in the 20 measures. This is seen to align with the government’s strategic goal to encourage foreign investments and support the development of local economy. In future, this may be an important factor in selection of project sites by foreign investors.

**New prohibitions on foreign investment in cultural sectors**

New prohibitions on certain industrial sectors have also been included in the new Catalogue. These prohibitions are mainly in the cultural sector, such as editing and publication of books, newspapers, magazines, audio-visual products and electronic publications [the 2015 Catalogue solely covered publication – the new Catalogue extend this to also cover editing]. Also prohibited in the new Catalogue are provision of radio and TV video on demand services, installation services for satellite TV broadcast receiving facilities, and broadcasting to China of radio and television programs. This is expanded from the 2015 Catalogue which merely prohibited radio and television program production. Also prohibited in the new Catalogue are internet-based news and information services and internet information publication services - only news websites were covered in the 2015 Catalogue.

This is in line with the new restrictions set out in the Cybersecurity Law issued in November 2016 and Measures for Internet-based News Information Services issued in May 2017 by the Cyberspace Administration of China (CAC). The latter rule provides that news agencies shall obtain an internet-based news information service license from the CAC before offering internet-based news information collecting, editing and publishing services. News reproduction services and transmission platform services shall also be subject to licensing and recordal filing with the administration for telecommunications. It also clarifies that no organisation may establish internet-based news information service agencies in the form of Sino-foreign joint ventures, Sino-foreign cooperative ventures or wholly foreign-owned enterprises (including news and information collecting, editing and publishing services, reproduction services and transmission services). (See KPMG China Tax Weekly Update (Issue 43, November 2016); China Tax Weekly Update (Issue 20, May 2017) for details).
Transition to the Negative List approach

In a bid to boost foreign inbound investment, China has also been committed to push the rollout of the Negative List approach.

In the first step, in October 2016, MOFCOM issued Interim Measures for Filing Administration of Establishment & Alteration of FIEs ("Interim measures") providing for the nationwide rollout, from October 2016, of the Negative List approach for FIE establishment and alteration (e.g. capital adjustment) of FIEs. This means that these matters shall be subject to MOFCOM recordal filings rather than to pre-approval procedures. This new administrative treatment holds so long as the FIEs in point are not subject to the Negative List as specified in the Catalogue (i.e., sectors for which foreign investment is restricted/prohibited). This differs from the old system which required MOFCOM FIE set up pre-approval first, and then allowed the FIE to continue with all the other registrations, which made for a very time consuming process. (See KPMG China Tax Weekly Update (Issue 39, October 2016) for details.)

In a second step, the MOFCOM released the draft Administrative Measures for Establishment and Alteration of FIEs in May 2017. This clarifies that domestically owned companies that become FIEs as a result of M&A transactions and strategic investments shall also transition from pre-approval to recordal processes. This also applies to investments in listed companies. Pre-approvals are still necessary for investments in Negative List sectors. See KPMG China Tax Weekly Update (Issue 22, June 2017) for details.

Potential impact of draft Foreign Investment Law

In the past, foreign investors have frequently used Variable Interest Entity (VIE) structures to invest in domestic companies which are licensed to operate in sectors which would otherwise be restricted or prohibited to direct foreign investment. Under these foreign investors may, via contracts between the locally owned licensed entity and a foreign owned WFOE, exercised effective control over the licensed entity. However, proposed regulatory changes in China could create challenges for the continued use of such structures.

In January 2015, MOFCOM issued the draft Foreign Investment Law (the “Draft”) to solicit public comments. The Draft refers to the “actual control” of a domestic enterprise in determining whether it has received foreign investment, such that VIE structure investment in a prohibited sector would be blocked, and investment in a restricted sector could be complicated.

It should also be noted that foreign investments in certain “sensitive” sectors (such as infrastructure, transportation, resources, energy), even if they do not fall within the Negative List, may be subject to national security review, and could be rejected on this basis. The Draft bolsters the national security review in a separate chapter in the proposed regulations.

Foreign investors who are utilizing VIEs structure to invest in China, and investors in “sensitive” Chinese sectors, should keep close attention to the legal developments in this space.
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