

Fangda Opinion: New Regulations on Fair Competition Review effective since 1 August: How would it affect Government's Financial and Tax Incentives?

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NEWSLETTER

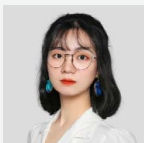
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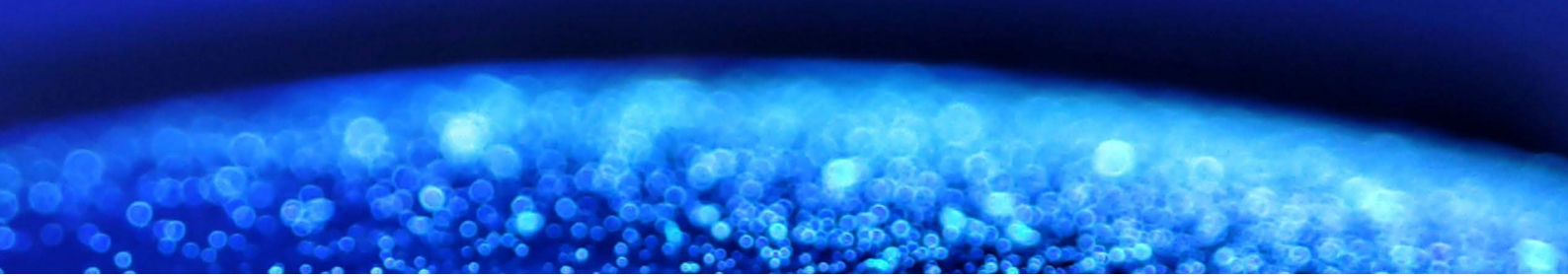
1. Overview

On August 1, 2024, the "Regulations on Fair Competition Review" (the "**Regulations**") officially became effective. The Regulations are the first administrative regulation to explicitly require that government bodies conduct a fair competition review in accordance with the Regulations whenever drafting policies that impact the economic activities of businesses. By establishing a pre-vetting mechanism for administrative legislation and policy formulation, the Regulations have laid a solid institutional foundation for eliminating local protectionism and preventing governmental abuse of administrative power to eliminate or restrict competition.

This fair competition review system actually started before the Regulations were enacted. In June 2016, the State Council issued the "Opinion on Establishing a Fair Competition Review System in Market System Construction" (the "**Opinion**"), stating the necessity to regulate government actions, prevent the introduction of policies that eliminate or restrict competition, and establish a fair competition review system. The proposed fair competition review system required local governments to gradually review and abolish policies and practices that hinder the establishment of a unified national market and fair competition. In 2017, the State Administration for Market Regulation ("**SAMR**") issued further implementation measures (revised in 2021, the "**Implementation Measures**") to promote the implementation of the fair competition review system. And in June 2022, the Anti-Monopoly Law (the "**AML**") was amended and the fair competition review system was formally recognized by the highest hierarchy of the Chinese antitrust legal norm.

Following these earlier efforts, the Regulations were newly announced to fill the legislative gaps in the fair competition review system and increase the legal force of the system by elevating the previous rules from policy to regulation in the national legal system.

Businesses and investors have taken interest in the promulgation of the Regulations. Of particular interest, the Regulations prohibit local governments from formulating



policies that offer specific companies tax incentives or financial subsidies without a legal basis or without the approval of the State Council. Businesses have expressed concerns that the new Regulations may trigger a review of existing tax incentives or financial subsidies that have been offered or paid to the businesses, as preferential treatment offered to specific undertakings under individually negotiated investment agreement could fall into the scope of fair competition review. In particular, since regional governments typically rely on financial and tax incentives to attract foreign investment, foreign investors are particularly concerned about whether regional governments will suspend their subsidy policies in response to the Regulations, or even demand repayment of subsidies already distributed.

To help businesses and investors with this concern, we have reviewed the Regulations within the context of the historical development of the State Council's fair competition review system. This brief provides our interpretation on how the Regulations might impact the fair competition review system in terms of government financial and tax incentives, and provides our suggestions for businesses to protect their legitimate interests.

2. Financial and tax incentives

(1) What types of tax incentives and financial subsidies fall within the scope of fair competition review? Do investment agreements between businesses and local governments which include tax incentives and financial subsidies fall within the scope of fair competition review?

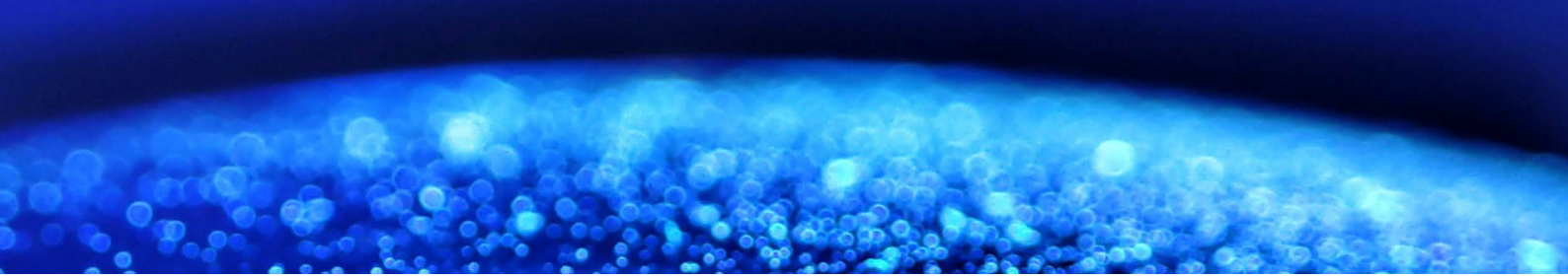
According to the Regulations, any policy that covers economic activities of undertakings must undergo a fair competition review during the drafting stage. This means that any governmental policy that involves providing businesses with any form of financial subsidy or tax incentives will fall within the scope of review.

As stipulated in Article 2 of the Regulations, the types of policy falling within the review scope include laws, administrative regulations, local regulations, rules, normative documents and specific policy measures (collectively referred to as "**policy measures**"). The "specific policy measures" can be in the form of notice, decision or contract issued or entered into by the governments on a "case-by-case" basis. Therefore, Contracts entered into between businesses and regional governments such as investment agreements could also fall within the scope of fair competition review.

(2) What types of tax incentives and financial subsidies incentives may be prohibited? Are there any exceptions?

The Regulations requires that policy measures shall not, without a legal or administrative regulatory basis or without the approval of the State Council, contain any of the following elements that affect the cost of production and operation:

- Giving tax preferential treatment to specific undertakings;
- Giving selective and differentiated financial incentives or subsidies to specific undertakings;

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- Preferential treatment for specific undertakings in terms of acquisition of factors of production, administrative fees, government funds, social insurance premiums, etc. (collectively referred to as “**financial and tax incentives**”).

According to the above regulation, any financial or tax incentives policies issued for specific undertakings without generality and are not based on laws, administrative regulations, or approval from the State Council may be prohibited as stipulated in Article 10 of the Regulations. These prohibited financial and tax incentives policies could potentially involve benefits, rewards, subsidies, or expenses granted to a specific type of undertaking (e.g., “foreign-invested enterprises”), as well as preferential treatments offered to specific undertakings under individually-negotiated investment invitation policies.

Exceptions to the prohibitions under the Regulations

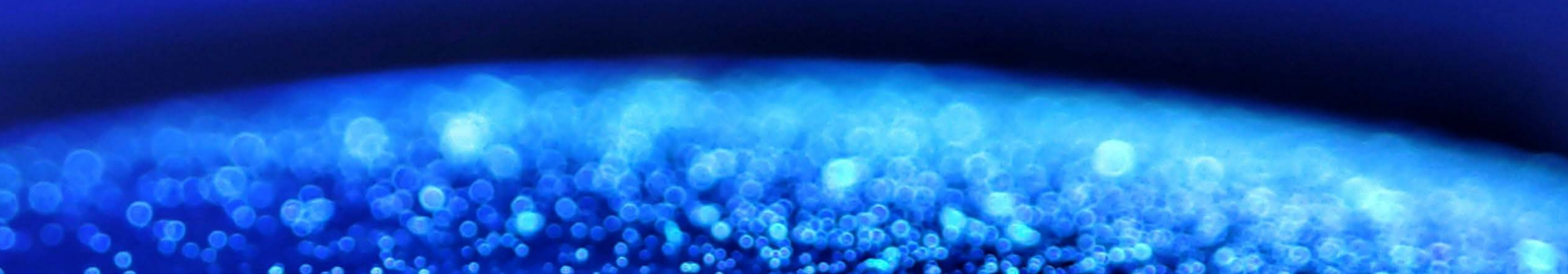
In addition to the general prohibition as mentioned above, the Regulations also provides four exceptions under Article 12 where specific financial and tax incentives policies may be authorized:

- To safeguard national security and national development;
- To promote scientific and technological development and enhance the country’s self-innovation capabilities;
- To achieve public interests such as energy conservation, environmental protection and emergency relief;
- Other circumstances stipulated by laws and administrative regulations.

It is worth noting that even if a policy measure falls under one of the above circumstances, it is not automatically exempted. Two additional conditions must be met: first, there should be no alternative with a lesser impact on fair competition; second, a reasonable implementation period or termination condition must be established. If the body responsible for drafting intends to apply the exceptions, the impact of the policy on fair competition and the conditions of implementation must be thoroughly assessed in order to pick the most reasonable approach. Additionally, there must be a clear policy termination date or condition to minimize the impact of the policy on fair competition.

(3) How does the fair competition review work in practice?

The fair competition review system primarily relies on self-examination by policy-making bodies, which reflects self-restraint and compliance with antitrust requirements within government departments during the policy formulation process. The Regulations stipulate that in carrying out fair competition review, the impact of relevant policies on fair competition shall be assessed according to the review standards thereof, and the opinions of the relevant businesses, industry associations, chambers of commerce and other stakeholders on the impact on fair competition shall be solicited. Where public interests are involved, the opinions of the public shall be solicited.



Both the new Regulations and previous fair competition review-related rules have established supervisory and spot-check mechanisms. Where policies fail to comply with such requirements, the SAMR can ask the drafting body to rectify. Any entity or individual can report policies that violate fair competition review regulations to the SAMR.

For businesses, prior to executing investment agreements with regional governments, they should confirm in advance whether the investment invitation policies proposed by the regional government, especially those involving financial and tax incentives, have proper legal basis or have obtained approval from the State Council. The policy should not fall under the prohibited circumstances of Article 10 of the Regulations, or should be eligible for the exceptions under Article 12 of the Regulations and have completed fair competition review. Exercising precaution can help avoid risks regarding the validity of the relevant clauses.

(4) Do the Regulations affect existing financial and tax incentives policies?

The Regulations do not specify the treatment of existing financial and tax incentives policies. Nonetheless, after the Regulations take effect, governments at all levels may seek to revise and amend any prior policy measure, in particular relating to fiscal and tax incentives that does not comply with the fair competition standards specified in the Regulations.

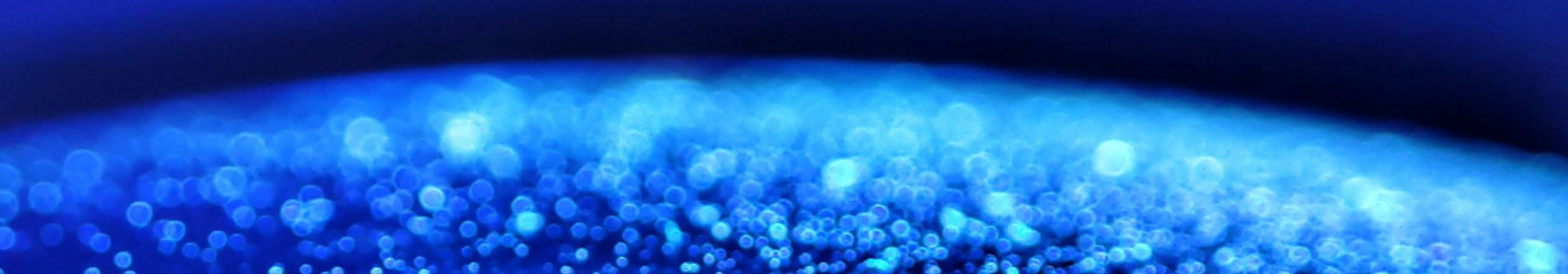
As early as 2016, the Opinion on fair competition review did stipulate that, according to the principle of “whoever formulates the policies shall be responsible for cleaning up”, all levels of government and their affiliated departments should systematically rectify and abolish existing policies and practices that hinder the establishment of a nationwide unified market and fair competition. And, in practice, SAMR pushed twice for this “clean-up” when it issued directives at the end of 2019 and in mid-2023¹ instructing all levels of government and relevant departments to collectively review and rectify policy measures formulated before December 31, 2019, and December 31, 2022, respectively.

Regarding financial and tax incentives policies, in addition to the fair competition review, from this year on, the State Council, the national audit work conference and the taxation work conference also emphasized regulating and rectifying the illegal financial and tax incentives policies in local investment promotion activities.

As an overall upgrade to the fair competition review system, the Regulations can address previous issues such as the low legal status, weak binding force, inadequate enforcement by local government, and insufficient rigor in the review process. It will be one of the “combined efforts” by the central government to regulate local financial and tax incentives policies, and local governments may feel further compelled to comprehensively clean up existing non-complaint policies.

Consequently, as a new opportunity for the development of the fair competition review system, government departments may intensify the review and clearance of existing financial and tax incentives policies. This trend is already beginning to emerge in current practice. For instance, on August 16, 2024, the Baotou Administration for Market Regulations announced that the Baotou Fair Competition Review

1. On December 25, 2019, SAMR and four other departments issued the “Notice on Conducting the Clear-out of Policy Measures that Impede the Unified Market and Fair Competition”, requiring a centralized review and clean-up of regulations, normative documents, and other policy measures formulated before December 31, 2019. This marked the official launch of the first centralized clean-up effort targeting policies that hinder fair competition. In June 2023, SAMR and other departments once again issued the “Notice on Conducting the Clear-out of Policy Measures that Impede the Unified Market and Fair Competition”, initiating the second centralized clean-up effort for regulations, normative documents, and other policy measures related to economic activities of undertakings that were formulated and in effect before December 31, 2022.



Inter-Agency Joint Office had discussions with the governments of four districts within Baotou for violating the 2021 Implementation Measures and engaging in irregular practices of offering preferential policies or agreements with businesses, which involved the rebate of taxes and non-tax revenues to businesses through financial support and subsidies.²

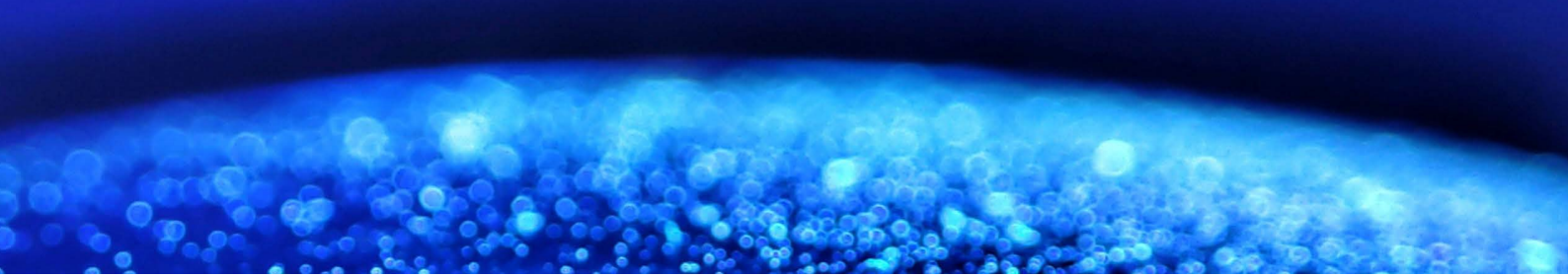
(5) If local governments review the existing financial and tax incentives policies, what is the risk that the financial and tax incentives terms in the contracts entered into between businesses and governments will be terminated or held invalid? Will local governments also require businesses to return the financial and tax incentives granted?

In theory, the financial and tax incentives terms in contracts between businesses and governments, as “specific policy measures,” fall within the scope of fair competition review. As such, they could potentially be revised or even terminated. However, considering the State Council’s relevant regulations and historical practices, we expect that after the Regulations are promulgated, the risk of the Chinese government conducting a sweeping overhaul and abolition of these incentives in business-government contracts is relatively low. It is also unlikely that they would demand the return of incentives already granted to businesses. The main reasons for this are as follows:

- Financial and tax incentives policies have been the major tool of investment promotion for local governments. If the national government uniformly cleans up the existing financial and tax incentives policies, terminate the financial and tax incentives terms in contracts or requires the return of incentives granted, the market will be impacted significantly, and business trust and confidence in local governments will be impacted as well. In the 2016 Opinion, a principle was established that *“for incentives granted to businesses through contracts, agreements, or other means—as well as for certain policy measures whose immediate termination would have a significant impact—a transition period shall be provided, allowing necessary buffer space; for incentives already granted, retroactivity will not apply.”* This demonstrates that, when establishing the fair competition review system, the State Council afforded local governments considerable flexibility in rectifying existing financial and tax incentives granted to businesses through contracts. This flexibility reflects major policy concerns in protecting the reasonable reliance interests of businesses, achieving smooth policy transitions, and avoiding significant impacts on the market.
- In accordance with this flexibility provided by the State Council, no large-scale clean-up of financial and tax incentives terms in contracts between businesses and governments has been conducted during the SAMR-led clean-ups of existing tax policies. Furthermore, the State Council’s routine policy briefings and related press conferences after the promulgation of the Regulations have not signaled any intent for future fair competition reviews to clean up financial and tax incentives terms in contracts.

Nevertheless, in the context of this year’s political target on regulating financial and tax incentives policies, it is still possible that local governments might use the fair competition review system to address non-compliant granting of financial and tax incentives or financial rebates on a case-by-case basis. This could involve a “retrospective” approach to review previously signed investment invitation agreements

2. Inner Mongolia Economy News, August 20 2024, available at <http://www.nmgsb.com.cn/system/mengshi/2024/0R0164552024.html>.



against fair competition standards. However, according to the State Council's desire to protect the reasonable reliance interests of businesses, achieve smooth policy transitions, and avoid significant impacts on the market, a business may request a transition period if a local government changes incentive policies based on the policy violating fair competition and not being covered by an exception. As for any benefits already granted under an incentive, businesses should be able retain those benefits, such as previous reductions in tax bills and previous in-kind contributions by local governments.

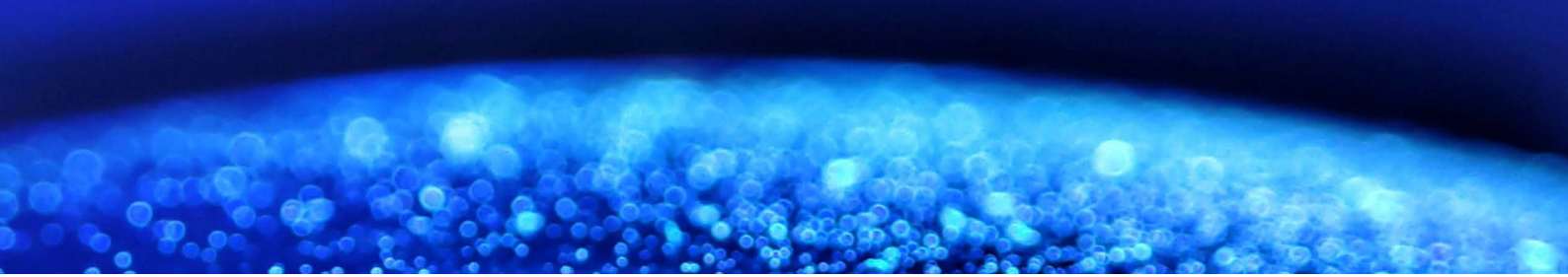
(6) What defenses or claims can businesses make if the financial and tax incentives terms in the contracts between businesses and local governments are subject to fair competition review or clean-up initiatives?

If the governments require to review or abolish existing financial and tax incentives granted to businesses through contract, the businesses may consider the following defenses or claims:

- 1) Businesses may argue that the relevant financial and tax incentives do not violate the fair competition review system. They might claim that these policies apply equally across an industry, rather than to specific companies. Alternatively, they could assert that even if such policies benefit specific companies, there is no effective competition in that area due to the companies' innovative products. Thus, they may contend that these financial and tax incentives will not limit or hinder market competition.
- 2) Businesses may claim that the relevant financial and tax incentives fall under exceptions. These exceptions could include safeguarding national security and development, promoting scientific and technological advancement, enhancing the country's self-innovation capabilities, or achieving public interests such as energy conservation, environmental protection, and emergency relief.
- 3) If relevant contracts were signed before 2015, businesses may claim exemption from fair competition review system prohibitions. This is based on the State Council's "Notice on Preferential Policies for Taxation and Other Aspects" (Guo Fa [2015] No. 25), issued on May 10, 2015. The notice states: "*The preferential policies in contracts between local governments and businesses shall remain in force, and fulfilled parts shall not have retrospective effect.*" This confirms the effectiveness of such policies and contract terms, potentially exempting them from the fair competition review system's restrictions.
- 4) The business may claim that a transition period should be established in accordance with the Opinion and claim that the business should be permitted to retain any financial and tax benefit already granted by the government.

3. Compliance implications involving fair competition review of financial and tax incentives policies

Although the fair competition review system has been in place for years, fair competition reviews conducted by local governments may become stricter in the future as the Regulations and other measures create

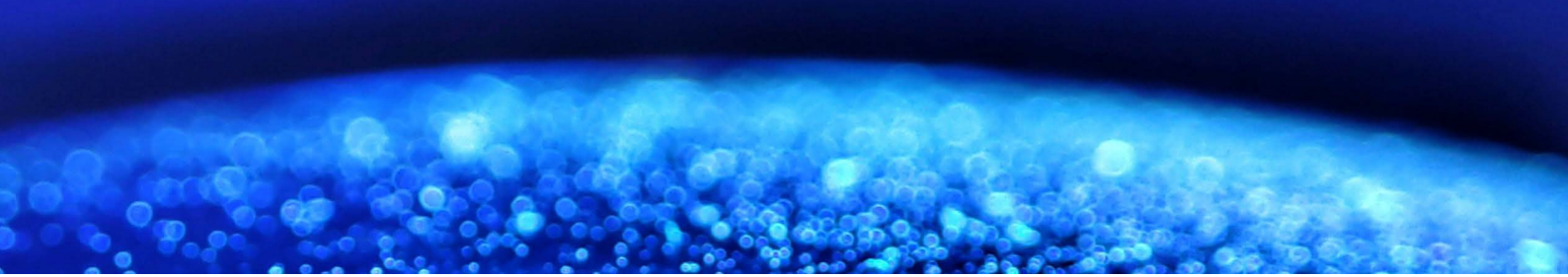


more sophisticated review standards and a more robust review system. To be prepared for these potential reviews, businesses should focus on the following five areas:

- 1) A business should closely monitor developments in the fair competition review system and in trends in review practice so that it can promptly assess the impact of any policy or practice changes on its financial and tax incentives. If a business has any doubt about the validity of a financial or tax incentives policy, it should consult with the government or with external lawyers.
- 2) A business should conduct self-assessments according to the Regulations on its current government contracts that include financial and tax incentives and consider consulting with the relevant local government not only to assess the validity of the contractual provisions but also to assess the potential risk that the government will conduct a formal fair competition assessment.
- 3) If the financial and tax incentive scheme are subject to a fair competition review, the business should promptly defend itself under the fair competition review system to safeguard its legitimate rights and interests to the extent possible.
- 4) When a business enters into new investment agreement with a local government in the future, it should assess the legality of the terms in the agreement and, if necessary, consult external lawyers to assess whether the new agreement may be subject to a fair competition review.
- 5) If a business believes that it has been unfairly treated or that another business possesses a competitive advantage illegally obtained due to a government policy, it may proactively resort to the fair competition review system to safeguard its legitimate rights and interests by whistleblowing and other methods. Currently, SAMR has published the methods for accepting whistleblower reports for fair competition reviews³ and is soliciting public comments on the draft “Work Rules for Handling Whistleblower Reports for Fair Competition Review”, which will further improve the standardization and transparency in handling whistleblower reports.

3. See:

https://www.gov.cn/lianbo/bumen/202408/content_6965762.htm#:~:text=%E4%B8%80%E3%80%81%E7%94%B5%E8%AF%9D%EF%BC%9A010-88651957,%40samr.gov.cn%E3%80%82

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