China to allow for-profit schools, except in compulsory education

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Education Alert

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On 7 November 2016, the Standing Committee of National People’s Congress (NPC) of China adopted an amendment to the Law of Promoting Privately Run Schools (the Amendment), with effect from 1 September 2017. Coming nearly 10 months after the issuance of a second draft form of the Amendment (Second Draft), the finalized Amendment liberalizes some aspects of the relevant law, but also, in a surprising move, the NPC has chosen to preclude for-profit schools from providing education for Grade 1 to Grade 9 (G1-G9), i.e., the grade levels of compulsory education in China. The Amendment thus comes as a mixed message, raising questions about the extent to which the Amendment will bring about a broadening of the education base.

The Amendment was expected to be published together with the Decision of Revising the Education Law and the Decision of Revising the Higher Education Law (collectively, the Amended Education Laws) in December 2015, but its release was postponed due to disagreements among legislators on the details of the new classifications of private schools, such as the standards of tuition, applicable preferential policies and transition matters.

The central aim of the Amendment is to encourage the development and operation of for-profit private schools and thereby make it more likely that such schools can attract more non-government investment. The most critical development is that for-profit schools are now officially allowed in pre-kindergarten, G10-12 and higher education, which could be recognized as a profound step in Chinese educational reform. By precluding for-profit schools in G1-G9, however, the NPC has not adopted a model followed in many other jurisdictions, in which for-profit private schools operate a complete primary and secondary system, ranging from pre-kindergarten to Grade 12.

Moreover, the Amendment does not lift the ban on foreign investors investing in private schools. In the absence of relaxation of this ban, it appears that the only viable approach that can be used to introduce foreign capital into this sector is through the sometimes controversial variable
interest entity structure (the VIE Structure), in which foreign investors may be able to achieve equity-like control over the operations of the VIE company and equity-like returns through contractual arrangements.

What is a "private school"?

Private school is a term of art in China that is not as simple as it looks, in particular because it does not encompass all types of educational institutions that are an alternative to traditional government-funded schools. For example, it does not include international schools, which are foreign-invested and enrolling only foreign students. It also does not include Sino-foreign cooperative education institutions (CEIs), which are cooperative ventures between Chinese and foreign institutions catering to Chinese students primarily (but see below for a discussion of the impacts of the Amendment on CEIs).

Instead, the concept of "private schools" specifically encompasses privately run institutions that potentially compete directly with the public government education system used to educate students, ranging from pre-school through tertiary education.

For-profit private schools vs. not-for-profit private schools

China has been cautious about liberalizing the education space, especially vis-a-vis the education of Chinese students at the K-12 level, taking incremental but sometimes uncertain steps towards liberalization, perhaps understandably so given the important position of schools in society and given all of the potential complexities and sensitivities involved. At first, space was only opened to "not-for-profit" private schools, and for-profit private schools were forbidden. Counter-intuitively, however, not-for-profit schools were permitted to remit "reasonable returns" to their funders, although what exactly was meant by this was unclear. This left investors uncertain about the prospects for their investments in schools, although some private schools in China were established and have been operating on this basis (including some with foreign investment, operating through VIE structures).

Later, the Amended Education Laws removed the restriction on establishing and running a school or any other educational institution for profit-making purposes. And the Amendment carries that further by explicitly classifying private schools into two categories, for-profit schools and not-for-profit schools, depending on whether or not the parties providing funding for the schools request profit distribution. Those that do not are classified as not-for-profit, and any surpluses generated by the school can only be used for the purpose of operating schools, with no distributions to the funders are allowed. Those that do are classified as for-profit and can distribute surplus to the funders in the form of dividends in accordance with the PRC Company Law and other applicable laws (i.e., after paying enterprise income tax and allocating the required amounts to the mandatory reserve funds, like other taxable companies in China). With these in place, the concept of "requesting reasonable returns" from operating surpluses by not-for-profit
schools is now done away with.

Overall, this development should lift uncertainty and encourage investment. Whether this happens in practice, however, remains to be seen as the implementation of the law goes into effect next year.

As for existing schools, as discussed below, the Amendment does not provide a specific transition period, but leaves this to local education authorities to develop rules.

**Identity as a legal person**

The Amendment also sheds light on the uncertainty surrounding whether a private school should be a legal person. Under the law in place before the Amendment was adopted, there were two approaches for the funders to engage in private education or training services:

- Setting up a school as a private non-enterprise unity (PNEU). The funders needed to obtain approvals from the MOE or the Ministry of Human Resources and Social Security (MHRSS) and register with the Ministry of Civil Affairs (MCA).
- Setting up a commercial training company that is registered with China's company registrar, the Administration for Industry and Commerce (AIC). However, to date the regulations for this approach have not yet been adopted.

The Amendment, which introduces the for-profit vs. not-for-profit classifications, somewhat clarifies this position based on classification. It says that for-profit schools, after obtaining a school license, can be registered as a legal person. This suggests that the Amendment is trying to solve the legal identity issue of the for-profit schools. Although the Amendment itself does not so state explicitly, it is understood that a for-profit school will be registered with the AIC as a company while the not-for-profit school will be registered as a PNEU with the MCA.

**Tuition standards**

Another key issue related to the two types of private schools is whether different tuition standards should apply. The increasingly expensive tuition of private schools is one of the concerns the authority aimed to address by passing this Amendment. According to the Amendment, the competent authority will formulate the tuition standards for not-for-profit schools, while for-profit schools can decide their own tuition standards based on their operating costs and market demand.

A somewhat troubling addition that was made after the Second Draft was circulated is language stating that the tuition standards of private schools (whether for-profit or not-for-profit) should accept supervision from the pricing bureaus. This appears to reflect the desire by the authorities to retain some degree of supervision and control over for-profit schools.

The question that many investors are concerned about is the tuition standards for not-for-profit schools, which are subject to the regulations of the local government. An optimistic
interpretation is that, as long as there is a good reason, such as the costs of hiring and retaining high-quality teaching faculty, private schools may still be able to charge relatively high tuition. However, it remains unknown whether the authorities will set a cap on the tuition for not-for-profit schools. This leaves uncertainties for investors who are interested in G1-G9 programs regarding whether they can still receive sufficient economic returns as expected, even by way of service fees, license fees and other contractual arrangements.

**Preferential policies**

In addition to the general support by local governments for private schools, the Amendment has provided additional incentives for not-for-profit private schools, including governmental subsidies, tax incentives that are similar to those for public schools, and preferential policies in allocation of land use rights. Not-for-profit private schools may now also find it easier to apply for tax exemption status and other tax benefits, which to date, though possible, has been difficult. This remains a local tax bureau determination, so there is not likely to be a uniform approach to this issue.

**For-profit schools are banned from compulsory education**

A significant and surprising change in the Amendment is a newly added provision banning for-profit private schools from offering compulsory education programs (i.e., G1-G9). In other words, private schools for G1-G9 (with accredited diplomas for high school entrance exam) must be not-for-profit. As the most controversial provision in the Amendment, it suggests the door for for-profit private schools offering G1-G9 education programs is closed.

**More restrictions on foreign investment**

Many premier global education institutions provide continuous education from kindergarten to high school education system (K-G12) in the various countries where they operate, and would like to be able to do so in China as well. However, with the prohibition on G1-G9, only two choices are left to these foreign investors, and neither is ideal for them.

- A not-for-profit school for K-G12: The funders could get reimbursed through contractual agreements like services fees, license fees, but whether this is economically attractive requires analysis, as well as an understanding of the impact of the pricing bureau's tuition review. Further, it is not clear whether these contractual arrangements will be subject to a stricter review of the government authority under the new legislation.

- A for-profit school for kindergarten and high school and a not-for-profit school for compulsory education: The different tuition standards are likely to cause the investor to separate its education system into two parts. The consistent education method and first-class teaching resources are the core values of many prestigious education institutions. The division into two types of teaching is obviously less attractive to educators.

**Curriculum to be regulated**
The Amendment to a certain extent corresponds with recent moves by authorities to tighten control over the private education sector. Last month, the Shanghai Municipal Education Commission called for stricter review on the curriculum for G1 – G9 for private schools with foreign background (for example, some schools introducing considerable foreign curriculae for G1-G9). More emphasis will be laid on the curriculum for the compulsory education, which should follow exactly the course requirements set by the MOE.

**Existing schools facing choices**

Existing private schools established under the earlier requesting reasonable returns model will either need to register as a not-for-profit school or seek approval to operate as a for-profit school. It is expected that the overall market of existing private schools for G1-G9 will not be materially affected since only 10% of private schools for G1-G12 (around 1,000) are requesting reasonable returns.

**Transition period**

A transition period of “three years” had been provided in the Second Draft for existing private schools to choose their nature after the new law took effect. The Amendment, however, removed such time limit and provides more flexibility for the local MOEs to craft a timeline.

The Amendment clarifies that, for the schools set up prior to the effectiveness of the Amendment, (i) if they choose to be not-for-profit after the implementation of the Amendment, they can continue their operation after amending their articles of association. If they choose instead to terminate operations, they can make this decision. Upon termination, the surplus may be used to compensate the funders, by taking into account of the factors such as the funders' investment, reasonable return request, and performance of the school. The remaining assets shall be used for running other not-for-profit schools; or (ii) if they choose to be for-profit, they shall go through a financial settlement to decide the ownership interest, pay applicable taxes and complete a new registration to continue operation. The education bureaus and the local governments shall fully consider “history and actual circumstances” in the reform process to ensure a smooth and stable transition.

It is not easy to predict the exact impact these will have on the existing private schools, particularly for those engaged in compulsory education. It is understood that the private schools offering G1-9 compulsory education programs can only choose not-for-profit; but it is not clear whether it means that they will also have to reduce their tuition scale as well.

**Impact on Sino-foreign cooperative institutions**

For Sino-foreign cooperative education institutions (CEIs), the current practice is that the funders can also choose to request reasonable returns. In practice, very few CEIs actually ask for reasonable returns because:
With such uncertainty, and the fact that the majority of foreign education institutions operating in China are not-for-profit, as a general matter, foreign education institutions usually prefer to choose not to request reasonable returns. For those for-profit institutions that wish to generate revenues from schools in China, the more common approach has been to use a series of commercial arrangements to transfer the revenues from the CEI.

Although the Amended Education Laws only provide a general policy that the State will support the Sino-foreign cooperative education activities, unfortunately, they do not directly address the issue whether the CEIs can also be for-profit. There is no clear indication whether the CEIs will still be regulated separately or will be deemed a part of the private schools if the parties thereto would like to choose to operate the CEI as a for-profit school. Currently, the Sino-foreign cooperative education activities are governed by the Regulations on Sino-Foreign Cooperative Operation of Educational Institutions issued in 2003 and its 2004 implementing rules, which are independent of the Private School Law. The possibility exists that the government intends to roll out an explicit for-profit option for CEIs as well once the model for private schools is formally established and mature.

### Detailed regulations to be tabled

In April 2016, the Central Leading Group for Comprehensively Deepening Reform adopted the Opinions to Enhance the Party’s Construction Work of the Private Schools (Trial), the Implementing Rules for the Registration of the Classified Private Schools, and the Implementing Rules on the Supervision and Administration of For-profit Private Schools, but these three rules have yet not been released to the public. After the issuance of the Amendment, it is anticipated that such regulations will be promulgated soon and help to clarify some issues with respect to the private schools under the new classifications such as the registration process, the requirements of the financial system and information disclosure.

### Conclusion

The Amendment has taken some further steps with a view to address the differences between for-profit schools and not-for profit schools, such as profit distribution, the legal person identity, preferential policies and tuition standards.

In some respects, the Amendment is good news for the education sector in China. But for degree education, it may cause a dilemma. Being not-for-profit comes with a potentially mixed bag of tax benefits, other incentives but also regulated tuition, while electing for-profit treatment might
result in a slightly different mixed bag of higher tax and operation costs, but hopefully more flexibility on tuition standards.

Before further guidance is issued, particularly for the tuition standards of not-for-profit and for-profit schools, it is hard for the funders of existing schools or potential investors to make a choice. Assuming tuition standards do not become a substantial obstacle, we believe some investors may still prefer the current widely used model of setting up not-for profit schools with contractual arrangements to obtain service fees and licensing fees, if it is still available under the then-effective legal framework. As such, it will be interesting to see what the PRC government will do to promote for-profit schools and what the market reaction will be to this new development.

Contacts

Steven N. Robinson
Partner

Sherry Gong
Partner

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