CHINA BRIEFING

Establishing and Operating a Business in *China 2018*

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Disclaimer
This edition of Establishing a Business in China was produced by a team of professionals at Dezan Shira & Associates, with Zhou Qian as technical editor and Adam Pitman as managing editor. Creative design of the guide was provided by Jessica Huang, Kking Lu & Belén Rodríguez.

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Preface

China's foreign investment landscaped changed significantly in 2017.

The economy is evolving away from manufacturing-centric economy towards a services- and consumption-based economy. GDP growth has slowed and wages have risen, but the economy's growth outperformed expectations and more industries are open to investment than ever before.

In 2018, strategic investors will find that their options have broadened significantly.

Decision-makers considering an expansion to China typically must first examine what type of entity to set up – or whether to set one up at all. Foreign investment into China can be made through several types of foreign-invested entities (FIEs). Choosing the appropriate investment structure for your business depends on a number of factors, including its planned activities, industry, and investment size.

This guide explores the establishment procedures for the Representative Office (RO), and two types of Limited Liability Companies – the Wholly Foreign-owned Enterprise (WFOE) and the Sino-foreign Joint Venture (JV) – along with related business considerations that decision-makers should examine at the pre-investment, setup, and operational stages of the expansion cycle.

This guide is based on best practices that we developed as foreign direct investment specialists during our 25 years of experience in the country. While each business has unique features and goals that should be discussed with professional advisors, we hope this guide serves as a useful reference for you and your team as you make plans for your expansion in China.

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About Dezan Shira & Associates

At Dezan Shira & Associates, our mission is to guide foreign companies through Asia's complex regulatory environment and assist them with all aspects of establishing, maintaining and growing their business operations in the region. With more than 25 years of on-the-ground experience and a large team of professional advisers, we are your reliable partner in Asia. Since its establishment in 1992, Dezan Shira & Associates has grown into one of Asia's most versatile full-service consultancies with operational offices across China, Hong Kong, India, Singapore, and Vietnam, as well as liaison offices in Italy, Germany, and the United States, and partner firms across the ASEAN region.

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Dezan Shira & Associates is a pan-Asia, multi-disciplinary professional services firm, providing legal, tax and operational advisory to international corporate investors. Operational throughout China, India, and ASEAN, our mission is to guide foreign companies through Asia's complex regulatory environment and assist them with all aspects of establishing, maintaining, and growing their business operations in the region. With more than 25 years of on-the-ground experience and a large team of lawyers, tax experts, and auditors, in addition to researchers and business analysts, we are your partner for growth in Asia.

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Pre-investment Considerations

- Representative office or foreign-invested entity
- Foreign-invested entities: WFOEs and JVs
- Business license and business scope
- Registered capital
- Expense and tax planning
- Another option: Foreign-invested partnerships
- Investing in free trade zones

Representative office or foreign-invested entity

The decision between setting up a representative office (RO), or an foreign-invested entity (FIE) has significant bearing on the foreign investor's activities in China. The main difference between the two is that an RO is an extension of the foreign company, whereas an FIE is a subsidiary.

The FIE is a separate legal entity – a limited liability company under Chinese law. When the FIE signs a contract, it is the FIE that is party to the agreement. When an RO signs a contract, it is the foreign company that is bound by the agreement. If the FIE makes a purchase, it owns the object; if an RO makes a purchase, the object belongs to the foreign company.

In addition, there are only a limited number of activities an RO is permitted to be engaged in. In any case, an RO is not permitted to make profit; it may only be used to facilitate the activities of the foreign company in China. These are:

- Market research, display, and publicity activities that relate to company products or services; and
- Liaison activities that relate to product sales or services, and domestic procurement and investment.

ROs acting in violation of their allowed activities will be fined, and their illegitimate income will be confiscated.

As an RO is not a capitalized legal entity in China, it may not directly hire Chinese employees. Instead, ROs are required to employ local staff through a qualified labor dispatch agency, such as FESCO (Foreign Enterprise Service Company). The agency acts as the employer for legal purposes, and sends employees to work at the RO for a fee. The RO may directly hire up to four foreign nationals, and these do not need to go through the agency.

Even though an RO does not earn revenue, it is still subject to Chinese tax. ROs are taxed at a percentage of their expenditures. This is an added reason for investors using an RO to keep a close eye on expenses, as the more it spends, the more it gets taxed. FIEs on the other hand are taxed on their revenue, which affords them more flexibility in tax planning.

However, as we shall see further in the guide, ROs are much easier to set up than FIEs.

ROs are, for example, a good solution for companies that are procuring from China but want to keep staff on the ground for quality control, or for maintaining short communication lines with suppliers.

Foreign-invested entities: WFOEs and JVs

SABRINA ZHANG
Partner
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Beijing Office

"The key difference between the RO and the WFOE is that a WFOE is an independent legal entity under Chinese law, whereas an RO is seen as an extension of a foreign company incorporated abroad."

The most common form of foreign investment in China is to incorporate a business entity. Chinese corporate law divides these into two categories:

- Wholly foreign-owned enterprises (WFOEs); and
- Sino-foreign joint ventures (JVs).

It is important to note that, for certain activities, foreign investors need to have a Chinese equity partner in the entity. In other words, incorporating a WFOE to engage in these activities would not be permitted. Investors that try to do so will see their application denied. WFOEs that engage in these activities illegally after being incorporated face fines or even the cancellation of their business license.

WFOE

A WFOE is a limited liability company wholly-owned by one or more foreign investor(s).

Unlike an RO, a WFOE can make profits and issue local invoices in RMB to its suppliers. Besides, the liabilities of shareholders to a WFOE are limited by the assets they bring to the business. A WFOE can also employ local staff directly, without any obligations to employ the services of an employment agency.

There are three distinct WFOE setups available:

- Service (or consulting) WFOE;
- Trading WFOE (or foreign-invested commercial enterprise [FICE]); and,
- Manufacturing WFOE.

While all three structures share the same legal identity, they differ significantly in terms of their setup procedures, costs, and the range of commercial activities in which they are allowed to engage. Trading WFOEs and manufacturing WFOEs must derive the majority of their revenue from their namesake business, but can also provide associated services. Service WFOEs are additionally permitted to conduct trading activities related to their services.

JV

A joint venture (JV) is formed by one or more foreign investor(s), along with one or more Chinese party(-ties). Generally, the foreign investor to a JV should own at least 25 percent of total shares. Note that a Chinese individual cannot normally be a shareholder in a JV except in some special circumstances; for example, in a JV incorporated in the Beijing Zhongguancun High-tech Park, or if the Chinese individual is shareholder to the target company in a merger or acquisition.

Reasons for setting up a JV include:

- The foreign company wants to invest in a restricted industry sector, where the law permits foreign investment only via a joint venture with a Chinese partner; and,
- The foreign investor wants to make use of the sales channels and network of a Chinese partner who has local market knowledge and established contacts.

There are two types of JVs in China, and they differ primarily in terms of how profits and losses are distributed:

- **Equity Joint Venture (EJV)**

    » Profits and losses are distributed between parties in proportion to their respective equity interests in the EJV;
    » Generally, the foreign partner should hold at least 25 percent equity interest in the registered capital of the EJV; and,
    » An EJV should be a limited liability company.

- **Cooperative Joint Venture (CJV)**

    » Profits and losses are distributed between parties in accordance with the specific provisions of the CJV contract; and
    » A CJV can be operated either as a limited liability company or as a non-legal person.

FICE

A foreign-invested commercial enterprise (FICE), which can be set up either as a WFOE or a JV, is a type of company for retail, franchising, or distribution operations. A WFOE or JV can be established exclusively as a FICE, or can combine FICE activities with other business activities, such as manufacturing and services.

Generally, a FICE is inexpensive to establish and can be of great assistance to foreign investors because it combines sourcing and quality control activities with purchasing and export facilities, thus providing more control and quicker reaction times compared to sourcing exclusively via an overseas headquarters.

FICEs are also the ideal choice for foreign companies that need to source in China in order to resell to its domestic consumer market. Without a Chinese trading company, the alternative would be to buy from overseas, and have the goods shipped out of China before then reselling them back to China (which would mean additional logistical costs, customs duties, and value-added tax).

Business license and business scope

VIVIAN MAO
Regional Manager
Dezan Shira & Associates
Shanghai Office

"For foreign businesses especially, it is imperative that company operations be reflected accurately in their business scope, as this is connected to the "Catalogue for the Guidance of Foreign Invested Enterprises" governing foreign investment into China."

When setting up a company in China, the investor must specify the intended business scope. This is a description of the business activities in which the investor plans to engage. Once it is incorporated, the company may only engage in the activities listed in the business scope. However, the business scope may not be phrased too broadly; otherwise it will not be approved.

There are important regulatory considerations in selecting the company's business scope. The incorporation procedure may vary, the tax treatment may differ, and zoning requirements are tied to the business scope as well. Having or not having certain activities in the business scope may therefore qualify or disqualify a business from being located in certain parts of a city, or from setting up in a development zone with preferential policies.

Depending on the business scope, FIEs can be classified as being a manufacturing company, a service company, a foreign-invested commercial enterprise (i.e. a trading company), regional headquarters, an R&D center, an investment company, or several others. Often, the capital requirements will differ depending on the type of company that is being incorporated.

Certain business activities require foreign investors to work with a Chinese equity partner in a JV. There are also activities where foreign investment is fully prohibited. The National Development and Reform Commission (NDRC) maintains a list of industries in which foreign investment is restricted (eg. requiring a JV) or prohibited, called the Catalogue of Industries for Guiding Foreign Investment. When applying for the incorporation of the FIE, the Administration of Industry and Commerce (AIC) will check the stated business scope for compliance with these regulations.

When the application to set up the FIE is approved, the AIC will issue the company's business license: a key piece of company documentation. Among other things, the business license will state the company's business scope.

Although it's not common for Chinese authorities to censure an organization for stepping outside the bounds of its officially authorized business activities to engage in auxiliary activities, the ability to issue tax invoices to its partners for the specific services rendered is very important.

These clients or customers will normally insist upon a specific invoice based on a certain value-added tax (VAT) rate for use as a tax offset or deduction, and it would not be unusual for them to refuse to make payment for services rendered if the appropriate invoice cannot be issued. Therefore, because a VAT invoice cannot be issued at the relevant tax rate for activities not specified in the business scope, it is critically important to negotiate approval of a sufficiently broad and relevant business scope with careful consideration from the beginning of one's anticipated scope of business activities.

Business license reform: Three-in-One to Five-in-One

China launched a new round of business license reform in September 2015 as part of a campaign to simplify companies' registration and establishment procedures. Specifically, companies newly established after October 1, 2015 are required to apply for an integrated business license. The integrated business license, sometimes referred to as the "Three-in-One" business license, combines the old business license, the organization code certificate, and the tax registration certificate into a single document with one social credit code.

In 2016, the "Three-in-One" business license was upgraded to a "Five-in-One" business license, with two more certificates, i.e. the social security registration certificate and the statistical registration certificate, being integrated to the business license. The deadline for converting to "Five-in-One" certification is December 31, 2017.

According to a document released by the State Council in May 2017, more certificates will be integrated into the business license to further reduce red tape and stimulate market vitality. Nevertheless, this policy is still under development. At the time of writing, there have not been clear timelines or other implementation details.

Registered capital

Setting up an FIE in China used to carry a statutory minimum registered capital. While there is no longer a minimum amount stipulated by law, the AIC will still require a minimum amount of registered capital before approving an application. This amount does not need to be paid completely up front. The investors may include a capital injection plan in their articles of association. Payment in terms is allowed, but the government will check whether the investors are following the plan.

Depending on a range of factors, the investors will have to dedicate a minimum amount of registered capital. These factors include the region, the company's business scope, the industry the company is in, and the planned scale of operations. This amount will be written on the business license as well. The registered capital may not be wired out again, but can be fully used for business purposes. Investors should make sure to commit sufficient funds to their registered capital. Due to China's capital controls, injecting capital into the FIE requires going through a time-consuming approval process. Changing the registered capital means the investor will have to go through this process again. The required steps are:

- Apply to increase the registered capital with the AIC;
- Apply with the State Administration of Foreign Exchange (SAFE) to transfer the funds into China;
- Wire the funds to the Chinese bank; and,
- Apply with the AIC to re-issue the business license.

This process can take between four to eight weeks. If additional funds need to be transferred because the company is running low on cash to cover operation expenses, this can put the company in a dire situation. To err on the side of caution, it is therefore advisable to commit additional capital.

If the parent company sends funds to the subsidiary in China without going through this process, the Chinese tax authorities will regard it as income, and tax the subsidiary at 25 percent corporate income tax.

What qualifies as registered capital

Registered capital can be contributed in cash or in kind, but in kind contributions may not exceed 70 percent of the registered capital. Common contributions in kind are intellectual property or equipment. Investors should be aware that using equipment as capital contribution can be arduous and time-consuming, and the process is subject to strict requirements. Often it is easier to simply contribute cash.

Only funds wired in from abroad qualify as registered capital; locally earned RMB cannot be used. Investors are advised not to wire any funds to China before the FIE is set up. Some investors wire funds to their local agents or staff to make some of the initial purchases, like office supplies, rent, overhead, etc. Apart from the obvious risks involved, these funds will not be recognized as registered capital, as they need to be deposited in a special capital account, which can only be opened after the business license is issued.

As part of China's capital controls, foreign investors are required to open two bank accounts: a current account and a capital account.

Current account foreign currency transactions may involve the import and export of goods and services, earnings from interest or dividends from portfolio securities, and regular transfers. Capital account transactions are mainly related to foreign direct investment (i.e. changes in a company's registered capital), the purchase and sale of equity or debt securities, and trade credit or loans.

In general, capital account transactions need approval from the SAFE, whereas current account transactions can be made directly through the bank.

One location/multiple office registrations

In April 2015, China announced its decision to allow multiple entities to list the same registered address on their respective licenses. This news has a significant impact on the professional services industry and especially those involved in corporate registrations and corporate secretarial work. While previously businesses had to be in a specific premises and were not allowed to share locations with any other company, this ruling means that offices may be shared and contain multiple companies, opening up scope for managing corporate secretarial work as is common in countries such as Singapore and Hong Kong. It also further liberalizes the serviced offices industry, which has had to operate in China under very specific agreements, and paves the way for 'virtual offices' to be operational in China.

Investment-to-capital ratios

It is important to note that FIEs are still required to abide by the ratio between registered capital and total investment as shown in the following chart. Unlike registered capital, total investment represents the debt of the investment and can be made up by loans from the investor or foreign banks.

Investment-to-Capital Ratios

Total investment (US$)	Minimum registered capital
3 million or less	7/10 of total investment
3 million - 4.2 million	US$2.1 million
4.2 million - 10 million	1/2 of total investment
10 million - 12.5 million	US$5 million
12.5 million - 30 million	2/5 of total investment
30 million - 36 million	US$12 million
36 million or greater	1/3 of total investment

Expense and tax planning

When setting up a company in China, one inevitably incurs costs prior to the company being formally incorporated. The question then arises what part of these costs may be deducted from the company's tax bill. This becomes especially relevant if the investment is a large project, such as setting up a factory and purchasing machinery, where the costs incurred prior to incorporation can be substantial.

At this point, it is important to note that ROs are taxed on their expenditure. It is therefore in the investor's interest to, within reason, keep expenses allocated to the RO to a minimum. For this reason, it is advisable to allocate the RO's pre-incorporation expenses to the foreign headquarters.

An FIE, being an independent legal entity registered in China, is taxed on its income, and may therefore deduct expenses from Chinese tax. As pre-incorporation expenses by definition have been incurred prior to the FIE formally existing, only some of these expenses can be taken on by the FIE. Of all the expenses made before formal incorporation, only the so-called pre-operation costs (开办费) may be allocated to the FIE and deducted. The key point in defining pre-operation costs is the time when they occurred.

In practice, the starting point of this period is seen as either the establishment date on the business license, or the day on which the investor gets the company name confirmation from the AIC. This is usually one month before the establishment date on the business license. The ending point of the pre-operation cost period is when the company issues its first invoice, or generates its first revenue.

Most of the costs incurred during this period, such as wages, training, printing, transport fees, registration fees, and purchases of items not considered fixed assets, may be deducted if relevant valid tax invoices can be provided. Up to 60 percent of advertising and business-related entertainment expenses (business dinners, gifts, baijiu, etc.) may be allocated to the FIE during this period.

It is often hard to predict what the establishment date of the company will be. This largely depends on how the incorporation process is conducted. However, the better the investor manages the incorporation from its side, the more clarity one can hope to get.

Before the company is incorporated, the foreign investor may open a temporary bank account in China. The investor may wire foreign currency into this account and spend these funds on pre- operation and other expenses. After the company has been established, it needs to open a capital account. The funds from the temporary account can then be wired to this account.

In practice, the only cost incurred prior to the pre-incorporation cost period is office rent. Allocation to the FIE is accepted, as an office lease is a required step of the incorporation process.

Enterprises, especially manufacturing companies, which often have a long pre-operation period, should take careful consideration of when their pre-operation period ends. These companies in particular need to make sure costs incurred can be carried forward as a loss over the next five years.

Another option: foreign-invested partnerships

An often overlooked option is the foreign-invested partnership, which was introduced in 2010. As the name suggests, this entity requires two or more investors to conduct business together. The option would therefore not work for foreign investors looking to set up an entity over which they have 100 percent control.

A partnership is not a separate legal entity, but a contractual arrangement between two or more parties to do business together under a common name, and is registered as such with the government. Instead of having to stay within the boundaries of the Company Law, a partnership affords investors broad freedoms to make internal arrangements as they see fit. For example, the profit shares and voting rights need not be aligned with the investor's capital contribution.

While the Partnership Enterprise Law says that, in principle, the unanimous approval of all other partners is needed when a partner sells their share in the partnership, investors are free to stipulate otherwise in the agreement. It can therefore be much easier to transfer one's participation in a venture this way.

Investing in free trade zones

The history of China's free trade zones (FTZs) began with the launch of the Shanghai Pilot Free Trade Zone in September 2013. Pitched as an experimental field in which to conduct economic reforms, the Shanghai FTZ served as a means to promote economic reform and facilitate foreign direct investment (FDI).

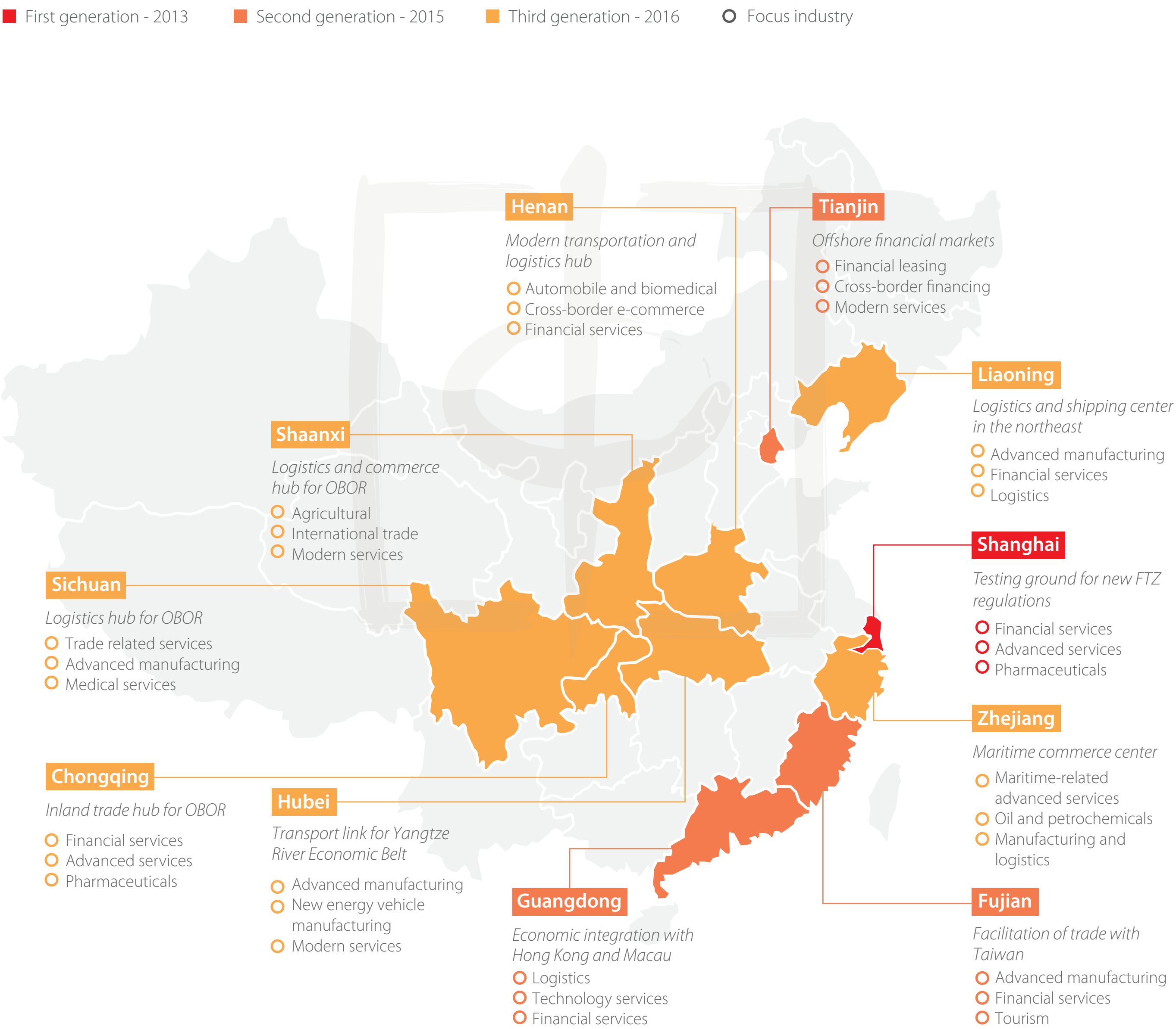
The Shanghai FTZ was essentially a testing ground for new reforms, and to a certain extent still is. Where proven successful, these would be expanded across the entire country. In this way we have seen, for example, the easing of restrictions on foreign currency exchange and foreign participation in China's e-commerce sector – both originally FTZ pilot schemes – implemented nationwide.

Following the success of the Shanghai zone, three more FTZs were established in Tianjin, Fujian, and Guangdong in April 2015, and the Shanghai FTZ was further expanded to include the Lujiazui financial district, Jinqiao development zone, and Zhangjiang hi-tech park.

Rather than being a testing ground for nationwide reforms like the Shanghai FTZ before them, the three new zones were intended to drive regional growth by encouraging selected industries to cluster in that area. Also, the government assigned strategic positions for each of the FTZs: Fujian supports trade with Taiwan; Guangdong supports economic integration with Hong Kong and Macao; Tianjin supports the northeastern region and helps develop offshore financial markets.

On August 31, 2016, the government announced plans for seven more FTZs, underlining the government's long-term plans to develop inland China and support the One Belt, One Road (OBOR) initiative, bringing China's total number of FTZs to 11. The seven new FTZs are in Chongqing, Liaoning, Henan, Hubei, Shaanxi, Sichuan, and Zhejiang.

Evolution of China's FTZs and Focus Industries



FTZs allow the government to test and adjust policies for eventual expansion. As such, many foreign investors are confused as to the strategic advantage of establishing inside an FTZ in the first place.

When first rolled out, the Shanghai FTZ was highly attractive to investors for its one-stop application processing and reduced minimum registered capital requirements. However, both of these policies were implemented nationwide, leading some to question: should investors focus only on FTZs or should they expand their focus to other classes of special economic zones? It depends on your industry and business needs.

According to Amber Liu, Senior Manager of Corporate Accounting Services in Shenzhen, preferential tax policies is one of the major advantages of establishing within the Qianhai Shenzhen-Hong Kong Zone. But she warns that companies should be vigilant about their eligibility and the application process. "Companies must first be within the industries that are encouraged within the FTZ, and fulfil revenue requirements. Furthermore, they should be aware of, and diligent in, the application process – otherwise their application may be denied."

The Chinese government plans to continue piloting policy innovations in FTZs, meaning that investors would be the first to benefit from any new policies. For example, the Shanghai FTZ debuted a corporate registration website that allows for online appointments, pre-registration services, and a trial mobile app. On the other hand, as the first to pilot new policies, entities within the FTZ are also the ones that would have to deal with the initial confusion and lack of clarity.

Establishing within an FTZ does not guarantee success. For some businesses, the policy and trade environment within the zone may present competitive advantages, while it may be less beneficial for others. Before making the decision, firms should do their homework and consult with experts to understand which path is best path for the company's expansion.

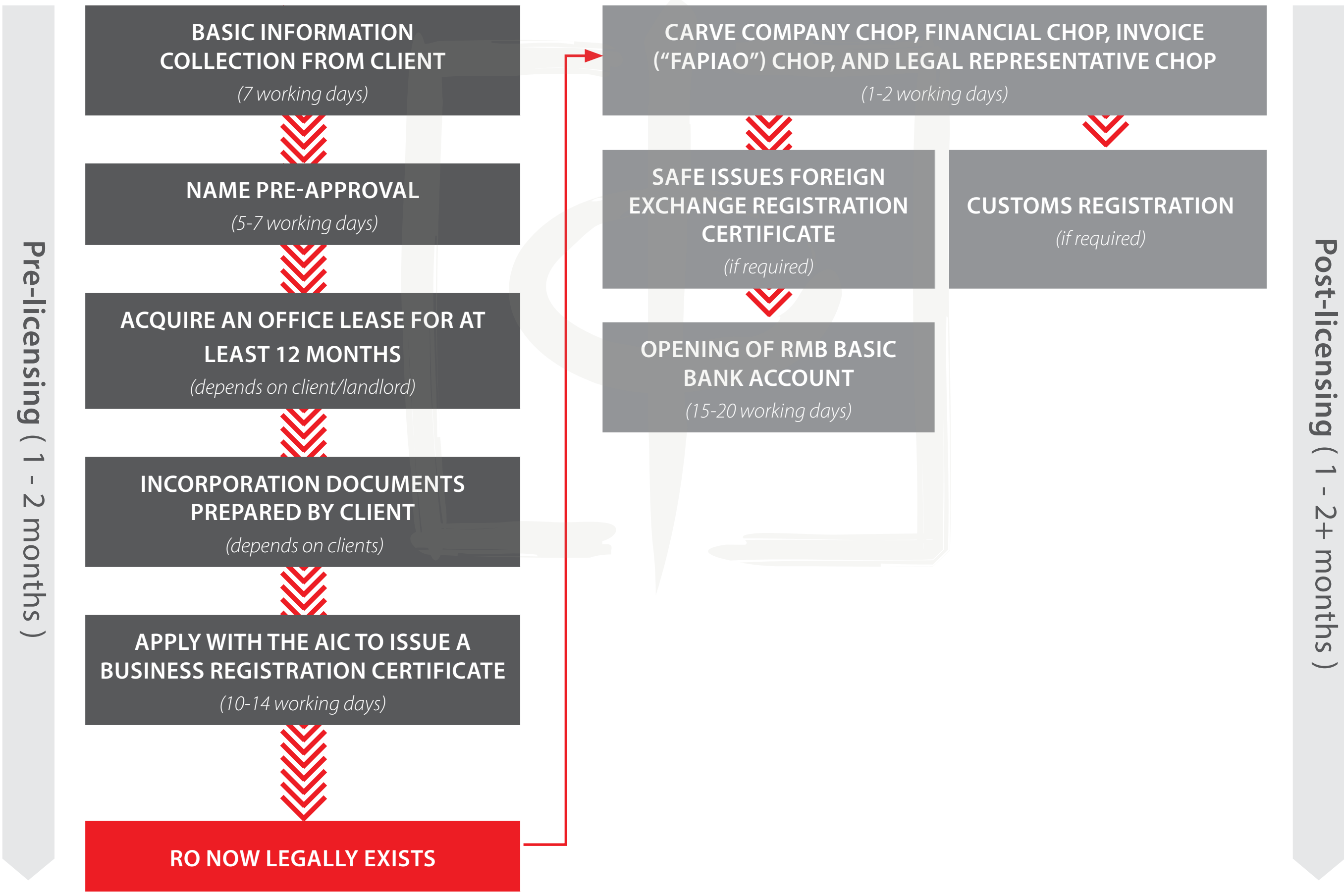
Set-up Procedure

- Representative office (RO)
- Wholly foreign-owned enterprise (WFOE)
- Issues specific to Sino-foreign joint ventures (JVs)
- Offshore holding companies
- Establishing a branch

Representative office (RO)

To set up an RO, the overseas parent company must have already been in existence for two years. The procedure is as follows:

RO Setup Procedure



It is important to note that this procedure may be subject to local variations.

When submitting the application to the AIC, the investor needs to bring the following documents, with a Chinese translation where needed:

- Certificate of the overseas company showing it has been in existence for over two years;
- Articles of Association of the overseas company
- Bank reference letter with basic information about the overseas company;
- Letter appointing the chief representative – and other staff if present;
- Identification document of the chief representative;
- Letter appointing the authorized signatory of the overseas company;
- Office premise lease agreement;
- Chief representative's resume with signature;
- Chief representative's photo; and,
- Application form.

The first six documents need to be notarized in the home country, and legalized by the Chinese embassy responsible for the investor's jurisdiction.

Office premises

To set up a business in China, it is a prerequisite to own or lease an office premises (as the primary place of business), and register this with the AIC. Doing so requires that the FIE possess all legal documents pertaining to the premises as required by the Chinese authorities. Usually, only one business may be registered per office unit. Under limited conditions, one office unit can be used to register multiple businesses. Many new entrants to the China market find success using serviced offices offered by any number of providers in major cities across China.

ROs require special attention when choosing suitable premises for AIC registration. Because an RO is technically not a Chinese enterprise but an extended arm of the overseas parent company in China, the local AIC may scrutinize the registered office premises more closely, and/or impose special requirements for its registration. Detailed rules vary by region.

For example, in Shanghai, the local AIC previously required that an RO only be registered at a commercial office premises with approval from the Public Security Bureau (PSB). While this requirement is no longer mandatory, the registered office of an RO still needs to be designated for non-residential purposes, or else risk being denied for registration by the AIC.

RELATED READING

An Introduction to Doing Business in ASEAN 2017

March 2017

This guide introduces the fundamentals of investing in the 10-nation ASEAN bloc, concentrating on economics, trade, corporate establishment and taxation. We also include the latest development news for each country, with the intent to provide an executive assessment of the varying component parts of ASEAN.

AVAILABLE HERE

When selecting an office location, make sure the building itself is certified to house businesses and to lease units to ROs. Investors should negotiate with the landlord to get an official VAT invoice for the rent paid. Issuing such an invoice may entail additional costs and tax liabilities to the landlord, so it is important to have clarity on this matter.

The landlord should provide the investor with copies of these three documents:

- Premises Ownership Certificate, affixed with the landlord's company seal;
- Landlord's Business License, affixed with the landlord's company seal; and,
- RO Resident's Certificate, issued by the management company.

Having these three documents lets the investor know that the office leased is eligible for use as an RO premises.

Chief representative

The chief representative needs to be appointed by the board of directors of the parent company and is responsible for the RO's day-to-day operations. While Chinese laws do not clearly state the scope or limit of a chief representative's authority, most government documents requires his or her signature.

Bank accounts

Foreign investors are advised to either open their Chinese bank account directly themselves, or outsource doing so to an experienced and well-reputed services company. When the account is opened, the bank will ask whose signature or what seals will be required to authorize transactions. Granting full power to manage the bank account to the chief representative may expose the company to undue risk, or the chief representative to blackmail.

Stipulating that the company chops, also known as corporate seals, are required to manage the bank account places an added layer of security. It is important to properly secure the company chops, as they can be abused if they fall into the wrong hands. It is unfortunately not uncommon for disgruntled employees to exert pressure on the company by seizing the company chops.

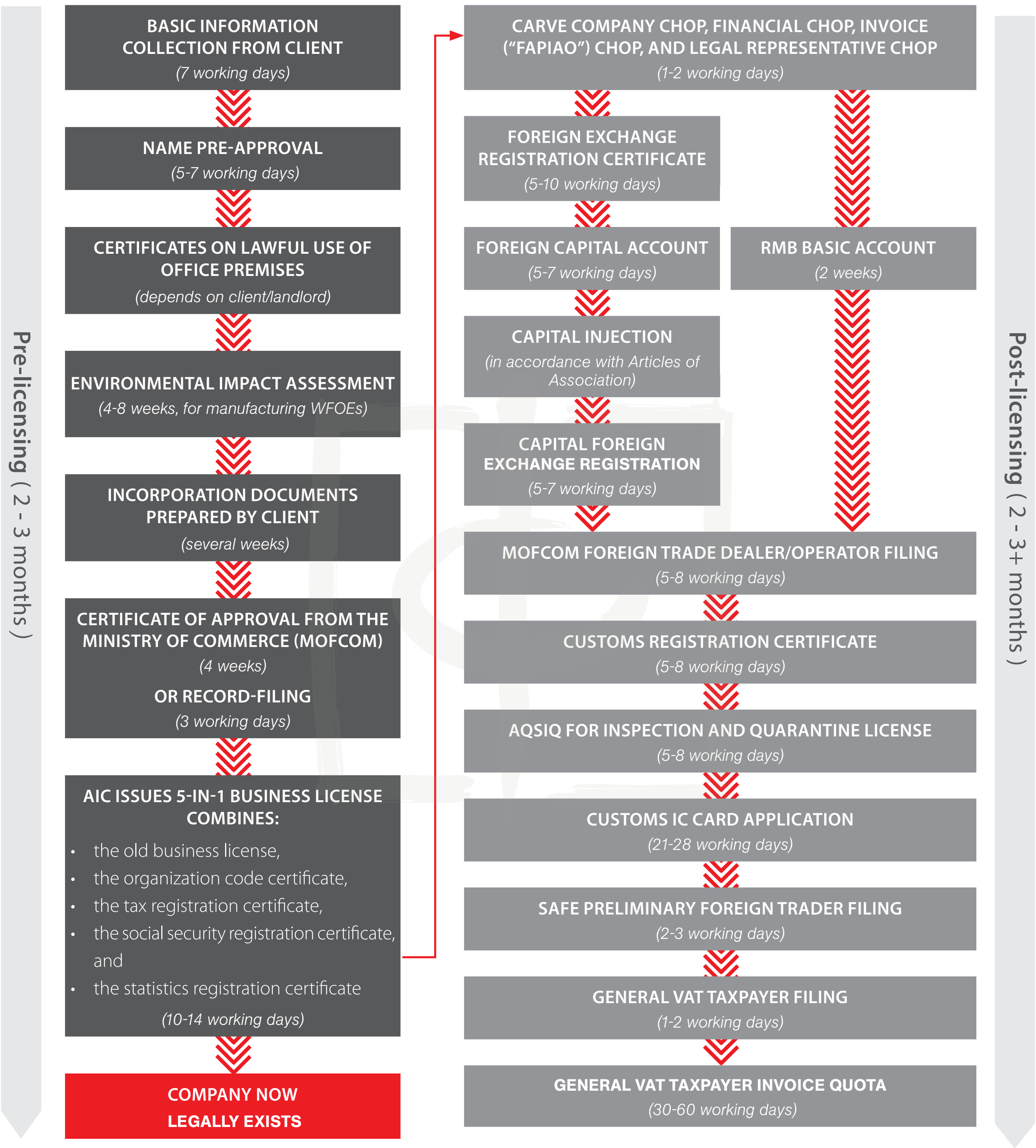
Wholly foreign-owned enterprises (WFOE)

Establishing a WFOE in China generally takes between three and six months and involves the following government authorities:

- Ministry of Commerce;
- Administration of Industry and Commerce;
- State Administration of Foreign Exchange;
- State Administration of Taxation;
- Customs Office;
- Quality and Technical Supervision Bureau;
- Statistics Bureau.

The establishment process varies based on one's chosen investment structure and planned business scope. For example, manufacturing WFOEs must complete an environmental evaluation report, while trading WFOEs need to undergo customs/commodity inspection registration. The general procedure and timeline is as follows:

WFOE Setup Procedure



Step 1: Name approval

One of the first steps for foreign companies is to decide on an appropriate name for the Chinese market. According to company naming rules, a qualified company name should contain at least the following elements:

- Administrative region name of incorporation;
- Brand name;
- Industry or business; and,
- Company Limited.

Additional guidelines restrict the content of names, forbidding the use of content that either misleads consumers or hinders fair competition, or damages or contradicts national unity, policies, social ethics, culture, or religion. Special characters, such as Arabic numerals, are not permitted, and certain words such as 'China', 'Chinese', 'National', 'State', or 'International' can only be used under limited circumstances.

Beyond these, a name must consist of more than two Chinese characters. The SAIC does not accept names containing foreign languages or alphabets, as well as numbers and special characters. Before submitting the application, businesses can conduct a preliminary check through the local Enterprise Name Query System to identify similar company names that are already registered. Further, businesses should prepare at least five potential names for AIC approval.

Upon approval of the company name, an "Enterprise Name Registration Certificate" will be issued, which is usually valid for twelve months. The whole process takes five to seven working days.

To be noted, while the company can register an English name for its manufacturing facility, the Chinese name is the legally binding one. The English name may have equal legal validity as a Chinese company name providing there is enough evidence to associate the English name of a company with its Chinese name, such as a bilingual company chop bearing the two names.

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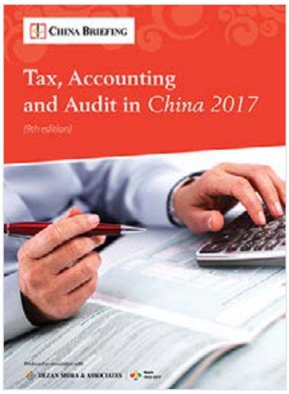


Tax, Accounting and Audit in China 2017 (9th Edition)
April 2017

This edition of Tax, Accounting, and Audit in China, updated for 2017, offers a comprehensive overview of the major taxes foreign investors are likely to encounter when establishing or operating a business in China, as well as other tax-relevant obligations.

AVAILABLE HERE

Step 2: Office/facility space lease

When registering a WFOE, if the intended office premises is owned by the same individual or entity applying for business registration, the applicant needs to show a Certificate of Premises Ownership (CPO) issued by the real estate authority and submit a copy of this to the local AIC. Most CPOs explicitly indicate the purpose of the premises; the AIC does not accept "residential" CPOs to be used as the basis of a business registration.

If the office premises is leased from another individual or organization, the applicant is required to produce the original lease agreement with a minimum one-year lease term, as well as a copy of the CPO of the property. The landlord should be an AIC registered business. Usually, a copy of the landlord company's business license is also required, including the company's official chop.

In addition, both parties to the lease agreement should complete lease registration and record-filing procedures with the local real estate authority within 30 days following the agreement's conclusion. Upon confirmation that the lease is legitimate, the authority will issue a Housing Lease Certificate, which legally allows the property to be used for manufacturing or business operations.

If a CPO cannot be produced for AIC registration due to a legitimate reason, a certificate issued by the local real estate administration authority, sub-district office, neighborhood committee, or the administrative institution of a development zone will be required to prove the legitimate ownership of the property by the applicant or landlord.

If the company intends to build up a facility from scratch, then it needs to apply for a Construction Land Use Permit from the local Land Resources & Urban Planning Committee before construction. After the facility is constructed, the company will need to go through a series of inspections, including an environmental check, fire inspection, quality acceptance, until finally obtaining a Certificate of Premise Ownership (CPO) from the local real estate authority.

Step 3: Environmental impact assessment (for manufacturing WFOE)

After obtaining proper premises, the company is obliged to submit an environmental impact assessment report to the local environmental protection bureau for approval. This is intended to control the impact that a manufacturing company has on China's environment. The bureau will require information on the raw materials to be used, the equipment and machinery, and the consumption and disposal of hazardous materials. In some cases, a more elaborate report by a third party may be required. The whole process takes around four to eight weeks. Upon approval, a certificate will be issued, which is valid for five years.

Step 4: MOFCOM approval or record-filing

The company will be required to go through an approval application or record-filing process with MOFCOM or one of its local branches, depending on which industry it will engage in, the total investment size, as well as the location of its facility.

For industries listed as "restricted" in the *Catalogue of Industries for Guiding Foreign Investment* ("the Catalogue", recently revised in 2017), a Certificate of Approval on Foreign Investment must be obtained, which requires companies to submit a Feasibility Study Report, an Enterprise Name Registration Certificate, a Facility Premises Certificate, and an approved Environmental Protection Valuation Report (if applicable), together with other documents which may vary from city to city. The whole process takes around four weeks. However, this process should be shortened to five working days with the implementation of the ongoing business registration reform. After acquiring the Certificate of Approval, companies have 30 days to register with the local AIC.

For industries not listed as "restricted" or "prohibited" in the Catalogue, a simplified record filing process applies. This was initially available only in the FTZs and certain pilot cities, and then extended nationwide starting from October 2016. Record filing can be done online by the representative or agent of the FIE after obtaining pre-verification of the enterprise name, and before or within 30 days of issuance of its business license. Digital confirmation of successful filing could be issued in as little as three working days. If MOFCOM requires additional documentation or clarification, this will be made clear within 15 days.

Step 5: Five-in-One business license

To apply for a business license from the local AIC, the Company needs to submit the following documents:

- The Company's business license (may need to be notarized in the country of origin);
- Bank statement to show the Company's creditworthiness;
- Copy of the Legal Representative's passport;
- Copy of the Directors' passports and CVs;
- Draft articles of association;
- Environmental Protection Valuation Report;
- Feasibility Study Report (if applicable);
- Intended name of the company, business scope, registered capital and business term; and
- Lease contract for the premises or CPO.

Under the current Five-in-One business license scheme, companies are only required to submit the application documents once to the local AIC, and then the AIC in charge will share the documents with other bureaus to complete the business registration process. This has reduced the registration period by about three weeks – all five elements previously required independent applications.

After obtaining the Five-in-One business license, the company legally exists.

Step 6: Carving chops

Unlike practices in the West, a company's official chop, or seal, in China has legal authority over the signature of a legal representative and has the power to validate documents and contracts, regardless of who uses it. Its possession and whereabouts are therefore of utmost importance.

All companies operating in China are required to have an official chop, which is round in shape and bears the official company name in Chinese, and where applicable, in English. A company chop can be obtained from the local PSB after successful registration with the AIC. When signing a contract, it is always the opposite party's responsibility to ensure that the signing party's seal is authentic – if not, the contract is not legally binding. The PSB therefore keeps a duplicated copy of the official company seal in the event of fraud or disputes.

Other than the official company chop, a company must also have a legal representative chop, a financial chop, a chop for use on fapiao, and in the case of trading WFOEs, a customs chop. A legal representative chop is used for specific license and certificate applications and banking documents, while the legal representative chop is square in shape and bears the name of the company's legal representative.

The financial chop is used to validate financial transitions such as cash withdrawals, wire transfers, and bank checks. The company's financial officer should keep possession of this chop separately from others, with a duplicate stored with the company's registered bank for verification and anti-fraud purposes. With legal authority in a Chinese company residing primarily in the hands of the person who currently holds its chops, it is advisable to put in place a mechanism to track, record, and monitor their use.

Step 7: Open foreign exchange and RMB bank account

A WFOE in China needs to have a minimum of two banks accounts: an RMB basic account, and a foreign currency capital contribution account. An RMB basic account is a must for a WFOE's daily business operations in China. This account is the only account from which the company can withdraw RMB cash, and often acts as a designated account for making tax payments. The foreign currency capital contribution account is necessary to receive capital injections from overseas. Approval to open this account can be obtained from SAFE.

Additional general RMB accounts and other types of foreign currency accounts can be opened for different purposes. For foreign currency accounts, these may include a settlement account for the collection of current items in a foreign currency, foreign debt special accounts, and temporary capital accounts.

A WFOE can establish bank accounts with both Chinese and international banks. Although many foreign investors prefer to establish an account with an international bank due to an existing business relationship, creating accounts with a Chinese bank has some advantages regarding efficiency, convenience, and security. A WFOE's financial and legal chops are usually required in order to verify the 'signature' of the company when opening a bank account in China.

Step 8: Customs registration procedures (for trading WFOE)

For a trading WFOE or a manufacturing WFOE with trading activities in its business scope, it needs to go through customs registration, which includes:

- Foreign Trade Dealer/Operator Filing with MOFCOM (5-8 working days);
- Customs Registration Certificate application (5-8 working days);
- Applying Inspection and Quarantine License from AQSIQ (5-8 working days);
- SAFE Preliminary Foreign Trader Filing (2-3 working days); and,
- Custom IC Card application (21-28 working days).

Step 9: General VAT taxpayer related procedures

Taxpayers in China are split into two categories when it comes VAT: general taxpayers and small-scale taxpayers. The latter are entities involved with wholesale and retail with sales of less than RMB 800,000 per year, manufacturers (including those providing processing, repair, and replacement services) with sales not exceeding RMB 500,000 per year, and taxpayers offering VAT-taxable services with maximum annual sales of RMB 5 million. All other taxpayers come under the general classification.

Despite lower VAT rates for small-scale taxpayers, general taxpayers can deduct input VAT from output VAT, reducing the overall tax burden of the company. General taxpayer status also permits the company to issue special VAT fapiao to its clients and customers. Fapiao are important in business transactions and can be used as legal receipts and for tax deduction purposes, where appropriate. Provided a sound accounting system can be demonstrated, entities who fall into the small-scale taxpayer category can also apply for general taxpayer status, the application process for which has recently been simplified.

To gain general taxpayer status, an application form and tax registration certificate must be submitted to the local tax bureau. The registration will then be checked and confirmed by the bureau. Previously, extra steps, such as an interview and on-site inspection, were required; the removal of these steps has considerably shortened the time required.

Issues specific to Sino-foreign joint ventures (JVs)

Before moving to incorporate a JV, the foreign investor needs to find one or more local partners. It is important to conduct thorough due diligence on the intended JV partner. Many FIEs in China have failed because of unpleasant experiences after the JV was created. If the targeted JV partner is uneasy about allowing due diligence to be performed, that is usually a bad sign.

While a large part of the due diligence is best left to trained professionals, there are a few elementary steps that investors can perform themselves.

- Chinese party's business license. This can provide the investor with valuable information as to who is authorized to make certain decisions in the company, what its registered capital is, the length of the license, the address, etc. Investors should cross-check this information with the information provided to them. For example, if the JV partner only has a few months on its business license, it would be in a poor position to negotiate a 10-year JV.

- Operation status. The SAIC maintains an official website, the National Enterprise Credit Information Publicity System, on which all companies' basic information can be searched. If a JV partner's business is marked as an "irregular operation", foreign investors should upgrade the alert degree. If the intended JV partner's business is put into the "blacklist for severe violations and dishonest acts", then foreign investors are not suggested to deal with this intended partner anymore.

- Land use rights. If the Chinese party is providing land, it is important to make sure it actually holds the title to that land and is valued correctly. Illegal land acquisition is a common problem in China, so foreign investors need to be particularly careful when the JV partner intends to inject land as its part of the JV contribution. Title to land can be ascertained with the Ministry of Land and Resources and its local branches.

- Financial reports. It is not uncommon for Chinese companies to operate with two sets of books, with the official books misstating financial information to reduce tax liability. For this reason, a Chinese partner may be less than forthcoming in disclosing these to the foreign investor.

If in doubt, one can engage an accounting firm to conduct an asset appraisal report. It is important to ensure that such practices are not carried over to the JV, as the Chinese tax authorities submit foreign-invested companies to a higher level of scrutiny.

Offshore holding companies

Many companies choose to establish holding companies, or "special purpose vehicles," in jurisdictions outside of mainland China to hold their Chinese entity. There are a variety of reasons why a foreign investor might want to set up a holding company to hold the shares of the FIE.

Asset transfer

For one, transferring equity in a Chinese company requires going through a time-consuming procedure, involving the MOFCOM, the tax authorities and the AIC. This can be avoided if the foreign investor has a holding company placed in between the FIE and the company actually making the investment. That way, the holding company is the entity that directly owns the shares in the FIE. To transfer the FIE, the investor can simply transfer the holding company owning the FIE. This has the same practical effect as transferring the FIE itself, without triggering the approval procedure in China. From the perspective of Chinese law, the owner of the FIE (the holding company) remains unchanged.

Tax on profit repatriations

Depending on the tax treaty that is in place between China and the country that the holding company is based in, there may be attractive tax rates for dividends, royalties, service fees, or other intercompany payments. Often, the investor will need to show that actual business functions are being performed in that country, as simply setting up a shell company to lower taxes will not be accepted by the Chinese tax authorities.

Cash pooling

Due to China's strict currency controls, moving funds in and out of the country can be challenging. If the investor wants to re-allocate profits from the FIE elsewhere instead of remitting them to the parent company, a holding company offers a solution. Funds can be pooled in the offshore holding company, where tax on the transaction is often lower, and re-invested elsewhere.

Anti-avoidance regulations

Tax authorities across the world are cracking down on the practice of funneling funds away to shell companies in low tax jurisdictions. It has therefore become important to show justifiable commercial reasons for the establishment of a holding company – both from the point of the subsidiary in China, as well as the ultimate parent company in the investor's home country.

These demands will often require the holding company to engage in some kind of business activity. Depending on the regulations in the countries in question, this can range from showing income, to having the holding company employ a certain number of staff. Often, having some local staff provide centralized services for the companies in the group is a suitable option.

Establishing holding companies in Hong Kong or Singapore

Both Hong Kong and Singapore are common jurisdictions to set up holding companies for China-based FIEs. There are several reasons that explain their popularity:

- Under their tax agreements with China, both Hong Kong and Singapore have a lowered five percent withholding tax rate for dividends. This applies to dividends issued by a Chinese entity to a Hong Kong or Singapore entity.
- Dividend income is exempt from CIT in Singapore, or profit tax in Hong Kong. If participation exemption applies, that means these amounts received by holding companies in Hong Kong and Singapore would not be deemed as taxable income. If the amounts are eventually to be remitted from the Hong Kong or Singapore holding company to the parent company, or another subsidiary, there is no further dividend withholding tax to be paid on sending these amounts out of these jurisdictions.
- No capital gains tax is levied on the transfer of capital assets in Singapore and Hong Kong. The transaction may however still be taxable in China.
- Low business tax rates: 17 percent in Singapore and 16.5 percent in Hong Kong.
- Singapore and Hong Kong are the two largest offshore RMB clearing centers. This means the two territories are the best equipped to handle RMB-denominated banking, including receiving dividends and other fees from China-based entities. It also enables the holding company to assume cash pooling functions.
- Singapore and Hong Kong lead the World Bank's Ease of Doing Business Index, with Singapore first and Hong Kong third. Both territories have well developed banking and legal systems.

In recent years, however, Singapore holding companies have been gradually earning the favor of foreign investors. For one, Singapore has almost three times as many double tax avoidance agreements (DTA) in place than Hong Kong, which is a key component in creating an effective and flexible holding structure. At the time of writing, Hong Kong has 37 comprehensive DTAs in place, whereas Singapore has signed DTAs with 88 countries.

A major obstacle for American companies planning to use Hong Kong has been the implementation of the Foreign Account Tax Compliance Act, or FATCA. The regulation imposes strict monitoring requirements on banks with American clients, both individuals and corporations. Failure to do so is penalized with a 30 percent tax on all US income by the American government, in addition to penalties from Hong Kong authorities. The costs of FATCA compliance are often so high that they do not measure up against the benefit of having American clients. For this reason, Hong Kong banks now often refuse American clients, or even shut down their accounts.

Establishing a branch

VALERIA MANUNZA
Assistant Manager
International Business Advisory
Dezan Shira & Associates
Guangzhou Office

“New branches need to register with the local tax authority, but only branches that wish to issue invoices must declare locally sourced taxable income – on a monthly basis.”

Companies that wish to expand across China can establish branches in other cities than where the original FIE is established. Branch companies may sign contracts in their own name, but do not have an independent legal personality. In other words, civil liability is still borne by the main company. Branches may open their own bank accounts, which makes it easier to pay local employees. Retail companies often use branch companies to expand retail stores across the country. Investors should note that branches have a narrower business scope than the original company.

New branches need to register with the local tax authority, but only branches that wish to issue invoices must declare locally sourced taxable income, on a monthly basis. Furthermore, only operational branches need to have their own accounting systems and undergo local annual audit. The branch set-up does not require approval from the Ministry of Commerce; just an application with the AIC. Also, while branches may open their own bank accounts, they are not obliged to. Branches may continue to use their main company's account, which accelerates the set-up process.

Branches do not require registered capital, but are supported by the main company's registered capital. If, however, the AIC deems that the FIE's registered capital needs to be raised to support the branch, that may add two to three months to the time required for the establishment.

Step	Time Required
Acquire an office lease for at least 12 months	5-10 days
Apply with the AIC to set up the branch AIC issues Business License Includes: Enterprise Code, Tax Bureau, Statistics Bureau Registration	10-14 days
Create corporate seals and file with the Public Security Bureau	1-2 days
Open an account with a local bank	1 day
Apply for general VAT taxpayer status	3-5 days

Operational Considerations

- Bank account management
- Intellectual property considerations
- Key positions in a foreign-invested entity
- Articles of association
- Corporate chops
- Human Resources
- Main business taxes
- Annual audit and tax compliance
- Foreign currency controls and profit repatriation

Bank account management

As mentioned above, an FIE can establish bank accounts with both Chinese and international banks. More often than not, foreign investors prefer to use an international bank with a local presence in China because of an existing business relationship. The major international banks used in China are Bank of East Asia, Citibank, DBS Bank, Hang Seng Bank, HSBC, and Standard Chartered.

However, establishing accounts with a Chinese bank has a number of advantages, such as:

- The application process for opening a bank account with an international bank in China will be more document-intensive and take longer compared to opening such an account at a Chinese bank;
- There are substantially more Chinese commercial banks than foreign bank branches, which is more convenient for management, especially when certain transactions must be conducted on the counter;
- Most Chinese companies have local bank accounts. Conducting transactions with them will be easier and faster if done from a Chinese bank instead of an international bank; and,
- Local banks usually have a stronger security system than international banks operating in China.

When opening a bank account in China, an FIE will need to specify what will act as the "signature" of the company. Usually the company's financial chop (seal) is required to do so, along with either the legal representative's chop (or chief representative's chop for an RO) and a handwritten signature. Banks generally prefer using the legal representative's chop instead of a handwritten signature, as the latter is easier to forge and harder to verify.

Many bank transactions can now be done online in English, including the approval of transactions and viewing account balances from abroad. It is possible and sometimes necessary to make tax payments online in certain areas (including Beijing) by signing a three-party agreement with an authorized Chinese bank.

For an entity's RMB basic account, it is possible to apply for different levels of e-banking access and multiple security keys (in the form of a key-ring/USB dongle) – one with access rights and another with approval rights. Another common security measure is a device that generates a new password for every written check.

Intellectual property considerations

Many FIEs in China have graduated from a manufacturing focus to a model where their real business value is now in their intellectual property. Unfortunately, intellectual property rights (IPR) violations has always been a problem in the country, including via the infringement of copyrights, trademarks, patents, and designs.

These types of IPR must be registered with the appropriate Chinese agencies and authorities to be enforceable in China. In practice, most FIEs adopt measures to proactively search the Internet for all known kinds of violation, in addition to sending staff to corporate functions and trade fairs. Companies can also pay RMB 800 to Chinese customs to have them monitor their trademarks and contact them if any violation is discovered. As of November 1, 2015, this service can be conducted without charge, but this is subject to change.

Copyrights

Strictly speaking, copyrighted works do not require registration for protection. Nonetheless, companies should consider registering their works with the National Copyright Administration, since this provides evidence of ownership that may be needed in the event of legal action.

Patents

Patents are territorial rights, meaning that a patent in another country has no effect in China. Companies should file applications for both their core and fringe technologies and make sure that their patents are properly translated into Chinese.

China follows a "first-to-file" system for patents, which means patents are granted to whoever files first, even if they are not the original inventors. A foreign patent application filed by a person or firm without a commercial office in China must be conducted through an authorized patent agent. Patents are filed with the State Intellectual Property Office in Beijing.

Trademarks

China has a "first-to-file" system for trademarks, meaning that the first party to file for the registration of a particular trademark will be granted the rights. Companies should register their brands' English and Chinese names, as well as any marks and/or logos with the Trademark Office. Careful attention should be paid to the product categories and sub-categories selected for filing (separate registration is required for each category under which protection is sought), and to check whether similar trademarks have already been filed.

Application to register a trademark should be made with the Trademark Office of the State Administration for Industry and Commerce (SAIC) in Beijing and its 13 newly established local offices, and costs a minimum of RMB 600 as of October 15, 2015. However, foreign companies are required to entrust a trademark agency to handle the registration, which means an additional agency charge ranging from RMB 500 to RMB 1,000. A list of trademark agencies can be found at *http://sbsq.saic.gov.cn:9080/tmoas/agentInfo_getAgentDljg.xhtml*. The Trademark Office will complete examination of the application within nine months from the date of receipt of the required documents.

The importance of trademark registration

As mentioned above, China has a "first-to-file" system for trademarks. This is a system whereby the rights to a trademark are awarded to the first party to apply, rather than the first to use it, even if the trademark is already registered in other countries. This gives rise to the common problem of 'trademark squatting', where some dishonest companies in China look out for well-known trademarks and register them before companies come and claim them.

Many of these trademark squatters wait for these companies to enter the China market and sell the trademark to them. This happened to Tesla Motors, the American electronic automotive company, when it decided to enter China. A Guangzhou-based man had acquired the rights to the Tesla trademark in China in 2009.

With this in mind, it is obvious that China's IP legal environment is perilous to even the largest of foreign investors, and registering a trademark within China is of upmost importance.

Key positions in a foreign-invested entity

The key positions in a foreign-invested entity vary by the investment structure and size, with some overlap.

ROs should designate a chief representative to sign documents on behalf of the company. In addition to a chief representative, an RO can also nominate three more general representatives.

For WFOEs and JVs, key positions include shareholders, an executive director (or board of directors), supervisor(s), general manager, and legal representative.

Legal Representative Candidates

	WFOE	JV
Executive Director	√	
Chairman of the Board of Directors	√	√
General Manager	√	√

Shareholders and executive director (or board of directors)

For a WFOE, the shareholder(s) represents the highest authority of the company, whose decisions regarding company operations are executed by the executive director or board of directors. For a JV, the board of directors is the highest authority. The board should have no fewer than three directors appointed by the parties to the JV, with the ratio between Chinese and foreign-appointed directors determined through mutual consultation.

Supervisor(s)

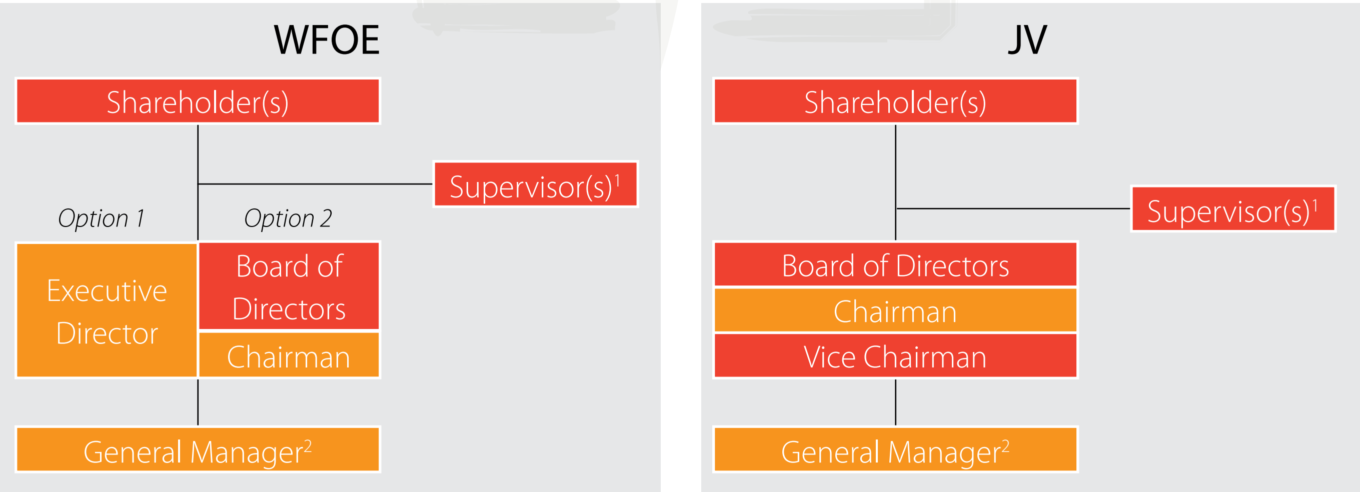
WFOEs and JVs must also have at least one supervisor to oversee the execution of company duties by the director(s) and senior management personnel. To ensure there are no conflicts of interest, a company's director(s) and/or senior management personnel cannot concurrently serve as supervisors. Where a company has a relatively small number of shareholders and is small in scale, one or two supervisors will suffice. For larger companies, a board of supervisors composed of no less than three members is required.

General manager

Both WFOEs and JVs need a general manager who is responsible for day-to-day company operations. This position may be concurrently filled by the executive director or a member of the board of directors. For JVs, several deputy general managers can also be appointed; this group is collectively referred to as the management office. A director of the board can concurrently hold the post of general manager, deputy general manager, or any other senior management position, which includes CFO or any other position designated as such in the company's Articles of Association.

Every business established in China, whether foreign or domestic, is required to designate a legal representative, i.e. the person responsible for performing the duties and powers on behalf of a company. The legal representative is, by definition of their role, one of the most powerful people in a foreign-invested entity. Yet this power comes with heavy responsibility, and if a single individual in a foreign-invested entity is to be held accountable for company actions, that person is more likely than not the legal representative. Eligibility for the role of legal representative varies by FIE type, as shown in the accompanying table.

Key Positions in WFOE and JVs



1. A supervisor or member of the board of supervisors cannot be a director or among senior management personnel. Larger companies require a board of supervisors composed of representatives for both shareholders and staff.
2. The general manager can also be a director or executive director. For JVs, in addition to the general manager, several deputy general managers can also be appointed, collectively referred to as the "management office."

Articles of association

According to PRC contract law, a number of items should be included in the articles of association:

- Scope of business: This needs to be detailed, as well as accurate. A business scope that is too broad may not be accepted by the AIC, and even if it is, might make it hard to apply for industry-related tax benefits. At the same time, it is advisable to keep some room open for expansion of the business, as amending the business scope at a later stage will be arduous.
- Production scale: This can be useful in terms of expressing an exit strategy. The investor may indicate what level of production or profitability is too low, and liquidate the company. This makes it far easier to obtain approval for closure if this eventuality occurs. These figures can also be linked to the liquidation provision in the articles of association.
- Profit repatriation.
- Mergers and acquisition: It is advisable to lay down a set of rules beforehand. These may include appointing professionals to make a valuation of the business, a stipulation to make their decision final and binding, a time limit for offers, and a mechanism for the payment and share transfer.
- Liquidation: Having the threshold for liquidation clearly defined in the articles of association makes it easier to wind up the company if necessary, as approval from the local government is required.
- Capital contribution plan: Registered capital may be contributed in terms, according to a plan laid out in the articles of association.

Corporate chops

An official company chop – sometimes referred to as a seal or stamp – is a necessity for doing business in China. In contrast to business places in the West, management and administrative teams in China use the chop to legally authorize documents, often in place of a signature.

Beyond the company chop, a business may need other chops to fulfill different functions. A company will likely need several chops – each for a different purpose and used on different types of official documentation – depending on its business scope. Regardless, every business should consider diversifying their use of chops.

For some chops, any person simply in possession is deemed as authorized to use it. Given the implications, businesses should consider working with independent advisors, who can manage the application process and design internal controls for their responsible use once obtained. In this article, we explain the different chops in China and how businesses can use them.

Company chop

The company chop is mandatory, and functions as the company's official signature. Businesses use the company chop for all legal documents as it can cover almost all the functions of other chops, except for the customs chop and the invoice chop.

The company chop is required when any important document is signed, and can provide legal authority when opening a bank account or altering the name or business scope of the company.

FIEs must produce the company chop after registering with the AIC. The company chop contains the full registered name of the company in Chinese, and must be approved by the PSB.

The chop must be recorded by the AIC, PSB, and the company's bank.

Finance chop

The finance chop is used for opening a bank account, issuing checks, authenticating financial documents such as tax filings and compliance documents, and for most bank related transactions. It is a mandatory chop, though the company chop can often be used in its place. Companies will often keep their finance and company chops separate to avoid exposure to misuse.

The chop must be recorded with the AIC, PSB, and the company's bank.

Customs chop

The customs chop is used for customs declarations on import and export goods. It is mandatory for companies engaged in cross-border trade.

Contract chop

Many companies use a separate contract chop for signing contracts with their employees or executing agreements between salespeople and clients.

While having a contract chop is not a statutory requirement, this chop can serve in place of the company chop when used for contracts. The contract chop grants less authority than the company chop, making it useful for delegating authority.

Invoice (fapiao) chop

The invoice chop is mandatory for issuing official invoices and tax receipts (fapiao). A chopped invoice is required to declare a purchase as a business expense.

Legal representative chop

The legal representative chop is a personal chop owned by the company's legal representative. The legal representative is the main principal of the company identified on the business license, and has the authority to enter into binding obligations on behalf of the company. A company can only have one legal representative.

The legal representative chop can be used in place of a signature, or alongside one. Upon registration, it must be recorded with the AIC, PSB, and the company's bank.

Electronic chop

An electronic chop is the digital equivalent of a given chop used for online transactions, including financial and contractual ones. These chops are similar to electronic signatures, which are encrypted to ensure the user's authority.

Companies using electronic chops are advised to monitor regulatory updates regarding their use, as technological developments have outpaced corresponding changes in legislation.

Other chops

In addition to the above chops, a variety of other chops can be used for different purposes, such as human resources chops. Although only the company, finance, and customs chops (if applicable) are legally required, various government departments may at times require other chops for specific purposes.

For example, a government department may require a document chopped with the company seal of the foreign investor's parent company. This can create complexities, as the use of seals by many smaller corporations is not mandatory and is not part of the typical administration process.

However, in order to satisfy requirements, a seal may be procured, which should be countersigned by a recognized person on the board of the parent company. Chinese authorities will normally specify whose signature should accompany the document and seal.

In-house counsel for US or EU corporations should determine the legal use of chops and seals within their own domestic legal framework. The Chinese, in requesting seals and chopped documents, are merely imposing their own domestic administration rules to foreign companies without necessarily appreciating that foreign investors are not governed abroad by the same regulatory framework.

Internal controls: secure your company chops

Chops yield immense power, and merely being in possession of one can be proof of authority to use it. Accordingly, companies are advised to secure their chops and ensure that they are not used for illicit purposes or stolen by disgruntled employees.

Chops are not necessarily held by one person; in fact, in many cases different chops are used by different departments. For example, the company accountant uses the finance chop, while the in-house lawyer may hold the contract chop.

A company can also mandate that all chops be accompanied by the company chop should it wish to add another layer of protection. Chops are also usually accompanied by the authorized signatory, thus providing an additional layer of security over and above that used in the West, which tends to rely on signature alone.

Regardless, it is a sensible idea to have only trusted individuals possess chops as required, and to establish internal controls to regulate and log their use. With the exception of company owners, it is unadvisable to give one individual control over all the chops and be signatory for all of them as well.

Further, given the importance of chops in China, companies are advised to conduct thorough HR audits to ensure their internal controls are robust and minimize risks relating to improper usage of chops.

Human Resources

ADAM LIVERMORE
Partner
Dalian Office

“Most people are aware of the importance of employment contracts in China, but many foreign investors ignore the value of the employee handbook and confidentiality agreement.”

Hiring employees

In China, the company can hire employees in the following three ways:

1. Direct hiring
2. Dispatching
3. Outsourcing

Direct hiring

Except for ROs, FIEs can hire employees directly by themselves. Chinese Labor Law requires employers to sign a written contract with their employees within one month, starting from the employee’s first day of work at the company. Failure to do so results in double salary compensation for each month without a contract, and a non-fixed term contract by default after one year without a contract. One exception to this rule is part time work, where an oral agreement is considered sufficient.

Generally, China allows three types of employment contracts:

- Fixed-term contract;
- Non-fixed term contract;
- Job contract.

Fixed-term contract

The fixed-term contract creates an employer-employee relationship for a fixed length of time, and can be used for part-time or full-time work. A fixed-term contract can be renewed only once, after which it will be necessary to give the employee a non-fixed term contract when renewing for a second time. Certain clauses may be inadmissible according to Chinese law, while others are mandatory.

Maximum Probation Period by Contract Term

Contract term	Maximum probation period
LESS THAN 3 MONTHS	NONE
3 months to 1 year	1 month
1 – 3 years	2 months
3+ years or non-fixed term contract	6 months

Note: An employer cannot make an employee take a new probation period, for example, after promotion or when the company has been merged or acquired by an investor.

Employers are able to stipulate a probationary period at the beginning of the contract, during which time it is comparatively easier to dismiss the employee. Also, the employer is allowed to pay the employee 80 percent of the full salary stated in the employment contract during the probation period, although this amount may not fall below the local minimum wage. The employee may resign after giving only three days' notice. It is therefore inadvisable to stipulate a very long probation period. The length of the fixed-term contract will determine the maximum length of probation the employer can set.

During the probation period, the employer may dismiss the employee if he/she is found to not meet the requirements for the position. The burden is on the employer to prove this.

For part-time workers:

- The employee may not work for more than four hours per day, or 24 hours per week;
- No probation period is allowed, and either the employer or employee may end the agreement at any time;
- The employee is not entitled to severance compensation;
- The employee must be paid at least every 15 days; and
- Part-time employees are not required to have a written contract.

Non-fixed term contract

Based on its unrestricted term and limited grounds for termination, the non-fixed term contract effectively guarantees the employee job security until retirement. Specifically, an employee on a non-fixed term contract can only be terminated based on grounds eligible for immediate dismissal, dismissal with 30 days' notice, or as part of a mass lay-off. During a mass lay-off, employees on non-fixed term contracts must be prioritized over other employees.

Job contract

Due to its lack of legal clarity, the job contract is an unpopular choice in China. This type of contract is defined by the specific task or project an employee is to work on, not the length of time. Once the project is completed, the employment relationship comes to an end, and the company must pay severance to the employee. No probationary periods are permitted.

Job contracts are sometimes used for seasonal jobs where the scope of work can be defined very clearly. However, in most cases, defining the completion of a project can prove to be a challenge. The relevant legal framework offers no guidance on what to do when a project is left uncompleted, or how employees should be compensated in such a case, making job contracts more prone to disputes and even litigation.

Dispatch

Labor dispatch is an alternative option for FIEs looking to hire Chinese staff. While the preparatory work of establishing a business often requires the assistance of Chinese employees, FIEs are not allowed to establish legal contracts with Chinese individuals before they obtain their business license. Additionally, as mentioned previously, an RO cannot hire staff directly, and their employees must be seconded from dispatch agencies.

Labor dispatching arrangements are only applicable for the following three types of positions:

- Temporary position: a position with duration of no more than six months;
- Auxiliary position: a position that provides auxiliary services to the main or core business of the employer; and,
- Replaceable position: a position that can be performed by a dispatched employee in place of a permanent employee during the period when such an employee is away from work for study, vacation, or other reasons.

The number of total dispatched employees used by an employer should not exceed 10 percent of its total number of employees, including regular employees and dispatched employees. ROs of foreign enterprises, however, are not subject to this restriction on dispatched employees' positions.

In addition, there must be a contract between the dispatching company and the dispatched employee, the dispatching company and the FIE, as well as the dispatched employee and the FIE, respectively. The contract between the dispatching company and the dispatched employee should have a fixed term of at least two years.

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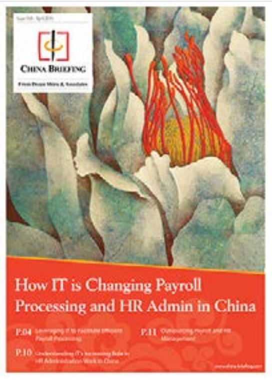


How IT is Changing Payroll Processing and HR Admin in China
April 2016

In this edition of China Briefing magazine, we examine how foreign multinationals can take better advantage of IT in the gathering, storing, and analyzing of HR information in China.

AVAILABLE HERE

Outsourcing

Outsourcing is an additional option for FIEs. Generally, the most commonly outsourced tasks are those that require specialist skills, a high degree of confidentiality, or those that have a clear scope, but incur major consequences if incorrectly implemented. Good examples in China include accounting, tax filing, and HR administration and payroll processing work.

Many small and medium-sized companies will choose to completely outsource some or all of these functions, whereas large companies will set up a separate entity to manage such back-office tasks on behalf of their regional subsidiaries. Generally, outsourcing has the following characteristics:

- Responsibility for the behavior of the outsourced employee is borne by the company contracted for the outsourcing;
- The role is often not a full-time one, and most of the work does not have to be completed on-site: working off-site improves the level of confidentiality;
- As the company does not need to hire a full-time internal resource for the role, outsourcing can often be a money-saving solution;
- The outsourcing company retains the right to use whichever resources it feels are best for each project—this ensures continuity in service provision; and,
- Outsourcing tasks will often use special software licensed by the company contracted for the outsourcing.

Employer's obligations

Minimum wages across China

Determining the minimum wage in China is complicated by several factors specific to the country. Firstly, wage standards are set for individual cities, provinces, and other administrative units by their respective local governments, rather than on a nationwide basis. Next, each of these principalities is divided into a number of wage classes, whose minimum wages vary according to local socioeconomic conditions. Lastly, minimum wage is differentiated between minimum monthly salary and minimum hourly wage (for full-time and part-time workers, respectively). According to China's "Employment Promotion Plan", the minimum wage in each jurisdiction must be increased at least once every two years.

Overtime

In China, overtime is paid differently depending on the work hour system adopted by the employer, by either standard work hours, comprehensive work hours, or non-fixed work hours. Note that comprehensive and non-fixed work hour systems require special approval to implement.

The standard work hour system requires that an employee's normal working day should not exceed eight hours, that the normal working week not exceed 40 hours, and that each employee should be guaranteed at least one rest day per week. The majority of white-collar jobs in China now operate according to this model.

Rather than a unit of one week, the comprehensive work hour system adopts a set period (typically one month) as the base to calculate the employee's working hours. Although the distribution of hours worked during this period can be irregular, the average number of working hours per day and per week should roughly correspond to the levels set out in the standard work hour system.

Lastly, the non-fixed work hour system is geared towards positions like senior management, salespeople, and employees in the transport, warehousing, and railway sectors who generally do not receive overtime payments, as it is considered impractical to measure their time spent working.

Social insurance

Social insurance payments in China (also called "social welfare" or "mandatory benefits") are mandatory contributions to government-run funds made by both the employer and the employee (whose contribution the employer is responsible for withholding each month).

Social insurance obligations from the employee and employer, respectively, can vary considerably depending on the city in which the contributions are being made. For a company with employees based in a number of cities around the country, this means that the overall cost to the company for an employee earning a monthly salary of RMB 10,000 in one city may be quite different to someone on the same salary based elsewhere.

In total, there are five different kinds of social insurances, including pension, unemployment, medical, work-related injury, and maternity

Added to these is a mandatory housing fund not strictly considered a type of social welfare, but generally included within the scope of social security. Housing fund contributions are mandatory and come from both the employer and the employee, apart from some special areas where the employee does not need to make a contribution. Money in the housing fund can be used by employees to pay the down-payment on a house, or to subsequently pay back a loan to the bank. While employees are also mandated to make their own contributions to several types of social insurance, the portion contributed by the employer is normally the higher of the two sides. In fact, social security payments typically add an additional cost of between 30 and 45 percent of an employee's salary each month.

Mandatory contribution rates are stipulated by local governments and the exact calculations involved can be quite complicated. Percentages are not technically based on the employee's monthly salary, but rather on a theoretical "base" salary stipulated differently from city to city. In 2016, many cities announced plans on temporarily reducing social security contribution rates to save costs for enterprises. FIEs should follow the local rates when calculating payroll and paying mandatory contributions for the social security of their employees.

To maintain compliance, it is not enough that employers are simply willing to pay. Whenever hiring new staff, employers need to register him or her with local Social Insurance Bureau and the Housing Fund Bureau to initiate or reactivate the corresponding accounts. Further, although both employer and employee are obligated to make contributions, it is generally the employer's responsibility to correctly calculate and withhold the payments for both parties.

Meanwhile, employers are obliged to make timely payments for themselves and their employees. A late contribution can result in a fine, while failure to contribute may lead to onerous labor disputes. In case of severe and multiple violations, the company might be put on an HR "name and shame" list, which is not only embarrassing but also could bring barriers to future recruitment. One thing to be noted is that employer's obligation to make adequate and timely contributions cannot be alleviated or exempted by reaching mutual agreement with employees. In practice, employers and employees (especially those whose gross salary is not high) may mutually agree not to contribute to the social security schemes or to make contributions on a smaller basis, to save labor costs and maximize employee's take-home payment.

However, the court would consider such an agreement invalid in the case of a labor dispute between the employer and employee. The employer might be required to repay the social security evasion or pay extra severance payment to its employee in case of termination.

Main business taxes

Corporate income tax (CIT)

Corporate income tax (CIT) is calculated against the company's net income in a financial year after deducting reasonable business costs and losses – in other words, it is effectively a tax on profits. CIT in China is settled on an annual basis but is often paid quarterly, with adjustments either refunded or carried forward to the next year.

The final calculation is based on a company's year-end audit. China's revised Corporate Income Tax Law, which took effect in 2008, unified the tax rates for foreign and domestic enterprises. The income tax rate applied to all companies in China today, both foreign and domestic, is 25 percent. Small and low-profit enterprises are entitled to a reduced CIT rate of 20 percent, and if a taxpayer qualifies as a high-tech enterprise, a reduced CIT rate of 15 percent applies.

CIT payable is calculated using the below formula:

CIT PAYABLE = CIT TAXABLE INCOME X CIT RATE - TAX EXEMPTIONS OR REDUCTIONS BASED ON TAX INCENTIVES

CIT taxable income is calculated on an accrual basis, meaning that income items are recorded when they are earned and deductions recorded when expenses are incurred.

Reasonable expenditure incurred in relation to income received by an enterprise could be deducted from gross income, including costs, expenses, taxes (except CIT and VAT), and losses; charitable donations and gifts within 12 percent of the gross annual profit; reasonable depreciation of fixed assets; amortization of intangible assets; amortization of long-term prepaid expenses; inventory cost; net value of an asset transferred; and other deductions stipulated by laws and regulations.

Caps apply when deducting certain expenses from taxable income, such as follows:

Deduction Caps for Certain Expenses

Expenses	Deduction cap
Employee welfare	≤14% of the total amount of employee salaries and wages
Labor union funds	≤2% of the total amount of employee salaries and wages
Employee education	2.5% of the total amount of employee salaries and wages (the excess can be carried forward to future years for deduction) ≤8% of the total amount of employee salaries and wages for technologically advanced services enterprises (the excess can be carried forward to future years for deduction) 100% deduction for enterprises in software and integrated circuit industries
Business entertainment relating to production and business operations	≤ 60% of the actual incurred amount but not more than 0.5% of the sales revenue of the current year
Advertising and publicity	≤15% of the sales revenue of the current year (the excess can be carried forward to future years for deduction)

Based on China's tax Law, CIT is prepaid on a monthly or quarterly basis in accordance with the figures shown in the accounting books of the company. Companies are required to file CIT returns within 15 days from the end of the month or quarter. Further, the SAT requires companies to submit an Annual CIT Reconciliation Report within five months after each year's year-end to determine if the company has met all tax liabilities, and whether the company needs to pay supplementary tax, or apply for a tax reimbursement.

Companies engaged in diversified businesses should be especially mindful that the SAT requires separate accounts to be prepared both for sales that meet the conditions for preferential treatment and those that do not. If eligible sales cannot be clearly differentiated, they are not entitled to preferential treatment. They also need to pay attention to other relevant certificates for qualification. There are usually special tax benefits for companies in encouraged industries, such as high-tech and environmental protection. However, in most cases, even if a company does qualify, it still needs to obtain certificates from relevant government departments to show its specialty in such areas to the tax authority.

Withholding CIT

In China, whenever a company need to pay the following China-sourced incomes derived by non-resident enterprises without establishments in China, or to that derived by non-resident enterprises with establishments in China but whose income is not related to these establishments, it need to withhold corresponding taxes before making remittances.

- Dividends, bonuses, and other equity investment proceeds;
- Interests, rents, and royalties and income from the transfer of property; and
- Any other incomes subject to CIT obtained by non-resident enterprises.

The withholding CIT rate is 20 percent (currently reduced to 10 percent). For dividends, interests, rents, and royalty income, if the respective rate in a tax treaty is higher than 10 percent, the 10 percent rate will prevail; if the rate in the tax treaty is lower than 10 percent, then the rate in the tax treaty should be adopted.

Here we take royalties payment as an example to demonstrate the procedure for make withholding CIT.

Procedure for the Outward Payment of Royalties

Step 1	Step 2	Step 3	Step 4	Step 5
Contract Registration	Tax Assessment	Application for Treaty Benefits	WHT Filing and Payment	Payment Registration
3-5 working days	15-20 working days	5-15 working days	2-3 working days	3-5 working days

Note: Procedure may be subject to regional variations.

Value-added tax (VAT)

VAT is one of two turnover taxes in China, the other being consumption tax. Previously, there was another turnover tax called business tax (BT) that was levied on goods and services at rates ranging from three to 20 percent. However, to avoid double taxation and support its modern services industry, China launched a pilot program in 2012 replacing BT with VAT for select industries, which was subsequently expanded nationwide in mid-2013. By May 1, 2016, the VAT reform was completed with Caishui [2016] No.36 coming into effect, although BT may still apply in certain industries while it is phased out. Starting from July 1, 2017, VAT rates are simplified to three levels — 6 percent, 11 percent, and 17 percent, with the 13 percent level eliminated.

Value-added tax is considered a neutral tax, allowing businesses to offset VAT incurred in relevant purchases from their VAT liability. VAT taxpayers are categorized into general taxpayers and small-scale taxpayers based on their annual taxable sales amount. Taxpayers with annual taxable sales exceeding the annual sales ceiling set for small-scale taxpayers must apply for general taxpayer status. The sales ceilings are:

- RMB 500,000 for industrial taxpayers, i.e. enterprises engaged primarily in the manufacture of goods or provision of taxable services;
- RMB 800,000 for commercial taxpayers, i.e. enterprises engaged in the wholesale or retail of goods; and,
- RMB 5 million for VAT reform taxpayers.

VAT payers whose annual taxable sales are below the ceiling, as well as those who have newly established their business, can voluntarily apply for general taxpayer recognition upon meeting the following conditions:

- Possess a fixed place of business; and
- Be capable of setting up legitimate, valid, and accurate bookkeeping.

Additional "soft" or unwritten requirements are also commonly found to influence the local tax authorities' judgment on whether or not an applicant is eligible for general taxpayer status, such as registered capital, office size, and number of employees.

Timeline of VAT Reform in China

2011 2012 2013 2014 2015 2016 2017 2018

November 16

VAT reform pilot scheme released.

January 1

First pilot VAT reform program in transportation (excluding railway transportation and postal service) and certain modern service sectors in Shanghai launched.

August 1 - December 1

VAT reform in transportation (excluding railway transportation and postal service) and certain modern service sectors extended to Beijing, Jiangsu, Anhui, Fujian, Guangdong, Tianjin, Zhejiang, and Hubei.

August 1

VAT reform in transportation (excluding railway transportation and postal service) and certain modern service sectors extended nationwide.

January 1

VAT reform expanded to include railway transportation and postal service, thereby completing the expansion to all transport sectors.

June 1

VAT reform expanded to include the telecom industry.

May 1

VAT reform expanded to include the construction, real estate, financial, and living services industries, thereby completing the expansion to all industrial sectors.

July 1

VAT rates was simplified to three levels: 6%, 11%, 17%.

A company must obtain VAT general taxpayer status in order to be able to issue Special VAT fapiao – a key requirement for conducting business with many Chinese suppliers and clients (with limited exceptions).

Fapiao

In China, invoices (or *"fapiao"* in Chinese) are more than just ordinary receipts - they are also the way in which the government monitors the tax paid on any transaction. *Fapiao* are printed, distributed, and administrated by tax authorities, and taxpayers are required to purchase the invoices they need from the tax authorities according to their business scope.

Fapiao can mainly be sorted into two categories – general invoices and special value-added tax (VAT) invoices. Although these terms are often used interchangeably, there are notable differences between the two, including applicability for tax deductions, detail of information recorded, and usage by different types of taxpayers. It is therefore important to check with your accountant with regard to which type of invoice is needed according to the intended purpose.

Small-scale taxpayers are subject to a lower uniform VAT levy rate of three percent, as compared to rates ranging from six to 17 percent for general taxpayers, but they cannot credit input VAT from output VAT, nor are they entitled to VAT export exemptions and refunds.

For general taxpayers, the basic formula for calculating VAT payable is:

VAT PAYABLE	=	OUTPUT VAT IN THE CURRENT PERIOD - INPUT VAT IN THE CURRENT PERIOD
OUTPUT VAT	=	SALES X VAT RATE
SALES	=	SALES INCLUDING OUTPUT VAT / (1 + VAT RATE)
INPUT VAT	=	SALES X VAT RATE

If the output tax for the current period is insufficient to offset the input tax of the current period, the difference can be carried forward to the next term for continued offset.

VAT	=	SALES X VAT LEVY RATE

SALES	=	SALES INCLUDING VAT / (1 + VAT LEVY RATE)

For small-scale taxpayers, the formula for determining VAT payable is:

The current VAT levy rate is three percent for small-scale taxpayers. Small-scale taxpayers cannot credit input VAT against output VAT.

VAT rates (A)

Taxable items	Rate
Export of goods (except where otherwise stipulated by the State Council)	0
Sales and import of the following: • Cereals and edible vegetable oils; • Tap water, heating, cooling, hot water, coal gas, liquefied petroleum gas, natural gas, methane gas, coal/charcoal products for household use; • Books, newspapers, magazines (excluding newspapers and magazines distributed by the Post Department); • Feed, chemical fertilizers, agricultural chemicals, agricultural machinery and plastic covering film for farming; • Agriculture, forestry, products of animal husbandry, aquatic products; • Audio-visual products; • Electronic publications; • Dimethyl ether; • Edible salt.	11%*
Sale and import of goods other than those listed above; processing, repairs and replacement services	17%

**This rate was reduced from 13% to 11% starting from July 1, 2017.*

VAT Rates for Newly Covered Industries*

Taxable items	Rate
Tangible property leasing services: • Financial leasing; • Operations leasing;	17%
Transportation services: • Land transportation services (including railway transportation services); • Water transportation services; • Air transportation services (including space transportation services); • Pipeline transportation services;	11%
Postal services: • Normal postal services; • Special postal services; • Other postal services;	11%
Construction and real estate	11%
Basic telecom services	11%
Value-added telecom services	6%
Financial services: • Loan services; • Direct charges financial services; • Insurance services; • Transfer of financial products;	6%
Modern services: • Research, development, and technological services; • Information technology services; • Cultural and creative services; • Logistics auxiliary services; • Authentication and consulting services; • Radio, film, and television services; • Business support services; • Other modern services	6%
Life services: • Cultural and sports services; • Education and medical services; • Tourism and entertainment services; • Catering and accommodation services; • Resident daily services; • Other life services;	6%
Sale of intangible assets: • Technology, trademark, copyright, goodwill; • Use rights of natural resources (except land use rights**); • Other equity intangible assets;	6%

**Since the VAT reform began.*
***VAT rate for transfer of land use right is 11%.*

Consumption tax

Consumption tax applies whenever certain luxury or other goods are manufactured, processed, or imported. Tax rates vary considerably depending on the product. The tax paid is generally computed directly as a cost and cannot be refunded. If a company undertakes processing of taxable goods in service of another party, the processor is liable to withhold and pay consumption tax based on the value of the raw materials and processing fees. Consumption tax should be filed and paid monthly.

Consumption Tax Rates (A)

Taxable items	Tax rate	Comments
Tobacco		
• Grade A cigarettes	56% plus RMB 0.003 per cigarette	
• Grade B cigarettes	36% plus RMB 0.003 per cigarette	
• Wholesale	11% plus RMB 0.005 per cigarette	Increased from May 10, 2015
• Cigars	36%	
• Cut tobacco	30%	
Alcohol		
• White spirits	20% plus RMB 0.5 per 500g/ml	
• Yellow spirits	RMB 240/ton	
• Beer	Type A: RMB 250/ton Type B: RMB 220/ton	
• Other alcoholic drinks	10%	
Precious jewelry and precious jade and stones	• Gold, silver, platinum and diamonds: 5% • Other precious jewelry and precious jade and stones: 10%	Includes all kinds of gold, silver, jewelry, and precious stone ornaments
Firecrackers and fireworks	15%	
Gasoline	Unleaded: RMB 1.52/liter	
• Passenger cars, with a cylinder capacity of		
» 1.5 liters and below	1 liter and below: 1% 1 to 1.5 liters: 3%	
» 1.5 to 2 liters	5%	
» 2 to 2.5 liters	9%	
» 2.5 to 3 liters	12%	
» 3 to 4 liters	25%	
» Above 4 liters	40%	
• Small-to-medium size commercial vehicles (e.g. cross country vehicles, minibuses, and vans)	5%	
• Ultra-luxury cars	1-40% depending on cylinder capacity for passenger cars, 5% for commercial vehicles in production process, plus an additional 10% for retail	Starting from December 1, 2016

Consumption Tax Rates (B)

Taxable items	Tax rate	Comments
Motorcycles, with a cylinder capacity of:		
• 250 ml	3%	
• Over 250 ml	10%	
High-end cosmetics & skincare products where the selling price/customs value (excluding VAT) at the production/import stage is at least RMB 10/ml (g) or RMB 15/pc	15%	Starting from October 1, 2016
Golf balls and equipment	10%	
Luxury watches	20%	
Yachts	10%	
Disposable wooden chopsticks	5%	
Solid wood flooring	5%	
Petroleum oil		The tax rate has increased multiple times
• Naphtha	RMB 1.52/liter	
• Solvent oil	RMB 1.52/liter	
• Lubricant oil	RMB 1.52/liter	
• Diesel oil	RMB 1.2/liter	
• Fuel oil	RMB 1.2/liter	
• Aviation oil	RMB 1.2/liter	Temporary exemption
Lead battery (Mercury-free battery, nickel-metal hydride battery, lithium ion battery, lithium battery, solar cells, fuel cells, and whole vanadium flow battery shall be exempted from CT)	4%	Starting from January 1, 2016
Paint (Paints with Volatile Organic Compounds (VOC) of less than or equal to 420 g/l shall be exempted from the CT)	4%	Starting from January 1, 2016

Other taxes

Stamp tax

Stamp tax is levied on contracts with regard to purchases and sales, processing, construction and engineering projects, asset leasing, goods transportation, storage and warehousing, loans, asset insurance, technology contracts, property rights transfers, accounting ledgers, and royalty licensing. The tax rates vary between 0.005 percent and 0.1 percent.

Surcharges

Foreign-invested enterprises, foreign enterprises, and foreign individuals who are subject to VAT or CT are also subject to urban construction and maintenance taxes (UCMT), education surcharge (ES), and local education surcharge (LES).

- UCMT rates are seven percent for urban areas, five percent for counties (towns), and one percent for other regions;
- The ES rate is three percent regardless of location ; and,
- The LES rate is two percent regardless of location.

The total surtaxes amount to 12 percent of the total turnover tax liability (i.e., VAT and CT) in urban areas, meaning that these taxes are levied on the amount of the turnover tax but not the total value of the transaction. Enterprises with the monthly turnover less than RMB 100,000 shall be exempted from ES and LES. The turnover threshold for UCMT exemption is RMB 30, 000 per month.

Property tax

All owners, mortgagees, custodians, and users of property for commercial purposes must pay real estate tax. This does not include residential property for self-use, but does include residential properties for lease. The applicable tax rate is 1.2 percent, calculated on the residual value minus between 10 percent and 30 percent of the original value of the property (as determined by the local government).

Urban and township land use tax

Individuals and enterprises that use land in cities and towns are subject to urban and township land use tax. The taxable amount per square meter for land use tax is as follows:

- RMB 1.5 to RMB 30 for large cities;
- RMB 1.2 to RMB 24 for medium cities;
- RMB 0.9 to RMB 18 for small cities; and,
- RMB 0.6 to RMB 12 for county towns, towns, and industrial and mining areas.

Local governments have the right to increase or reduce the tax rate according to their socioeconomic conditions. However, the reduction amount may not exceed 30 percent of the minimum level.

Land appreciation tax

All organizations and individuals who transfer state-owned land use rights, buildings, and other structures on that land, and who earn income from the transfer, should pay land appreciation tax in accordance with relevant laws and regulations.

Calculation of land appreciation tax is based on the appreciation amount gained by the taxpayer through the transfer of real estate (i.e., the balance of the proceeds received by the taxpayer on the transfer of real estate after deducting the sum of deductible items), and should be levied in accordance with a four-step progressive tax rate based on the percentage amount by which the appreciation amount is in excess of the amount of deducted items.

The deductible items include:

- Amount of funds paid to obtain land use rights;
- Costs and expenses incurred in the development of the land; and,
- Tax related to the transfer of real estate and other items to be deducted as stipulated by the MOF.

Land Appreciation Tax Rate Levels

Level	Appreciation/Deduction	Tax rate	Quick deduction
1	≤50%	30%	0%
2	> 50% and ≤100%	40%	5%
3	> 100% and ≤200%	50%	15%
4	> 200%	60%	35%

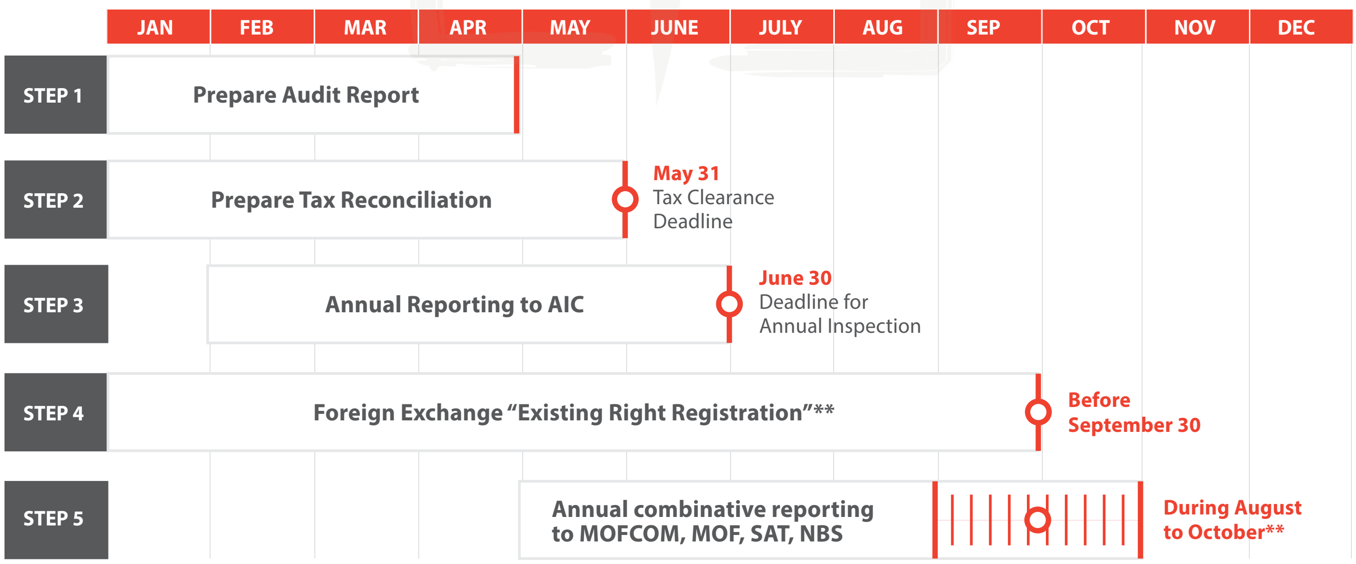
Annual audit and tax compliance

China has various nuanced annual audit procedures that FIEs have to follow in order to achieve full compliance. Here, we provide a step-by-step guide to these procedures, including general requirements, key considerations, and materials to be prepared, with notes on regional differences and tips from experienced accountants and auditors.

Annual audit and tax compliance for JVs, WFOEs, and FICEs

For WFOEs, JVs, and FICEs, achieving annual compliance can be a long and complicated process. The work primarily involves producing a statutory annual audit report, a CIT reconciliation report, making "existing right registration" for foreign currency reconciliation, and reporting to relevant government bureaus. These procedures are not only required by law, but are also a good opportunity to conduct an internal financial health check. The relevant procedures and key considerations vary slightly by region and entity type. Companies should either contact a service provider or the local government to achieve full compliance.

Annual Compliance Timeline*



**Subject to regional variation*
***Subject to yearly variance*

Step 1 - Prepare a statutory annual audit report

The statutory annual audit report consists of a balance sheet, an income statement, and a cash flow statement. To ensure that foreign-invested companies meet Chinese financial and accounting standards, including proper use of China GAAP, the annual audit report must be conducted by external licensed accounting firms and signed by a Certified Public Accountant (CPA) registered in China for compliance purposes.

The requirements for the audit report vary by region. For instance, in Shanghai, companies must include a taxable income adjustment sheet in the audit report, which is not a necessary supplement in Hangzhou, Beijing, or Shenzhen. The audit procedure takes about two months, and the audit report should be completed before the end of April in order to meet the May 31 tax reconciliation deadline.

Step 2 - Prepare CIT reconciliation report (annual tax returns)

In China, CIT is paid on a monthly or quarterly basis in accordance with the figures shown in the accounting books of the company; companies are required to file CIT returns within 15 days from the end of the month or quarter. However, due to discrepancies between China's accounting standards and tax laws, the actual CIT taxable income is usually different from the total profits shown in the accounting books. As such, the SAT requires companies to submit an Annual CIT Reconciliation Report within five months from the previous year's year-end to determine if all tax liabilities have been met, and whether the company needs to pay supplementary tax or apply for a tax reimbursement. Generally, the Annual CIT Reconciliation Report must include adjustment sheets to bridge the discrepancies between tax laws and accounting standards.

Every year around March, depending on the area, the local Tax Bureau will issue annual guidance on CIT reconciliation. The Annual CIT Reconciliation Report is examined by the Tax Bureau to see if all tax liabilities have been fulfilled under tax law. FIEs that additionally conduct frequent transactions with related parties should prepare an Annual Affiliated Transaction Report on transfer pricing issues as a supplementary document to the Annual CIT Reconciliation Report.

Moreover, FIEs in certain regions need to engage a Certified Tax Agent firm in China to prepare another separate CIT audit report. In Beijing, this requirement applies to firms that meet the following conditions:

- Yearly sales revenues exceed RMB 30 million;
- Carrying over last year's losses to deduct this year's income; or,
- Yearly losses exceed RMB 100,000.

In Shanghai, the CIT audit report is needed when:

- Taxpayers who have made a loss (current year loss) of more than RMB 5 million;
- Taxpayers who have offset losses carried forward from previous years.

The deadline for submitting the CIT Reconciliation Report to the Tax Bureau is May 31 every year, but the investigation of the tax compliance could last to the end of the year, and companies should be prepared to provide supporting documents upon demand from the tax bureau.

Step 3 - Annual reporting to AIC

According to the "Interim Regulations for the Publicity of Corporate Information", each year from January 1 to June 30, all FIEs should submit an annual report for the previous fiscal year to the relevant AIC. This should be done through the corporate credit and information publicity system. In case the company failing to make annual reporting as required, it might be marked as "irregular operation" or even be put into the blacklist.

The annual report submitted should cover the following information:

- The mailing address, post code, telephone number, and email address of the enterprise;
- Information regarding the existence status of the enterprise;
- Information relating to any investment by the enterprise to establish companies or purchase equity rights;
- Information regarding the subscribed and paid in amount, time, and ways of contribution of the shareholders or promoters thereof, in the case that the enterprise is a limited liability company or a company limited by shares;
- Equity change information of the equity transfer by the shareholders of a limited liability company;
- The name and URL of the website of the enterprise and of its online shops; and,
- Information of the number of business practitioners, total assets, total liabilities, warranties and guarantees provided for other entities, total owner's equity, total revenue, income from the main business, gross profit, net profit, and total tax.

Step 4 - Annual foreign exchange reconciliation

All foreign exchange transactions in and out of China are strictly controlled by SAFE, the bureau under the central bank of China (the People's Bank of China), which drafts rules and regulations governing foreign exchange and market activities, as well as supervises and inspects foreign exchange transactions.

Previously, SAFE required that all FIEs complete a Statement of Foreign Investors' Equity to demonstrate the legality of their foreign currency inflow and outflow, and hire an authorized Chinese CPA firm to issue a Foreign Exchange Annual Inspection Report. However, according to the "Notice on Further Simplifying and Improving the Foreign Exchange Management Policies for Direct Investment" (Hui Fa [2015] No.13), effective since June 1, 2015, the foreign exchange annual inspection for direct investment has been canceled.

In its place, relevant market players are required to make an "Existing Right Registration" before September 30 each year. Failure to comply with the registration requirements results in the foreign exchange bureaus taking control over the parties in the capital account information system. Further, banks will not carry out foreign exchange business under the capital account for offending companies.

Step 5 - Annual combinative reporting to MOFCOM, MOF, SAT, and NBS

FIEs in China have been required to undergo an Annual Combinative Inspection jointly conducted by several governmental departments since 1998. However, pursuant to a notice jointly released by MOFCOM, MOF, AIC, SAT, SAFE, and NBS in 2014, the annual combinative inspection has now been replaced by an annual combinative reporting system.

Unlike the annual inspection, annual reporting entails that relevant government bureaus take on the role of supervisors rather than judges. They no longer have the right to disapprove reports that are submitted, even if they think the reports are unqualified – they can only suggest that the FIEs make modifications. Accordingly, relevant government bureaus no longer affix any seals on a report.

With this new rule implemented, the annual compliance requirements for FIEs have become much more manageable. All information can be submitted online and paper materials are no longer required.

The deadline for this combinative report is subject to yearly variance. In 2014, it was June 30, but it has been extended to October 30 for 2015. In 2016, the reporting period was from May 16 to August 31.

Annual audit and tax compliance for ROs

For ROs, annual compliance procedures are simpler. While ROs are exempt from annual exchange reconciliation and combinative reporting, they still need to prepare a statutory audit report, a tax reconciliation report, and then report to AIC.

Step 1	Step 2	Step 3
Prepare Audit Report	Tax Filing **Deadline May 31***	Annual Reporting to AIC **Deadline June 30***

** Deadlines can vary depending on the locality of the enterprise. FIEs should consult their local tax authorities in charge.*

Step 1- Prepare statutory annual audit report

Similar to the annual audit for JVs, WFOEs, and FICEs, the annual audit report for ROs should also be prepared by external licensed accounting firms and signed by a CPA registered in China. When doing the annual audit works, auditors should pay special attention to the following factors:

- **Bank statements, cash, staff, and IIT -** The balance on the bank book should be the same as that stated in the bank statement. If not, a bank reconciliation should be prepared to verify the differences. The balance on the account should be the same as the cash contained in the cash box. The auditors will perform a cash count during their field work. Employment of staff has to be registered in accordance with the relevant regulations (local employees registered with FESCO and valid work permits for expatriate staff), and IIT correctly assessed and filed.

- **Expenses report -** Audit fees, salaries, rentals, utilities, FESCO fees, and any expenses belonging to the calendar fiscal year should be properly accrued with contracts or agreements as support. The total salary of the chief representative, whether paid offshore or locally, has to be included in the expenses. If employees are involved in overseas social security plans, these payments have to be included in the expenses report. Expenses paid on behalf of the head office may also be required to be recorded.

- **Deemed taxable income -** On February 20, 2010, the SAT issued "Provisional Measures on Administration of Tax Collection for Resident Representative Offices of Foreign Enterprises" (Guo Shui Fa [2010] No. 18, hereinafter "Circular No. 18"), which addresses the question of how ROs of foreign enterprises in mainland China file and pay PRC taxes. Circular No. 18 explicitly stipulates that ROs must pay CIT on their deemed taxable income, as well as VAT and CT when it is applicable, and will be required to assess CIT liability using the deemed profit method, cost-plus method, or actual revenue method. Among these three methods, the cost-plus method is most commonly used to calculate deemed taxable income, since the other two methods require ROs to submit numerous supporting documents.

All expenses incurred by or related to the RO must be included in office expenses to calculate the deemed taxable revenue. Expenses include rent, transportation, telephone, salary, office purchases, and entertainment, regardless of whether these are paid from the RO or directly from its head office. The total salary of the chief representative should be included in the RO's expenses.

Step 2 - Annual tax filing

The responsibility for tax filing in China is with the taxpayer. The tax bureau does not send out tax returns; the taxpayer has to collect and file tax forms according to relevant regulations. The tax authority additionally requires that accounting records and ledgers be set up and kept properly and that details of the accounting system be filed.

The annual tax reconciliation is finished through the online filing wholly. ROs usually will need to submit the Annual Taxation Consolidation Report to the tax bureau by the end of May each year, but regional variations may exist. If the audited taxes due are found to be different from the taxes paid by the RO, the RO shall discuss the variation with the tax bureau. For foreign companies that suspect this might occur, it is wise to hold preemptive discussions with tax advisors prior to audit submission.

Step 3 - Annual reporting to AIC

ROs are required to submit an annual report between March 1 and June 30 every year providing information on the legal status and standing information of the foreign enterprise, ongoing business activities of the RO, and an audit report. The registration authorities will issue an RMB 10,000 to RMB 30,000 penalty if the RO fails to provide these reports on time, and an RMB 20,000 to RMB 200,000 penalty if the report includes false information. Fraud may also lead to license revocation.

During the annual reporting process, the following documents should be provided in paper or online:

- Annual report (the template is usually distributed by AIC around March);
- Business registration certificate;
- Audit report; and,
- Proof of information on the legal status and standing of the headquarters overseas.

Foreign currency controls and profit repatriation

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"Not all profit can be repatriated or reinvested. A portion of the profit (at least 10 percent for WFOEs) must be placed in a reserve fund a ccount."

China implements a strict system of capital controls, limiting the inflow and outflow of foreign currency. This system distinguishes between transactions made under an enterprise's current account and capital account, and requires foreign investors to open separate bank accounts for the two. The SAFE and its local branches are the bureaus in charge.

China's foreign exchange currency controls

The SAFE divides foreign currency transactions into two separate categories: those under the current account and those under the capital account. Current account foreign currency transactions may involve the import and export of goods and services, earnings from interest or dividends from portfolio securities and regular transfers. Capital account transactions are mainly related to foreign direct investment (i.e. changes in a company's registered capital), the purchase and sale of equity or debt securities, and trade credit or loans.

In general, capital account transactions need approval from the SAFE, whereas current account transactions can be made directly through the bank. Here, we introduce the general control policies on these two type of accounts.

Capital account

- **Currency conversion**

Capital account conversion of foreign currency was expanded by the SAFE's Circular 19, which came into effect June 1, 2015. And in 2016, the SAFE released another circular — Huifa [2016] No.16 — to further relax the capital account conversion.

Currently, FIEs are allowed to convert up to 100 percent of foreign currency in their capital account into RMB at their own discretion. FIEs looking to convert currency are no longer required to turn to the SAFE for approval or registration in order for the action to occur. Instead, FIEs must consult local SAFE approved banks to adhere to proper currency conversion protocol. These banks will handle the registration procedure, where previously foreign companies would have to report the transaction to the SAFE themselves.

The SAFE still regulates the percentage of foreign currency a company may have as part of its capital account. These fluctuate according to China's Balance of Payments, which refers to transactions between the entities and individuals of two countries. The SAFE maintains the right to decrease the percentage of permitted foreign currency conversions in order to keep China's balance positive. This means that currency controls are still there, but they intervene far less with a foreign investor's day-to-day operations.

- **Permitted income scope of the capital account**

The following income are allowed to be put in the capital account:

1. Foreign exchange capital transported from overseas or by foreign investors;
2. Foreign exchange capital for security deposits of overseas remittances;
3. RMB funds returned after legal transfers (or funds returned as a result of revoked transactions); and,
4. Received interest income (must be approved by SAFE certified bank).

- **Restrictions**

It is also important to note that conversion to RMB currency in capital accounts remains strictly prohibited by the SAFE for the following four usages according to Huifa [2016] No.16:

5. Expenditure beyond business scope or state laws/regulations, directly or indirectly;
6. nvesting in securities or other financial products not secured by the bank, directly or indirectly(unless currently existing laws or regulations state otherwise);
7. RMB entrusted loans to non-related enterprises (unless included in the company's business scope); and,
8. Constructing or purchasing real estate not for the company's use (unless the company deals in real estate as part of its business activities).

Although the SAFE greatly reduces the restrictions for companies to convert currency, investors are advised to stay informed about SAFE approved bank currency conversion requirements and SAFE conversion percentage regulations. Violation of SAFE or bank policy can lead to fines or FIE license suspension or revocation.

- **Cross-border transactions**

The SAFE has also recently expanded the ability of FIEs to engage in cross-border transactions under the capital account. Currently, FIE transactions across nations do not require SAFE notification or approval. However, cross-border transactions must only occur with the aid of SAFE qualified banks, which will register and approve the transactions.

FIE capital accounts are also no longer subject to annual SAFE inspection of foreign exchange. Capital account foreign exchange will now be tracked by a comprehensive inbound outbound report, which must be submitted by FIEs to the SAFE each year by September 30th.

Current accounts

Current accounts have a history of relatively lenient regulation by the SAFE and are much simpler for FIEs to navigate than capital accounts.

RMB conversion of foreign currency in current accounts is not monitored by the SAFE and may occur at any certified bank.

Similar to capital account violations, failure of FIEs to convert and transport current account funds with proper banks can lead an FIE to serious legal and financial ramifications. Minor infractions can be fined at up to 30 percent of the funds involved and serious violations may lead to fines of up to 100 percent of the transaction in question.

Further relaxation of currency controls

In addition to expansion of capital account currency conversion capabilities, Circular 19 and Huifa [2016] No.16 have increased general financial freedom of FIEs in China.

Firstly, the maximum monthly reserve fund amount has been increased from US$50,000 to US$ 200,000. FIEs are now no longer necessarily required to provide documentation to certify the authenticity of reserve funds to local banks (this remains at the banks' discretion).

Investment FIEs are now also permitted to directly use capital account RMB funds for domestic equity investment. This increased freedom of investment-based FIEs greatly expands their power in China, as previous regulations prohibited any FIE from engaging in domestic equity investments. This opens the door to foreign venture capital and private equity firms to tap the burgeoning Chinese equity markets.

Repatriating profits

For foreign companies with subsidiaries in China, repatriating profit from their subsidiaries has always been an important and challenging issue. China maintains a strict system of foreign exchange controls, meaning funds flowing into and out of China are tightly regulated. It is important for foreign investors to incorporate a profit repatriation strategy into the set-up planning of a subsidiary in China to ensure its ability to access the profits earned and to achieve significant cost savings.

There are several ways to repatriate profit from China, the most obvious being for a company's China-based entity to pay dividends directly to its foreign parent company. However, this is subject to certain prerequisites – only profits that have undergone annual audit can be repatriated using this channel, ensuring that the gross profit will be subject to 25 percent CIT. Dividends are subject to a further 10 percent withholding CIT when distributed to foreign investors.

Further, an FIE can only distribute dividends out of its accumulated profits, which means that its prior accumulated losses must be more than offset by its profits in other years, including the current year. An FIE must also place 10 percent of its annual after-tax profits into a reserve fund until it reaches 50 percent of the FIE's registered capital. The chart below illustrates the tax burden and reserve requirements applicable to dividends in China before they can be remitted abroad.

Based on the above constraints, many multinational corporations have adopted certain implicit policies, such as minimizing their profits in China in a legitimate manner via intercompany payments, i.e., charging their Chinese entity royalty or service fees.

Tax Burden and Reserve Requirement on Dividens

Item	Formula	Amount (example)
Gross profit	(1)	100.00
CIT	(2)=(1) x 25%	25.00
Net profit	(3)=(1)-(2)	75.00
Surplus reserves	(4)=(3) x 10%	7.50
Maximum dividend	(5)=(3)-(4)	67.50
Withholding CIT	(6)=(5) x 10%*	6.75
Net payment	(7)=(5)-(6)	60.75

** If a double tax avoidance agreement (DTA) is available and the parent company qualifies as the beneficial owner, a preferential dividend withholding CIT rate of five percent may apply.*

Although these transactions will be subject to turnover tax, and possibly withholding CIT, the fees are deductible from the CIT taxable income and thus are exempt from the 25 percent CIT, resulting in significant cost savings. Below, we discuss the procedures and requirements for remitting service fees, royalties, and dividends to the foreign parent company from its subsidiary in China.

Service fees

Service fees paid to overseas related parties are deductible for CIT purposes provided they are directly related to the FIE's business operations and charged at normal market rates - the service charges between a parent company and its China subsidiary must be based on an arm's length principle. Further, all applicable taxes must have been withheld.

Service fees are subject to VAT, as well as other surtaxes, including urban construction and maintenance tax (UCMT), education surcharge (ES), and local education surcharge (LES). The service provider (i.e., the parent company) is liable for these taxes, and the service recipient (i.e., the China subsidiary) is responsible for withholding and paying these taxes before remitting the service fees to the parent company.

It is important to note that the tax officer always has the right to call into question the legitimacy of a service agreement. To prove that the service fees remitted are based on genuine transactions, the taxpayer should be prepared to provide further evidence, including a detailed service agreement to clarify the nature of the services provided. The agreement should state the service items, the nature and location of the services provided, the relevant service descriptions, as well as the basis for calculating the service fee amounts.

Royalty remittances

Royalties are fees paid in relation to the use of intellectual property, such as trademarks, patents, copyrights, and proprietary technology. Royalties are deductible for CIT purposes provided they are directly related to the FIE's business operations and charged at normal market rates. Royalty remittances are subject to a 10 percent withholding CIT and six percent VAT, as well as UCMT, ES, and LES.

The Chinese entity acts as a withholding agent to withhold the tax on royalties at the source. The royalty remittance process is similar to remitting service fees, with a few key differences, one of which is that the royalty agreement must be registered with the relevant government bureau.

The statutory CIT withholding tax rate of 10 percent can be reduced to a lower rate if a tax treaty is applicable.

Loans

FIEs may also remit undistributed profits to a foreign related company with which it has an equity relationship by extending a loan. The WFOE's interest income will be subject to 25 percent CIT and six percent VAT, although the CIT paid in China may later be used to offset tax liability incurred in the foreign country if there is a DTA in place.

Repatriating funds through an offshore loan has traditionally not been very common because of the intricate remittance procedure and repayment issues. The situation has changed since the promulgation of Hui Fa [2014] No.2 (Circular 2) by SAFE in January 2014. Under Circular 2, offshore lending is limited to 30 percent of the owner's equity in a Chinese WFOE unless special approval has been obtained from SAFE. Circular 2 further relaxed the two-year restriction on loan terms, so that WFOEs may now apply for longer-term offshore loans according to their business needs.

Remitting profits as dividends

In the previous sections, we discussed various channels for remitting funds to a parent company. However, these methods may not always apply, and some funds may have to be repatriated as dividends.

As mentioned, only profit that has undergone annual audit can be repatriated. Annual audit for tax compliance as conducted by the local tax authority is usually completed around June or July every year. The audit allows the SAT to make sure that all CIT has been paid up with regard to the profits to be distributed. In addition, no profits can be distributed before losses from previous years have been made up, after which the remaining balance will be available for redistribution. The tax authorities will confirm how much a company can repatriate based on the net profit percentage. When remitting the funds, banks will generally require an audit report and annual CIT return to substantiate the distributable profit for the year. If the company chooses to postpone repatriation to the following year because of cash flow concerns, an additional special audit report will be required.

Not all profits can be repatriated or reinvested after tax clearance. A portion of the profit (at least 10 percent for WFOEs) must be placed in a company's reserve fund account. This account is capped when the amount of reserves reaches 50 percent of the registered capital of the company. The investor can also choose to allocate some of the remainder to a staff bonus or welfare fund or an expansion fund, although these are not mandatory for WFOEs. Joint ventures are also required to allocate money for welfare funds, staff incentives, and the enterprise's development fund (for investment purposes), with the exact percentages determined by the Board of Directors.

China levies withholding CIT on profits or dividends repatriated to non-resident taxpayers, with the rate varying from zero percent to 10 percent depending on the stipulations of the relevant DTA.

Procedure for the Declaration & Repatriation of Dividends

Step 1 Tax Clearance & Annual Audit

Step 2 Calculate Tax Payment & Net Profit

Step 3 Board of Directors/ Executive Director of WFOE Drafts Profit Distribution Plan with Shareholder's Approval

Step 4 Application for DTA Preferential Tax Rate & Payment of Withholding Tax

Step 5 Application for Foreign Exchange Approval with State Administration of Foreign Exchange

Step 6 Dividend Remittance

4

Changes to a Business and Closure

- Changes to a business
- Closing a foreign-invested enterprise
- Closing a representative office

Changes to a business

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Making changes to a Chinese entity after establishment – such as to its range of commercial activities or registered address – can be a challenging, time-consuming, and expensive procedure. In some cases, closing the entity all together and starting from scratch may be easier, or even mandatory. For these reasons, it is always better to start out with a clear and informed business plan, rather than attempt to make on-the-fly adjustments later on.

"Changing the business scope of a company in China is a lengthy process, involving the majority of government authorities involved in the original corporate establishment process. If approved, such a change will take a minimum of two months to complete."

Company name

The procedure for changing the name of a company in China is quite complex, albeit far simpler, for example, than changing one's business scope. Because a company's name is displayed on several types of official documents (such as its business license, company chops and all other certificates), any changes to this information must be filed with each respective governing authority. It is crucial that companies duly prepare for each step in the process prior to filing an initial application, as deadlines at later steps take effect upon the completion of earlier ones.

Step 1 – The name change must be filed with the local AIC at which the company was originally registered.
Step 2 – The company must file an application with its original AIC body of registration for a change of information on its business license. The application to do so must be submitted within 30 days of the change in company-registered information as completed in Step 1.
Step 3 – Within 30 days of the change of business license, the company should make record-filing to MOFCOM.
Step 4 – After the name change has been registered with the AIC for both the company (Step 1) and its business license (Step 2), the company must then go about updating other documents on which its name appears, including various types of chops (financial chop, company chop, customs declaration chop, etc.), which must be newly carved and registered with the company's local Public Security Bureau. Moreover, the company will have to make changes to all ongoing contracts with suppliers and clients.

Some of the processes could be conducted through online management system, such as filing with AIC and record-filing with MOFCOM. Companies are suggested to check with local bureaus in charge.

Registered capital

For a number of reasons, the foreign investor may want to increase the FIE's registered capital. Companies adjust their registered capital for one of three types of reasons – financial, strategic, or regulatory. The investor may have underestimated the time required for the FIE to start earning a profit, and needs additional capital to cover operations. As the company's registered capital is printed on the business license, having a high registered capital is a way to show potential clients or investors that the company's financials are strong. In addition, a certain amount of registered capital is required for matters such as expanding the company's business scope, opening a branch or acquiring special licenses. Also, the amount a company is allowed to borrow depends on the level of registered capital as well.

Considering increases are far more common than decreases, we discuss the former first. Similar to changing a company's name, increasing registered capital is a time-consuming process that involves working with most of the government authorities involved in the entity's initial setup.

Step 1 - The company must provide a reasonable explanation for the increase in registered capital to MOFCOM and obtain its approval if it engages in specially administrated industries, i.e. restricted or prohibited categories in the Catalogue. If the company focuses on industries not listed in the specially administrated industries, then it could be exempted from the onerous approval application process. Instead, a simplified record-filing process will apply, which could be conducted either before the AIC registration or within 30 working days of the change being made.
Step 2 - The company should file an initial application with the original AIC of registration within 30 days of the decision to increase registered capital.
Step 3 - The company must apply to the original AIC of registration for a new business license.
Step 4 - The company should transfer the additional capital directly into its capital account. The company will be charged a fee for the increase of registered capital, which varies according to the chart below.

Schedule of Fees

Registered Capital (RMB)*	Fee
10 MILLION OR LESS	0.08 PERCENT OF THE INCREASE
10 million - 100 million	0.04 percent of the increase
100 million or above	Zero

**Here it refers to the registered capital after the increase.*

Conversely, investors can apply to reduce registered capital as well, for example if the Chinese subsidiary has proven to be sustainable ahead of plan, and the investor has better use of the capital elsewhere. As the ability to issue dividends is tied to the company's registered capital, decreasing the registered capital is a way to accelerate a dividend issuance as well.

The procedure for reducing registered capital is slightly different, such as within 30 days of the company resolution being taken to decrease the registered capital, the creditors of the company should be notified.

In certain cases, however, the application to lower the registered capital is likely to be refused:

- The reduction would lead to the registered capital falling below the minimum;
- The company is involved in legal proceedings; and,
- The reduction would lead to an amount below the minimum as stipulated in the articles of association.

Business scope

Changing the business scope of a company in China is a lengthy process, involving the majority of government authorities involved in the original corporate establishment process. If approved, such a change will take a minimum of two months to complete.

Generally, when an enterprise intends to change its business scope, it must first submit its amended Articles of Association and a Board Resolution (or Shareholder Resolution), among other documents, to the MOFCOM in charge for approval or record-filing[1]. Besides, within 30 days of the decision to make the alteration, the company should lodge an application with the AIC. If the amended scope is approved, the AIC will grant a new business license within 30 days. With the business scope amended, a number of related documentation needs to be updated.

Investors should note that the expansion of the business scope often requires raising the company's registered capital. Depending on the type of activity, investors should also make sure that the premises that the business occupies is fit for that activity.

[1] *If the company focuses on industries not listed in the specially administrated industries, then it could be exempted from the onerous approval application process. Instead, a simplified record-filing process will apply, which could be conducted either before the AIC registration or within 30 working days of the change being made.*

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Registered address

Investors may want to change the registered address of the company for a variety of reasons. Apart from expanding workspace, certain business activities require specialized buildings, such as for certain types of manufacturing.

Similar to other changes, the company apply to relevant MOFCOM in charge and obtain its approval if it engages in specially administrated industries, i.e. restricted or prohibited categories in the Catalogue. If the company focuses on industries not listed in the specially administrated industries, then it could do a simplified record-filing process, which could be conducted either before the AIC registration or within 30 working days of the change being made.

Besides, the company must apply for a change of registered information. To do so, it must submit the following documents to the original AIC:

- A photocopy of the company's business license; (After the change has been approved, the original business license along with a copy should be submitted to the registration authority to acquire a new business license)
- Identification documents of the legal representative or an entrusted party :
- Certificate for legal use of the domicile ;
- A resolution or decision on the change of address, made in accordance with the relevant articles of association ;
- The amendment to the articles of association (or revised articles of association) signed by the company's legal representative; and,
- A Chinese translation affixed with the seal of a translation company for any materials submitted in a foreign language.

The AIC will then issue a new business license. If the new registered address is in the jurisdiction of a different AIC branch, that office will issue the new license.

At the same time, the company needs to update its tax information. The registered address defines the jurisdiction where the company pays its local taxes. Taxes are managed directly by local tax bureaus, and no tax officer wants to lose out on revenue by allowing a lucrative company to relocate to another tax district.

Thus, once the company decides to move to another district, or even city, the previous tax office will lose out on its portion of taxes paid and may thus be inclined to make the process more difficult by deciding to look over the company's tax records for the past three years before granting the documents needed for the change of registration. This can take anywhere from six to 10 months, which can seriously disrupt company operations, as it will be unable to issue invoices to suppliers and customers until registered at the new location.

“The registered address defines the jurisdiction where the company pays its local taxes. When the company pays taxes, although delivered locally, a portion is always paid to the State level State Administration of Taxation (SAT), as well as to the local tax authorities.”

Even under the Five-in-One business license scheme, foreign investors are still suggested to actively coordinate between bureaus in both tax districts to closed old account and set up new tax account.

In addition, there are various other possible changes – such as the company bank account, rights of import and export, and foreign exchange registration – which, depending on the circumstances, might also need to be made.

Shareholder structure

A company typically decides to make changes to its shareholder structure upon the entrance of a new shareholder who is to receive an equity transfer from one or more existing shareholders. Alternatively, it may be necessary to revise the shareholder structure as the result of equity transfers between shareholders or the exit of a shareholder from the company.

Though information on company shareholders is not explicitly listed on a Chinese business license, in most cases, the company will still need to apply for a new business license, considerably complicating the overall application process.

Step 1 – An equity transfer agreement should be signed between the transferor and the new shareholder. The company must issue a capital contribution certificate for the new shareholder (if applicable) and revise the list of shareholders.
Step 2 – The equity transferor or transferee (the taxpayer) shall file with the competent tax authorities and obtain a tax payment certificate for individual income tax or a tax exemption certificate.
Step 3 – The company must apply to the original AIC of registration for a change of company shareholders and obtain a "Notice of Acceptance."

Similar to other changes, the company need to obtain approval or conduct record-filing with the MOFCOM in charge, depending on whether it's listed as specially administrated industries in the Catalogue. Besides, if the change to the shareholder structure leads to the change of actual controlling person, the company need to submit additional documents including an "equity structure chart of ultimate actual controlling person".

Furthermore, the company will also need to file with relevant departments when it is applicable.

Closing a foreign-invested enterprise

For whatever reason, investors in China may be faced with the decision to cease their company's operations. Economic circumstances change rapidly, and the business assumptions that underlie the investment may have proven flawed. In such a situation, it may be tempting to simply walk away from the entity in China and cut one's losses. For a variety of reasons, this can be ill-advised.

The Chinese government imposes severe sanctions on investors who do not properly deregister their company, including barring companies and individuals from doing business in China. Closing down a company requires both time and cost – simply walking away might seemingly save the investor these expenses in the short term. However, for investors with a future perspective on doing business in China or looking to close potentially significant liabilities, deregistering properly will pay off in the long term. With the option of doing future business in China at stake, it is beneficial for a company to carry out its deregistration in the prescribed manner.

To close down an FIE, its assets need to be liquidated, and the company needs to be de-registered with the government authorities. On average, the entire FIE liquidation process normally takes between 12 to 14 months to complete. Good preparation, efficient coordination, and close cooperation with the involved authorities (especially the tax authority) are critical.

FIE deregistration process

Applying for termination

To initiate the liquidation process, the FIE should first apply to the government authority that gave the original approval. This is usually the Ministry of Commerce. However, where an investment is categorized as restricted or otherwise requires pre-approval from other governmental agencies, the investor would have to submit the application to these as well.

Liquidation

By law, the liquidation committee of an FIE should be comprised of the legal representative, a representative for the company's creditors, a government representative, as well as certified public accountants and lawyers. In practice, however, the liquidation committee can generally be comprised of anyone designated by the shareholders.

Once the committee has been created, it needs to liquidate the assets and allocate the returns from the sale of the assets in the following order:

1. Liquidation expenses;
2. Outstanding employee salary or social security payments;
3. Outstanding tax liabilities; and,
4. Any other outstanding debts owed by the FIE.

After the above debts have been discharged, the liquidation committee can distribute the remaining returns among the shareholders.

Here, we take WFOE deregistration as an example to demonstrate the deregistration process, as shown in the following flowchart:

De-registering a Wholly Foreign-owned Entity

- Termination of Articles of Association
  De-registration of Certificate of Approval with MOFCOM — **1** month
- Liquidation Committee Filing with AIC — **10** working days
- 1. Determine the closing date
  2. Prepare liquidation plan
  3. Prepare financial statement as of closing date
  4. Asset disposal, debt collection, settlement of liabilities

  about **15** working days
- Notice of creditor's rights and debt — **1** working day
- Announcement of the Liquidation Committee in the newspaper — **3** working days
- De-registration with Customs Bureau (If applicable) — **5-10** working days
- Prepare Tax Audit Report for past three years — **5-7** working days
- De-registration with state and local tax bureaus — **6** months
- After liquidation, if no major changes in the bank balance are expected:
  Prepare liquidation audit report issued by CPA firm — **5-7** working days
- Prepare liquidation report signed by liquidation committee — **5** working day
- De-registration of Business license with AIC — **10** working days
- De-registration of Statistic Registration Certificate with Statistic Bureau — **1-2** working days
- Request updated bank statement from bank;
  De-registration of SAFE Certificate;
  Application with SAFE for remittance of liquidation income — **5-10** working days
- Closure of bank accounts — **1** month
- De-registration of Enterprise Code Certificate with State Bureau of Technical Supervision — **1** working day
- Cancellation of company seals with Public Security Bureau — **1** working day

Note: The timeframe mentioned here is the official approval time from the government authorities, which assumes that all the needed documents are completed and ready-to-go.

Understanding the simplified deregistration process

On December 26, 2016, the SAIC issued guiding opinions on promoting a simplified deregistration process for enterprises, with March 1 2017 set as the date for nationwide implementation. The new procedure's primary aim is to accelerate market exit for qualified enterprises, including FIEs, while also improving the accuracy of data for policymakers regarding business volume, corporate structure, and management.

Simplified application procedure and documents

Companies applying for the simplified deregistration procedure must first publish an announcement for 45 consecutive days through the National Enterprises Credit Information Public System to allow for any objections. The deregistration information must be submitted to the local AIC, which will then pass it on to the relevant tax, HR, and social security authorities. For FIEs, the MOFCOM will also be notified. If there is no objection during the announcement period, the company can apply for the simplified deregistration procedure, and AIC will issue a decision on the deregistration application within three days.

Under the simplified deregistration procedure, the 'commitment letter of all investors', which covers information such as the investor's decision, liquidation report, and other related documents, will serve as the key application document and basis for the AIC's administration and supervision. The following documents are required by the AIC for the deregistration procedure of FIEs:

- The application letter for deregistration;
- The power of attorney to agent;
- Certificate for approval of deregistration by administrative authorities; and,
- The resolution or decision made by the company according to the Company Law; or the ruling on bankruptcy and the adjudication document on dissolution made by the People's Court; or documents of the administrative institution on company closure.

Previously, on top of these documents, a liquidation report and the sample of the publicized announcement, certificate of branch deregistration, tax clearance certificate, business license (original and duplicate copy), and other related documents were required to complete the application process.

Applicable scope of the simplified deregistration procedure

Companies legally registered as either a limited liability company, non-corporate legal person, sole proprietorship, or partnership enterprise that had not started operation after obtaining a business license, or had started operation but already settled all of their claims and obligations, can now apply to the local AIC for the simplified deregistration procedure.

Companies under the following circumstances are not qualified for the simplified procedure:

- FIEs involved in special administration measures (industries on the negative list) as stipulated by the state;
- Those recorded on the list of enterprises with abnormal operation, or list of enterprises which have committed serious violations;
- Entities whose equity (investment rights and interests) are frozen or pledged, or its assets are mortgaged, etc.;
- Those under investigation, compulsory administrative measure, judicial assistance, or administrative penalty, etc.;
- Non-legal person branches of the company that have not yet been deregistered;
- Those who have previously been ordered to terminate the simplified deregistration procedure; and,
- Those requiring approval before deregistration according to laws, regulations, and the State Council's decisions.

Legal risks

Submission of false statements or of fraudulent concealment during the simplified deregistration procedure may result in rejection, and may be listed as in violation of the law, being discredited, as well as becoming 'blacklisted' through the National Enterprises Credit Information Public System. In addition, parties affected by such conducts may claim damages from the investors of the enterprise, and depending on specific circumstances, investors may also face administrative and criminal punishments.

Observations

As part of a broader commercial system reform, the simplified market exit mechanism promotes business efficiency as well as reduces the additional administrative burdens of an enterprise. However, as for procedures involving several authorities, considerable efforts for coordination across the various administrations will be required, especially for FIEs. In addition, for new foreign market participants, keeping updated with related administrative and public information through different sources, such as local authorities and online platforms, is critical for avoiding legal and business risks.

Common questions about WFOE deregistration

1.Are there alternative options to deregistration?

Yes.

For a company looking to end operations in China, other than deregistering the company or simply "walking away", a company may choose to explore the option of selling the company. However, if a company may want to continue operations at a later point, the company should consider reducing operations while continuing to meet statutory company requirements, such as maintenance of an office lease and corporate bank account, tax filings, and annual reporting and inspections at a reduced level.

2. Why does it take so long to deregister a company?

Tax deregistration is the main culprit.

The longest and perhaps most difficult part of the deregistration process is usually the tax closure process. Before deregistering with other government authorities, a company will first need to complete a tax deregistration with both the state and local tax bureaus where tax authorities will be looking to see that all taxes have been paid correctly and in full. This process, both at the local and state tax bureau, takes roughly six months for a WFOE to complete. However, the process can take considerably longer if unpaid taxes or other irregularities are found.

If so, the company may be required to submit additional documentation, settle any unpaid or incorrectly filed taxes, and/or pay late payment surcharges and/or penalties.

This can be particularly frustrating as tax filings that were previously reviewed and accepted while the company was in operation will again be reviewed and can be found to have irregularities, which will then need to be settled with the tax authorities. This point, in particular, underscores how important it is to have a competent and experienced accounting team or accounting service provider in place.

3. How will assets be handled during the deregistration process, and what is the role of the liquidation committee?

These will generally either be liquidated, or transferred to the shareholders. A liquidation committee is formed to liquidate the assets.

The timing and method of asset disposal will largely depend on the type of assets and the situation of the company.

Early on in the deregistration process, a liquidation committee, consisting of all shareholders, will need to be formed. Once formed, the liquidation committee will be responsible for preparation of the balance sheet and a detailed list of all assets, properties evaluation, and formulation and implementation of a company liquidation plan, including liquidation of assets. Assets include intellectual property.

The liquidation committee will also be responsible for a number of other matters concerning the deregistration process, including notifications to creditors and the preparation of the liquidation report to submit to authorities. Here, it should be noted that a company should refrain from paying back creditors, until the liquidation plan has been made and approved by the board of shareholders.

4. What are the core maintenance issues investors should consider during the deregistration process?

Tax filing and business license compliance requirements.

Even after the official deregistration date of the company, a company will still need to continue to file taxes until the official tax deregistration process has been completed with both the local and state tax bureaus. Additionally, until the official deregistration certificate has been issued by AIC, a company will be required to maintain a valid business license and office lease during the deregistration process.

5. What are common tax incompliance issues?

Different issues can be raised by local and state tax authorities.

During the local tax deregistration process, authorities will review company contracts, accounting vouchers, and employee IIT payments. Common incompliance issues cited by the tax bureau include unpaid stamp taxes on contracts as well as unpaid or improperly calculated employee IIT.

State tax authorities on the other hand will be looking to review tax filing reports and financial reports. Common incompliance issues cited by the state tax bureau will typically be related to variances between bookkeeping, reporting, and tax filings, so a company will need to be able to explain these variances should they be challenged by the state tax bureau. Having annual tax audit reports may help in this process and, depending on the requirements of tax authorities, a three-year tax clearance audit report will often be required, though not all tax bureaus will require this.

6. What if the company lease or business license expires during deregistration?

Penalties can be imposed, so investors should make sure to stay in full legal compliance until the entity is closed.

Under Chinese law, for deregistration noncompliance in these areas, a WFOE may be liable for penalties ranging from RMB 30,000 to RMB 100,000, though enforcement of these penalties is left broadly to the discretion of local authorities.

Given that the period of validity for a WFOE business license is quite long, this is typically not an issue during the deregistration process. However, for maintaining a valid lease agreement during the deregistration process, a company is advised to plan ahead and weigh the costs of maintaining a lease agreement against potential penalties.

To reduce costs of maintaining a valid lease agreement, the company may want to consider moving to a smaller, cheaper office if they will not require their current office space during the deregistration process. Speaking with the landlord about possibly negotiating a cheaper rental fee is an additional option.

Closing a representative office

There are cases in which an investor needs to close its RO, such as:

- The RO is required to shut down in accordance with the law;
- The RO no longer engages in business activities upon the expiry of its period of residence;
- The foreign enterprise terminates its business (meaning the parent company is being closed);
- The foreign enterprise terminates its RO; or,
- The RO is no longer suitable for facilitating foreign investor's business in China, as ROs are unable to engage in profit-making commercial activities.

Investors should note that one cannot simply walk away from the RO without properly closing it. As the RO will soon be in non-compliance with taxes and other regulations, fines and penalties will be imposed. If no rectification is made, the RO's license may be revoked. At this point, the foreign company and the RO Chief Representative will be blacklisted and barred from setting up a new RO in China for the next five years.

The de-registration procedure

As an RO is not a legal personality, the term "deregistration" is used instead of "liquidation", though the two processes share many similarities.

The procedures are as follows:

- **Step 1 –** Prior to actual deregistration, the RO must apply to both its local tax bureau and the state tax bureau for tax audit and tax deregistration. To do so, the RO must first undergo an audit by a local Chinese CTA firm for taxes owing from the past three years. Once the audit is completed, the enterprise should submit to the tax bureau a board resolution affixed with the signature and seal of the chairman of the board of directors, as well as a cancellation application signed by the chief representative of the RO. Should any unpaid taxes or other irregularities be found by the tax authorities at any point during this process, the RO may be required to submit additional documentation, pay penalties, or settle unpaid taxes with the authorities.
- **Step 2 –** The RO should then deregister its foreign exchange registration at the local SAFE and customs registration in the local Customs. In case it does not have such registrations, it still needs to get corresponding official statements from the bureaus in charge as proof.
- **Step 3 –** The enterprise should close its bank account. Unissued checks and deposit slips will need to be returned to the bank and any funds remaining in the account should be transferred out. If the RO intends to transfer the account to its parent company, it will be required to provide reasons for doing so and seek approval from the bank.

- **Step 4 –** The enterprise can then proceed to deregister with its local AIC where its application will be processed within 10 workdays of receipt. If successful, the enterprise will be issued a "Notice of Deregistration" and all the registration certificates will be cancelled, as well as the chief representative's working card (工作证). Announcement of the RO's deregistration must be listed in a media outlet designated by the AIC. The RO's business registration and office lease must be valid up until the official notification of deregistration has been issued by the AIC.
- **Step 5 –** The enterprise should conduct deregistration in the Quality and Technical Supervision Bureau and Statistics Bureau in case the RO has not received its five-in-one business license.
- **Step 6 –** Notification of the RO's deregistration should then be filed with the Public Security Bureau to cancel its chops.

The total time required for deregistration is typically three to six months (depending on the region), but can take over a year in cases containing irregularities, particularly in the tax deregistration phase.

To be noted, obtaining a de-registration certificate from both the SAFE and customs authorities is a mandatory part of the RO de-registration process, regardless of whether the RO has ever obtained a registration certificate from either of these authorities. Moreover, if the RO business license has expired before this date, the investor will need to pay a fine.

RO Deregistration Procedure and Timeline

	Step & Instruction	Time
Phase 1	Deregistration with National Tax bureau	20 days
	Deregistration with Local Tax bureau	20 days
Phase 2	Deregistration with customs	10 days
	Deregistration with SAFE	7 days
Phase 3	Closure of bank account	1 day
Phase 4	Deregistration with AIC	5 days
Phase 5	Cancellation of Organization Code Certificate If a five in one business license is used, then this step shall be omitted.	1 day
Phase 6	Cancellation of chops with Public Security Bureau	20 days
		Minimum total time 84 days