



SOVEREIGN™

DOING BUSINESS IN CHINA



SOVEREIGN CHINA

Sovereign China is part of Sovereign (SovereignGroup.com), one of the largest independent corporate and trust service providers in the world. Sovereign currently manages over 20,000 clients that include companies, entrepreneurs, private investors or high net worth individuals and their families – and has assets under administration in excess of US\$10 billion. Our comprehensive service offering is structured around three core segments:

- Corporate Services – company formation and management across all major jurisdictions, together with the necessary support to assist companies of all sizes to establish and sustain operations successfully in foreign markets.
- Family Office Services – providing trustee services and wealth management and succession planning to internationally mobile families and entrepreneurs, together with the specialist support needed to secure current goals and long-term sustainability.
- Retirement Planning – providing and administering market-leading international pension schemes that offer choice, transparency and portability across multiple jurisdictions.

With offices in Shanghai and Beijing, Sovereign China (SovereignGroup.com/China) accelerates international clients' ability to understand and operate in the China market, and has successfully assisted more than 700 companies from over 50 countries with their China market entry and operational activities.

Sovereign China provides a suite of services designed to lead foreign investors through the market entry process and stay with them to develop long-term success in China. From assistance with market understanding, developing market entry strategy and establishing operations to finally providing back office and compliance support services, Sovereign China guides its clients from planning through to execution.

Disclaimer: The information provided in this guide is intended for general reference only and is not a substitute for professional advisory services. The following information reflects the market situation and regulatory guidelines at the time of writing and is not intended as advice for specific circumstances.

International Copyright, Sovereign China 2018. All rights reserved.

CONTENTS

1. A Conversation about China: Frequently Asked Questions	5
2. Establishing a Legal Entity in China	12
2.1 Pending Changes to China's Foreign Investment Laws	12
2.2 Nature of the Investment	12
2.3 Registration Steps	14
2.4 Registered Capital	14
2.5 Actual Controlling Person	15
2.6 Nature of the Business	15
Case: Multi-National Malaise	17
3. Taxation of Foreign Invested Enterprises in China	18
3.1 Tax registration and Tax Entry	18
3.2 Main Tax Categories for Foreign Enterprises	18
3.3 Taxation of a Representative Office	19
3.4 Tax Incentives	20
3.5 Other Taxes	20
3.6 Annual Audit and Annual Examination	23
3.7 Profit Repatriation	24
Case: The Graft Spiral	24
4. Employing Personnel in China	26
4.1 Employee Contracts	26
4.2 Employee Personnel File and Staff Handbook	26
4.3 Basics of Compensation	27
4.4 Terminating an Employee and Severance Payments	29
4.5 Consequences of Breaching The Labour Contract Law	30
4.6 China's 'Labour Dispatch' rules	30
Case: You're Fired!!!	31
5. Individual Income Tax (IIT) in China	32
5.1 Taxation of Local Employees	35
5.2 Taxation of Foreign Employees	36
5.3 Annual Income Tax Filings	36
5.4 Repatriation of salary paid in China	36
6. Protecting Intellectual Property (IP) in China	38
6.1 Legal Protection	39
6.2 Contractual Protection	40
6.3 Practical Protection	42
Case: The Shanzhai IP Agent	42
7. Sovereign Global Offices	44



1. A CONVERSATION ABOUT CHINA: FREQUENTLY ASKED QUESTIONS

WHAT ASPECTS OF THE CHINA MARKET DO I NEED TO BE AWARE OF?

There are several generalities in respect to China that will have an impact on most industries. These include, but are not limited to:

- i. **Geography and population:** With a landmass that is roughly the size of the United States, China's population is equivalent in size to the combined populations of North and South America, Western Europe, Norway, Sweden, Australia and New Zealand. It is also a highly diverse country due to substantial regional differences. For example, a person from Shanghai may find it impossible to understand the local dialect in Sichuan, not to mention the province's spicy cuisine. This diversity affects companies entering China because selecting a region for entry can have a significant impact on future commercial success. China is not a single monolithic market.
- ii. **Uneven development:** Since market principles were first introduced by economic reforms in 1978, the Chinese government has focused on developing the coastal regions; in particular, three key economic development areas that are now typically more developed than those inland:
 - Bohai Bay area in the north, which embraces Beijing, Tianjin and surrounding areas
 - Yangtze River Delta, which embraces Shanghai, Zhejiang Province and Jiangsu Province
 - Pearl River Delta, which embraces Guangdong Province and surrounding areas, including Hong Kong.

To illustrate the disparity in development, consider that the GDP of Shanghai, a provincial-level city, is equivalent to the country of Finland, while the inland province of Guizhou boasts a GDP that is equivalent to Libya.

There are also significant differences in the development of cities. There is no official classification of cities into tiers, but it can be useful to consider cities with similar economic development when evaluating the opportunities and challenges in China's incredibly diverse landscape. 'Tier 1' cities include Shanghai, Beijing, Shenzhen and Guangzhou, while there are about two-dozen 'Tier 2' cities – Tianjin, Nanjing, Hangzhou and most of the provincial capitals. Tier 2 cities are relatively well developed and have received increased attention from foreign investors in recent years because operating costs can be significantly lower than in

Tier 1 cities. Further, there are many 'Tier 3' and 'Tier 4' cities that have also seen significant development.

In addition to giving a useful measure of population size, GDP and levels of infrastructure development, the Tier-level of a city also provides a quick and dirty way to assess its potential familiarity with, and receptiveness to, foreign businesses and brands.

In 'Business-to-Consumer' (B2C) sectors, the Tier 1 cities are saturated with foreign brands and local brands competing for business. Many brands are now therefore starting to focus on the Tier 2 cities because their wealth levels are beginning to approach those of Tier 1 cities.

In 'Business-to-Business' (B2B) sectors, headquarters will often be based in a Tier 1 city while the key business activities may take place in a lower-tier city or a development zone. China has intentionally clustered industries within specific development zones and there are likely to be several such zones nationwide that can cater to a particular sector.

- iii. **Undeveloped or nascent industries:** Many industries remain highly fragmented, sometimes with thousands of competing manufacturers, or their supply chains are unsophisticated and highly inefficient. Where industries are under-developed, regulations tend to be inconsistent or non-existent. This can pose a significant challenge for foreign investors.
- iv. **Constant and rapid change:** What was true about an industry last year may not be true this year. Both the competitive and regulatory environments are subject to rapid and considerable change, so it is essential for foreign businesses to be flexible and highly adaptable in China.

Market and industry conditions will vary greatly between different business sectors so it is essential that, in addition to these generalities, foreign investors should also fully understand the specifics in respect of their sector.

WHAT INDUSTRY SPECIFIC INFORMATION DO I NEED TO KNOW?

Before entering China, foreign investors should honestly assess how well they understand the opportunities by considering what they know about the following areas within their potential market in China:

- The market size, growth potential and possible opportunities for products or services
- The potential barriers or challenges to business entry, including market competition, protection of intellectual property (IP) or regulatory constraints
- The ability to identify target customers, pricing of products and services, key sales and distribution channels, and effective marketing activities
- Market segmentation and regional differences in China
- The most appropriate legal entity (if any) for your business needs
- The best location for your business and business activities in China.

Although it is possible to dive right into the market, this approach can waste time and resources and has led many foreign investors, both large and small, into untimely exits. Undertaking methodical market research before you enter China can provide an objective understanding about your market opportunities that could take years to discover by trial and error.

HOW DOES CHINA'S BUSINESS ENVIRONMENT COMPARE TO OTHER COUNTRIES?

China is an emerging market that has experienced unprecedented growth. It may appear to be a modern and sophisticated country in the Tier 1 cities – Shanghai, Beijing, Guangzhou and Shenzhen – but the challenges facing foreign companies will often be similar to those experienced in other emerging markets, including:

- A lack of independent institutions, i.e., non-governmental organisations (NGOs), consumer protection or judicial bodies can lead to an absence of transparency in both state and local government operations.
- Vague and inconsistently enforced regulations: Clear legislation that is enforced equitably encourages adherence to written, verbal and implied agreements. In China, foreign-invested enterprises (FIEs) are in many cases held to a higher standard than their locally-invested counterparts, which often have local connections to officials that may have a vested interest in their success.

- The paramount concern of government – ultimately the Chinese Communist Party (CCP) – is to maintain stability and the legitimacy of its power. It is important to understand this fact because it may help to explain otherwise confusing policies.

HOW MIGHT THIS AFFECT MY ABILITY TO OPERATE IN CHINA'S MARKETS?

You will need to be actively involved in monitoring your relationships with both your suppliers and customers, enforcing and protecting your IP, and being explicit about the conduct expected of any local employees. Contracts are therefore critical because they:

- Provide you with a framework to discuss your relationship with a distributor or supplier
- Act as a last resort in the event that a dispute should arise.

You cannot assume that employees, business partners or government officials will share the same values as you, or value your presence and investment as much as you think they should. The active involvement of senior managers in your China operations can dramatically increase your chances for success.

You should not expect simply to set up a China operation, hire local employees, set targets and wait for the returns. China can be a lucrative market, but only for those who are willing to commit the necessary time and resources to understand it and contend with the complexities of running a business here.

See "Multi-national Malaise" on page 17.

ARE CONTRACTS IN CHINA ENFORCEABLE?

The ability to enforce contracts is improving as China's commercial sector matures, particularly in those regions and cities that are popular destinations for foreign investors. That is not to say that enforcement is likely to be as straightforward as you could expect in your home country. In other words, while there is a possibility of having an agreement enforced in China under a contract, there is almost no possibility of having an agreement enforced without one.

IS IT POSSIBLE TO PROTECT INTELLECTUAL PROPERTY (IP) IN CHINA?

IP protection is a serious concern for most companies in China – foreign or domestic. The key is to pursue a combined strategy of seeking legal protection through trademarks and patents, whilst also engaging in proactive, rather than reactive, enforcement. This entails educating employees, maintaining internal controls over access to your IP and identifying the means to limit its external availability. Of course, continuous innovation is often the best way to maintain an advantage over potential competitors and to avoid IP infringements impacting your business.

IF THE CHINESE MARKET IS SO RISKY AND COMPLEX, DO I BELONG THERE?

It is, and you might not. Analysing the strategic importance of China to your business and then assessing whether you have the resources to execute your plan is generally the best way to determine if a presence in China makes sense. Remember, a 'China plan' is not limited to setting up a company. You could begin by working with distributors to find out if sufficient demand exists for your products before committing to a real presence, or you could hire a sourcing firm to assist with finding suitable and reliable contract manufacturers to produce products to sell in your home country.

IS IT POSSIBLE TO OPERATE FROM HONG KONG INSTEAD?

Given its proximity to Mainland China, the Hong Kong Special Administrative Region could be a viable initial option either for selling into or sourcing from China. However Hong Kong is a distinct commercial jurisdiction with different legislation, legal system and currency from Mainland China. You will not be able to hire local Mainland Chinese to work for you legally on the Mainland, issue official invoices ('fapiao') that are recognised by the Mainland tax authorities to your Mainland Chinese clients, or spend a substantial amount of time on the Mainland developing and conducting business. As your business grows, you will have to consider a presence on the Mainland. Hong Kong may, however, be a good location to set up an offshore holding company for a Mainland China company.

WHAT WOULD BE THE BEST CORPORATE VEHICLE IF I DECIDE I NEED A REAL PRESENCE IN CHINA?

The most popular entity for doing business in China is the Wholly Foreign Owned Enterprise (WFOE), which is a company established in China according to Chinese laws and wholly owned by one or more foreign investors. A WFOE is a Limited Liability Company (LLC) that can:

- Conduct business activities and generate revenue based upon a limited business scope
- Hire local employees directly and, in many cases, has no limit for the number of foreign employees.

A WFOE's registered capital must be declared during the licensing phase of the company set-up process. This should cover initial investment expenses and may be used immediately for the company's operations. From commencement of the registration process, you should anticipate four to six months before a company is fully operational, depending on location.

A Representative Office (RO) can represent the interests of a foreign investor by acting as a liaison office for the parent company but has decreased in popularity due to its many restrictions. ROs are permitted to conduct market research and to develop partnerships and business channels, but all business transactions, including the issuance of invoices, must be managed by the parent company. An RO is taxed on its expenses and cannot generate revenues.

- The parent company must have existed for at least two years in order to be eligible to set up an RO in China
- ROs may not hire local employees directly and must rely on a government-authorised employment agency
- An RO is limited to four foreign employees
- There is no investment requirement because ROs are not classed as a legal entity in China
- The registration process takes around four months to complete, depending on location.

WOULD AN RO BE A BETTER CHOICE IF IT'S FASTER TO SET UP AND PROVIDES A PRESENCE IN CHINA?

An RO may be suitable for businesses looking to establish a short-term presence in China with no need to generate revenue, or for very limited sourcing ventures. However an RO should not be regarded simply as a way for new entrants to China to minimise their exposure in the event of failure because, in most cases, ROs do not provide the optimum platform for success and have the following disadvantages:

- **Liability:** An RO is not an independent entity. It is an extension of its parent company. As such, the parent company and the RO's Chief Representative take responsibility and liability for its operations. A WFOE provides greater protection because it is a form of Limited Liability Company (LLC). However it does not offer the same level of protection as in other jurisdictions, so an offshore holding company is often inserted between the Chinese entity and its ultimate beneficiary.
- **Capitalisation:** An RO has no registered capital requirement and instead generally pays taxes on its expenses (effective tax rate approximately 11%) because its purpose is not altruistic and it contributes indirectly to the revenue potential of its parent. If the Chinese tax authorities decide that an RO is generating revenues from outside its intended activities, they can levy a tax on its deemed revenues and income. A WFOE, on the other hand, is required to make an initial capitalisation, which is tax free, but is expected to pay taxes on both its revenues and profit. If a Chinese entity's expenditures exceed a certain threshold, a WFOE is, in fact, more tax efficient than the RO.
- **Scope of activities:** ROs are limited to providing business development, market research and support activities (such as quality control for sourcing from China), while a WFOE is permitted to generate revenues from the commercial activities prescribed in its business licence. If a business operating through an RO decides to begin selling products or services in the future, it will be required to re-establish as a new company. With a WFOE, however, it is generally possible to expand the scope of business to accommodate this.
- **Human resources:** An RO is not permitted to hire Chinese citizens directly but must use a licensed 'labour dispatch' service provider. However, many of these providers are refusing to dispatch local employees to new ROs due to recent changes in the labour laws. Furthermore, an RO is limited to no more than four foreign employees as Representatives, which includes the Chief Representative. A WFOE, however, can hire as many PRC citizens as it wishes, while its ability to employ foreign nationals is generally based on the size of its registered capital. Some local employees dislike being hired via a dispatch service provider and prefer direct-hire relationships.
- **Ongoing costs:** Generally speaking, the RO has fewer ongoing compliance costs than a WFOE, particularly in respect of accounting and tax compliance. However, depending upon the length of operations and the size of annual expenditure, a WFOE may be significantly less expensive to operate as a whole due to the lower effective tax rates and a five-year carry forward of losses.
- **Marketability:** A WFOE is perceived as a more substantial market presence and suggests to prospective clients or partners that a business has made a long-term commitment to the Chinese market. New market entrants often overlook this, but such a perception can be a significant barrier to business development.
- **Office location:** ROs are limited to leasing office space in locations that are specifically licensed to host ROs. Typically this means paying Grade-A office rents. A WFOE, however, can lease any office space that is zoned for its intended business. Neither an RO or a WFOE should use a 'virtual office' – this is unlawful and will create problems at both the registration and operational phases.
- **Flexibility:** It is generally possible to set up branch offices of a WFOE in other cities and expand the scope of a business to include additional lines of business, but this is not possible with an RO. ROs also cannot be converted into a WFOE. If you want to restructure, you will have to set up a new WFOE and consider if you need to close the RO.
- **Parent company:** The parent company of an RO must be at least two-years-old before it is permitted to establish in China. The Chinese government is discouraging the use of ROs and different locations may place additional restrictions upon the parent company before an RO is permitted to establish.

WHAT IS THE MINIMUM INVESTMENT REQUIRED TO SET UP A WFOE?

In 2014, China amended its Company Law to abolish minimum capital requirements. However, nearly every city with significant foreign investment can impose its own capital requirements for setting up a company. Furthermore, if your business is subject to additional licensing requirements, then a minimum capital investment may be imposed.

For most companies, the amount of minimum capital will depend on the location and the nature of the business. In other words, the officials reviewing your application will determine whether the amount you intend to invest is sufficient for your business activity. Authorities in the Tier 1 cities – Beijing, Shanghai and Guangzhou – generally regard CN¥1 million (approx. \$160,000) as a baseline and work on the basis that the capital investment should be sufficient to cover two years of expenses. Ultimately the investor should invest sufficient capital to cover operating expenses until

such time as it is anticipated that the WFOE will be cash flow positive.

It should be borne in mind that a company's registered capital can affect more than its registration. It is also relevant in the following circumstances:

- **Local employees' residence permits:** With a low registered capital, companies may not be able to sponsor temporary residence permits for local employees who reside outside the administrative district where the company is located. This could forcibly limit a company's talent pool.
- **Foreign employees:** Certain administrative districts in China will limit the number of foreign employees that a company can employ based on that company's registered capital.
- **Future adjustments:** The ability to make changes to a company's structure or set up branch offices could be hindered by a low registered capital.
- **Tax bureau relationship:** General VAT taxpayer status and export VAT rebate applications may be held up by the local tax bureau.

It may be that none of these four issues currently applies in the administrative district where a company is looking to establish. However conditions can change suddenly at the local level and this could have an impact on a company's future operations.

IS IT NECESSARY TO INVEST THE TOTAL AMOUNT AT ONE TIME AND, ONCE INVESTED, CAN THE FUNDS BE ACCESSED?

The sum invested covers both operating and capital expenses. China's Company Law has been revised to abolish the mandatory schedule for capital contributions. Restrictions may apply at the local level or special licences may impose an investment schedule, so it is helpful to be aware of the previously mandated schedule: for registered capital below \$2.1 million dollars, all funds were required to be paid up within six months of issuance of a business licence, or, if paid in instalments, 20% should be paid up within 90 days and the remainder paid over a maximum of two years from the issuance of the business licence.

SHOULD I INVEST ONLY THE MINIMUM CAPITAL REQUIRED BY THE LOCAL AUTHORITIES?

No. You should invest sufficient funds to sustain the company until such time as you expect it to be cash flow positive. Too many investors spend too much time finding ways to minimise their capital investments, only to find out that business expenses are greater than anticipated. Operating in China is not cheap; office rent and remuneration of experienced hires can rival that of developed nations.

It is also important to keep in mind that if funds are transferred to the WFOE in excess of the registered capital amount, it is treated as income and therefore subject to tax.

DO I NEED A PHYSICAL OFFICE ADDRESS TO SET UP A COMPANY?

Yes, in most cities you are required to have signed at least a one-year lease agreement. You must identify a location with a unique address that is correctly zoned for your intended business. Virtual office addresses are illegal and should be avoided in most cases. Some new ventures use virtual offices for their company set-up because disreputable agents mislead them. Potential problems often don't emerge until later but there are a number of situations where site visits are probable.

- **Initial registration inspections:** Companies that trade in certain goods will require additional permits to operate. It is not uncommon for these permits to require a visit to your office by a government official.
- **Approvals from State Administration of Taxation (SAT):** Whether it's an application for VAT-payer status or to begin processing export VAT rebates, visits may be required from the local SAT bureau.
- **Spot checks:** It is not uncommon for local authorities to visit offices to check the licences and certificates. If your company's licences do not match your physical set up, this could create problems and potential penalties.

As with the registered capital, it may be that the authorities in a particular district currently have a relaxed stance; but attitudes can change quickly and often in line with the prevailing outlook towards foreign-invested companies. You should consider that while locally-invested companies may flagrantly breach the law, foreign-invested companies are scrutinised more carefully. Chinese officials often favour high-profile campaigns to discourage illegal practices instead of blanket enforcement. Foreign-invested companies are almost always the first to be targeted.

See "The Graft Spiral" on page 24.

IS SHANGHAI'S PILOT FREE TRADE ZONE A GOOD LOCATION TO SET UP A COMPANY?

The China (Shanghai) Pilot Free Trade Zone (SFTZ) was formally launched in September 2013 in Shanghai's Pudong district. Initially the SFTZ comprised four existing bonded areas in Shanghai but this is to be dramatically expanded to include Shanghai's financial district and neighbouring development zones. The SFTZ, like many Chinese government initiatives at launch, remained ill-defined until the authorities gradually fleshed out the details of how it would be administered. The intended goal of the SFTZ is two-fold:

- To experiment with economic reforms that may eventually be rolled out nationwide (similar to the original Special Economic Zone in Shenzhen in 1980)
- To advance the prospect of its participation in global and regional trade and investment agreements.

An important feature of the zone is found in its 'negative list' approach to foreign investment, which is permitted in all sectors unless explicitly prohibited by the inclusion of a given sector on the Negative List published by the Shanghai Municipal Government. The SFTZ remains an important location for export-related businesses and could potentially be valuable for businesses in sectors that have been removed from the 'negative list'. It is important to bear in mind that many of the policies initiated in the zone have already been rolled out to the rest of the country. This trend is likely to continue.

WHERE SHOULD I SET UP MY OFFICE?

This is a complicated question but the main factors are likely to be the proximity to your customers and suppliers, as well as to available talent. If you are producing equipment for mining, for instance, then setting up in northeast China probably makes more sense than southern China. If you intend to establish in an area with little or no foreign investment, the challenges of operating in China will increase.

SHOULD I CONSIDER TAX INCENTIVES OFFERED BY DIFFERENT DISTRICTS?

State-sanctioned tax incentives were introduced in 2008 and focused on attracting specific kinds of foreign investment i.e high tech, environmental, certain professional services, and others. Many local governments also provide tax incentives but these are not necessarily sanctioned by the state. In other words, business decisions should not solely be based on local tax incentives because these can be easily withdrawn.

SHOULD I CONSIDER AN OFFSHORE HOLDING COMPANY IN HONG KONG OR SINGAPORE?

Hong Kong or Singapore can provide a good base from which to access China, as well as other Asian markets. A holding company can act as a buffer between the ultimate beneficiary and the China entity, which could be beneficial for taxation and profit repatriation purposes. However there is a risk that the business could be deemed to be liable for taxes in China as follows:

- **Effective Management Rule:** If SAT deems an offshore company's day-to-day management to be located in Mainland China, the offshore company may be subject to corporate income tax in Mainland China. Offshore company residence can only be achieved if the offshore directors, wherever they are located, are permitted to exercise effective management of the company.
- **Reduced tax rate exclusions:** Offshore holding companies with no substantive business activities may be excluded from reduced withholding tax rates under tax treaties with Mainland China.
- **Indirect transfer of assets:** An investor that has structured an equity interest in a Mainland China enterprise through an offshore holding company could, in the event that the investor sells interests in the offshore company, be subject to an additional tax burden within China.

WHAT SHOULD I CONSIDER WHEN WORKING WITH SERVICE PROVIDERS IN CHINA?

- **Local government kickbacks:** China isn't cheap. It may appear to be so at first because it is not uncommon for local service providers to undercharge for their services and make it up with government kickbacks. Local tax bureaus will often provide subsidies to accounting firms based on how much their clients pay in taxes, while development zones offer agents percentages of the committed investment. Not all commissions are dubious but you should ask your service provider if they are receiving one.
- **One-stop-shops:** No one company has licences for every service, accounting, recruitment, real estate, HR or to practice law. It's OK to work with one company for everything, but make sure it is very clear who is doing what.
- **The China Expert:** There is no such thing as a 'China expert'. Run, do not walk, from anyone who tells you that they are one! This also applies to anyone who talks more about their great relationships ('guanxi') rather than demonstrating meaningful knowledge of the subject at hand.

I HAVE A LABOUR CONTRACT AND EMPLOYEE HANDBOOK FROM MY HOME COUNTRY. IS IT POSSIBLE TO USE THIS FOR MY CHINESE EMPLOYEES?

China's labour law heavily favors the employee. The labour contract in China must have specific provisions that may not be in the contracts you currently use in your home country. Furthermore, the Staff Handbook needs to be very specific in terms of the company's policies and procedures, especially with regard to what constitutes offences that will result in termination. The language in which the contract and staff handbook are written must also be in Chinese to have any legal authority, although there can be an English copy to act as a reference. Therefore, we would suggest that you have a contract and staff handbook drawn up specifically for China, although you can certainly draw key elements from your global contract and handbook.

WHAT SHOULD ALL FOREIGN INVESTORS CONSIDERING CHINA KEEP IN MIND?

"Trust, but always verify" should be the mantra for operating in China. From the expat who has lived in China for ten years to the landlord of the new office you intend to rent, you must have systems in place to verify what you are being told. Not everything in China is fake but at some point nearly everything has been faked, even the eggs.



2. ESTABLISHING A LEGAL ENTITY IN CHINA

2.1 RECENT CHANGES TO CHINA'S FOREIGN INVESTMENT LAW

2016 saw significant changes to the system for government control over foreign investment and therefore to the process of entering the China market. The change was accomplished by revising, as of 1 October 2016, the statutes concerning wholly foreign owned entities (WFOEs), equity joint ventures and contractual joint ventures and by promulgating a new basic regulation governing registration of foreign invested entities (FIEs).

The big change is that government regulation of FIEs has moved from a system that requires MOFCOM (China's Ministry of Commerce) approval to one that will now just require simple registration with MOFCOM. The Foreign Investment Catalogue, which set out the sectors of the economy in which foreign investment was encouraged, while restricting or prohibiting investment in many others, has been abolished. In its place, two 'National Negative Lists' have been introduced, one covering domestic and foreign investors, and another list with additional limits on foreign investment, which delineate sectors of the economy where certain Chinese agencies would continue to require investors to secure approval from those agencies for investment projects.

For FIEs that are not restricted or regulated under the National Negative Lists, MOFCOM requires online registration through a national website employing a standard set of documents. This registration will apply to initial formation of the FIE and to most changes in FIE structure, such as changes in management, ownership and registered capital. A new element in the registration process is the appointment of the actual controlling person.

Overall, some changes have been for the better, others have made setting up a company in China one step more difficult. In this chapter we set out what you need to know to set up an entity in China.

2.2 NATURE OF THE INVESTMENT

When a foreign investor chooses to enter the China market, they will first need to decide whether to launch their business by establishing a legal entity with a capital investment in China or to start more cautiously by testing the market, building networks, hiring local representatives or both.

If a legal entity is the preferred route, the foreign investor will have to consider, in addition to the general commercial and strategic considerations, the following:

- The business sector
- The amount to be invested
- Whether a Chinese partner is desirable or even mandatory.

Government rules for specific industries may affect the size and form of the investment. For instance, the media, automotive and telecom industries are all sectors that may require FIEs to have local partners. The new 'Negative List' provides guidance as to which sectors are open or restricted.

i. REPRESENTATIVE OFFICE (RO)

A Representative Office (RO) can represent the interests of a foreign investor by acting as a liaison office for the parent company. ROs can conduct market research, develop partnerships and business channels and, since they do not have a minimum investment requirement, ROs are not considered to be a Foreign Invested Enterprise (FIE). ROs were the least complicated way for a foreign firm to have a legal presence in China and were, at one time, the first choice for foreign companies with little or no previous experience in the country.

However all business transactions, including the issuance of invoices, must be managed by the parent company and ROs can only hire a maximum of four foreign employees. Any local employees must be hired through government-authorised employment agencies. ROs are usually taxed on a proportion of gross monthly expenses. Given the restrictions on transactions, employment and the taxation on expenses, WFOEs are generally considered a better option for entrants seeking to develop their business in the China market.

ii. WHOLLY FOREIGN OWNED ENTERPRISE (WFOE)

A WFOE is a Limited Liability Company (LLC) that is fully invested by one or more foreign investors. Along with the rights afforded to an RO, a WFOE may also conduct business transactions within China and hire local employees on its own accord. However, foreign investors are required to make an investment into the company and, depending upon the business activity, there may be a minimum capital requirement. WFOEs have begun to outpace joint ventures as the most popular vehicle for a China presence.

iii. JOINT VENTURE (JV)

There are two types of joint venture structure in the China market:

1. **Equity Joint Venture (EJV):** EJVs have capital investments from both local and foreign firms. The percentage of the capital investment determines the amount of profit and risk that both the foreign and local company assumes. Foreign firms entering business sectors where WFOEs are prohibited often use EJVs, although this is becoming less prevalent as more and more sectors are being opened up to WFOEs.
2. **Cooperative Joint Venture (CJV):** CJVs are also partnerships with a local company; however, the amount of risk and profit shared by each party is not determined by capital investment but is agreed upon at the beginning of the partnership. CJVs were used more frequently in the 1990s when the Chinese economy was not as developed. International companies often injected funds, while local Chinese companies provided equipment and other necessities. Laws, regulations and procedures for establishment can vary substantially between sectors. The common risks associated with entering into partnerships also apply in China but this is often exacerbated by disparities in the culture and business practices between the foreign and local partners.

Foreign companies should enter into JVs only when both parties have established a clear understanding of the business objectives and appropriate exit strategies have been developed.

Steps that a foreign company could take to assess the viability of the JV are:

- Undertake thorough due diligence on your proposed JV partner. If there are no legal, financial or reputational issues, you can proceed with a clear mind. If something does come up, you can choose your next step. Good due diligence will always give you leverage.
- Ensure that the JV agreement states that any disputes must be handled in China. Foreign companies often believe that litigation or arbitration is best done outside China, preferably in their home country. But in reality this will offer little protection to a foreign company. A foreign court or arbitrator has NO authority in respect of a China JV.
- Ensure that you retain the power to appoint the legal representative and the general manager, because this will give you effective control over the JV. Securing a majority of board seats or even a majority shareholding will not.
- Hire your own legal counsel when setting up the JV. Do not rely on the Chinese JV partner to undertake the legal work for establishment. Your interests in this process are not aligned. Find a foreign lawyer with experience in China.
- Hire an independent accountant, rather than using one that is recommended by your JV partner. This should ensure that you retain transparency on what is happening within the JV.
- Outsource the control and maintenance of sensitive documentation, such as company certificates, seals (known as 'chops' in China), permits or licences. This will ensure that no contracts can be signed without your knowledge or approval.

iv. MERGER AND ACQUISITION (M&A)

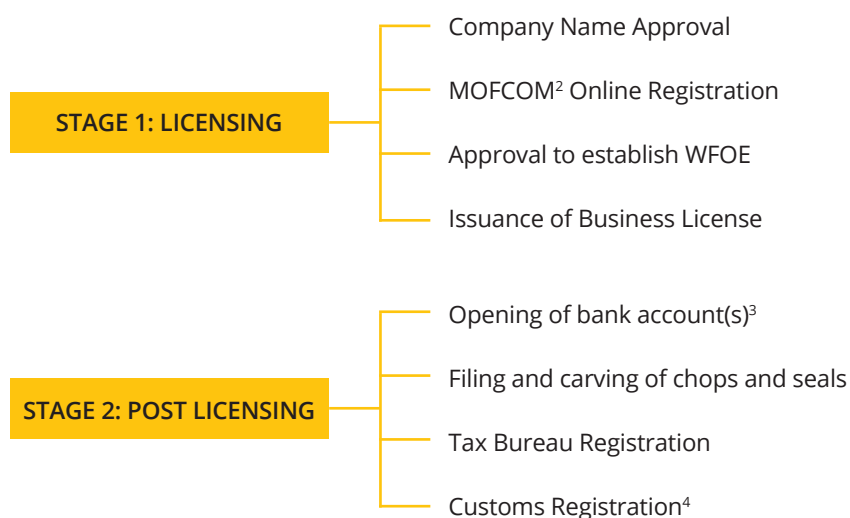
M&A has become an increasingly popular route to foreign investment in China in recent years. There are many options for M&A in China, including equity and asset acquisitions, as well as mergers. As a form of foreign direct investment, the general rules on establishment of FIEs also apply to any M&A.

2.3 REGISTRATION STEPS

In 2015, the Chinese authorities revised the company registration process to unify the business licence. To simplify the registration process, the new business licence combines the organisation code certificate, tax registration certificate and the business licence into one certificate. This is known as the Three-in-One Business License. Further streamlining with the process occurred in 2016 with the Five-in-One Certificate, which combines the enterprise's business certificate, organisation code certificate, tax registration certificate, social security registration certificate and statistics registration certificate.

The graphic illustrates is the typical process for setting up both FIEs and ROs in China. The government offices involved in this process include the Commission of Commerce, the Administrative Bureau for Industry and Commerce, the Tax Bureau and the Customs Office.

Typical WFOE Registration Process¹



1) This is a general process for establishing a WFOE in China, some sectors may require additional steps

2) MOFCOM – Ministry of Commerce

3) Conducted by the client or during the accounting set-up in China

4) When required

2.4 REGISTERED CAPITAL

Registered capital is the amount of capital required to support the operations of a WFOE until such time as it becomes cash flow positive. Effectively it is the company's working capital. It is important that the registered capital amount is sufficient because any funds injected by the parent company in excess of the registered capital amount will be treated as income to the WFOE and therefore subject to tax.

Prior to March 2014, all FIEs were required to register a minimum capital amount and to pay up their capital over a prescribed period of time. With the introduction of China's amended company laws, both minimum capital requirements and the prescribed investment schedule have been abolished.

Although the Chinese government has abolished minimum capital requirements, local bureaus may in practice still require foreign investors to commit to a minimum amount, based upon previous investment expectations, before approval is granted. In general, the investment required is dependent upon the business scope, volume of sales, company size and location. This is judged on a case-by-case basis. The Chinese authorities will assess what would be a reasonable capital injection for each specific project.

The amount of registered capital must be declared during the licensing phase of the registration process. The total investment figure is represented by the ratio between foreign-contributed capital and debt. The registered capital should cover all the FIE's initial investment expenses and may be used immediately for the newly-formed company's expenses. It is unlawful to inject the funds as stated and then withdraw them. One purpose of the registered capital is to provide confirmation to creditors of a company's financial adequacy. A general rule of thumb is that the injected capital amount should be sufficient to cover the first two years of expenses.

If the declared registered capital is not enough to cover operating expenses, the registered capital can be increased at any time. However, if you find that the declared registered capital is too high, it cannot be lowered. Therefore, it may be beneficial to have a conservative estimate when determining the declared registered capital amount.

2.5 ACTUAL CONTROLLING PERSON

The 2016 revisions to China's Foreign Investment Laws now require that the controlling person or persons of an FIE must be identified. The actual controlling person is defined as either those person or persons who:

- Collectively have 50% ownership in the foreign investor that will establish the FIE in China; or
- The persons who actually control the foreign investor through means other than ownership (e.g. control over the decision-making).

As a result, special purpose vehicles (SPVs) and other structures used to hide the identity of investors will no longer be viable options for investing in Chinese entities. The policy is primarily intended to prevent 'round-tripping' – where Chinese individuals invest in overseas companies that then reinvest in China – but will affect most companies investing in China and potentially create a significant amount of additional documentation requirements. Unless the investor in an FIE is a publicly-traded company, the individuals that have control must be identified. Since control of many private companies is purposefully decentralised, all individuals that collectively control the investing entity will need to be identified.

2.6 NATURE OF THE BUSINESS

For FIEs, both WFOEs and JVs, the activity of the business must be declared during the licensing phase of the registration process. This is known as the 'Business Scope'. The intended scope of operations that a foreign company declares will determine its business category in China.

The following categories represent the most common classifications for FIEs operating in China today:

- **Service Company:** An FIE providing services to either companies or consumers. In most cases, the company may not manufacture or trade goods. Examples of service activities include consulting, training, restaurants and management services.
- **Manufacturing Company:** An producing goods for sale. Manufacturing companies do not require an intermediary to sell goods locally or internationally and may import raw materials for production. The registration process, however, may be more complicated than other business categories because manufacturing plants often require additional certifications.
- **Foreign-Invested Commercial Enterprise (FICE):** FICE provides greater flexibility in terms of business activities. These activities include retail, wholesale and franchising operations. When established, a FICE is often granted both import and export rights, although additional certifications from various bureaus will be required to commence international trade. FICEs may also buy and sell products freely in China without an intermediary. It is possible for manufacturing FIEs to apply to extend their business scope to include FICE capabilities and vice versa.

Other categories of business include: Purchasing Centres, Research & Development Centres, Investment (Holding) Companies, Trading Companies, Regional Headquarters and so on.

As foreign companies entering the market begin to navigate the bureaucratic landscape, having a clear understanding of the investment and business options available will be crucial to operating successfully in China. As China's compliance with its World Trade Organisation (WTO) obligations develops, the business registration process should continue to improve and further business sectors should be opened up to foreign investment.

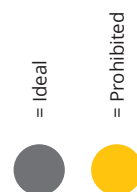
When choosing a business registration agency, foreign companies should consider the agency's knowledge of policies, its transparency in respect of the registration process and its track record of successful registrations. Another important consideration when selecting a business registration agency is the company's reputation. Selecting a service provider that can effectively guide foreign investors through this complicated process should ensure a smooth market entry.

A detailed summary of entity types and their respective permitted business scope, tax treatment and registration process can be viewed on the following Legal Entity Comparison Chart.

Chart: Comparison of Different Legal Entities in China

	Business Activities*					Registration Process					Notes	
	Import	Export	Domestic Commercial Activities	Service Activities	Manufacturing / Assembly Rights	Tax Treatment	Min. Registered Capital**	Duration of Entity †	Potential for Future Expansion of Scope ‡	Registration complexity		Approx. Time to Register#
Representative Office							N/A	1 Year			1 Month	<ul style="list-style-type: none">• Cannot issue invoices• Intended for market research and business development activities only• Cannot directly hire local employees• Taxed on expenses
							N/A	30 Years			2 Months	<ul style="list-style-type: none">• Products may only be sold coupled with services
Manufacturing							N/A	30 Years			3 Months	<ul style="list-style-type: none">• Distribute products manufactured in-house• Additional time may be needed for special licences
FICE							N/A	30 Years			2 Months	<ul style="list-style-type: none">• May be authorised for Retail and/or Wholesale• Franchising and direct selling available through approval• Commercial activities are limited to like products
FICE + Manufacturing							N/A	30 Years			3 Months	<ul style="list-style-type: none">• Tax incentives at risk if production is less than 50% of total revenues

Source: Sovereign Analysis



* Denotes activities that may generate revenue streams for the entity.

** This reflects the minimum as stated in China's Company Laws and does not guarantee approval.

† This reflects the maximum duration the entity may be approved by the government. All entities' licences may be renewed before expiration.

‡ Capability of the entity to expand to include additional capabilities (i.e., Manufacturing entity expands to include FICE capabilities; Distribution FICE expands to include franchising and retail).

Approximate Time refers to the time required to obtain the licence, commencing only upon the complete collection of all required documents.



CASE: MULTINATIONAL 'MALAISE'

A developer of automated manufacturing control systems establishes an office in Shanghai to attract talent and to be near its potential clients. It appoints a high-performing senior manager from North America to head up the office for a year in order to cultivate the team and oversee its integration into the international business. By the time the senior manager returns home, the sales team has generated a robust pipeline that outperforms initial expectations.

Soon after, the parent company acquires a value-added reseller in Singapore. Due to cultural affinity, the parent company decides to place the Shanghai office under the supervision of the newly-acquired Singapore operation instead of promoting an employee in the Shanghai office to lead its China initiative. Within six months, half the sales team in Shanghai has quit and most of the other employees are on their way out the door.

Market entry does not end with the company set-up and cultures are not necessarily the same across ethnic groups.

3. TAXATION OF FOREIGN INVESTED ENTERPRISES IN CHINA

Foreign companies that engage in business operations in China are required to pay taxes according to the local tax codes. The most important tax categories for these forms of businesses are the Corporate Income Tax (CIT) and Value Added Tax (VAT).

3.1 TAX REGISTRATION AND TAX ENTRY

When a business licence is issued, an RO or WFOE must register with the relevant tax authorities within 30 days. This includes both the national taxation bureau and its municipal branch; however, only one application needs to be submitted. Generally, the application process takes ten working days. Companies are not required to hire an authorised agent for this process and can apply themselves. However, if the investor has used a registration service provider for the registration of the RO or WFOE, a tax application service will often be included.

3.2 MAIN TAX CATEGORIES FOR FOREIGN ENTERPRISES

- Corporate Income Tax (CIT)

CIT is levied on income of companies derived from production, business operations and other sources, both within and outside China. Companies are required to pay this tax quarterly and the applicable tax rate is currently 25%. If a company is not registered in China, however, it only has limited tax liabilities for all revenues generated from within China. The applicable CIT rate for this kind of company is ten per cent.

The method of computation for CIT is as follows:

$$\text{Tax Payable} = [\text{Total Annual Income} - \text{Expenses} - \text{Loss Carry Forward}] \times \text{Applicable Tax Rate} - \text{Value Added Tax (VAT)}$$

Value Added Tax is a general tax that is charged at each stage of commercial activity involving the production and distribution of goods and the provision of services. The tax is applied only to the 'value added' at each particular stage of production and distribution of goods, or the provision of services.

China's tax system distinguishes between general and small-scale payers of VAT as illustrated in the chart below.

Classification of VAT Payers	VAT Rate	Note
General Tax Payer (GTP)	Regular Rate: 6-16% Preferential Rate: 3-13% (non-services only)	GTP Status is typically given to enterprises with annual revenues exceeding RMB 5 Million. An FIE's VAT classification can be changed by application.
Small Scale Tax Payer	Unified Rate: 3%	

Source: Sovereign Analysis

- General VAT Payers

The actual amount of VAT payable by general VAT payers is the excess amount of output VAT over input VAT. The tax rate can vary between 6% and 16% depending on whether it is applied to the production and distribution of goods or the provision of services. The type of goods and services will also affect the applicable tax rate.

The tax payable for general VAT payers is computed as follows:

$$\text{VAT Payable} = \text{Current Output VAT} - \text{Current Input VAT} - \text{Input VAT Credit (from previous months)}$$

$$\text{Output VAT} = \text{Sales Volume} \times \text{Applicable Tax Rate}$$

- Small-scale VAT Payers

The VAT payable by small-scale taxpayers is calculated more simply on the basis of the overall sales value and the tax rate without deduction of an input VAT. This means that input VAT paid by small-scale VAT payers on the purchase of goods from general taxpayers is not refunded by the tax authorities. The applicable tax rate is 3% for wholesale, retail, manufacturing enterprises and services.

The tax payable for small-scale VAT taxpayers is computed as follows:

$$\text{VAT Payable} = \text{Sales Volume} \times 3\% / (1+3\%)$$

- VAT Surcharge

In addition to the VAT Payable, there is also a VAT Surcharge, which may be applied at the local administrative level. The actual VAT surcharge will vary depending on the jurisdiction, but typically ranges from 0% to 12%.

$$\text{VAT surcharge payables} = \text{VAT Payable} \times \text{Surcharge Rate}$$

- VAT on Manufacturing, Wholesale and Retail Sectors

VAT for the Manufacturing, Wholesale and Retail Sectors has been fairly consistent over the years. In 2012 several pilot programmes were launched throughout China to replace the Business Tax (BT) system with a VAT system for services. The purpose of this transition was to reduce double taxation, increase the competitiveness of China's service industries by reducing the overall tax burden and to improve tax collection. Initially limited to transportation and modern service industries, the new VAT programme was extended nationwide in August 2013. The process of phasing out BT was completed in May 2016.

3.3 TAXATION OF A REPRESENTATIVE OFFICE (RO)

ROs (except for those engaged in legal or accounting services) are not permitted to generate revenue, so their tax base for CIT and VAT is presumed on the basis of their expenses. In Shanghai and Beijing, a minimum presumed profit rate of 15% is used for the CIT calculation¹ but this could be determined elsewhere on a case-by-case basis. For VAT the tax is based solely on the amount of expenses incurred. The result of this computation is an estimated 11% tax on operation expenses. This rate excludes any surcharges that may be levied at a local level, which can raise the effective rate up to 11.8% depending on the city or district. ROs make tax filings on a quarterly basis².

¹ This method of calculating tax liability for ROs is applicable in Shanghai and Beijing. It is possible that the minimum presumed profit rate could be determined on a case-by-case basis.

² With the phase out of Business Tax for a VAT system in 2016, there has been some conflicting thoughts on the Taxation of a Representative Office. Some argue that because ROs do not file VAT, they do not need to pay Tax. Because the law does not specifically address ROs and no clear answer has been provided by the Tax Authorities, Sovereign recommends paying taxes as described above and apply for a refund. This will prevent the tax bureau from later coming after a company for not paying taxes, which they reserve the right to do, and which involves fines, late fees, and interest charges.

3.4 TAX INCENTIVES

Many foreign companies, registered before 16 March 2007, enjoyed preferential CIT treatment if they were located in special economic zones or if they were involved in production-orientated businesses. Following implementation of a new income tax law from 1 January 2008, the preferential tax rates were phased out rising to the standard CIT rate of 25% by 2012.

However some tax incentives remain for certain industries and projects that are being encouraged by the government. Below are some examples:

Industries/Projects	Corporate Income Tax Rate
Certain advanced and new technology enterprises	15%
Certain small-scale enterprises with low profitability	20%
Income derived from <ul style="list-style-type: none">- Certain agriculture, forestry, animal husbandry or fishery projects- Certain investment in, or operation of, certain public infrastructure projects- Qualified environmental protection and conservation projects- Certain technology transfer projects- A non-resident enterprise	Tax exemption or reduction
Enterprises located within certain ethnic autonomous regions (subject to approval from the local government of the relevant region)	Tax exemption or reduction

Source: Sovereign Analysis

3.5 OTHER TAXES

i. WITHHOLDING TAX

Non-resident enterprises are subject to a withholding tax at source, ranging from 6% to 16%. Instances in which withholding tax is applied include:

- Dividend payment to non-resident parent company
- Interest, rent, royalties and management fees paid to non-resident foreign enterprises
- Net capital gains from transfer of shares or equity interest in FIEs
- Payment of contracted projects and services to non-resident enterprises

The taxpayer is required to withhold the tax payable from the payment to be remitted to the non-resident enterprise and submit it to the tax authorities. China has negotiated tax treaties with several countries, which offer reduced withholding tax rates. Examples of such countries include Hong Kong, Singapore, Mauritius, Barbados, Japan, Korea and Switzerland. Foreign investors may be able to apply these reduced tax rates if the local entity is structured underneath a parent company located in one of these treaty partner countries. From 2009, however, China has also issued a number of anti-avoidance circulars that may require the parent company in one of these jurisdictions to prove that it is a substantive business before the local China entity is permitted to enjoy the benefits of these tax treaties.

ii. STAMP DUTY

Contracts and related documents are subject to a Stamp Duty. Different tax rates, varying from 0.03% to 0.1%, apply to different types of contracts. For a purchasing and distribution contract, for example, a 0.03% tax rate is applied to the total contract amount. The Stamp Duty ticket must be attached to the contract when the contract is signed.

iii. PROPERTY TAX

Property Tax is imposed on the owners, users or custodians of houses and buildings. This is applied at the rate of either 1% to 3% of the original value with certain deductions, or 12% of the rental value. Property Tax has to be paid twice a year, in May and November.

iv. VEHICLE AND VESSEL TAX

Consumption tax is payable on the sales value of certain consumer goods. This includes 11 general items: cigarettes, alcohol, cosmetics, jewellery, precious stones, firecrackers, gasoline, diesel oil, motor vehicle tyres, motorcycles and small motor cars. The applicable tax rates range from 3% to 50% in addition to the VAT. Producers include the tax in the consumer price of their products. Retailers and wholesalers are not required to pay consumption tax when they trade goods in this category and consumption tax is fully rebated for exported goods.



v. VAT ON EXPORTS

In most, but not all cases, the value of exported goods can be exempt from VAT and consumption tax. To gain exemption, companies must apply for a tax rebate with the relevant tax authorities after the goods have left China's territory and a number of conditions have been met:

- The exporter must have general taxpayer status
- All documentation and payments must be completed
- The goods must have a non-zero refund rate
- The rebate must be applied for prior to 15 April in the following year.

If these requirements are not met, the export will be subject to VAT as if it were a domestic sale. The formulas for calculating the rebate for a general VAT taxpaying company producing goods for export and domestic sales are as follows:

$$\text{Tax Payable} = \text{Domestic Output} - [\text{Input VAT for Total Purchases} - \text{Non-refundable VAT}]$$

$$\text{Non-refundable VAT} = \text{Export Sales} \times [\text{VAT Rate} - \text{Refund Rate}]$$

$$\text{Refundable VAT} = \text{Export Sales} \times \text{Refund Rate}$$

Note that the rebate rate for certain goods can be less than the VAT rate, which means that the full amount paid as VAT on exported goods will not be refunded. To understand the process of the VAT rebate calculation, see the following example:

A	B	C	D	E	F	G
Total Purchases	Input VAT A x 16%	Domestic Sales	Export Sales	Domestic Output VAT C x 16%	Non- Refundable VAT D x (16% - 16%)	Tax Payable E - [B - F]
3,800,000	608,000	2,000,000	3,000,000	320,000	0	-288,000

Source: Sovereign Analysis

In the above example, the VAT and the rebate rate are both 16%. The tax payable is negative, meaning that it will be refunded up to the amount of refundable VAT.

For companies engaged only in trading activities, the formula for VAT on exports is much simpler. They only need to apply for the VAT rebate. The formula for a trading company's rebate is as follows:

$$\text{Export VAT Rebate} = \text{Exported Goods Purchase Price} \times \text{Refund Rate}$$

Small-scale VAT paying companies cannot apply for export tax rebate and are required to pay VAT on exports as per the following formula:

$$\text{Tax Payable} = \text{Export Sales} \times 3\% / (1+3\%)$$

vi. VAT ON IMPORTS

VAT is also applied to imported goods, which is calculated as follows:

$$(\text{Dutiable value} + \text{Custom duty}) \times \text{Consumption tax rate} / (1 - \text{Consumption tax rate})$$

The dutiable value of imported goods includes the purchase price, and the transport and insurance costs. See the example below with the VAT rate of 17%, a consumption tax rate of 3% and the customs duty of 12%.

Example:

A	B	C	D	E
Dutiable Value	Customs Duty A x 12%	Consumption Tax [A + B] x 3% / (1 - 3%)	Import VAT Payable (A + B + C) x 16%	Total Tax Payable (B + C + D)
3,800,000	456,000	131,629	702,020	1,1289,649

Source: Sovereign Analysis

3.6 ANNUAL AUDIT AND ANNUAL EXAMINATION

Both ROs and FIEs are required to be audited on an annual basis. The annual audit has to be filed before the end of May of the following year and must be conducted by a firm of Certified Public Accountants (Chinese or foreign JVs) that is registered in China under Chinese regulations. An FIE must also undertake an annual examination whereby it must submit various certificates and financial documentation to local authorities for inspection.

The following chart summarises the obligations of both the RO and FIE with respect to payment dates and deadlines.

Table: Tax Related Filing Deadline

Item	RO	FIE
Tax Registration	Within 30 days of the issuance of the business license	
Income Tax	Quarterly	Quarterly
VAT and Consumption Tax	N/A	Monthly
Housing and Vehicle Tax (Deduct Stamp Tax)	May and November	
Annual Audit and Clearance	End of May	
Annual Examination	End of June	

3.7 PROFIT REPATRIATION

FIEs may only distribute and repatriate profits back to their investors after completion of the annual audit, settlement of income tax liabilities and having made up any losses that were carried forward from previous years. An FIE must also set aside a minimum 10% of after-tax profits into a reserve fund until the accumulated reserve fund reaches 50% of the registered capital. The remaining amount is distributable profits from which the board of directors may declare dividends (less withholding tax) to the investors in proportion to their contribution to the registered capital. Once the accumulated reserve fund threshold of 50% is reached and maintained, the FIE may repatriate all profits to its home country (less withholding tax). The mandatory reserve fund ensures that a portion of the profits are re-invested into the FIE.

CASE: THE GRAFT SPIRAL

A famous European textile brand, for the sake of expediency, uses a virtual address to establish its presence in China while actually operating out of one of its distributor's offices. The registered address is therefore not a properly zoned physical office that is also its place of business. In order to obtain its general VAT taxpayer status, the firm is forced to choose between paying a bribe to its local tax official to overlook this irregularity or moving its registered address and employees to a properly zoned office space.

The company chooses to pay the bribe so that it can fulfil a customer's order that would otherwise have been lost. Unfortunately, additional requests for payoffs from the tax official follow. If the company had been properly established from the outset, it would have avoided having to make payoffs for what otherwise should have been a routine procedure.

Although short term gains may be made, it is always recommended to follow proper procedure. Engaging in graft may seem like a quick solution, but it usually comes back and creates a significantly worse situation than the one in which it was meant to help bypass.





4. EMPLOYING PERSONNEL IN CHINA

Staff employment is a key issue for companies operating in China. China's labour laws favour the employee over the employer and include very specific provisions for the employment of local and foreign staff. Companies without a registered entity in China cannot legally employ staff in China. It is therefore critical that companies entering the market understand the rules and regulations.

In addition to the basic employment requirements, signing contracts with workers, meeting wage standards and paying salaries in a timely manner, employers in China are also obliged to:

- File staff employment and dismissal notices with relevant government bureaus
- Maintain employees' personnel files – a unique Chinese document that records the academic and employment history of employees
- Withhold and pay individual income tax on behalf of employees
- Make monthly contributions to employees' social benefits and housing funds

Most of these processes are further complicated by the involvement of multiple government bureaus and copious paperwork. For FIEs, staffing their China operations may pose a considerable challenge and many choose to rely on service providers to guide them through the HR processes.

4.1 EMPLOYEE CONTRACTS

Under China's Labour Law, all companies are required to sign employment contracts with their employees. While WFOEs are allowed to sign employment contracts directly with local Chinese staff, ROs must engage authorised service providers to hire and dispatch local employees. While there is no standard contract form, the agreement should include:

- Term of contract and probation period
- Job title and description
- Labour protection and working conditions
- Compensation
- Termination conditions
- Breach of contract provisions and disciplinary rules
- Other provisions, such as training bonds, non-disclosure and non-compete agreements

4.2 EMPLOYEE PERSONNEL FILE AND STAFF HANDBOOK

Every employee in China has a personnel file detailing their education and employment history. Responsibility for maintaining this file is transferred from one employer to the next when an employee changes employer for the duration of the employment period. ROs must engage a local labour agency to maintain these files.

The staff handbook usually contains information about a company's policies and procedures. A written employee handbook gives clear guidance to employees such that any employment issues can be dealt with fairly and consistently.

4.3 BASICS OF COMPENSATION

i. BASE PAY

Base pay is paid monthly and varies from 12 to 14 months. A '13-month' pay scheme is common in China, with the additional month's pay being issued during the Spring Festival month (usually February). The minimum wage in Shanghai and Beijing is CN¥2,420 per month and CN¥2,120 per month respectively (as of 2018). New minimum wage amounts are issued each year.

ii. INCENTIVE PAY

Incentives can be paid monthly, quarterly or annually and are increasingly tied to individual performance. Many organisations and Chinese employees welcome the concept of performance-based variable pay. Success and monetary reward through performance differentiation are concepts that employees appreciate, especially in China's Tier 1 cities.

Some of the incentives in use include: individual performance plans, team performance plans, cash profit-sharing plans (payouts based on organisational profitability), comprehensive performance plans (awards based on the performance of the company, team and individuals), sales bonus plans, sales commissions and special recognition awards.

iii. ALLOWANCES

Personal allowances are a unique and very important form of compensation in China. Although FIEs are not obliged to provide them, allowances are often regarded as more valuable in the Chinese culture than the cash equivalent. Highly valued cash allowances include transport, meals, clothing and child care allowances.

iv. SOCIAL BENEFITS

Social benefits for Chinese employees can be classified either as mandatory or supplemental. Mandatory benefits are contributed to by both employers and employees as stipulated by China Labour Law and comprise a significant portion of the total compensation. According to the law, these benefits are also required for foreign employees. In most cities this has not been implemented, but social benefits are mandatory for foreigners in Beijing, except the public housing fund, while they remain optional in Shanghai.

Each benefit has its own percentage that is applied to an employees' gross salary. In addition, for most cities in China, a minimum and maximum base range is set and, for gross salaries outside the base range, the contribution percentage is applied to the minimum or maximum base depending on which side the gross salary amount falls. Each city and region sets its own minimum and maximum base amounts, and applies percentages for each benefit.

The following example provides the different social benefit payment types and the percentage of gross salary paid by the employee and employer for Shanghai in 2018.

Chart: Shanghai Social Benefit Contribution (2018)

Social Benefits	Employer Contribution	Employee Contribution
Pension Insurance	20%	8%
Unemployment Insurance	0.5%	0.5%
Medical Insurance	9.5%	2.0%
Workplace Insurance	0.3%	0%
Maternity Insurance	1%	0%
Public housing fund	7%	7%
Total	38.3%	17.5%

*percentages based on gross salary

Source: Sovereign Analysis

Note: The above table is illustrative of Shanghai as of 2018 only. Percentages are based on gross salary. Each city has a different maximum and minimum base as well as contribution percentage. In some cases, the minimum and maximum base can be different for each type of social benefit. It is important to confirm the social benefit base and contribution percentage for the city in which you have established an entity and employ personnel. The minimum and maximum base as well as the percentage contribution changes each year.

Based on the contribution percentages and minimum/maximum base range, the net salary of a Chinese employee, including social benefits contribution, is computed as:

$$\text{Net Salary} = \text{Gross Salary} - \text{Social Benefit Contributions (by employee)} - \text{Housing Fund Contribution (by employee)} - \text{IIT (Individual Income Tax)}$$

The employee cost to the company is calculated by taking the employee's gross salary, and adding the employer social benefit contributions and housing fund contributions. The minimum and maximum base range is applied to the employer contribution percentages. In Shanghai, as an example, the total cost to the company is 38.3 percent above the employee's gross salary, so long as the gross salary is within the minimum and maximum salary range for social benefit contributions.

The below chart provides an example of an employee earning RMB 10,000 per month gross salary in Shanghai. As seen below, an employee with a gross salary of RMB 10,000 per month costs the company RMB 13,830 per month and only receives RMB 8,135 a month as their net salary.

Employer's and Employee's Share of Social Benefit and ITT

Components		Calculation	RMB Total
	Total Cost		13,830
Employer Social Benefit & Housing fund Contribution		Add 3,830 (10,000 x 38.3%)	↑
	Gross Salary		10,000
Employee Social Benefit & Housing Fund Contribution		Deduct 1,750 (10,000 x 17.5%)	↓
Employee Individual Income Tax		Deduct 115*	↓
	Net Salary		8,135

The above is illustrative only and percentages and amounts are subject to change depending on the year and city in which staff are employed.

* For more information on Individual Income Tax, please refer to the next section.

DISABILITY FUND

In addition to employee social benefits contributions, cities in China also require companies to contribute to a disability fund if they do not employ a certain proportion of workers with disabilities. The contribution percentage is different for each city; below is an example illustrating the calculation for Shanghai's Disability Fund Contribution as of August 2018:

$$\text{Shanghai Disability Fund Contribution} = [(\text{Number of Total Employees} \times 1.6\%) - \text{Number of Employees with Disabilities}] \times \text{Previous Year's Average Salary of the Company}$$

The company pays into the disability fund once per year. In Shanghai, for example it is paid in October, while in Beijing the contribution payment is made in July. Cities may change the contribution percentage.

IMPORTANT – PROVIDING A NET SALARY TO EMPLOYEES

Careful consideration must be given to how salary packages are structured for each job role in companies based in China. Some businesses – both domestic and foreign-invested enterprises – seek to reduce their Chinese Individual Income Tax (IIT) and mandatory social security benefits contributions by paying a low gross salary that is then augmented through various reimbursements or allowances as part of a 'net salary' package.

You may be told that this practice is common in China but we strongly advise against net salary packages of this type. In many cases such schemes involve the purchase of inflated or bogus invoices – 'fapiaos' – in exchange for payment. As an employer this could expose your company to significant risk in respect of tax audit or labour law violations. It could also make it extremely difficult to terminate an employee, with or without cause, because the employee can threaten to report. Employee termination is discussed in the next section.

4.4 TERMINATING AN EMPLOYEE AND SEVERENCE PAYMENTS

China's Labour Law requires companies to pay severance unless the employer dismisses its staff for a specifically defined cause, which is stated in the company's Staff Handbook. In other situations, the employer will be required to give 30-days' notice to the employee, or pay compensation, or both as stipulated by the provincial government. The Labour Law also requires companies to consult with the appropriate labour union if they wish to reduce their workforce.

Specifically defined causes for dismissal include those where it can be proved that an employee has:

- Been unable to satisfy the conditions of employment during the probation period
- Materially breached an employer's specified rules and regulations, as stated in the company's staff handbook
- Caused substantial damage to an employer through serious negligence of duty
- Been unable to complete conflicting tasks given by two different employers

A severance payment is not required if an employee fails to agree to a renewed contract that contains the same or better conditions than those stipulated in the current contract.

Where severance payments are required, they are generally equivalent to one month of salary per year of employment with the company (plus one month's notice). For employment periods of less than six months, half of one month's salary would be paid as severance.

IMPORTANT - Employee termination is often an area in which foreign invested enterprises violate China labour law by not following the correct procedures, which usually ends up costing the company a hefty sum. There is a specific process for terminating employees, with or without cause, and even when the process is followed precisely, it does not guarantee that the employee will not file an arbitration case against the company, which usually costs the employee less than RMB 200. It is suggested that any company considering the termination of an employee seek professional advice to minimise potential risk.

4.5 CONSEQUENCES OF BREACHING THE LABOUR CONTRACT LAW

Companies should not breach the Labour Contract Law or take advantage of their employees in any way for short-term gains. Even if an employee does not make a complaint during the period of employment, employers remain liable for damages up to one year after an employee has left a company.

Foreign companies should note that the labour rights of employees are well publicised and understood in China, and costly litigation or settlements are increasing in frequency. HR departments should keep up-to-date with the Labour Contract Law and, if any changes to the working environment or duties are deemed necessary, or a dismissal is required, should ensure that everything is clarified in writing and signed by an employee in advance of action being taken.

China's Labour Contract Law applies to foreign workers only when they are directly employed by an entity registered in China, including both domestic Chinese companies and FIEs. The law does not apply to foreign workers working in China but directly employed by an overseas company.

4.6 CHINA'S 'LABOUR DISPATCH' RULES

'Interim Regulations on Labour Dispatch' were issued by China's Ministry of Human Resources and Social Security (MOHRSS) and came into force on 1 March 2014. It was the first comprehensive labour dispatch regulation issued at ministerial level and introduced several changes to the current rules that have an impact on FIEs.

Under the Interim Regulations, labour dispatching arrangements apply to the following types of position:

- **Temporary:** A position with a duration of less than six months
- **Auxiliary:** A position that provides auxiliary services to the main or core business of the employer
- **Replaceable:** A position that can be performed by a dispatched employee during the period when a permanent employee is away from work for study, vacation or other reasons.

A dispatch contract must state the specific type of position and the number of dispatched employees should not exceed ten per cent of the total number of employees, including both regular and dispatched employees. These rules apply to all the FIEs except ROs, which are not subject to the rules.

The key rules that FIEs should note are:

- **Contract Arrangement:** A contract signed between the labour dispatching company and the dispatched employee should have a fixed employment term of at least two years. With the consent of the dispatched employee, the dispatching company may introduce a probationary employment period in the contract. Dispatching companies are only allowed to arrange a probationary period once with each dispatching employee.
- **"Equal Pay for Equal Work":** According to the Interim Regulations, the principle of "equal pay for equal work" applies to all labour dispatching agreements, such that dispatched employees are entitled to the same remuneration levels as those enjoyed by an employer's direct-hire employees holding similar positions. This includes overtime salaries and bonuses. In the absence of similar direct-hire employees, local market rate salaries should be used to determine the remuneration payable to dispatched employees.
- **Termination of Labour Contracts:** Upon termination of a contract, dispatched employees are entitled to a 30-day notice period (or three days if still within a probationary period). Under the Interim Regulations, an employer may return dispatched staff to the dispatching company due to major changes in objective circumstances, i.e. financial difficulties, dissolution of its host entity or discontinuation of its operations. A labour dispatching company can only terminate an employee's contract if the employee refuses to agree to a new dispatch arrangement that provides equal or better conditions.

Dispatched employees are entitled to local social insurance rates and standards. The local branch of the dispatching company will be responsible for paying the insurance. In the absence of a local branch, the employer must pay the social insurance on behalf of the labour dispatching company.

It is important for FIEs to comply fully with the rules under the Interim Regulations. In the event of a breach of the rules, which must be remedied within a time frame specified by the relevant labour bureau, foreign employers may be liable for fines between RMB 5,000 and RMB 10,000 per dispatched employee.

CASE: 'YOU'RE FIRED!'

An employee of a foreign SME contacted her manager one morning and stated that she would have to take the afternoon off in order to help an uncle move. The company owner said this was unacceptable at such short notice. The manager accordingly warned the employee that failure to work that afternoon would result in termination. The employee left for the afternoon and was terminated. The employee filed a labour arbitration suit against her former employer. At arbitration, she presented a note from a hospital stating that her mother was terminally ill and stated that her reason for leaving that afternoon was the need to visit the hospital.

The employer had not consulted with a lawyer and had failed to provide any evidence substantiating the reason for termination. The employer lost the case.

Even if the employer had been in a position to provide conclusive supporting evidence to the arbitration, it would probably still have lost the case because appropriate termination procedures had not been followed. Unless, for example, its Staff Handbook specifically stated that missing half a day without prior approval was cause for immediate termination, there would be no cause. Further, an employee typically needs to be given a written warning, sometimes more than one, before termination proceedings can begin. It is essential that foreign-invested enterprises in China should issue and maintain a comprehensive Staff Handbook and always follow the proper procedures for termination.

5. INDIVIDUAL INCOME TAX (IIT) IN CHINA

Individuals residing in China are subject to the country's individual income tax (IIT). Estimated taxes payable are generally withheld from wages by employers or a qualified agent and paid to the tax authorities on a monthly basis. Taxes are reconciled annually and the individual is then given a refund or pays taxes due. This guide focuses on the taxation of foreign and local employees' income and how it is taxed.

RECENT REFORMS TO CHINA'S IIT LAW

On 31 August 2018, significant changes were made to the Individual Income Tax Law. Although the reforms covered more than ten areas, the four most impactful are:

- i. The adjustment of the standard deduction and income tax brackets
- ii. Changes to the tax resident rules
- iii. The introduction of general anti avoidance rule (GAAR) for individuals
- iv. Allowing itemised deductions for specific expenses

As the reforms are quite recent, there are still some areas of the law that are unclear; however, clarification and implementation guidelines are expected to be released by the end of October 2018. The adjustment of the standard deduction and income tax brackets are effective as of 1 October 2018, whilst other changes are effective as of 1 January 2019.



i. ADJUSTMENT OF STANDARD DEUCTION AND INCOME TAX BRACKETS

With the purpose of relieving some of the tax burden on individuals with lower income levels, the standard deduction increased from RMB 3,500 to RMB 5,000 per month and the tax brackets for those earning below RMB 35,000 per month were widened. Specifically, the bottom tier tax bracket, with a marginal tax rate of 3%, was widened from RMB 0 to RMB 1,500 per month to RMB 0 to RMB 3,000 per month. Furthermore, the second tier tax bracket, with a marginal tax rate of 10%, was widened and those that now have a taxable income of up to RMB 12,000 per month are paying a marginal tax rate of 10%. Prior to the revision, an individual with a taxable income of RMB 12,000 per month was paying a marginal tax rate of 25%. The table below illustrates the previous tax brackets and compares them with the revised tax brackets. The revision of tax brackets and increasing deduction went into effect on 1 October 2018.

Table: Income Tax Brackets (Figures in RMB)

Previous Tax Brackets (Prior to 1 Oct 2018)				Revised Tax Brackets (Effective from 1 Oct 2018)			
Income from salary and wages				Comprehensive Income*			
Taxable Income (Monthly)	Marginal Tax Rate	Quick Deduction (Monthly)			Taxable Income (Monthly)**	Marginal Tax Rate	Quick Deduction (Monthly)
≤1,500	3%	0	3%	3%	≤3,000	3%	0
1,501 to 4,500	10%	105	10%	10%	3,001 to 12,000	10%	210
4,501 to 9,000	20%	555	20%				
9,001 to 35,000	25%	1,005	25%	20%	12,001 to 25,000	20%	1,410
				25%	25,001 to 35,000	25%	2,660
35,001 to 55,000	30%	2,755	30%	30%	35,001 to 55,000	30%	4,410
55,001 to 80,000	35%	5,505	35%	35%	55,001 to 80,000	35%	7,160
>80,000	45%	13,505	45%	45%	>80,000	45%	15,160

Source: Sovereign Analysis

* The revised income brackets are based on a comprehensive global income, although there are different tax rates for things such as royalties and author's remuneration.

** Previously, taxes were based on monthly income and are now based on annual income. The table breaks down the annual income into a monthly amount for reference only. An individual's actual tax bracket will be based on their annual taxable income.

ii. CHANGES TO TAX RESIDENT RULES

Residency rules primarily apply to foreign individuals. Prior to the revision, foreigners were able to maintain their 'non-tax resident' status by leaving the country 31 contiguous days (not-including travel days) in a five-year period and would only pay IIT on income sources within China. The revised tax law now defines a tax resident as an individual who resides in China for 183 days or more during a tax year. Thus, the effective threshold for tax liability on global income was reduced from five years to 183 days. The changes in the tax resident rules are effective as of 1 January 2019.

This change to the tax law is most concerning for foreign employees, who before were, in practice, not subject to tax on their global earnings and now are.

iii. ANTI AVOIDANCE RULE (GAAR)

Several GAAR have been put into place under the revised tax law. These include, but are not limited to, the additional taxation of transactions that are not deemed to be arms-length, tax avoidance by use of offshore tax havens, and inappropriate tax benefits derived through unreasonable commercial arrangements. Where tax is assessed late, late payment surcharges would also be collected accordingly.

The key tools to tackle tax avoidance are CRS (also known as Common Reporting Standards, of which China is a signatory), public information, tax filing data analytics and information sharing amongst government departments.

iv. ITEMISED DEDUCTIONS FOR SPECIFIC EXPENSES

Under the revised IIT Law Article 6, resident tax payers (i.e. those who have resided in China for 183 days consecutively or cumulatively in a tax year) will be able to make the following deductions from their taxable income:

- Education expenses for children
- Expenses for further self-education
- Healthcare costs for serious illness
- Housing loan interest
- Housing rent
- Support for elderly
- Charitable donations (up to 30% of income).

However, most of the deductible categories are quite broad and it is not entirely clear how deductions are made. For example, what kind of education expenses can be deducted? Is it only their core education expenses, or can other expenses such as extra-curricular courses also be deductible? For housing loan interest and rent, is it for the primary resident only, or does it cover all rental payments and housing loans?

5.1 TAXATION OF LOCAL EMPLOYEES

Local employees are taxed based on the balance of their annual income after deducting their social benefits contribution, Standard Deduction, which as of 1 October 2018 is RMB 60,000 per year, usually amortised over 12 months and other itemised deductions. The calculation for Taxable Income, IIT Payable, and Net Salary is as follows:

$$\text{Taxable Monthly Income} = \text{Gross Salary} - \text{Social Benefits Contribution} - \text{Standard Deduction} - \text{Other Itemised Deductions}^3$$

$$\text{IIT Payable} = \text{Taxable Monthly Income} \times \text{Marginal Tax Rate} - \text{Quick Deduction}^4$$

$$\text{Net Salary} = \text{Gross Salary} - \text{Social Benefits Paid} - (\text{IIT Payable})$$

The employer is obliged to withhold the full tax amount and submit the taxes to the appropriate Chinese authorities on behalf of their employees each month and then perform an annual tax reconciliation, which is to be submitted to the appropriate authorities between March and May in the subsequent year.

The table below details the annual income ranges, marginal tax rates, and annual quick deduction as of 1 October 2018. Quick Deduction amounts are subject to change on a yearly basis:

Taxable Annual Income (RMB)	Marginal Tax Rate	Quick Deduction (Annual)
Not more than 36,000	3%	0
RMB 36,001 to RMB 144,000	10%	2,520
RMB 144,001 to RMB 300,000	20%	16,920
RMB 300,001 to RMB 420,000	25%	31,920
RMB 420,001 to RMB 660,000	30%	52,920
RMB 660,001 to RMB 960,000	35%	85,920
In Excess of RMB 960,000	45%	181,920

Source: Sovereign Analysis

³ As of 1 October 2018, items that can be included as Itemised Deductions are unclear, but clarification is expected in updates to the 2018 IIT Law.

⁴ The actual Marginal Tax Rate and Quick Deduction are based on the annual taxable income. Therefore, when calculating the Marginal Tax Rate and Quick Deduction for the monthly salary, an estimate of the annual income and associated marginal tax rate and quick deduction are used.

5.2 TAXATION OF FOREIGN EMPLOYEES

The IIT liability of foreign individuals in China depends on the individual's duration of stay in China.

A non-resident individual who has worked in China continuously or cumulatively for fewer than 183 days in a tax year is exempt from IIT on their global income and will only be liable for their locally sourced income within China. The Chinese tax year follows the calendar year.

Article 1 of the new IIT Law states that an individual who has resided in China for more than 183 days, consecutively or cumulatively, is now considered to be a 'tax resident' and subject to Chinese IIT on their global income. This replaces the previous five-year rule, in which a foreigner could avoid taxation on their global income by leaving the country for 31 days consecutively in a five-year period. Some of the taxes payable may be mitigated depending on whether or not a double taxation treaty exists between a foreign country and China.

i. REGISTRATION PROCEDURES

If the employee is liable for China tax filing, the following procedures for registration apply and the following documents are required:

- Original salary certificate from overseas employer
- Copy of employment contract
- Copy of all pages of passport

If the employer has a 'permanent establishment' in China then the employee's work permit, and the employer's tax registration certificate and business licence are required.

ii. TAX CALCULATION

Having established which incomes are subject to Chinese IIT, foreign employees are subject to the same tax obligations as local employees. However, depending on the city in which the employee is working, social benefits' contribution may or may not be needed. Some allowances and benefits paid by the employer are currently not taxable. To determine which benefits are not taxed, the company's HR department should speak with a professional services provider.

5.3 ANNUAL INCOME TAX FILINGS

Under the new IIT Law, taxpayers or their representative agent must make an annual income tax filing. The filing is due to the tax authorities between March and May of the following year. The new procedures for the annual income tax filings are expected to be released before January 2019.

5.4 REPATRIATION OF SALARY PAID IN CHINA

Foreign employees may remit their total monthly net salary back to their home country. In order to convert their CN¥ salary into foreign currency, they will be required to present their local bank with proof of income, proof of tax payment, their Alien Employment Permit, as well as other documents.



6. PROTECTING INTELLECTUAL PROPERTY (IP) IN CHINA

Contributed by Harris Bricken Law Firm

China is often perceived as a lawless frontier where anything goes when it comes to intellectual property (IP)⁵. This is somewhat misleading. China has excellent laws that offer a great deal of protection for intellectual property. What it lacks is consistent, effective enforcement of those laws.

Many of China's IP laws are still relatively new. Until recently Chinese companies were not creating much IP, and neither the Chinese government nor Chinese companies saw much value in protecting it. However, as a condition of its accession to the World Trade Organisation in 2001, China was required to harmonise its IP laws with those of Western countries. Although a law can be changed in a single day, understanding and proper enforcement often takes longer.

To be clear, inconsistent enforcement is not the same as non-existent enforcement. Companies that formally register their IP with the appropriate authorities, ensure their contracts with Chinese suppliers are well drafted and perform proper due diligence before selecting their Chinese partners have a fighting chance of preventing third-party infringement. Companies that do none of the above have no one to blame but themselves.

⁵ There is no single definition of intellectual property, but it is generally understood as intangible property resulting from creativity or invention that is protectable either as a trade secret or via copyright, trademark or patent.



6.1 LEGAL PROTECTION

i. TRADEMARKS

China employs a 'first-to-file' system for trademark registration and affords no protection to unregistered trademarks⁶. This can come as a shock to companies that are used to the Anglo-American system, under which a company gains common law rights by virtue of using a brand in commerce. In China, a third party can both register 'your' trademark and prevent you from using it without selling a single product themselves. They may even be able to prevent you from using 'your' trademark in China if all you are doing in China is manufacturing products for export. Such trademark 'squatting' is fairly common and, when it occurs, the options are not particularly appealing: pay a licensing fee to the trademark squatter, buy the trademark outright or change your trademark.

Companies doing business in China should register as a trademark any 'distinctive phrase' or 'logo' used on their products or their packaging, or in the marketing or sale of services. Companies that sell products or services in China should also select and register a Chinese-language mark. No matter how well-known or simple your English-language mark may be, if you don't consciously choose a parallel Chinese-language trademark, then Chinese consumers and retailers will come up with one of their own. And you'll have ceded to someone else the opportunity to name and own your product.

Even companies that aren't doing business in China should consider registering their trademarks in China as a preventative measure. China does not require a trademark owner to prove use in commerce (unless challenged), with the result that a canny trademark owner can craft a large, wide-ranging trademark portfolio in China that arguably offers more protection than in the West. Also, having a trademark registration in China is always helpful (and sometimes necessary) when attempting to remove infringing goods from e-commerce sites like Taobao.

The first mover advantage is considerable and the risks associated with inaction can be high. If you plan to use a brand name in China, register it yourself before someone else beats you to it. It takes approximately 15 months for China's Trademark Office (CMTO) to issue a trademark if everything goes smoothly. While your application is pending, no one can stop you from using the mark, but neither can you legally stop anyone else from using it. The main caveat is that you should not apply too early; a trademark that is not used in commerce for a three-year period is at risk of cancellation.

One important note regarding the above: China's new Trademark Law, which came into effect on 1 May 2014, introduced several changes to trademark protection in China. In theory, these changes have made it easier to (among other things) challenge trademark squatters and improve the efficiency and speed of filing, appealing and opposing trademarks. But the devil is in the detail and we haven't seen any improvements to date in respect of either the efficiency or quality of the CTMO's decisions.

ii. PATENTS

Like every other country in the world, China is a 'first-to-file' country for patent registrations. China is also a party to the Paris Convention, which means that a company that first files a patent application in another Paris Convention signatory nation (i.e. nearly every developed and developing nation in the world) has 12 months to file a patent application in China and 'backdate' its application to the date of the original application⁷.

Patent law is highly technical and is not conducive to distillation into a few sentences, except for the following: any company that plans to sell or manufacture patented products in China should register its patent(s) there⁸; and design patents are becoming increasingly important and should be considered an essential part of any manufacturer's IP portfolio.

⁶ The one exception to this rule is for internationally well-known trademarks, but only brands with name recognition on the level of Starbucks and Nike qualify as 'well-known'. Even Starbucks had to fight a long, costly court battle to prove it was a well-known brand. By contrast, Chinese courts have deemed Dell Computer, Hermès and Chivas Regal not to be well known.

⁷ As of March 16, 2013, the United States (which had been the last holdout) became a "first to file" country with respect to patent registration.

⁸ The Paris Convention grants the same rights to trademark holders, except that they only have six months to file a trademark application.

iii. COPYRIGHT

China protects copyrighted material in much the same way as the Western world. This tends to surprise visitors to China, who have no trouble finding pirated movies, games and albums online. Again, the problem is not the lack of laws, but the lack of enforcement. But things are getting better on this front. Many websites are actively engaged in anti-infringement efforts, not least because the big Chinese streaming sites have started paying real money for the rights to stream content, which makes them suddenly very interested in taking down pirated content.

A creative work first published in another country (the US, for example) automatically gains copyright protection in China upon its creation. No formal registration is required; however, just as in the US, it is advisable to register copyrights in China, because doing so provides better evidence of ownership and stronger enforcement remedies. A toy company worried about a Chinese company manufacturing copycat dolls for export should register its copyrights in China, because doing so will allow the copycat goods to be seized at customs. A film company worried that a Chinese company will remake its movie should copyright the script, because doing so would allow the true owner to block a copycat movie⁹.

iv. CUSTOMS

Simply registering your trademarks, patents or copyrights will not limit the spread of counterfeit goods. Registration merely gives you the legal capacity to enforce your rights to that IP, and should therefore be seen as just one of the pieces in an overall strategy.

For any company that is concerned about counterfeit goods coming from China, the next step after registering IP should be registering that IP with China Customs. This is not a legal requirement but a practical one. Customs officials have discretion to check every outgoing shipment for trademark, copyright, and patent infringement, but in reality they only check against the Customs' database. No separate registration with Customs therefore means no enforcement by Customs.

If you register your mark with China Customs, it will contact you if it discovers a shipment of potentially infringing goods. At that point you have three working days to request seizure of the goods. Assuming you request seizure (and post a bond), Customs will inspect the goods. If Customs subsequently concludes the goods are infringing, it will invariably either donate the goods to charity (if the infringing mark can be removed) or destroy the goods entirely. The cost of destruction and of storing the goods during the inspection process will be deducted from your bond.

Registration with China Customs takes approximately five months and can only be done after your trademark, patent or copyright is registered. In other words, the sooner you start the process of registering your IP, the sooner Chinese Customs could be helping to stop counterfeit goods from being exported from China.

6.2 CONTRACTUAL PROTECTION

i. NON-DISCLOSURE AGREEMENTS

Any foreign company entering the Chinese market should have a written contract with its Chinese counterpart that addresses IP protection. The most familiar example of such a contract is the non-disclosure agreement (NDA) that many companies require prospective suppliers, designers or employees to sign before sharing sensitive or secret information.

However, a typical 'off the shelf' NDA used by many foreign companies is insufficient and often completely ineffective in China. Foreign companies should instead insist that their Chinese partners sign non-disclosure/non-use/non-circumvent agreements (often called NNNs) specially crafted for use in China, along the following lines:

- **Non-disclosure Agreements:** Non-disclosure to an unrelated third party in China is fairly uncommon. The bigger risk is disclosure to a related third party. Many Chinese businesses have multiple subsidiaries, and manufacturing is often done through a large network of sub-contractors. Chinese companies are quite relaxed about passing around information within this network. A good NDA must therefore focus on control of information within a network that the Chinese manufacturer itself may not consider as falling within the scope of a non-disclosure requirement.

⁹ Although in theory, the local State Administration of Radio, Film and Television (SARFT) would block such a film before it even began, because every script must be submitted to SARFT for approval prior to filming.

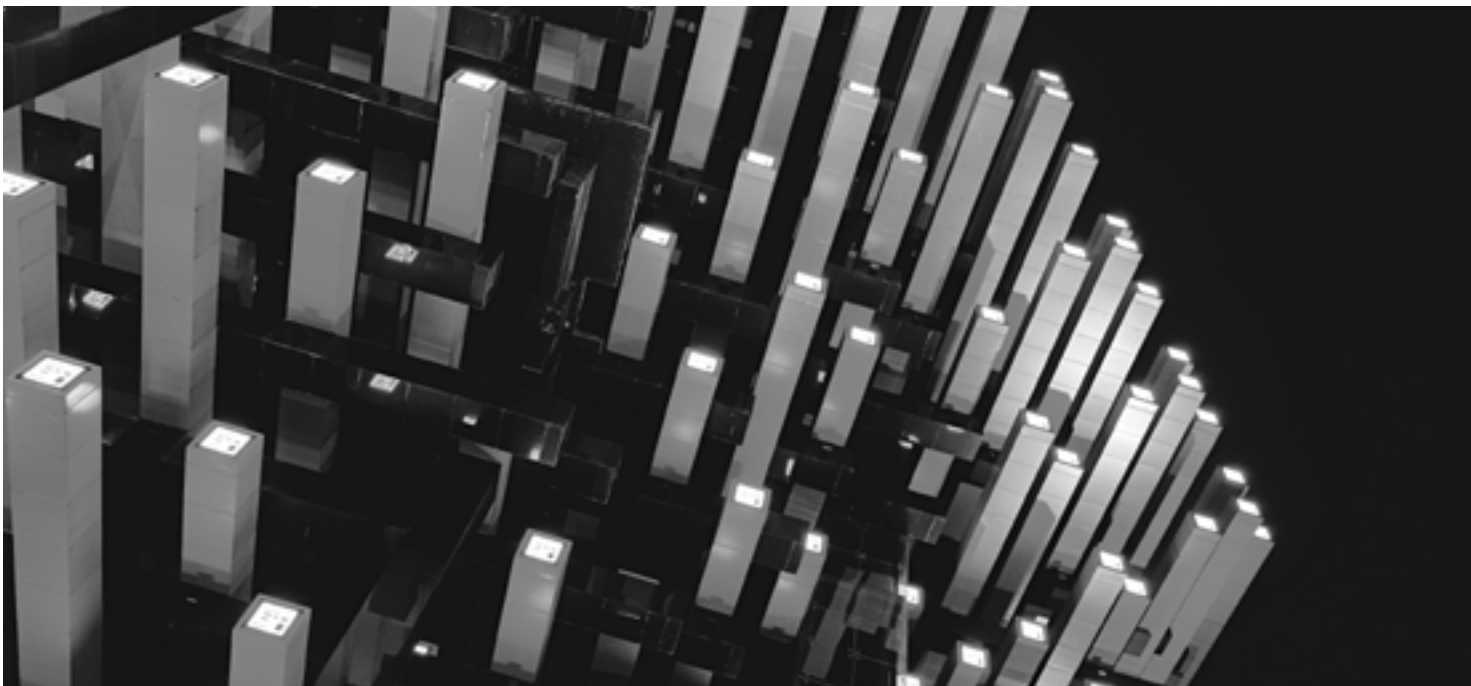
- **Non-use Agreements:** Often, a foreign company's biggest concern is that a Chinese manufacturer will use its IP to compete against it. For this purpose a non-use agreement is required. A good non-use agreement focuses on two issues. First, the agreement identifies the applicable IP of the foreign company and authorises the Chinese manufacturer to use that IP solely to manufacture the product for the foreign company. Second, the agreement requires the manufacturer to agree not to manufacture the product or any similar product under any circumstances, other than for the foreign company. This second provision is the most important because it prevents the Chinese manufacturer from manufacturing a similar product under its own trademark. Many companies have products that are only protectable as trade secrets because there is nothing to patent or copyright. A non-use agreement is the only way to prevent copycat manufacturing.
- **Non-circumvention Agreements:** A foreign company does not want a Chinese manufacturer to undermine it by selling the product directly to its existing or future customers. This is called circumvention and it is extremely common in China. A non-circumvention agreement is required to avoid getting 'cut out' in this way.

ii. ENFORCEABILITY

Even the best agreement is of no use unless it can be enforced in China, another fatal flaw of most off-the-shelf NDA agreements. Any agreement governed by non-Chinese law with enforcement by litigation or arbitration outside of China is almost always useless. US courts rarely have jurisdiction over Chinese companies and therefore a judgment from a US court is of no value. Similarly, arbitration outside of China is expensive and slow and a non-Chinese arbitral body cannot impose an injunctive remedy in China.

Foreign companies can take several steps to increase their chances of having an NNN agreement that will actually be enforced in China. The contract, which must be accurately translated into the Chinese language, should provide for enforcement through litigation in a Chinese court or through arbitration with a recognised Chinese arbitral body such as the China International Economic and Trade Arbitration Commission (CIETAC). The contract should also identify specific monetary damages that will be awarded in the case of a breach. Unlike common law jurisdictions, China encourages specific contract damage provisions because they simplify the court's work. Moreover, specific damage amounts make the cost of a breach clear to the Chinese manufacturer and will go a long way towards discouraging a breach. This assists in quick and effective dispute resolution, which is much to the advantage of the damaged party.

Ultimately, well-crafted NNNs are effective in China for three reasons. First, they help to weed out those Chinese companies that intend to steal foreign companies' IP. Such companies are happy to sign a poorly drafted, unenforceable agreement, but are not so eager to sign a contract that could be used against them. Second, legitimate Chinese companies do not like to be sued any more than companies in the rest of the world, and will seek to avoid a lawsuit when the odds are stacked against them. Third, Chinese courts are increasingly familiar with NNNs and will generally enforce them.



6.3 PRACTICAL PROTECTION

Foreign companies entering China should not leave common sense at the border. When selecting a Chinese company to work with, they should exercise the same due diligence (if not more) as in their home country. Look up the Chinese company on the Internet. Find out what sort of reputation they have. Contact other companies that have previously worked with a Chinese company. Visit the factory or the offices, or both. Meet with the Chinese company's executives and managers. Do a corporate records' search. If things don't stack up, it's probably because there's something amiss.

Foreign companies should also institute a clear and consistent policy for sharing confidential information, and insist that the Chinese company does the same. For instance, mark all confidential information as secret. Ensure the Chinese company acknowledge receipt, in writing, of all such information. Strictly limit access to such information to people who need to use it. Confidential information that is treated in the same way as non-confidential information ceases to be confidential. And in most cases involving theft of trade secrets, the culprit is an employee.

Finally, when you have entered the Chinese market, continue to monitor your IP closely. Pay attention to what your Chinese partners are doing, the manner in which your IP is being used and the actions of your competitors. You cannot rely on your Chinese partners to do this work. Like every other company in the world, your Chinese partner has its own agenda and that agenda may not coincide with yours.

CASE: THE SHANZHAI IP AGENT

A North American food company that had become quite successful selling its food product in China learned that a company in Beijing was selling counterfeits of its product. Believing it had registered its trademark in China, the North American company began preparing to sue the Beijing company. In the process of doing so, the North American company learned that while it had retained and paid a purported trademark agent to file a trademark, it had never received a trademark certificate and the 'trademark agent' had in fact taken their money and done nothing.

Without a registered trademark in China, the North American company was powerless to stop the counterfeiter. Its only option was to register its brand name as a trademark, wait more than a year until the trademark proceeded to registration, and then send out a cease and desist letter.

The best way to protect your brand name in China has not changed: register the brand name as a China trademark at the earliest opportunity, so that you already have the registered trademark in hand if you need to defend it. And don't be afraid to ask for references. Reputable service providers will not hesitate to give them.





8. SOVEREIGN GLOBAL OFFICES

BAHAMAS

Tel: +1 242 322 5444
bh@SovereignGroup.com

BAHRAIN

Tel: +973 17 1515 71
bahrain@SovereignGroup.com

BRITISH VIRGIN ISLANDS

Tel: +1 284 495 3232
bvi@SovereignGroup.com

CAYMAN ISLANDS

Tel: +1 949 7555
cay@SovereignGroup.com

CHINA, BEIJING

Tel: +86 10 5661 7052
china@SovereignGroup.com

CHINA, SHANGHAI

Tel: +86 21 5211 0068
china@SovereignGroup.com

CYPRUS

Tel: +357 25 733 440
cy@SovereignGroup.com

GIBRALTAR

Tel: +350 200 76173
gib@SovereignGroup.com

GIBRALTAR - YACHT REGISTRATION

Tel: +350 200 51870
ray@SovereignGroup.com

SOVEREIGN ACCOUNTING SERVICES (GIBRALTAR) LIMITED

Tel: +350 200 48669
sasgib@SovereignGroup.com

SOVEREIGN WEALTH

Tel: +350 200 41054
sw@SovereignGroup.com

SOVEREIGN INSURANCE SERVICES LIMITED

Tel: +350 200 52908
sis@SovereignGroup.com

GUERNSEY - TRUST & PENSIONS

Tel: +44 1481 729 965
ci@SovereignGroup.com

HONG KONG

Tel: +852 2542 1177
hk@SovereignGroup.com

ISLE OF MAN

Tel: +44 1624 699 800
iom@SovereignGroup.com

MALTA

Tel: +356 21 228 411
ml@SovereignGroup.com

MAURITIUS

Tel: +230 244 3210
mu@SovereignGroup.com

PORTUGAL

Tel: +351 282 340 480
port@SovereignGroup.com

SEYCHELLES

Tel: +248 4321 000
sc@SovereignGroup.com

SINGAPORE

Tel: +65 6222 3209
sg@SovereignGroup.com

SOUTH AFRICA

Tel: +27 21 418 2170
sact@SovereignGroup.com

SWITZERLAND

Tel: +41 21 971 1485
ch@SovereignGroup.com

TURKS & CAICOS ISLANDS

Tel: +1 649 946 2050
tci@SovereignGroup.com

UNITED ARAB EMIRATES, ABU DHABI

Tel: +971 4 270 3400
dubai@SovereignGroup.com

UNITED ARAB EMIRATES, DUBAI

Tel: +971 2418 7640
ad@SovereignGroup.com

UNITED KINGDOM, LONDON

Tel: +44 20 7389 0555
uk@SovereignGroup.com

UNITED KINGDOM - AIRCRAFT REGISTRATION

Tel: +44 20 7389 0555
rana@SovereignGroup.com

UNITED KINGDOM, WIRRAL

Tel: +44 151 328 1777
ukpensions@
SovereignGroup.com



SHANGHAI OFFICE

Suite 805, Tower A, Guangqi Culture Plaza
2899 Xietu Road, Xuhui District
Shanghai, China 200030

Tel: +86 21 5211 0068
Fax: +86 21 5211 0069

BEIJING OFFICE

Office 613 6/F, No. 6 Zhongyu Plaza North
Workers' Stadium Road, Chaoyang District
Beijing, China 100027

Tel: +86 10 5661 7052
Fax: +86 10 6582 0251

china@SovereignGroup.com

SovereignGroup.com/China