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An Introduction to

Doing Business in China 2021

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This edition of Doing Business in Hong Kong was produced by a team of professionals at Dezan Shira & Associates, with Zhou Qian as technical editor.
Creative design of the guide was provided by Aparajita Zadoo.

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About Dezan Shira & Associates

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

Preface

ALBERTO VETTORETTI
Managing Partner
Dezan Shira & Associates

The year 2020 was challenging for businesses around the world. With the COVID-19 pandemic breaking out early in the year, and still ongoing, companies around the world have had to make difficult decisions.

Nevertheless, China emerged stronger and more resilient as an investment destination, having suffered through the worst of the outbreak in the initial months of 2020. China's successful containment of the coronavirus outbreak within its borders enabled the quick recovery of its economy. This was further helped by the country's stable social environment, integrated industrial system, efficient and advanced service and logistic networks, well-educated human resources, as well as a sizeable domestic market. For many companies, China is now their largest market for growth.

Yet, Beijing is determined to attract all kinds of investors by relaxing more market access restrictions and continuously introducing improvements to the business and regulatory environment. With the *Foreign Investment Law* coming into force last year, together with the revision of the Negative Lists, as well as other reforms in the areas of company establishment, tax, finance, reporting and compliance management, foreign investors are playing on more even ground with domestic competitors.

Under these circumstances, it is important for investors to get familiar with the changes in China's business landscape, identify areas of risk, and take steps to prepare for new market opportunities. Only in this way, investors can stay nimble in an otherwise challenging time.

Designed to introduce the fundamentals of investing in China, this publication is compiled by the experts at Dezan Shira & Associates, a specialist of foreign direct investment, providing corporate establishment, business advisory, tax advisory and compliance, accounting, payroll, due diligence, and financial review services to multinationals investing in emerging Asia.

Since its establishment in 1992, the firm has grown into one of Asia's most versatile full-service consultancies with operational offices across China, Hong Kong, India, Singapore, Vietnam, and Indonesia. The firm also maintains partner firms across the ASEAN region and client liaison offices in the United States, Europe and Russia.

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Table of Contents

1

Establishing and Running a Business

- What are my options for investment?
- How do I establish a business?
- How do I make changes to my business?

What are my options for investment?

SABRINA ZHANG
Partner
Beijing Office
Dezan Shira & Associates

"Choosing an investment structure depends largely on your goals in China. For companies looking to target the Chinese consumer, the foreign-invested commercial enterprise (FICE) has become the gold standard investment model."

Foreign investment into the People's Republic of China (hereafter "China") can be made via one of several types of investment vehicles. Choosing the appropriate investment structure for your business depends on a number of factors, including its planned activities, industry, and investment size.

In this section, we discuss:[1]

- Representative office (RO);
- Wholly foreign-owned enterprise (WFOE);
- Joint venture (JV); and
- Other options.

We will also discuss the impact of the *Foreign Investment Law* (FIL) on choosing the investment structure.

Representative office (RO)

An RO is an attractive way for foreign investors to get a feel for the Chinese market as it is the easiest type of foreign investment structure to set up. Unlike more robust vehicles, such as the WFOE, an RO is an extension of the foreign company without independent legal personality. That is to say, it does not possess the capacity for civil rights and cannot independently assume civil liability. When an RO signs a contract, it is the foreign company that is bound by the agreement.

Besides, there are only a limited number of activities an RO is permitted to be engaged in. ROs are generally forbidden from engaging in any profit-seeking activities and may only be used to facilitate the activities of the foreign company in China. These are:

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

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

In addition, as an RO is not a capitalized legal entity in China, it is limited in its hiring ability. An RO cannot directly hire Chinese employees. Instead, it is required to employ local staff through a qualified labor dispatch agency. The agency acts as the employer for legal purposes, and sends employees to work at the RO for a fee. An RO may directly hire up to four foreign nationals as the representatives, and these do not need to go through the agency.

Even though an RO does not earn revenue, it is still subject to Chinese tax. ROs are taxed as a permanent establishment in China, which usually amounts to a liability of approximately eight percent of the total expenses of the RO.

[1] Under the FIL, the terms of the WFOE Law and the JV Law are no longer binding. Nevertheless, we still use WFOE and JV to refer to relevant investment forms for consistency and easier communication.

RO is generally a good solution for companies that are procuring from China and want to keep staff on the ground for quality control, or for maintaining short communication lines with China-based suppliers, agents, and distributors.

Wholly foreign-owned enterprise (WFOE)

A WFOE is a limited liability company wholly owned by one or more foreign investor(s), which offers a very straightforward management structure.

Unlike an RO, a WFOE can make profits and issue local invoices in RMB to its suppliers. A WFOE can employ local staff directly, without any obligations to employ the services of an employment agency. A WFOE can also expand to create subsidiaries in China.

And compared to a JV, a WFOE has better autonomy and flexibility to execute the company policies intended by the investors without considering the Chinese partner. It is also believed to be better at protecting the company's intellectual property and technology.

However, the set-up procedure of a WFOE is more complicated. And WFOE is not feasible if the targeted sector is listed as "restrictive" in the *Special Administrative Measures on Access to Foreign Investment ("National Negative List"*) or the *Free Trade Zone Special Administrative Measures on Access to Foreign Investment ("2020 FTZ Negative list")*, where foreign investors need to have a Chinese equity partner to form the business. In other words, incorporating a WFOE to engage in these sectors would not be permitted. Investors that try to do so will see their application denied. WFOEs that engage in these activities illegally after being incorporated face fines or even the cancellation of their business license.

There are three distinct WFOE setups available:

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

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

Joint venture (JV)

A JV is formed by one or more foreign investor(s), along with one or more Chinese party(-ties). Previously, Chinese individuals are explicitly excluded to be the shareholders in a JV with few exceptions. However, under the new FIL, which took effect from January 1, 2020, this limitation was no longer existed. Chinese individuals could jointly invest with foreign investors, which offers more flexibility in choosing business partners.

There are mainly two reasons for foreign investors to choose a JV structure:

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

Before the FIL enacted, there were two types of JVs in China, and they differ primarily in terms of how profits and losses are distributed:

1. Equity Joint Venture (EJV):

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

2. Cooperative Joint Venture (CJV):

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

With the new FIL coming into force, the newly established JVs will be subject to the provisions of the *Company Law*, which implies changes in many aspects, such as governing structure and operating rules. However, JVs established before January 1, 2020 following the old *EJV Law* or *CJV Law* will have a five-year transitional period to arrange relevant transitions to be compliant with the new requirements.

VIVIAN MAO
Partner
Shanghai Office

“An RO is an extension of a parent foreign enterprise, and does not form its own separate legal entity. They are often used by foreign companies to facilitate activities in China, such as communicating and liaising with China-based agents and distributors.”

Foreign invested commercial enterprise (FICE)

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

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

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

Other options

Foreign invested partnership (FIP)

An often-overlooked option is the FIP, which was introduced in 2010. As the name suggests, this entity requires two or more investors to conduct business together. The option would therefore not work for foreign investors looking to set up an entity over which they have 100 percent control. In addition, foreign investors cannot engage in sectors subject to equity limitations as provided in the negative lists via an FIP.

An FIP can be newly established by foreign investors contributing to the partnership, or by acquiring the equity interests in an existing domestic partnership.

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

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

In practice, FIPs sometimes are used by foreign private equity funds to manage money in China through limited partnerships.

Variable interest entity (VIE)

VIE structures are adopted by many foreign investors to engage in sectors that are restricted or prohibited to foreign investment in China as provided in the negative lists, such as telecommunication and education.

Under this model, foreign investors retain final control over the China domestic operating entities through a series of contractual arrangements rather than direct shareholding. Consequently, there are risks that the investors' control over the structure might be threatened by the intentional breach of the contractual arrangements.

In addition, the government's attitude towards VIE structure remains vague. There is no clarification in the new FIL whether it is legitimate and whether it falls within the scope of 'foreign investment'. However, in a recent legislative draft regarding pre-school education, VIE structure is explicitly prohibited in the sector. VIE structure could be regarded as illegal in such sectors that are not yet open to foreign investment. Moreover, some recent cases show that the SAMR is strengthening the anti-monopoly review for merger and acquisition with a VIE structure.

Comparison of Different Investment Options

Investment options	Common purpose(s)	Pros	Cons
RO	• Market research • Liaise with overseas headquarters	• Easiest foreign investment structure to set up • Paves way for future investment	• Cannot invoice locally in RMB • Must recruit staff from local agency; no more than four representatives • Heavily taxed if expenses are high
WFOE	• Manufacturing • Servicing • Trading (if a FICE)	• Greater freedom in business activities than RO • 100% ownership and management control	• Registered capital requirement (for select industries) • Lengthy establishment process
JV	• Entering industries that by law require a local partner • Leveraging a partner's existing facilities, workforce, sales/ distribution channels	• See common purposes	• Split profits • Less management control than a WFOE • Technology transfer/IP risks • Inheriting partner liabilities
FIP	• Investment vehicle • Servicing	• Allows for domestic and foreign ownership • Easier setup	• Unlimited liability of the general partner • Newness of structure (potential challenges with taxation or foreign currency exchange)

The impact of the Foreign Investment Law

On March 15, 2019, China passed a new *Foreign Investment Law* (FIL), a landmark legislation whose stated aim is twofold: improve the business environment for foreign investors and ensure that foreign invested enterprises participate in market competition on an equal basis. The FIL came into effect on January 1, 2020 and thus became a new guiding document governing foreign investment in China.

For foreign investors who maintain operations in China, or plan to enter the market, figuring out the impact of the new FIL on their plans is a business-critical task.

Among the incentive, management, and protection measures introduced, Article 31 and Article 42 of the new FIL clarify issues related to the organizational form, governing structure, and operating rules for foreign investments.

According to Article 31 of the new FIL, the organizational form, governing structure, and operating rules of FIEs shall be subject to the provisions of the *Company Law,* the *Partnership Enterprise Law*, and other applicable laws, in the same way as enterprises established by domestic investors are treated.

According to Article 42 of the new FIL, the *Law on Wholly Foreign-owned Enterprises* (WFOE Law), the *Law on Sino-foreign Cooperative Joint Ventures* (CJV Law), the *Law on Sino-foreign Equity Joint Ventures* (EJV Law) shall be repealed simultaneously when the new FIL came into force on January 1, 2020.

However, FIEs established before the FIL took effect - and in accordance with the three laws on WFOE, CJV and EJV - may keep their original organizational forms for five years after January 1, 2020.

For foreign investors who are looking to establish new operations in China, the impact of the new FIL is limited.

Firstly, and most importantly, foreign investors planning to enter the market need to learn more about the investment structures that are available. As mentioned, previous investment structures, such as a CJV, will no longer exist since the FIL came into effect. Foreign investors need to set up their businesses in accordance with the provisions of the *Company Law*, the *Partnership Enterprise Law*, and other applicable laws, similar to domestic investors.

On the one hand, the unified treatment of foreign domestic investments will make the investment path less complicated in the long run. However, on the other hand, it also means that anything foreign investors have learned about investment structures in China has become partly outdated.

Foreign investors should pay close attention to relevant legislative updates and seek professional advice before making an investment following the implementation of the FIL.

RELATED READINGS

The New Foreign Investment Law in China
China Briefing Magazine
July, 2019

China passed a new *Foreign Investment Law* in March 2019. The law establishes a new framework to govern foreign investment in China and addresses a number of common concerns among overseas businesses. Critics, however, have questioned the extent to which the law addresses these issues in practice, pointing to the law's at times broad and vague language. This issue of China Briefing magazine offers a comprehensive analysis of China's new *Foreign Investment Law*.

AVAILABLE HERE

How do I establish a business?

FANNY ZHANG
Manager
Business Advisory Services
Beijing Office

“Setting your business up right from the start can save a lot of hassle in the long run.”

When establishing a company in China, it is highly advisable to seek professional assistance to guide you through the complex setup procedure and outline the roles and responsibilities of key positions in the company. This can be a critical factor in ensuring the success of the venture and avoiding time-consuming changes to the company later on down the line.

In this section, we discuss:

- Pre-establishment considerations;
- Corporate establishment;
- Key positions in a foreign invested entity;
- Office premises requirements;
- Opening a bank account; and
- Intellectual property.

Pre-establishment considerations

Business scope

The business scope is an enumeration of the commercial activities in which a business is authorized to operate in. It is administered by two state bodies - the Ministry of Commerce (MOFCOM) and the local Administration for Market Regulation (local AMR)[1] - and is printed on its business license along with other registered information such as its name, registered capital, and legal representative.

For foreign businesses, it’s imperative that the company operations must be reflected accurately in the business scope. Under the current laws and regulations, foreign investors are still restricted or prohibited to engage in certain sectors, as stipulated in the Special Administrative Measures on Access to Foreign Investment (2020 edition) (National Negative List) and the Free Trade Zone Special Administrative Measures on Access to Foreign Investment (2020 edition) (FTZ Negative List).

In addition to the legal risk of disingenuously operating in an unregistered domain, not keeping the company’s commercial operations within the range of activities set out in its registered business scope can also be detrimental to a company’s ability to issue official invoices (fapiao) to its clients. While a company still can issue fapiao for occasional activities out of the business scope, regular discrepancies may trigger potential tax investigations. It is therefore critical that companies carefully plan their business scope prior to initial incorporation in China, or else risk having to undergo the onerous and time-consuming process of changing this later.

Depending on the business scope, FIEs can be classified as being a manufacturing company, a service company, a foreign invested commercial enterprise (i.e. a trading company), regional

[1] In 2018, China announced a sweeping restructuring of its government institutions, under which the the State Administration for Industry and Commerce (SAIC) was integrated into the State Administration for Market Regulation (SAMR). In practice, SAMR and its local branches might still be referred as AIC as the body in charge among business society.

headquarters, an R&D center, an investment company, or several others. Often, the capital requirements will differ depending on the type of company that is being incorporated.

Registered capital

Registered capital is the fund all the shareholders contribute or promise to contribute to the company when they apply to the local Administration of Market Regulation (AMR) for incorporation of the company. The amount of the registered capital depends on a range of factors, which include the region, the sector, the company's business scope, the planned scale of operations, etc. It will show in the company's business license, this information is available to the public to show the fund strength or capacity of a company to some extent.

The registered capital does not need to be paid completely up front. The previous system of paid-up capital has been replaced by a subscribed capital model, under which a schedule of contributions must be declared in the Article of Association and be registered with the local AMR in charge. The government will check whether the investors follow the capital injection plan.

There is no minimum registered capital requirement for corporate establishment except few industries, such as banking, financing, insurance, etc. Despite this, in practice, the governing authorities will ensure that a company's registered capital is sufficient to support its business operations for at least one year, including its rent, labor costs, and office expenses.

Moreover, the registered capital can affect the amount of offshore debt the FIE can borrow from other investors or foreign banks, if the FIE chooses to follow the ratio between registered capital and total investment[1] as shown in the following chart. The upper limits of the offshore debt is the gap between the total investment and the registered capital.

Investment to Capital Ratios

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

[1] *Offshore debt can also be decided by another method called "macroprudential management of foreign debt" method, the calculation of which is more complicated.*

Registered capital contributions can be made in cash, as a lump sum, or in installments. However, locally obtained RMB cannot be injected as registered capital – it must be contributed from outside China by the overseas investor. The company's payment schedule for contributions must be specified in its Articles of Association, and once paid, the amount cannot be freely wired out again.

Expense and tax planning

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

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

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

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

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

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

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

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

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

Location

Choosing a location is one of the first decisions that companies must make when entering a new market. Location and a strategic site selection plan can have a major impact on the success of the business, affecting production, operation, and sales. Therefore, companies must take steps to ensure they have the right information before committing their time and money.

Some locations offer more preferential policies to foreign investment based on the local economic priorities, such as the pilot free trade zones (FTZs). By far, China has established 21 FTZs, which constitutes part of China's efforts to transform into a more innovative, service, and consumption-driven economy and the creation of sustainable and high-end manufacturing capacity to attract international businesses.

However, investors are not suggested to make decisions solely based on preferential policies. Rather, there are multiple considerations that companies must grapple with when choosing a location, including but not limited to real estate, infrastructure, supplier and customer market, cost, operating environment, legal and regulatory environment, and human resources.

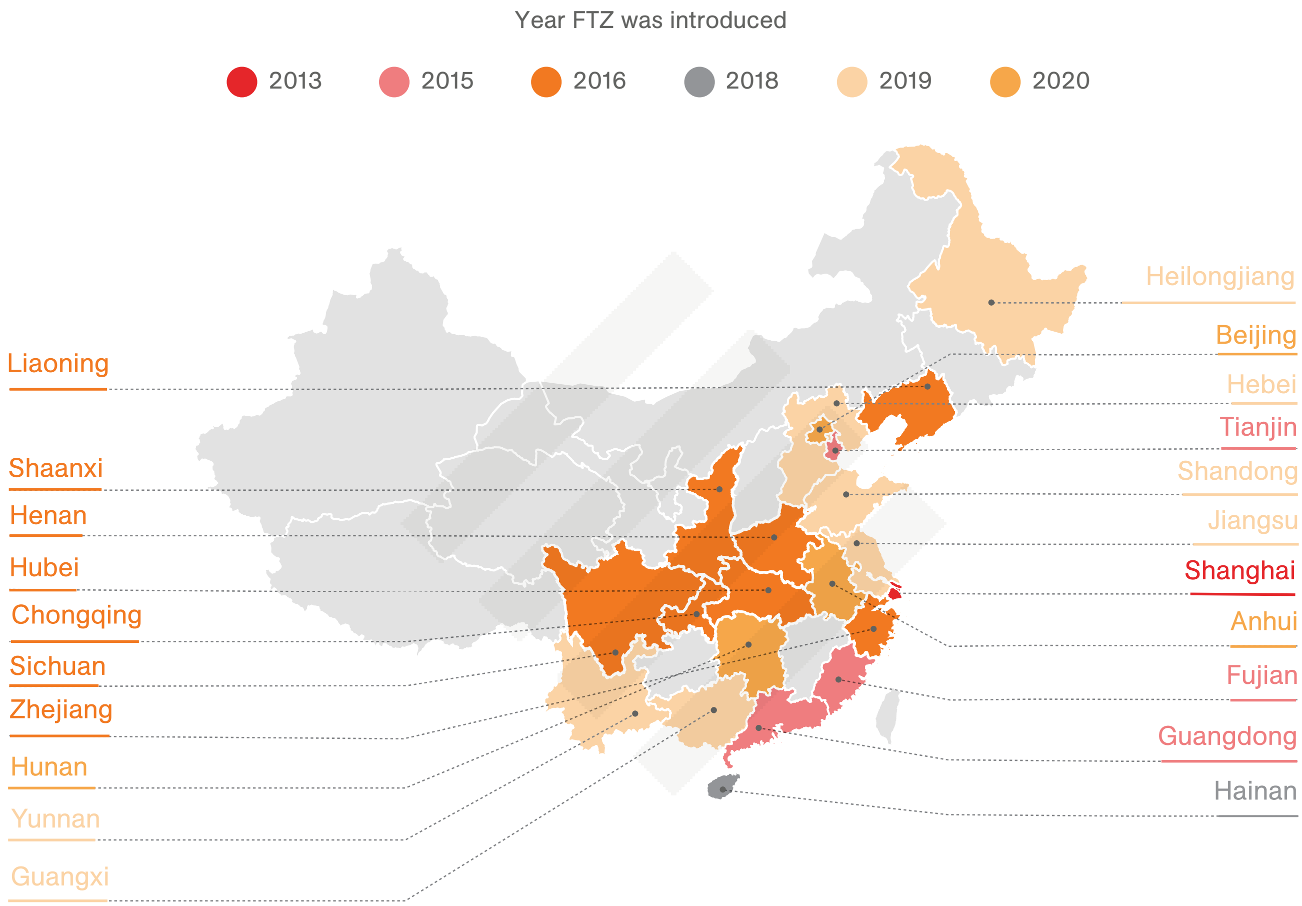
Below, we share some tips on location selection:

Establish search metrics

The most important factor in site selection is the specific needs of the enterprise, which can be refined into the enterprise's business priorities and goals. Generally, businesses usually consider the below metrics during location selection:

- Cost metrics – real estate (such as rental or purchasing cost or site and building amenities), utilities (water, gas, or power), labor costs (including social insurance);
- Supply Chain – number of upstream and downstream enterprises, number of competitors;
- Connectivity – major infrastructure, transportation options, ease of access to customers and suppliers;
- Work force – availability of skilled workers, labor productivity;
- Legal environment – industry permit or certifications, special requirements on targeted industries; and,
- Incentives – tax, financial supports, visa.

FTZs in China as Updated in 2020: New Zones and Expansion



Analyzing your shortlist

Enterprises need to conduct an in-depth analysis of their search findings, and chose the most suitable options based on the business priorities and goals set at the beginning.

At this stage, some quantitative tools, such as a table to weigh all the metrics based on the significance, can be really helpful when the decision maker is flooded by the data gathered and has difficulty to make any evaluations. Enterprises are also advised to seek professional services for at least this step, to take advantage of the insight of independent advisors.

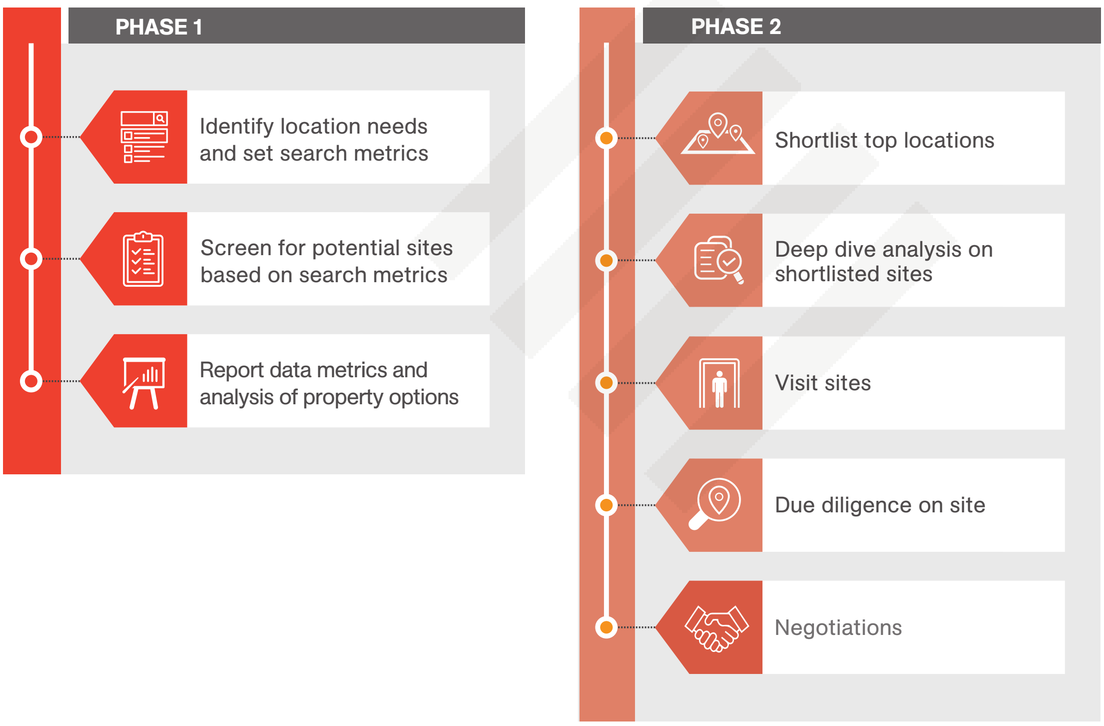
Due diligence for property options

After collating information based on the search metrics, a business will likely get several potential options. The final step is to conduct a due diligence check on the shortlisted properties or preferred destination. This is particularly important for businesses entering a new region.

For example, an industrial park might have wonderful promotion brochures for marketing, but the infrastructure or the facilities are nothing like those printed on paper. The property option might not have the proper landowner certifications. In worst-case scenarios, the incentives promised by the authority-in-charge might not be in compliance with the national policies.

Given these risks, a due diligence check in advance is not a simple procedural step, but serves as necessary and important measures to save investors from potential troubles.

A Typical Location Search Service Process



Corporate establishment

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

- Ministry of Commerce (MOFCOM) and its local branches;
- State Administration for Market Regulation (SAMR) and its local branches;
- State Administration of Foreign Exchange (SAFE) and its local branches;
- State Taxation Administration (STA) and its local branches;
- General Administration of Customs (GAC) and its local branches; and
- National Bureau of Statistics (NBS) and its local branches.

The establishment process varies based on one's chosen investment structure and planned business scope. For example, manufacturing WFOEs require an environmental evaluation report be completed, while trading WFOEs need to comply with the customs/commodity inspection requirements.

Holding company

Many companies choose to establish holding companies, or "special purpose vehicles", in jurisdictions, such as Hong Kong or Singapore, to hold their Chinese entity. Holding companies allow for an additional layer of distance between the Chinese subsidiary and parent company, and can "ring-fence" the investment to an extent, protecting it from the potential risks and liabilities of the Chinese subsidiary. In the case that an investor wishes to sell their Chinese business, or introduce a third-party partner/shareholder into the structure, the administrative changes can also be done at the holding company level, rather than at the China level, where the regulatory environment is tougher and procedures are more time-consuming.

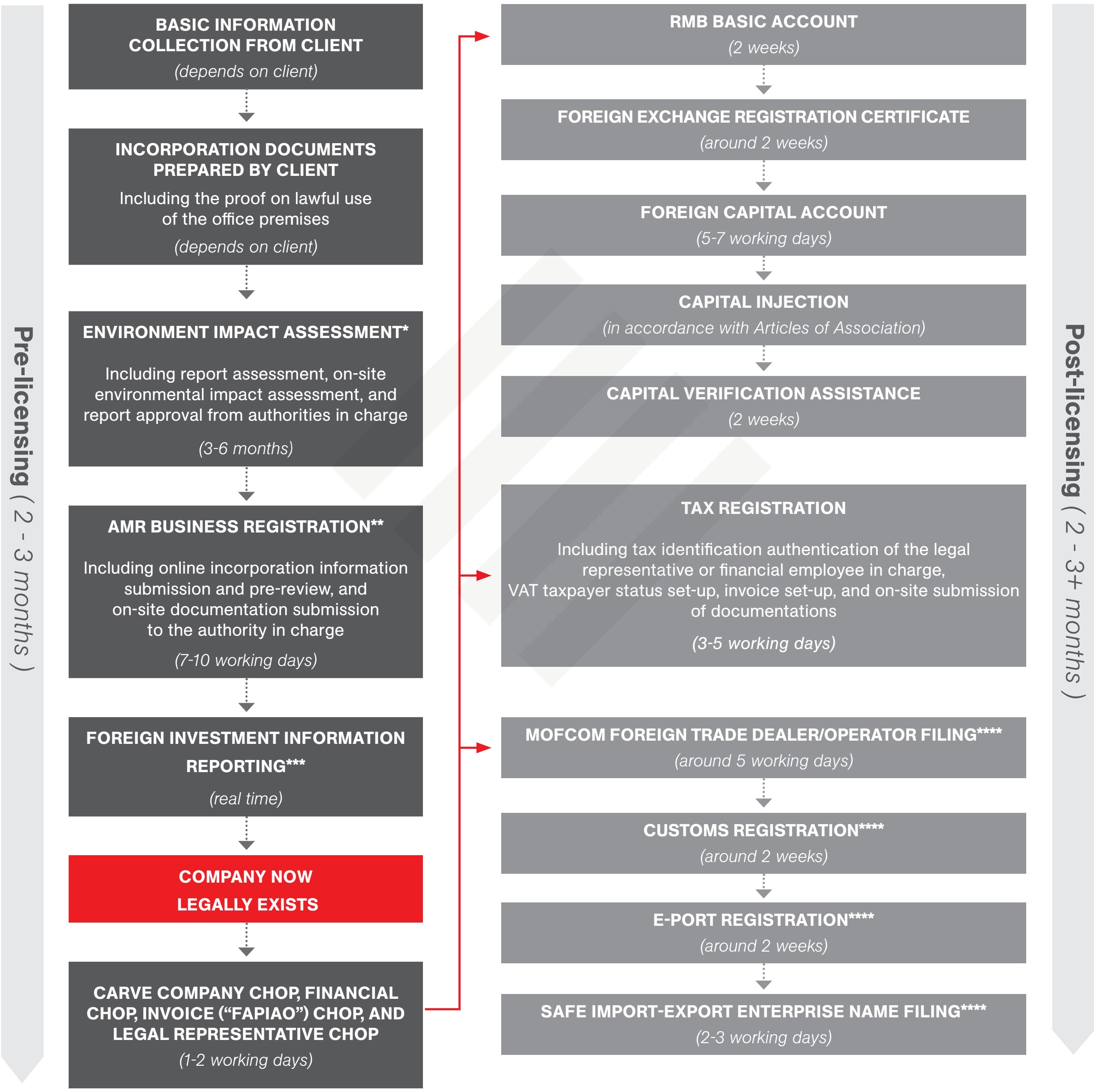
Given the comparatively sophisticated banking systems of Hong Kong and Singapore, establishing a holding company in either jurisdiction is a popular option for foreign companies wishing to hold their China-earned profits offshore. In this way, the profits can be re-invested into China if the need arises, or used to further expand operations elsewhere in Asia. Subject to the parent country's anti-avoidance tax rules, this method is often used as a tax deferral mechanism for foreign companies who do not want to remit their China profits immediately back to the home country.

In addition, Hong Kong and Singapore holding companies present a number of tax advantages, including reduced withholding tax rates on the repatriation of profits and limiting tax exposure on capital gains.

Note that the Foreign Account Tax Compliance Act (FATCA) has significantly disrupted the ability of U.S. investors to open or maintain bank accounts through Hong Kong, threatening to cut off the cash flow to their mainland China subsidiaries. Although also a signatory to FATCA, Singapore appears to be less affected by these developments.

Below we take WFOE as an example to demonstrate the setup procedure.

WFOE Setup Procedure*



*In an effort to simplify company establishment procedures, the government intends to integrate the customs registration with the AMR business registration. However, at the time of writing this guide, the reform hadn't yet been fully implemented in practice.

** No separate reporting is needed in cities offering one-stop service such as Shanghai. The reporting can be conducted contemporaneously after the company name is filed for record.

*** For manufacturing WFOE only.

****For manufacturing and trading WFOE only.

Key positions in a foreign invested entity

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

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

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

Shareholders and executive director (or board of directors)

For WFOEs, the board of shareholders represents the highest authority of the company, whose decisions regarding company operations are executed by the executive director or board of directors. For JVs established before January 1, 2020, i.e. the effective date of the FIL, the board of directors is the highest authority. But they will need to make relevant changes within the five-year transitional period. For JVs established after January 1, 2020, the board of shareholders will be the highest authority of the entity.

Supervisor(s)

WFOEs must have at least one supervisor to oversee the execution of company duties by the director(s) and senior management personnel. For JVs, this used not to be a mandatory obligation before the FIL enacted. However, starting from January 1, 2020, JVs are also required to have supervisors following the rules stipulated in the *Company Law*.

To ensure there are no conflicts of interest, a company's director(s) and/or senior management personnel cannot concurrently serve as supervisors. Where a company has a relatively small number of shareholders and is small in scale, one or two supervisors will suffice. For larger companies, a board of supervisors composed of no less than three members is required.

General manager

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

INES LIU
Manager
International Business Advisory
Beijing Office

"The legal representative is the person who really carries responsibility for a company in China. You will need to appoint someone who is not just technically competent, but China competent."

Legal representative

Every business established in China, foreign or domestic, is required to designate a legal representative, i.e. the person responsible for performing the duties and powers on behalf of a company. The legal representative is, by definition of their role, one of the most powerful people in a FIE. Yet this power comes with heavy responsibility, and if a single individual in a foreign invested entity is to be held accountable for company actions, that person is more likely than not the legal representative. For WFOEs and JVs established after January 1, 2020, the executive director, the chairman of the board of directors, or the general manager are all eligible to be legal representatives. Before that, only chairman of the board of directors can take the legal representative role of the JVs.

Powers and responsibilities of a legal representative

The *Company Law* does not clearly define the powers of a legal representative. However, it is clear that a legal representative is authorized to perform all acts regarding the general administration of a company according to the company's aims and objectives. This may include:

- Acting (legally) to conserve the company's assets;
- Executing powers of attorney on the company's behalf;
- Authorizing legal representation of and litigation by the company; and
- Executing any legal transactions that are within the nature and scope of that company's business.

The new FIL's impact on key positions in FIEs

Considering that WFOEs are generally limited liability companies, which are basically in line with the *Company Law*, the new FIL has a limited impact on key positions in WFOE. For existing FIEs in the form of a CJV or EJV, they need to change their governing structure within the five-year transitional period to the three-tier structure (the board of shareholders, the board of directors, and the general manager), in accordance with the *Company Law*. Below, we take EJV as an example.

New FIL's Impact on Key Positions in EJV

Items	Under the EJV Law	Under the new FIL
Highest authority	Board of directors	Board of shareholders or the general meeting of shareholders
Board of shareholders	No board of shareholders	The following matters must be be reviewed and approved by shareholders holding two-thirds or more of the voting rights on the shareholders' meeting: • Amendment to the article of associations; • Increase or reduction of registered capital; and • Company merger, division, dissolution, or change of company structure.
Board of directors	• The board of directors shall comprise no less than three members; • Directors shall be appointed and removed by EJV parties; • Where a Chinese national takes the position of chairman, the position of the deputy chairman shall be held by the foreign party, or vice versa; and • The tenure of a director shall be four years.	• Company can choose to appoint an executive director instead of establishing a board of directors; • The board of directors shall comprise three to 13 members for limited liability companies, or five to 19 members for joint-stock companies; • Directors who are not employee representatives shall be elected and replaced by the board of shareholders/shareholder; and • The tenure of a director shall not exceed three years.
Supervisor	Board of supervisors/supervisor is not obligatorily required	• Board of supervisors should comprise no less than three members; • Limited liability companies with fewer shareholders may appoint one to two supervisors instead of establishing a board of supervisors; • The tenure of supervisor is three years; and • Directors and senior management personnel shall not hold the post of supervisor concurrently.
Legal representative	Chairman	Chairman, executive director, or general manager
Senior management personnel	Where Chinese party takes the position of general manager, the position of the vice-general manager shall be held by the foreign party, and vice versa	No limitation

Office premises requirements

To register a FIE in China, it is a prerequisite to own or lease office premises[1] (as the primary place of business), and register this with the local AMR in charge. Doing so requires that the FIE possess all legal documents pertaining to the premises as required by the Chinese authorities. Usually, only one business may be registered per office unit. Under limited conditions, one office unit can be used to register multiple businesses. Many new entrants to the China market find success using serviced offices offered by any number of providers in major cities across China.

Representative office (RO)

Registration of ROs requires the relevant lease agreement and a copy of the Certificate of Premises Ownership (CPO). ROs require special attention when choosing suitable premises for business registration. Because an RO is technically not a Chinese enterprise but an extended arm of the overseas parent company in China, the local AMR may scrutinize the RO premises more closely, and/or impose special requirements for its registration. Detailed rules vary by region.

For example, in Shanghai, the local AMR previously required that an RO only be registered within commercial office premises with approval from the public security bureau. While this requirement is no longer mandatory, the registered office of an RO still needs to be designated for non-residential purposes, or else risk being denied for registration by the AMR.

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[1] *In some cases, virtual offi ces might be accepted as registered address, such as in some industrial parks.*

Wholly foreign-owned enterprise (WFOE)

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

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

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

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

Foreign invested commercial enterprise (FICE)

In addition to completing the checklist of office premises requirements for WFOEs, FICE engaged in retail activities need to undergo additional legal procedures for opening a retail shop in China.

China's *Administrative Measures for Foreign invested Commercial Enterprises* stipulates that foreign investors applying to open a retail shop as part of establishing a FICE should be in compliance with the relevant development plan of the city. This generally requires the foreign investor to obtain approval documents from their local office of the MOFCOM before being able to complete business registration with the AMR.

The land use rights certificate and/or lease agreement for the premises of the shop are also usually required to be presented to the authorities.

VIKTOR ROJKOV
Associate
International Business Advisory
Shanghai Office

"If a FICE intends to include retail activities in its business scope, the company needs to be registered at an address suitable for the specific retail activities. The investor is advised to double-check the suitability of the premises before signing the lease agreement."

Opening a bank account

Once obtaining a business license in China, the newly established FIE must choose a specific bank to open the bank account, without which the entity will not be able to carry out its daily operation.

Account types

FIEs in China need to establish at minimum two bank accounts: an RMB basic account and a foreign currency capital contribution account.

1. **RMB basic account**

   An FIE must have one (and only one) RMB basic account for daily business operations in China[1]. This account is the only account from which the company can withdraw RMB cash. The RMB basic account often acts as a designated account for making tax payments.

2. **Foreign currency capital contribution account**

   An FIE must also have a foreign currency capital contribution account to receive capital injections from the foreign investor. Approval to open this account can be obtained from the SAFE.

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

International and Chinese banks

Foreign investors can establish the above accounts in China through international banks with a local presence, the major banks being Bank of East Asia, Citibank, DBS Bank, Hang Seng Bank, HSBC and Standard Chartered; or through a Chinese bank, the largest being Industrial and Commercial Bank of China, Bank of China, China Construction Bank, Agricultural Bank of China, and Bank of Communications.

Foreign investors in China often prefer to establish an account with an international bank because of an existing business relationship. However, establishing accounts with a Chinese bank has a number of advantages, namely:

- The application process for opening a bank account with an international bank in China will be more document-intensive and take longer compared to opening such an account at a Chinese bank;

[1] *China is piloting to remove the RMB basic account requirement in Lingang arear, Shanghai FTZ.*

- There are substantially more Chinese commercial banks than foreign bank branches, which allows for more convenient and faster RMB remittance;
- Most Chinese companies have local bank accounts - conducting transactions with them will be easier and faster if done from a Chinese bank instead of an international bank; and
- Bank account security.

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

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

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

What are the latest requirements for opening a bank account in China?

Foreign investors might get the feeling that it will not be a straightforward process to become the bank's new clients.

This is because banks in China are subject to high scrutiny from the People's Bank of China (PBOC), resulting in the emphasis now given to the KYC (know your client) policy. Under PBOC direction, Chinese banks have also become stricter about opening bank accounts since April 2020, especially for newly established companies – no matter whether it is a domestic company or a foreign invested company.

To validate the "real business" of the applicant, banks have now implemented an on-site visit procedure. This procedure includes a bank officer visiting the physical location (the office) of the applicants to verify that they have a physical location and staff. The photo of the location with the company nameplate and a business license will be taken for the bank's internal compliance purposes.

Based on this situation, the bank will require the individual who has submitted their passport as verification documentation on behalf of the company (the legal representative, that is) to be present at the time of the account opening.

MONIA LI
Assistant Manager
Business Advisory
Beijing Office

“To protect their IPR, most FIEs adopt measures to proactively search the internet for violations, in addition to sending staff to corporate functions and trade fairs.”

However, considering the travel ban due to COVID-19, many companies and foreign individuals confronted the burden of being present in the bank to open any kind of bank account necessary for their business to be operational.

To facilitate foreign investment, some banks are advancing and improving their compliance and control policies while also complying with the official requirements established by the government. For example, some of the bank branches will allow the specific information to be provided in the scripted video made by the individual who is affected by the travel ban. This video is then validated through the bank controlling department. After the video is accepted by the compliance team, the “physical office” location visit is performed.

To be noted, this kind of relaxation is subject to frequently changes. Investors are suggested to consult with professional services for the up-to-date information.

Intellectual property considerations

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

These types of IPR must be registered with the appropriate Chinese agencies and authorities to be enforceable in China. To protect their IPR, most FIEs adopt measures to proactively search the internet for violations, in addition to sending staff to corporate functions and trade fairs. Companies can also apply to Chinese customs to have them monitor their trademarks and contact them if any violation is discovered.

Copyrights

Strictly speaking, copyrighted works do not require registration for protection. Nonetheless, companies should consider registering their works with the National Copyright Administration, since this provides evidence of ownership that may be needed in the event of legal action. Moreover, China amended its *Copyright Law* in November 2020, which enhanced the legal protection to copyrights by reforming the damage calculation methods and introducing punitive damages, among others. The new *Copyright Law* will take effect from June 1, 2021.

Patents

Patents are territorial rights, meaning that a patent in another country has no effect in China. Companies should file applications for both their core and fringe technologies and make sure that their patents are properly translated into Chinese. China follows a first-to-file system for patents, which means patents are granted to whoever files first, even if they are not the original inventors. A foreign patent application filed by a person or firm without a commercial office in China must be conducted through an authorized patent agent. Patents are filed with the National Intellectual Property Administration in Beijing or its local agencies in more than 30 cities.

China revised its *Patent Law* in October 2020, which increased the protection to patents by ensuring law enforcement and increasing the penalties triggered due to IPR infringements. The new *Patent Law* will take effect from June 1, 2021.

Trademarks

China has a first-to-file system for trademarks, meaning that the first party to file for the registration of a particular trademark will be granted the rights. However, the 2019 amendments to the *Trademark Law* stipulates that “Applications for the registration of trademarks in bad faith that are not intended to be used should be rejected”. Companies should register their brands’ English and Chinese names, as well as any marks and/or logos with the Trademark Office. Careful attention should be paid to the product categories and sub-categories selected for filing (separate registration is required for each category under which protection is sought), and to check whether similar trademarks have already been filed.

Application to register a trademark should be made with the Trademark Office in Beijing, its branch offices in other cities, or through the trademark online registration system. However, foreign companies are required to entrust a trademark agency to handle the registration unless they have a local presence in China. A list of trademark agencies can be found at the trademark online registration system. The Trademark Office will complete examination of the application within nine months from the date of receipt of the required documents. Upon passing the initial review, the application shall be publicly gazetted for three months. If no objections are raised within this three months announcement period, the trademark office will issue the trademark certificate within one month.

How do I make changes to my business?

Making changes to a Chinese entity after establishment – such as to its range of commercial activities or registered address – can be challenging and onerous.

In some cases, closing the entity all together and starting from scratch may be easier, or even mandatory. For these reasons, it is always better to start out with a clear and informed business plan, rather than attempt to make on-the-fly adjustments later on.

In this section, we discuss:

- Company name;
- Business scope;
- Registered capital;
- Shareholder structure;
- RO to WFOE conversion; and
- Relocation.

Company name

The procedure for changing the name of a company in China is quite complex. Because a company's name is displayed on several types of official documents (such as its business license and company chop), any changes to this information must be filed with each respective governing authority.

- **Step 1:** After preparing several new company name options that are in line with the company name requirements imposed by the laws and regulations, the company should conduct a company name self-declaration on the platform maintained by the AMR, which can spotlight duplications, similarities, and other prohibitive or restrictive situations at the same time. In some cities, the self-declaration might be integrated with the company name change registration. Under certain situations, the company may need to go through a company name pre-approval procedure instead, such as when the new company name contains "China", "national", "international", etc.

- **Step 2:** The company should prepare the documentation required for the company name change registration, which includes a board resolution[1] (or shareholder resolution) on the matter and an amended Articles of Association signed by the legal representative, among others.

- **Step 3:** The company must file an application with the local AMR for company name change registration. Upon examination and approval, a new business license with updated information will be issued to the company.

- **Step 4:** FIEs are also required to submit a change report through the foreign investment reporting system, which might be integrated with the company name change registration in cities offering one-stop services.

[1] *JVs that havn't adapt to the new governing structure based on the new FIL need to pass a board resolution on the matter.*

- **Step 5**: After the name change procedures has been successfully made with the AMR, the company must then go about updating other documents on which its name appears, including various types of chops (Financial Chop, Company Chop, Customs Declaration Chop, etc.), which must be newly carved and registered with the company's local public security bureau. Moreover, the company will have to make changes to all ongoing contracts with suppliers, clients and employees.

Business scope

Generally, when an enterprise intends to change its business scope, it must first come out with a board resolution (or shareholder resolution) and amend its Article of Association on this matter. After that, the company need to filed the modified business scope with the local AMR within 30 days of the resolution being made, and submit a change report through the foreign investment reporting system (which might be integrated with the AMR registration in cities offering one-stop services). Upon registration with AMR being completed, the enterprise will get a new business license. Following this, other business certificates and bank information may need to be amended correspondingly.

To be noted, if the new business scope diverges significantly from the original business of the company, the company name should be changed as well, since this must generally reflect the main business of the company.

Registered capital

If companies plan to adjust their registered capital bases on financial, strategic, or regulatory considerations, similar to other changes, it is a time-consuming process that involves working with multiple government authorities. Generally, increasing registered capital is easier than decreasing registered capital, the latter of which involves additional procedures.

- **Step 1:** The company should reach a board resolution (or shareholder resolution) on the matter and revise the Article of Association accordingly.

- **Step 2:** For decreasing registered capital, the company needs to inform the creditor within 10 days of the company resolution, or announcing the decrease on a designated newspaper for the 45 days within 30 days of the company resolution.

- **Step 3:** The company should apply to the AMR for business license update within 30 days of the company resolution.

- **Step 4:** The company should make relevant updates in the bank regarding capital increase/decrease.

- **Step 5:** The company should apply to the SAFE to make relevant foreign exchange registration.

- **Step 6:** FIEs are also required to submit a change report through the foreign investment reporting system, which might be integrated with the company name change registration in cities offering one-stop services.

The bank will facilitate the capital increase afterwards. And other business certificates may need to be amended correspondingly.

Shareholder structure

A company typically decides to make changes to its shareholder structure upon the entrance of a new shareholder who is to receive an equity transfer from one or more existing shareholders.

Alternatively, it may be necessary to revise the shareholder structure as the result of equity transfers between shareholders or the exit of a shareholder from the company. Though information on company shareholders is not explicitly listed on a Chinese business license, in most cases, the company will still need to apply for a new business license, especially where the registered information listed on the business license needs to be changed as a consequence.

- **Step 1:** An equity transfer agreement should be signed between the transferor and the transferee. The transfer agreement must be a valid agreement that is reached through due procedure stipulated in relevant laws and regulations. For example, when equity is transfered to someone other than the original shareholders, there must be proper documents to show the transfer agreement are agreed by the current shareholders. In addition, there must be proper documentation to show the qualification of the new shareholder.

- **Step 2:** The equity transferor or transferee (the taxpayer) shall file with the competent tax authorities and obtain a tax payment certificate for relevant taxes incurred or a tax exemption certificate.

- **Step 3:** The company must apply to the original AMR of registration for a change of company shareholders within 30 days of the change being made.

- **Step 4:** The company should submit a change report through the foreign investment reporting system, which might be integrated with the AMR registration in cities offering one-stop services.

- **Step 5:** The company must apply a new business license if relevant information listed on the business license gets changed.

Following this, other business certificates and bank information may need to be amended correspondingly.

"RO to WFOE conversion"

Multinational companies operating in China through an RO occasionally encounter the need to convert their existing operations to a WFOE, as ROs are unable to engage in profit-making commercial activities. In fact, the act of "converting" an RO to a WFOE is a misnomer; rather, deregistering an RO and establishing a new WFOE are two separate procedures that must be done either in sequence or simultaneously. As an RO has no legal personality, the term "deregistration" is used instead of "liquidation", though the two processes share many similarities.

- **Step 1:** Prior to actual deregistration, the RO must apply to the local tax bureau in charge of tax audit and tax deregistration. To do so, the RO may first undergo an audit by a local Chinese certified tax agent (CTA) firm for taxes owing from the past three years. Once the audit is completed, the enterprise should submit to the tax bureau a board resolution affixed with the signature and seal of the chairman of the board of directors, as well as a cancellation application signed by the chief representative of the RO. Should any unpaid taxes or other irregularities be found by the tax authorities at any point during this process, the RO may be required to submit additional documentation, pay penalties, or settle unpaid taxes with the authorities.

- **Step 2:** The RO should then deregister its foreign exchange registration in the local SAFE and custom registration in the local customs. In case it has not registered, the RO will still need to get corroborating official statements from the bureaus in charge as proof.

- **Step 3:** The enterprise can then proceed to deregister with its local AMR where its application will be processed within 10 workdays of of receipt by law. If successful, the enterprise will be issued a "Notice of Deregistration" and all the registration certificates will be cancelled, as well as the chief representative's work certificate. Announcement of the RO's deregistration must be listed in a media outlet designated by the AMR. The RO's business registration and office lease must be valid up until the official notification of deregistration has been issued by the AMR.

- **Step 4:** The enterprise should close its bank account. Unissued checks and deposit slips will need to be returned to the bank and any funds remaining in the account should be transferred out. If the RO intends to transfer the account to its parent company, it will be required to provide reasons for doing so and seek approval from the bank. In cases where the company is required to submit the company chops during AMR deregistration, the bank account is suggested to be closed before AMR deregistration, as company chops are needed in this process.

- **Step 5:** Notification of the RO's deregistration should then be filed with the public security bureau to cancel its chops.

ALLAN XU
Senior Manager,
Business Advisory Services
Shanghai Office

"Investors need to consider the time and cost involved in the conversion process, and weigh this against the lower tax treatment and other benefits. The higher the RO's expenses are, the more convincing the case is for conversion."

The total time required for deregistration is typically three to six months (depending on the region), but can take over a year in cases containing irregularities, particularly in the tax deregistration phase. Fortunately, the new WFOE can be established according to the procedure outlined in the previous section while the RO deregistration process is underway.

RO Deregistration Procedure and Timeline

	Steps and instruction	Approximate time
Phase 1	Deregistration with tax bureau in charge	*1-2 months*
Phase 2*	Deregistration with customs Deregistration with SAFE	*10-20 working days*
Phase 3	Deregistration with AMR	*5-10 working days*
Phase 4	Closure of bank account	*1-2 months*
Phase 5	Cancellation of chops with public security bureau	*1 working day*

** Even if the RO did not register with customs and the SAFE, it still needs to get corroborating official statements from the bureaus in charge as proof.*

Relocation

Where possible, relocation to a new business address should be avoided to prevent the loss of time and money necessarily incurred. Relocating within a tax district is a relatively simple process, but cross-district relocations are significantly more involved, requiring several months to complete. The challenges involved in relocation are largely related to taxation, which is decentralized in China. Taxes are managed directly by local tax bureaus, and transferring to a new tax district requires the foreign investor to actively coordinate between bureaus in both districts. These are often in competition with each other and no tax officer wants to lose out on revenue by allowing a lucrative company to relocate to another tax district. Under the current policy, companies transferring to a new tax district need to close their tax account in the original tax bureau and then apply for a new business license in the new tax district. Besides, labor disputes usually arises in the relocation process, as employees are usually not willing to transfer to a new location due to commute concerns.

If relocation is not possible, or to avoid interruptions in business operations, establishing an entirely new company and then closing the old company represents the "default" option for relocation. Opening a branch office in the desired location is also a possibility. Branches are easier to set up and maintain, but limited in many ways, such as not being able to expand beyond their parent company's business scope.

Branch Office (BO)		
Common purposes	**Pros**	**Cons**
• Geographic expansion • Alternative to relocation	• Simple establishment • Easy maintenance (only branches wishing to invoice must declare taxable items from locally produced invoices)	• Limited business scope (must be within that of the parent; cannot import or export) • Not a legal entity (all liabilities born by the parent company)

KYLE FREEMAN
Partner
Beijing Office

"While the steps for deregistering an RO are few, the difficulty of tax deregistration should not be underestimated."

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Tax, Audit, and Accounting

- What are the major taxes in China?
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What are the major taxes in China?

Income taxes

Corporate income tax (CIT)

According to China's *Corporate Income Tax Law*, which was recently amended in 2018, all enterprises (except sole proprietorships and partnerships), including all organizations that generate income in China, are subject to CIT.

CIT payable is calculated using the below formula:

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

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

The income tax rate applied to all companies in China today, both foreign and domestic, is 25 percent. Small and low-profit enterprises are entitled to a reduced CIT rate of 20 percent on 25 percent or 50 percent of the taxable income amount (i.e. the de facto CIT rate is five percent or ten percent), and if a taxpayer qualifies as a high-tech enterprise or engaged in certain sectors within certain regions (such as Lingang and Hengqin), a reduced CIT rate of 15 percent applies. At the same time, China provides multiple CIT incentives to enterprises satisfying certain qualifications, such as high-tech enterprises and qualified advanced technology service enterprises.

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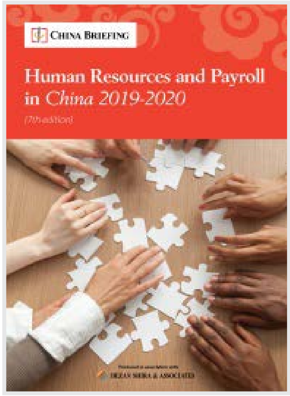

Tax, Accounting and Audit in China 2019-2020 (11th Edition)
October 2019

This edition of Tax, Accounting, and Audit in China, updated for 2019-2020, offers a comprehensive overview of the major taxes foreign investors are likely to encounter when establishing or operating a business in China, as well as other tax-relevant obligations.

AVAILABLE HERE

Key Preferential CIT Incentives Checklist

- [ ] CIT incentives for small and low profit enterprises
- [ ] CIT incentives for high-tech enterprises
- [ ] CIT deductions on R&D expenditures
- [ ] CIT incentives for advanced technology service enterprises (ATSE)
- [ ] CIT incentives for qualified enterprises making investment to encouraged industries in the west China region
- [ ] Tax incentives for enterprises engaging in pollution control
- [ ] CIT incentives for enterprises making investments in or operating of public infrastructure projects specially supported by the state
- [ ] CIT incentives for enterprises that are established in development zones, such as Hengqin area and Qianhai area in Guangdong Free Trade Zone (FTZ), and Pingtan area in Fujian FTZ, and are engaged in encouraged industries
- [ ] Tax reduction for enterprises investing in seed-stage or start-up technology enterprises
- [ ] Tax incentives for software enterprises and integrated circuit enterprises
- [ ] Income derived from eligible technology transfers

Deduction Cap for Certain Expenses

Expenses	Deduction cap
Employee welfare	≤14% of the total amount of employee salaries and wages
Labor union funds	≤2% of the total amount of employee salaries and wages
Employee education	≤8% of the total amount of employee salaries and wages (the excess can be carried forward to future years for deduction) * 100% deduction for enterprises in software and integrated circuit industries
Business entertainment relating to production and business operations	≤ 60% of the actual incurred amount; and ≤ 0.5% of the sales revenue of the current year.
Advertising and publicity **	≤15% of the sales revenue of the current year (the excess can be carried forward to future years for deduction)

**Originally, the 8% deduction cap was only available for advanced technology service enterprises. But starting from January 1, 2018, it was extended to cover all enterprises unless it is stipulated otherwise.*
*** From January 1, 2021 to December 31, 2025, for enterprises manufacturing or selling cosmetics, enterprisesmanufacturing pharmaceuticals, and enterprises manufacturing beverages (excluding alcohol), the deduction cap of advertising fee is 30% of the sales revenue of the current year (the excess can be carried forward to future years for deduction). Advertising fees paid by the tobacco enterprises are not deductible.*

Individual income tax (IIT)

In accordance with the *Individual Income Tax Law of China* (the IT Law), which was recently revised in 2018, IIT is imposed on all individuals, including Chinese and foreign nationals, residing in or deriving income from China.

The IIT Law divided IIT taxpayers into two categories: resident taxpayer and non-resident taxpayer. Resident taxpayers refer to individuals who have a domicile in China, or individuals who do not have a domicile in China but have resided in China for 183 days or more cumulatively within a tax year. Non-resident taxpayers refer to individuals who do not have a domicile in China and have not resided in China, or individuals who do not have a domicile in China and have resided in China for less than 183 days cumulatively within a tax year. A tax year starts from January 1 of a calendar year and ends on December 31. Having a domicile here means habitually residing in China due to household registration, family, and economic interests.

Generally, individuals who have no domicile in China won't be subject to paying IIT on their worldwide income until they reside in China for 183 days or more in a year for more than six consecutive years. According to the official statement, the six-year rule counts starting from January 1, 2019. Besides, the count of the six-year can be reset by living in China for less than 183 days in a tax year, or by leaving China for more than 30 days continuously where their days of residence in China has reached 183 days in a tax year.

Under the new IIT Law, the following income of an individual shall be subject to IIT:

- Income from wages and salaries;
- Income from remuneration for personal services (20 percent of the income is regarded as deductible expenses);
- Income from author's remuneration (20 percent of the income is regarded as deductible expenses, and a further 30 percent discount is available when computing the taxable income);
- Income from royalties (20 percent of the income is regarded as deductible expenses);
- Income from business operation;
- Income from interest, dividends and bonuses;
- Income from lease of property;
- Income from transfer of property; and
- Contingent income.

For resident taxpayers, the first four types of income are consolidated into a new category - comprehensive income, and are subject to yearly computation (but employers are still required to compute and withhold the IIT on a monthly basis). The taxable income amount of comprehensive income of a resident individual shall be the balance after deduction of the standard deduction (RMB 60,000 per year, approx. US$8,500), as well as special deductions, special additional deductions and other deductions determined pursuant to the law, from the income amount of each tax year. The comprehensive income is subject to three to 45 percent of progressive rates on a whole.

IIT Withholding Rates Table for Resident Individuals			
Level	Taxable income amount subject to cumulative withholding (RMB)	Withholding rate	Quick deduction (RMB)
1	≤36,000	3%	0
2	36,000 - 144,000	10%	2,520
3	144,000 - 300,000	20%	16,920
4	300,000 - 420,000	25%	31,920
5	420,000 - 660,000	30%	52,920
6	660,000 - 960,000	35%	85,920
7	>960,000	45%	181,920

For non-resident taxpayers, the first four types of income are computed separately per time or per month when it occurs. The taxable income amount for income from wages and salaries of a non-resident individual shall be the balance after deduction of the standard deduction (RMB 5,000 per month, approx. US$710), as well as other applicable deductions. The IIT rates for non-resident taxpayers are generally equal to those for resident taxpayers.

IIT Rates Table for Non-resident Individuals (Monthly)		
Taxable income amount (RMB)	IIT rate	Quick deduction (RMB)
≤3,000	3%	0
3,000 - 12,000	10%	210
12,000 - 25,000	20%	1,410
25,000 - 35,000	25%	2,660
35,000 - 55,000	30%	4,410
55,000 - 80,000	35%	7,160
>80,000	45%	15,160

RELATED READINGS

China's New IIT Rules: A Guide for Employers
China Briefing Magazine
February 2019

China introduced the biggest changes to its individual income tax (IIT) system with the passing of a new IIT law in 2018. The new law brought forward a host of changes to individual taxation in China. To help foreign investors and taxpayers understand the ins and outs of the updates, this issue of China Briefing magazine offers a comprehensive guide to China's IIT reforms.

AVAILABLE HERE

Turnover taxes

Value-added tax (VAT)

VAT is one of two major turnover taxes in China, the other being consumption tax. Previously, there was another turnover tax called business tax (BT) that was levied on goods and services at rates ranging from three to 20 percent. However, to avoid double taxation and support its modern services industry, China launched a pilot program in 2012 replacing BT with VAT for selected industries, which was subsequently expanded nationwide in mid-2013. By May 1, 2016, the VAT reform was completed with Caishui [2016] No.36 coming into effect.

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

Previously, taxpayers engaging in different sectors have different sales ceilings. Starting from May 1, 2018, the sales ceilings of small-scale taxpayers was unified to RMB 5 million (approx. US$710,000) for all types of taxpayers. Besides, taxpayers registered as general taxpayers are allowed to change back to small-scale taxpayers within the given period, the recent deadline of which is December 31, 2020.

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

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

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

Traditionally, a company must obtain VAT general taxpayer status in order to be able to issue special VAT invoices. However, starting from August 2016, the SAT launched pilot programs to allow small-scale taxpayers in certain industries to issue special VAT invoices by themselves. The pilot program has since expanded from the hotel sector to the authentication and consulting sector, construction sector, industrial sector, and the information transmission, software, and information technology services sector. Starting from March 1, 2019, the pilot program was further expanded to the leasing and business service industry, scientific research and technical service industry, residential service, repair and other service industry. In addition, the revenue requirement for eligible small-scale taxpayers was removed. And starting from February 1,

TAMMY TIAN
Senior Manager,
Corporate Accounting Services
Beijing Office

"Understanding the workings of VAT in China is crucial to the success of any business, especially in terms of securing export refunds. This can be a challenge for US investors, who are typically unfamiliar with VAT systems."

2020, all small-scale taxpayers (except other individuals) can voluntarily use the VAT invoice administrative system to issue the special VAT invoice by themselves.

Where a small-scale taxpayer opts to issue special VAT invoices on its own, the tax authorities shall no longer issue special VAT invoices on its behalf.

Small-scale taxpayers are subject to a lower uniform VAT rate of three percent, as compared to rates ranging from six to 13 percent for general taxpayers, but they cannot credit input VAT from output VAT, nor are they entitled to export VAT refunds.

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

VAT PAYABLE	=	OUTPUT VAT IN THE CURRENT PERIOD - INPUT VAT IN THE CURRENT PERIOD

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

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

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

To support the development of small and micro enterprises, the STA provides a preferential VAT exemption policy during the period between January 1, 2019 and December 31, 2021. According to this policy, small-scale taxpayers shall be exempted from VAT where their monthly sales do not exceed RMB 100,000 (or RMB 300,000 for taxpayers who pay tax quarterly).

RELATED READINGS

Back Office Automation in China
China Briefing Magazine
October 2019

The use of information technology to automate basic business processes is making steady gains across mid- to large-size firms, increasing the ability of business leaders to transform their operational efficiency and profitability. In this issue of China Briefing magazine, we explain how business leaders can prepare for automation by implementing simple, cost-effective solutions. Especially, we focus on what this automation of back office departments looks like, specifically for HR administration and payroll processing and finance and accounting.

AVAILABLE HERE

Fapiao

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

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

China has been quickly expanding the pilot program on electronic special VAT invoices. Firstly trialed in Ningbo, Hangzhou, and Shijiazhuang, this program was expanded to 11 regions from December 21, 2020 and then another 25 regions from January 21, 2021.

The pilot program is another step forward in China’s ambition to digitize its large and intricate fapiao system. The country originally planned to fully implement the electronic special VAT invoice system nationwide by the end of 2020. By far, although only eligible taxpayers in listed regions can issue electronic special VAT invoices, the recipients can be entities nationwide.

With the pilot program being rolled out widely, companies are advised to prepare themselves for a digital transformation of the fapiao system.

VAT Rates for General Taxpayers (A)	
Taxable items	**Rate**
• Export of goods (except where otherwise stipulated by the State Council); • International transportation services if taxpayers obtaining qualifications; • Space transportation services; and • Certain type of cross-border services provided to overseas entities, which are fully consumed overseas.	0
Sales and import of the following: • Cereals and edible vegetable oils; • Tap water, heating, cooling, hot water, coal gas, liquefied petroleum gas, natural gas, methane gas, coal/charcoal products for household use; • Books, newspapers, magazines (excluding newspapers and magazines distributed by the Post Department); • Feed, chemical fertilizers, agricultural chemicals, agricultural machinery and plastic covering film for farming; • Agriculture, forestry, products of animal husbandry, aquatic products; • Audio-visual products; • Electronic publications; • Dimethyl ether; • Edible salt.	9%*
Sale and import of goods other than those listed above; processing, repairs and replacement services	13%**
Tangible property leasing services: • Financial leasing; • Operations leasing;	13%**
Transportation services: • Land transportation services (including railway transportation services); • Water transportation services; • Air transportation services (including space transportation services); • Pipeline transportation services;	9%*
Postal services: • Normal postal services; • Special postal services; • Other postal services;	9%*

VAT Rates for General Taxpayer (B)	
Taxable items	**Rate**
Construction and real estate	9%*
Basic telecom services	9%*
Value-added telecom services	6%
Financial services: • Loan services; • Direct charges financial services; • Insurance services; • Transfer of financial products;	6%
Modern services: • Research, development, and technological services; • Information technology services; • Cultural and creative services; • Logistics auxiliary services; • Authentication and consulting services; • Radio, film, and television services; • Business support services; • Other modern services	6%
Life services: • Cultural and sports services; • Education and medical services; • Tourism and entertainment services; • Catering and accommodation services; • Resident daily services; • Other life services;	6%
Sale of intangible assets: • Technology, trademark, copyright, goodwill; • Use rights of natural resources (except land use rights***); • Other equity intangible assets;	6%

**This rate were reduced from 10% to 9% starting from April 1, 2019.*
*** This rate was reduced from 16% to 13% starting from April 1, 2019.*
****VAT rate for transfer of land use right is 9%.*

Export VAT refunds

An “export VAT refund” refers to a refund of part or all of the VAT already paid in China on export goods. Export goods from China are subject to zero rate VAT, meaning VAT will not incur during export and the VAT paid when manufacturing the export goods domestically is refundable.

There are two ways of obtaining VAT exemption and rebate benefits:

- Exemption, credit, and refund method (ECR method); and
- Exemption and refund method (ER method).

ECR method

The ECR method is generally applicable only to production enterprises qualified as general taxpayers (no credit and refund is available for small-scale taxpayers). Exemption means that goods which are exported by production enterprises either directly or on consignment through foreign trade companies are exempt from output VAT.

Credit means that, for enterprises whose self-produced goods are both exported and sold domestically, the input VAT credit on materials purchased for the production of export goods is offset against the output VAT on domestic sales.

Refund means that, after offsetting the input VAT against the VAT payable, any excess amount of input VAT is refundable.

ER method

The ER method is applied to the export of goods or services by export enterprises or other enterprises with no manufacturing capabilities. Under the ER method, output VAT of the exported goods is exempted, and a certain portion of input VAT is refundable, but not creditable.

Consumption tax (CT)

Consumption tax is imposed on all the individuals and organizations which manufacture and import taxable products, process taxable products under consignment, or sell taxable products. Generally, consumption tax is levied on the below categories of products:

- Products whose over-consumption is harmful to health, social order and the environment, e.g., tobacco, alcohol, firecrackers and fireworks;
- Luxury goods and non-necessities, such as precious jewelry and cosmetics;
- High-energy consumption and high-end products, such as passenger cars and motorcycles;
- Non-renewable and non-replaceable petroleum products, such as gasoline and diesel oil; and
- Financially significant products, such as yachts.

A company processing taxable goods for others is liable to withhold and pay consumption tax based on the value of the raw materials used. Consumption tax is filed and paid monthly.

Tax rates vary considerably with the type of product in question. Consumption tax is calculated ad valorem or based on quantity. The formulae are:

a. Ad Valorem:

CONSUMPTION TAX PAYABLE	=	TAXABLE SALES AMOUNT X TAX RATE

b. Quantity-based:

CONSUMPTION TAX PAYABLE	=	TAXABLE SALES QUANTITY X TAX AMOUNT PER UNIT

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

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

Other taxes

Withholding tax

Withholding tax is a tax levied on passive income (i.e., dividends, bonuses, other equity investment gains, interests, rentals, royalties, transfer of property) received by non-resident enterprises from China. The withholding income tax rate is currently 10 percent. If a foreign party is a tax resident of a country or jurisdiction that has entered into a double tax treaty with China that includes reduced withholding tax, the foreign party can enjoy these reduced rates upon approval from the designated tax bureau. The China enterprise remitting the fund overseas should be the withholding agent.

Stamp tax

Stamp tax is levied on contracts with regard to purchases and sales, processing, construction and engineering projects, asset leasing, goods transportation, storage and warehousing, loans, asset insurance, technology contracts, property rights transfers, accounting ledgers and royalty licensing. The tax rates vary between 0.005 percent and 0.1 percent, or RMB 5 per document. During the period between January 1, 2019 and December 31, 2021, small-scale taxpayers can enjoy up to 50 percent tax reduction, based on the decision made by provincial governments.

Surcharges

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

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

The total surtaxes amount to 12 percent of the total turnover tax liability (i.e., VAT and CT) in urban areas, meaning that these taxes are levied on the amount of the turnover tax but not the total value of the transaction.

Enterprises with monthly turnover less than RMB 100,000 (approx. US$14,000), or quarterly turnover less than RMB 300,000 (approx. US$42,000) shall be exempted from ES and LES. For UMCT, this surcharge will be exempted if the taxpayer is categorized as small-scale taxpayer and the monthly turnover is less than RMB 100,000 (approx. US$14,000), or quarterly turnover is less than RMB 300,000 (approx. US$42,000).[1] During the period between January 1, 2019 and December 31, 2021, small-scale taxpayers can enjoy up to 50 percent surcharges reduction, based on the decision made by provincial governments.

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"If a foreign party is a tax resident of a country or jurisdiction that has entered into a double tax treaty with China that includes reduced withholding tax, the foreign party can enjoy these reduced rates upon approval from the designated tax bureau."

[1] *If the small-scale taxpayer issues special VAT invoices, then the taxpayer shall have to pay VAT and UMCT regardless of the invoicing amount.*

Customs duties

Customs duties include import duties and export duties, which are computed either on an ad valorem basis or quantity basis. Import duty rates consist of most-favored-nation (MFN) duty rates, conventional duty rates, special preferential duty rates, general duty rates, tariff rates for quota items, and provisional duty rates. Among others, MFN duty rates are the most commonly adopted import duty rates. They are much lower than the general rates which apply to non-MFN nations. The complete list of products affected by MFN duty rates can be found in China's Customs Tariff Implementation Plan, which is subject to yearly update.

The amount of import taxes and customs duty payable is calculated based on the price or value of the imported goods. This value is called the duty paying value (DPV). DPV is determined based on the transacted price of the goods.

Import taxes and duties can be calculated after determining the DPV and the tax and tariff rates of the goods. The formulae are:

Ad valorem basis:

DUTY PAYABLE	=	DPV X TARIFF RATE

Quantity-based:

DUTY PAYABLE	=	QUANTITY OF IMPORTED GOODS X AMOUNT OF DUTY PER UNIT

Compound formula:

DUTY PAYABLE	=	DPV X TARIFF RATE + QUANTITY OF IMPORTED GOODS X AMOUNT OF DUTY PER UNIT

Export duties are only imposed on a few resource products and semi-manufactured goods. In 2021, China imposes export duties on 107 items including lead ores and concentrates, non-alloy aluminum strip, benzene, etc. The tax base for export duties is the same as import duties, i.e. the DPV. The DPV for export duties is based on the transaction price, i.e. the lump sum price receivable by the domestic seller exporting the goods to the buyer. Export duties, freight-related expenses, and insurance fees after loading at the export spot, and commissions borne by the seller, are excluded.

Property tax

All owners, mortgagees, custodians and users of property for commercial purposes must pay real estate tax. This does not include residential property for self-use, but does include residential properties for lease. The applicable tax rate is 1.2 percent, calculated on the residual value minus between 10 percent and 30 percent of the original value of the property (as determined by the local government). During the period between January 1, 2019 and December 31, 2021, small-scale taxpayers can enjoy up to 50 percent tax reduction, based on the decision made by provincial governments.

Urban and township land use tax

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

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

Local governments have the right to increase or reduce the tax rate according to their socioeconomic conditions. During the period between January 1, 2019 and December 31, 2021, small-scale taxpayers can enjoy up to 50 percent tax reduction, based on the decision made by provincial governments.

Land appreciation tax

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

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

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

The deductible items include:

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

Resource tax

Companies or individuals engaged in the exploitation of certain mineral resources or salt production are liable for resource tax, which was originally calculated ad valorem or based on quantity.

On August 26, 2019, China passed its new *Resource Tax Law*, which came into force on September 1, 2020. The new *Resource Tax Law* codifies taxes on resources that are already in place. There are currently 164 resources, mostly minerals, subjected to taxes ranging from one percent to 20 percent. Besides, the new *Resource Tax Law* simplifies the time limit for tax declaration—taxpayers can make tax declarations on a monthly or quarterly basis, and make tax declarations within 15 days. During the period between January 1, 2019 and December 31, 2021, small-scale taxpayers can enjoy up to 50 percent tax reduction, based on the decision made by provincial governments.

Vehicle and vessel tax

Owners or administrators of certain types of vehicles and vessels are subject to vehicle and vessel tax. Preferential policies are available for energy-saving vehicles/vessels or vehicles/vessels using new energy technology. Tax exemptions may be applied to diplomatic vehicles and vessels. According to the Caishui [2018] No.74, released by the SAT in July 2018, eligible energy-saving vehicles/vessels can enjoy a half-reduced tax rate, and eligible new energy vehicles/vessels can be exempt from vehicle and vessel tax. Automobile manufacturers and importers who are engaged in making or importing qualified vehicles may apply to the Ministry of Industry and Information Technology (MIIT) for the tax incentives.

Environmental protection tax

On January 1, 2018, China's first *Environmental Protection Tax Law* (the EPT Law) came into effect, replacing the previous Pollutant Discharge Fees (PDF) system in a bid to strengthen the enforcement of environmental regulations. The EPT Law provides guidelines for levying taxes on entities that emit air and water pollutants, solid wastes, as well as noise pollution.

Major contents of the EPT Law, such as taxable items, tax rates, and specification of taxpayers, are largely consistent with the previous PDF system. However, changes concerned with tax incentives and administrating authorities significantly differ from the previous law.

Related authorities are currently drafting detailed regulations for implementing the EPT Law. Guidelines concerning how to monitor pollutants, how to collect taxes, and how to deal with appeals by taxpayers are still in the drafting process. It is recommended that enterprises keep up to date with the ongoing regulatory changes.

What are some of the key compliance requirements?

AMBER LIU
Senior Manager
Corporate Accounting Services
Shenzhen Office

"Making changes to your business can be complex and time consuming, so it is strongly recommended to plan ahead and utilize the most tax efficient structure from the start."

Accounting and bookkeeping

Businesses operating in China are required to follow the Chinese Accounting Standards (CAS), also known as the Chinese Generally Accepted Accounting Principles (GAAP). The CAS framework is based on two standards:

- Accounting Standards for Business Enterprises (ASBEs); and
- Accounting Standards for Small Business Enterprises (ASSBEs).

The current ASBEs were released in 2006 and came into force in January 2007. It is widely viewed by the international community that ASBEs are now substantially converged with IFRS, with only some minor discrepancies in wording. Starting January 1, 2021, several new accounting standards will apply to all entities that have adopted the CAS. The changes will mainly pertain to accounting treatment of revenue and leases.

RMB is the base currency for ledgers and financial reports. For enterprises using currencies other than RMB in their business transactions, foreign currencies can be used as the bookkeeping base currency; however, financial reports are required to be shown in RMB. Furthermore, accounting records must be maintained in Chinese. FIEs can choose to use only Chinese or a combination of Chinese and a foreign language.

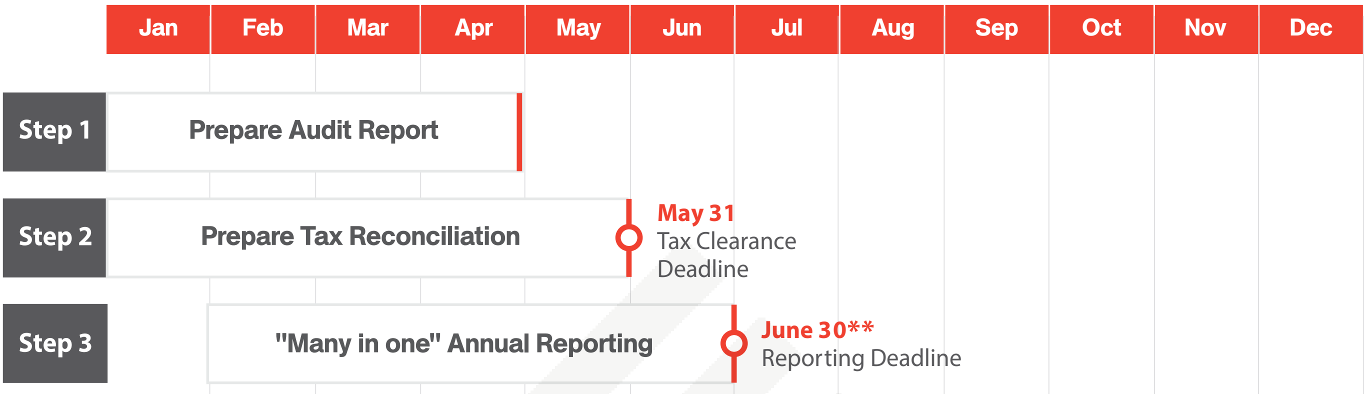
Enterprises in China should adopt the accrual basis of accounting in performing recognition, measurement, and reporting for accounting purposes. FIEs, including their legally responsible persons, must take full responsibility for the truthfulness, legitimacy, and completeness of financial statements. These statements will be used for computing the FIE's taxable and distributable profit.

Books and records have to be retained for at least 10 years under Chinese law. By law, any business transactions carried out in mainland China require a fapiao. In practice, a significant portion of small to medium-sized companies conduct certain sales under the table out of reluctance to part with their fapiao. This is because for each fapiao issued, tax will be payable on the profit from the transaction. For purchasing goods and services, receiving fapiao from the seller is essential for claiming VAT refunds and lowering one's tax liability.

Annual compliance

In advance of being able to distribute and repatriate profits, FIEs must complete annual compliance procedures, involving the following steps: producing a statutory annual audit report, making a CIT reconciliation report, and reporting to relevant government bureaus. These procedures are not only required by law, but are also a good opportunity to conduct an internal financial health check. The relevant procedures and key considerations vary slightly by region and entity type. Companies should either contact a service provider or the local government to achieve full compliance.

Annual Compliance Timeline*



**Subject to regional variation*

***A postponement of the deadline might happen. Please refer to the offi cial notice posted by the authority in charge.*

- **Step 1: Prepare an annual audit report**

The annual compliance procedures start from the annual audit of the business. As mentioned in the first article, although the audit report is generally not required to be submitted in the compliance process for FIEs nowadays – companies only need to disclose whether they have done annual audit during annual reporting – most companies still conduct their audit on a yearly basis out of various considerations, and get the audit report ready before the end of April to meet the May 31 tax reconciliation deadline.

The annual audit report for FIEs generally consists of a balance sheet, an income statement, a cash flow statement, a statement of change in equity, and a supplementary statement of financial indicators. To ensure that FIEs meet Chinese financial and accounting standards, the annual audit report should be conducted by qualified accounting firms and signed by two Certified Public Accountants (CPAs) registered in China.

To be noted, in the case where an annual report is required, the requirements for the report may vary by region. For instance, in Shanghai, companies must include a taxable income adjustment sheet in the audit report, which is not a necessary supplement in Hangzhou, Beijing, or Shenzhen.

- **Step 2: Conduct CIT reconciliation**

Although the State Taxation Administration (STA) oversees all kinds of tax, only corporate income tax requires annual reconciliation to the tax bureau at the company level.

In China, CIT is paid on a monthly or quarterly basis in accordance with the figures shown in the accounting books of the company – companies are required to file CIT returns within 15 days from the end of the month or quarter. However, due to discrepancies between China's accounting standards and tax laws, the actual CIT taxable income is usually different from the total profits shown in the accounting books.

As such, the STA requires companies to conduct annual CIT reconciliation within five months from the previous year's year-end to determine if all tax liabilities have been met, and whether the company needs to pay supplementary tax or apply for a tax reimbursement.

All companies engaging in production and operation, including pilot production and operation, are required to go through this procedure, regardless of whether or not the company is under a tax deduction period, and whether or not the company makes profit. For companies maintaining branch offices in multiple locations and required to pay tax on a consolidated basis, there are special rules and requirements regarding CIT reconciliation procedures. Companies should pay special attention to the matter if they fall into this scope.

Generally, the Annual CIT Reconciliation Report must include adjustment sheets to bridge the discrepancies between tax laws and accounting standards among other documents. FIEs that conduct transactions with related parties should prepare an Annual Affiliated Transaction Report on transfer pricing issues as a supplementary document to the Annual CIT Reconciliation Report.

Moreover, FIEs in certain regions might be required to prepare another separate CIT audit report by meeting certain conditions, which also vary from city to city.

In the current trend of digitalization and business reform, annual CIT reconciliation can be conducted through online channels, under which companies can conveniently submit relevant information in the appointed system. This is specially recommended in the context of the COVID-19 pandemic. However, if companies cannot make online CIT reconciliation due to certain circumstances, they can still go to the tax bureau in person to submit relevant materials as required.

The deadline for conducting annual CIT reconciliation is May 31 every year, but the investigation of the tax compliance could last to the end of the year, and companies should be prepared to provide supporting documents upon demand from the tax bureau. Besides, where companies are unable to conduct CIT reconciliation within the stipulated deadline due to a force majeure event, such as where the company was quarantined due to COVID-19 control measures, they may apply for an extension. But they must submit a report to the tax bureau immediately upon cessation of the force majeure event. The tax bureaus shall investigate the facts and approve accordingly.

Every year around March, depending on the location, the local tax bureau will issue annual guidance on CIT reconciliation. FIEs are suggested to keep an eye on the guidance for any potential changes regarding the requirements and procedures.

- **Step 3: "Many-in-one" annual reporting**

  The third step of annual compliance is to conduct annual reporting to multiple government bureaus. Starting from 2020, with the new *Foreign Investment Law* coming into force, the annual reporting to the local Administration of Market Regulation (AMR, which previously was called Administration of Industry and Commerce or AIC) and the annual combinative reporting were merged into one "many-in-one" annual reporting, under which the FIEs can submit all relevant information at once through the National Credit Information Publicity system (www. gsxt.gov.cn).

  The annual report submitted should cover the following information:

  » Basic information of the enterprise, including the contact information, the existence status of the enterprise, the business scope, the licensing situation, the staffing and salary information, the social insurance contributions, the IP situation, etc.
  » Investor profile, including information regarding the subscribed and paid in amount, time, ways of contribution, the actual controller of the investor, etc.
  » The name and URL of the website of the enterprise and of its online shops.
  » Equity change information of the equity transfer by the shareholders of a limited liability company.
  » Information relating to any investment by the enterprise to establish companies or purchase equity rights.
  » The balance sheet information of the enterprises, including total assets, total liabilities, total owner's equity, etc.
  » Warranties and guarantees provided for other entities.
  » Information regarding the operation of the enterprise, including total imports and exports, total revenue, income from the main business, operational cost and expenses, R&D expenses, total tax payment, gross profit, net profit, profit distribution, etc.
  » Information regarding the credit and debt.
  » Tax breaks information if the enterprise enjoys preferential treatment for importing equipment.
  » Customs relevant information if the enterprise is subject to the administration of the customs.

  Part of the information will be synced from the statistics maintained by other government bureaus, such as the social security bureau and tax bureau, automatically. Enterprises are required to prepare and submit other information online during the period between January 1 and June 30.

  If the enterprise fails to submit the annual reporting information on time, it will be put into the Catalogue of Enterprises with Irregular Operations (Irregular Operations Catalogue), which is open to the public. Besides, the enterprise will also be put into the Irregular Operations Catalogue if fraudulent information or serious concealment are discovered by authorities in the random check following the annual reporting.

If the enterprise is listed in this Catalogue for three years in a row, there will be more serious consequences – the enterprise will be put into the Catalogue of Enterprises with Illegal and Dishonest Behaviors, which serves as a blacklist for future operations and investments.

The legal representative and the general manager of the blacklisted enterprise will be banned from taking the legal representative or general manager role in other enterprises for three years, and the blacklisted enterprise will be at a disadvantageous position in bidding, government procurement, licensing application, obtaining land, as well as making new investment in the future.

FIEs are suggested to pay attention to the deadlines and requirements, or make timely correction where incompliance happen, to avoid serious consequences.

Pilot program of rolling annual reporting in selected cities

Starting from 2019, China has introduced the pilot program of rolling annual reporting in selected cities. Under the pilot program, the annual reporting is required to be done on a rolling basis, rather than by June 30.

First introduced in five cities – Liaoyuan (Jilin Province), Quzhou (Zhejiang Province), Yueyang (Hunan Province), Shenzhen (Guangdong Province), and Zhuhai (Guangdong Province) – enterprises are required to submit the annual reporting of the previous year within two months from the anniversary of its establishment. In 2019, enterprises subject to customs administration were excluded from the pilot program, which meant they still needed to follow the traditional reporting path and deadline. In 2020, FIEs have also been excluded from the pilot program.

In Hainan, starting from October 1, 2019, the rolling annual reporting system started to get implemented as well. Different from the system in the first five cities, enterprises in Hainan can choose any date as the annual reporting deadline. If they do not want to choose a different date, enterprises need to submit the annual report of the previous year within two months from the anniversary of their establishment. However, enterprises subject to customs administration, companies limited by shares, and FIEs are excluded from the rolling reporting system. Moreover, enterprises without business activities can apply to be dormant and are thus exempted from annual reporting. Hainan's pilot program will end on December 31, 2021.

Although this pilot program seems quite unstable presently and FIEs are excluded from the pilot scope, the pilot program is more in line with international practices. There might be a possibility that the pilot program gets expanded to other cities. FIEs are suggested to follow up with future updates.

For ROs, annual compliance procedures are simpler. They also need to prepare a statutory audit report and a tax reconciliation report, and then report to AMR between March 1 and June 30 every year. In certain cities, RO is also required to submit an existence certificate of headquarter during the annual compliance process.

Annual Compliance Timeline for RO

**Deadlines can vary depending on the locality of the enterprise*

Following the annual audit and completion of tax payment, a net profit figure can be derived. The decision to repatriate and/or reinvest profit will depend on the current situation of the China-side FIE and its parent company abroad.

However, not all profit can be repatriated or reinvested. A portion of the profit (at least 10 percent for WFOEs) must be placed in a reserve fund account, and treated as part of owner's equity on the balance sheet. This account is capped when the amount of reserve funds equals 50 percent of the registered capital of the company. In addition, the investor may choose to allocate some of the remainder towards a staff bonus welfare fund or an expansion fund, although these are not mandatory for WFOEs.

The remaining net profit is available for redistribution. Following a resolution of the board of directors, an application form for the repatriation of funds can be submitted to the tax bureau to authorize the bank to disperse funds.

HANNAH FENG
Partner
Beijing Office

“We typically recommend one of two types of assurance to our clients: a ‘health check’ or a ‘full scope.’ In a health check, we run through a general internal control checklist and try to gauge whether an organization is under control risk.”

Due diligence

Broadly speaking, due diligence is a thorough review of a company so as to uncover any fraud, non-compliance, or other issues posing a risk to potential partners. Due diligence procedures, which can vary widely based on the intended business transaction and industry of the companies involved, are often split into legal, financial and operational due diligence. However, it can also include market, reputational and cultural considerations. A due diligence checklist in China is generally quite similar to those used elsewhere, likely including a review of:

- Legal documents for company establishment and any additional government approvals and licenses;
- Financial documents, including annual audits, tax returns, current financial statements and loans;
- Documentation for real estate and land use rights (in China, land is owned by the state; an individual can merely purchase land use rights);
- Documentation for intellectual property and hard assets;
- Major contracts, distribution records, etc.;
- Litigation history and outstanding litigation (if any); and
- HR administration documents.

One of the key differentiating aspects of due diligence in China is the variety of issues commonly discovered in accounting books, from a company completely misrepresenting its financial situation to minor accounting errors that may come from misguided actions to help the company (i.e. by avoiding tax) or lack of knowledge. Some very common points to pay attention to in financial due diligence investigations in China include the following issues:

- Two or more sets of financial accounts - many companies keep two or more sets of financial accounts so as to avoid tax, but this practice can also be used to cover up inappropriate financial behavior.
- Revenue received “off the books” - underreporting of accounts receivable is often used to hide sales and reduce taxable income.
- Employees paid “off the books” - employees are sometimes paid “off the books” so as to increase expenses and avoid paying taxes on labor salaries. This can result in high liabilities related to IIT and social security.
- Phantom assets and contracts - the assets list on the books are often an overstatement or understatement of assets actually held. Assets are sometimes “mixed” with those of shareholders. Depending on the seriousness of infractions discovered in the course of an investigation (if any), it may be necessary to reevaluate one’s dealings with the subject company.

DAISY HUANG
Senior Manager,
Corporate Accounting Services
Guangzhou Office

"Whenever foreign investors want to figure out whether internal control exists and is sufficient in their Chinese subsidiaries, an internal control review (ICR) might be the best and very first step to achieve that."

Internal control and audit

Strong internal control systems and periodic audits are essential to preventing fraud when running a company in China. The following is a list of common types of fraud in China-based enterprises (including FIEs with less than adequate internal control systems), separated by department:

- **Payroll**
  - Discrepancy between contract salary and payroll payments;
  - Deliberate over-accrual/unauthorized use of welfare benefits; and
  - Ghost employees (non-existent employees, whose salary is often sent to the bank account of another employee).
- **Supply Chain**
  - Purchasing of overpriced raw materials due to relationship/inappropriate agreement between staff and supplier;
  - Improper disposal of scrap;
  - Fake VAT invoices; and
  - Poor inventory control.
- **Sales**
  - Sale of goods at/below cost due to relationship/inappropriate agreement between sales staff and purchaser;
  - Payment of unauthorized sales commissions to employees or friends; and
  - Lack of competitive bidding process.

A key aspect of the Chinese legal environment is the use of official company seals, or "chops", to legally authorize documentation (often in place of a signature). To safeguard against fraud, chops should not all be held by one person and steps should be taken to ensure that chops are not misused.

Depending on its business scope, a company may hold any number of chops, all for different purposes and used on different types of official documentation, including a company chop, financial chop, contract chop, customs chop, invoice chop, etc.

An internal audit ordered directly by company headquarters is the best way to evaluate the effectiveness of internal control systems and prevent fraud in a China-based entity. An internal audit engaged by the China-based entity and reporting only to that entity runs the risk that fraud discovered at the local level may not be reported to the overseas headquarters.

Transfer pricing

Transfer pricing concerns the prices charged between associated enterprises established in different tax jurisdictions for their intercompany transactions. Specifically, any Chinese taxpayer engaged in related party transactions with other group entities is required to demonstrate that such transactions are conducted in a manner consistent with the "arm's length standard" – under which taxpayers should be able to demonstrate that they transact with related parties in a similar manner, under comparable conditions as they would with third parties.

In China, the relationship threshold for transfer pricing rules to apply between parties is low compared to other countries. All transactions between the HQ and its China-side entity should be conducted based on the arm's length principle, as the two are related parties according to Chinese tax laws. From a transfer pricing perspective, taxpayers operating in China have to be aware of their tax filing obligations. This consists of two parts: (a) ensuring that related party transactions are appropriately disclosed in the tax return; and (b) preparing and maintaining detailed transfer pricing documentation, if required.

When filing annual tax returns, all resident enterprises under the scheme of tax assessment by accounts inspection and non-resident enterprises establishing organizations or premises in China, should submit the Enterprise Annual Reporting Forms for Related Party Transactions of the People's Republic of China, which in total consists of 22 separate forms. Of the 22 forms, six are country-by-country reporting forms, which must be prepared bilingually, while the other 16 must be prepared in Chinese. These should be submitted in Chinese by May 31 of the following year (the same deadline as annual tax returns).

In addition to filing the Related Party Transaction Forms, enterprises exceeding relevant transaction threshold (except those that are covered by an advance pricing agreement or that only transact with domestic related parties) should prepare and maintain a contemporaneous transfer pricing documentation, prepared in line with Chinese transfer pricing regulations. Although this report need not be submitted as part of the tax return, it must be provided to the local tax bureau within 30 days upon request. Note that the tax authorities can make special tax adjustments and levy additional tax and penalties to include years when documentation may not have been strictly required. The limitation period is up to 10 years. Correlative relief under a double tax treaty cannot be claimed for any interest or penalties.

SHIRLEY CHU
Manager
Tax
Dalian Office

"If done properly, transfer pricing can save a foreign investor a substantial amount on their tax bill. However, careful planning is advised: transfer pricing transactions are under special scrutiny. In case of non-compliance, the back taxes and penalties can be severe."

RELATED SERVICES

Dezan Shira & Associates provide tax consulting for foreign companies in China. For more information, please contact us at tax@dezshira.com

Scope of Enterprises to Prepare Contemporaneous Documentation in China

	Scope of enterprises	Deadline
Master file	• Enterprises that make cross-border related party transactions during the year, and the ultimate holding company that consolidates the enterprise's financial statements has prepared the master file; or • Enterprises with annual related party transactions that amount to RMB 1 billion (US$142 million) and above.	Within 12 months of the end of the fiscal year for the group's ultimate holding company
Local file	• Enterprises with annual related party transactions for transferring the ownership of tangible assets that exceed RMB 200 million (US$28 milllion); • Enterprises with annual related party transaction for the transfer of financial assets exceeding RMB 100 million (US$14 million); • Enterprises with annual related party transaction for the transfer of ownership of intangible assets that exceed RMB 100 million (US$14 million); • Enterprises with other types of related-party transactions that exceed RMB 40 million (US$5.7 million) in total; or • Single function companies that incurred a loss should prepare the local file regardless of the annual related-party transaction amount, including both domestic and cross-border transactions.	Before June 30 of the year that follows the related party transaction
Special file	• Enterprises entering cost sharing arrangements with related parties; or • Enterprises that need to state whether arm's length principle is complied with due to related party debt equity ratio exceeding the standards.	Before June 30 of the year that follows the related party transaction

Foreign currency controls

China implements a strict system of capital controls, limiting the inflow and outflow of foreign currency. This system distinguishes between transactions made under an enterprise's current account and capital account, and requires foreign investors to open separate bank accounts for the two. The SAFE and its local branches are the bureaus in charge. The SAFE divides foreign currency transactions into two separate categories: those under the current account and those under the capital account. Current account foreign currency transactions may involve the import and export of goods and services, earnings from interest or dividends from portfolio securities and regular transfers. Capital account transactions are mainly related to foreign direct investment (i.e. changes in a company's registered capital), the purchase and sale of equity or debt securities, and trade credit or loans. In general, capital account transactions need approval from the SAFE, whereas current account transactions can be made directly through the bank.

Currently, FIEs are allowed to convert up to 100 percent of foreign currency in their capital account into RMB at their own discretion. But the SAFE reserves the right to regulates the percentage of foreign currency a company may have as part of its capital account. These fluctuate according to China's Balance of Payments, which refers to transactions between the entities and individuals of two countries.

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

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

The following usages are still strictly prohibited to justify the conversion of foreign exchange to RMB currency:

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

3

Human Resources and Payroll

- How do I hire employees?
- How do I manage foreign employees?
- What obligations do I have as an employer?
- Termination

How do I hire employees?

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

- Direct hiring;
- Dispatching; and
- Outsourcing.

Direct hiring

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

Generally, China allows three types of employment contracts:

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

Fixed-term contract

The fixed-term contract creates an employer-employee relationship for a fixed length of time, and can be used for part-time or full-time work. More often than not, a fixed-term contract can be renewed only once, after which it will be necessary to give the employee a non-fixed term contract when renewing for a second time. Certain clauses may be inadmissible according to Chinese law, while others are mandatory. Employers are able to stipulate a probationary period at the beginning of the contract, during which time it is comparatively easier to dismiss the employee. Also, the employer is allowed to pay the employee 80 percent of the full salary stated in the employment contract, although this amount may not fall below the local minimum wage. The employee may resign after giving only three days' notice. It is therefore inadvisable to stipulate a very long probation period. The length of the fixed-term contract will determine the maximum length of probation the employer can set.

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

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July 2018

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AVAILABLE HERE

ADAM LIVERMORE
Partner
Dalian Office

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

Maximum Probation Period by Contract Term	
Contract term	**Maximum probation period**
Less than 3 months	None
3 months to 1 year	1 month
1 – 3 years	2 months
3+ years or non-fixed term contract	6 months

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

For part-time workers:

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

Non-fixed term contract

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

Job contract

Due to its lack of legal clarity, the job contract is an unpopular choice in China. This type of contract is defined by the specific task or project an employee is to work on, not the length of time. Once the project is completed, the employment relationship comes to an end, and the company must pay severance to the employee. No probationary periods are permitted. Job contracts are sometimes used for seasonal jobs where the scope of work can be defined very clearly. However, in most cases, defining the completion of a project can prove to be a challenge. The relevant legal framework offers no guidance on what to do when a project is left uncompleted, or how employees should be compensated in such a case, making job contracts more prone to disputes and even litigation.

Dispatch

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

According to relevant laws and regulations, labor dispatch arrangements are only applicable for the following three types of positions:

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

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

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

Outsourcing

Outsourcing is an additional option for FIEs. Generally, the most commonly outsourced tasks are those that require specialist skills, a high degree of confidentiality, or those that have a clear scope, but incur major consequences if incorrectly implemented. Good examples in China include accounting, tax filing, HR administration, and payroll processing work. Many small and medium-sized companies will choose to completely outsource some or all of these functions, whereas large companies will set up a separate entity to manage such back-office tasks on behalf of their regional subsidiaries.

The below points should be noted for outsourcing:

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

Comparision between Dispatching and Outsourcing

	Labor dispatch	Outsourcing
Relationship	The company has a direct relationship with dispatched staff and can monitor their performance.	The company monitors the progress and outcome of the project rather than the individual staff members.
Fees	Payment is made monthly to the labor dispatch agency per individual dispatched worker.	Payment (outsourcing fees) is generally made based on the progress of the project.
Qualification rules	Dispatched staff must adhere to the company's qualification rules and standards.	Usually, the company does not have obligatory qualification rules to outsourced staff who provide service to them. However, the company has the right to replace any workers assigned by the outsourcing service provider.
Supervision	The company directly supervises the performance of dispatched staff.	The outsourcing service provider supervises the performance of assigned staff.
Regulation compliance	Dispatched staff shall abide by the rules and regulations of the company.	Outsourced staff are not required to abide by the rules and regulations of the company.
Assessment	The company assesses the performance of dispatched staff.	The company assesses the outcome of the project.

How do I manage foreign employees?

Hiring foreign employees in China usually entails additional procedures, just like any other country. According to the revised *Administrative Regulations on the Employment of Foreigners in China* and the *Entry-Exit Regulation* released in 2013, the due procedures for a company to hire foreign employees include:

- Applying for Notification Letter of Foreigner's Work Permit in China;
- Applying for Z-visa or R-visa;
- Applying for Foreigner's Work Permit; and
- Applying for Residence Permit.

Unified work permit system and tiered talents system

To legally work in China, the company must help its foreign employees to get the proper work permit. Under the unified work permit system, this entails two steps: one, apply for Notification Letter of Foreigner's Work Permit in China after they decided to hire the foreign employee; and two, apply for Foreigner's Work Permit for each foreign employee after they come to China with proper visa.

Previously, China's work permit system included two different kinds of work permits - the Alien Employment Permit and the Foreign Expert Permit. While the Alien Employment Permit is issued for general employment, the Foreign Expert Permit is issued to "high-level" talent or candidates whose skills are urgently needed in China's labor market. These two permits are issued and administrated by different government entities.

To avoid deterring high-quality foreign candidates from working legally in China with these issues, the government has prioritized streamlining the foreign employment system from the application process to the permits themselves.

Under the new single work permit system, a unified model is administered by the State Administration of Foreign Expert Affairs (SAFEA) and its local branches, thereby eliminating the confusion and inconformity of the two-permit system.

Together with the unified work permit system, a tiered talents classification system was also introduced to attract more high-level foreign talents. Under this system, foreign workers are classified into three tiers: highly qualified top talents (Tier A), professional talents in line with labor market demand (Tier B), and other foreign talents in line with labor market demand (Tier C).

The classification is based on the desirability and eligibility of the expats through a comprehensive evaluation system, which includes a point-based system, a catalogue for guiding foreigners working in China, a labor market test, as well as a quota administration system. Among others, applicants are assigned points based on their education background, salary level, age, past achievements, work experience and length, and Chinese language level. Candidates applying to work in less developed areas may receive additional points. The SAFEA has released the detailed scoring criteria and other specific standards to evaluate expats.

The three-tiered talents are subject to different administrations. Applicants placed in the Tier A are eligible for service through a "green channel", which offers paperless verification, expedited approval, and other facilitation measures. Tier A talents shall not be limited by their age, education degree, or working experience. In contrast, applicants placed in Tier B are controlled according to the labor market demand, and applicants placed in Tier C are strictly limited by quotas and other relevant rules.

China's visa system

After obtaining the Notification Letter of Foreigner's Work Permit in China for the foreign nationals it intends to hire, the company need to make sure the expatriates entering into China with proper visa. Among the 12 types of visas stipulated in the *Entry-Exit Regulation 2013,* both Z-visa and R-visa can be used as work visas, while the requirements for the latter are considerably higher than the former.

Z-visa is the most commonly used visa for employment. It is used by foreigners who are actually employed by a company that has been incorporated in China (either domestic or foreign invested), or who plan to give commercial performance in China.

R-visa is a relatively new type of visa, issued to high-level foreign personnel and those possessing skills that are in shortage of China. Under China's tiered talents system, R-visa is usually applicable to Tier A talents.

Besides these, another type of visa might be useful for doing business in China is M-visa, which is known as business visa. Although it cannot be used for employment purpose, it enables company to invite foreigners to China for commercial and trade activities.

Generally, there is no regulation explicitly stipulating the number of expats a single company can hire in China. In practice, however, local government agencies tend to refuse applications if they think the company unnecessarily hired too many foreign employees. Based on the experience of Dezan Shira & Associates, when assessing the necessity of hiring foreigners, the authorities consider things like the applicant's business scope and size, registered capital, and internal structure, as well as the specific position in question. There are, however, no firm rules on the matter, and companies are instead reviewed on a case-by-case basis.

Residence permit

After the employee is granted a work visa and successfully enters China, the hiring company needs to help him or her to apply for a residence permit within 30 days of the entrance. Receipt of a residence permit signifies the completion of the administrative procedures for hiring foreign employees, allowing the employee to travel into and out of China as regularly as they require.

The term of validity of the residence certificate is determined in accordance with the validity of the Foreigner's Work Permit in China, which is usually up to one year. In some cities, such as Beijing and Shanghai, certain foreign employees can apply for five-year residence permits, subject to higher qualifications.

Accommodation registration

After entering China, the foreigner needs to register with the police where he/she is staying. If the individual is staying in a hotel, the hotel staff tends to do this. If the individual rents an apartment, they need to take a copy of the passport and the signed rental agreement to the nearest police station. In certain cities such as Shanghai, the accommodation registration could be done through an online system.

What obligations do I have as an employer?

DAVID NIU
Senior Manager
Human Resources
Beijing Office

“Outsourcing payroll processing allows for greater transparency, efficiency, accuracy, confidentiality, and continuity as well as cost savings and ensured compliance with all laws and regulations.”

Minimum wages across China

A minimum wage is the lowest remuneration that employers can legally pay their employees. It is regarded as an important indicator considering it reveals the minimum labor cost level, serving as a bedrock for wage costs within a region.

As different parts of the country have very different living standards, China does not have a unified minimum wage level for the entire country. Instead, the task of setting minimum wages falls on the shoulders of local governments. Previously, provinces had to adjust their minimum wages at least once every two years. Since 2016, China started to give provinces more independence and flexibility in determining minimum wages.

Notably, minimum wage generally doesn’t include overtime payment, allowance for special working environment, as well as different forms welfare, such as social security contributions.

Overtime

In China, overtime is paid differently depending on the work hour system adopted by the employer, by either standard work hours, comprehensive work hours or non-fixed work hours. The standard work hour system requires that an employee’s normal working day should not exceed eight hours, that the normal working week not exceed 40 hours, and that each employee should be guaranteed at least one rest day per week. The majority of white collar jobs in China now operate according to this model.

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

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

Note that comprehensive and non-fixed work hour systems require special approval to implement.

Social security

Generally speaking, China's social security system is made up of five different kinds of insurance, plus one mandatory housing fund, as follows:

China's Social Security System			
Category	**Contribution***		**Description**
	Employer rates	**Employee rates**	
Pension insurance	Around 20%**	Around 8%	Designed to provide necessary financial support to individuals after their retirement
Unemployment insurance	0.5%-1%	Around 0.5%	In the event of redundancy, the employee may claim unemployment benefits for a maximum of 24 months
Medical insurance	5%-12%	Around 2%	Designed to cover part of the employee's treatment cost in the event of illness or non-occupational injury
Work-related injury insurance	0.5%-2%	-	Designed to cover the cost of treatment should an occupational injury or illness occur
Maternity insurance	0.5%-1%	-	Designed to cover the female employee's medical expense of childbirth and their salary during the maternity leave.
Housing fund	5%-12%***	5%-12%***	Designed to ensure that employees save to purchase or rent house

** The amount of contribution in each category is calculated by utilizing the employee's payment base figure and multiplying it by different percentages required by each local government entity.*
***Pension insurance contributed by employer can be lowered down to 16 percent starting from May 1, 2019.*
****In certain cities, employer and employee are allowed to contribute more than 12 percent.*

Under China's system, whenever hiring new staff, employers need to register him or her with the local social insurance bureau and the housing fund bureau to initiate or reactivate the corresponding accounts. Further, although both employer and employee are obligated to make contributions, it is generally the employer's responsibility to correctly calculate and withhold the payments for both parties.

Meanwhile, employers are obliged to make timely payments for themselves and their employees. A late contribution can result in a fine, while failure to contribute may lead to onerous labor disputes. In case of severe and multiple violations, the company might be put on an HR "name and shame" list, which is not only embarrassing but also could bring barriers to future recruitment.

One thing to be noted is that employer's obligation to make adequate and timely contributions cannot be alleviated or exempted by reaching mutual agreement with employees. In practice, employers and employees (especially those whose gross salary is not high) may mutually agree not to contribute to the social security schemes or to make contributions on a smaller basis, to save labor costs and maximize employee's take-home payment. However, the court would consider such an agreement invalid in the case of a labor dispute between the employer and employee. The employer might be required to repay the social security evasion or pay extra severance payment to its employee in case of termination.

Foreign employees working in China have been required to participate in China's social insurance scheme starting from 2011, when the Ministry of Human Resources and Social Security (MOHRSS) released the *Interim Measures for the Participation in Social Insurance of Foreigners Employed in China.*

However, since social security is managed at regional level, a range of inconsistencies exists among cities. For example, cities such as Beijing, Tianjin, Shenzhen, and Nanjing treat foreign employees the same way as domestic employees, meaning that social insurance payments are compulsory. On the other hand, Shanghai does not currently require foreign employees to contribute towards social insurance. And in Dalian, foreign employees are only required to pay pension and medical insurance.

Foreign employees are also eligible for social insurance exemptions if they come from countries that have social insurance exemption agreements with China. To date, 12 countries have reached such agreements with China and 10 such agreements have been implemented between China and the following countries: Germany, South Korea, Denmark, Canada, Finland, Switzerland, and the Netherlands, Spain, Luxembourg, and Japan. China has signed agreements with France and Serbia, but these are not yet in effect.

The exemption scope and qualifications may vary from one agreement to another, and the local social insurance bureaus may have different policies towards the implementation of the exemptions. Employers should consult and apply with the local bureau in charge before they decide not to contribute for their foreign employees.

Expatriates generally cannot participate in the housing fund scheme. Nevertheless, some regions, such as Shenzhen and Tianjin, allow foreign employees to make contributions to the housing fund on a voluntary basis. This is designed as a preferential measure to attract talents rather than being a mandatory obligation.

Termination

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"Setting up a fair and watertight mechanism of internal company rules and disciplines could reduce the risk of potential labor disputes. Outsourcing these tasks can reward a company with significant time savings."

From a legal perspective, terminating employees in China can be more difficult than expected, especially under the comparatively stringent regulations on terminating employment contracts since 2008. Employers should follow the below steps to ensure full compliance:

- **Step 1:** Determine whether the termination is an early termination or not. If the employer chooses to terminate the employer prior to the expiration of the fixed-term contract, this is considered "early termination" and certain additional requirements apply.

- **Step 2:** In case of early termination, the employer should attempt to negotiate an agreement with the employee, including the termination date, severance payment, and any other necessary details. This is often the safer option even if there are grounds for unilateral termination.

- **Step 3:** If unable to come to a termination agreement, consider whether there are grounds to support immediate termination for extreme causes or 30-day notice termination for other causes, keeping in mind the statutory obstacles to such forms of termination.

If none of the above measures can be adopted, then the termination is likely to be considered an unlawful termination and additional severance payment might be required.

Terminating Staff in China

Type of termination	Admissible grounds	Type of employee	Severance payment
Mutual agreement	• Agreed with employee	• Fixed-term • Non-fixed term	Yes (if the termination is put forward by the employer)
Immediate (unilaterally)	• Serious violation of company rules • Serious loss attributed to employee • Giving false information to employer • Criminal offense during employment • Employee takes up second job, harming the first employer • Employee doesn't meet the job requirement during probation	• Fixed-term • Non-fixed term	No
30 days' notice (unilaterally)	• Employee incompetent for position after training or job transfer • Employee unable to work after sickness/injury • Job cannot be performed due to fundamental change in objective circumstances	• Fixed-term • Non-fixed term	Yes
Not renewing contract	• After one or two fixed-term contracts, differs per city	• Fixed-term	Yes (unless the employee refuses to renew the contract upon maintained or raised provision proposed by the employer)
Mass lay-off	• Company being restructured under the PRC *Enterprise Bankruptcy Law* • Serious difficulties in production or operations • Company changes production method, making staff unnecessary • Objective economic situation makes employment impossible	• Fixed-term • Non-fixed term	Yes
Automatic termination upon bankruptcy/ revoke/dissolution	• The employer is declared bankrupt pursuant to the law • The employer's business license is revoked • The employer is ordered to close down • The employer has decided to dissolve prematurely	• Fixed-term • Non-fixed term	Yes
Termination with 30 days' notice and mass layoff not allowed for	• The employee is suspected of having occupational disease(s) and waiting for diagnosis; • The employee has completely or partially lost labor capability due to occupational disease(s) or work injury; • The employee is still in the legal recuperation period for non-work-related illness/ injury; • The employee is pregnant, on maternity leave or in nursing period; and • The employee has continuously worked for the employer for more than 15 years and is less than five years before retirement.		

Note: When unilaterally terminating an employee, the employer needs to notify the labor union if there is one.