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AN INTRODUCTION TO

Doing Business in China 2023 for US Companies

Special Focus

- Getting Ready for China's Rebound in 2023
- US China Trade, Investment & Relations
- Key Sectors for US Businesses

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This edition of Doing Business in China 2023 for US Companies was produced by a team of professionals at Dezan Shira & Associates, with Qian Zhou as Editor and Yi Wu as contributor.
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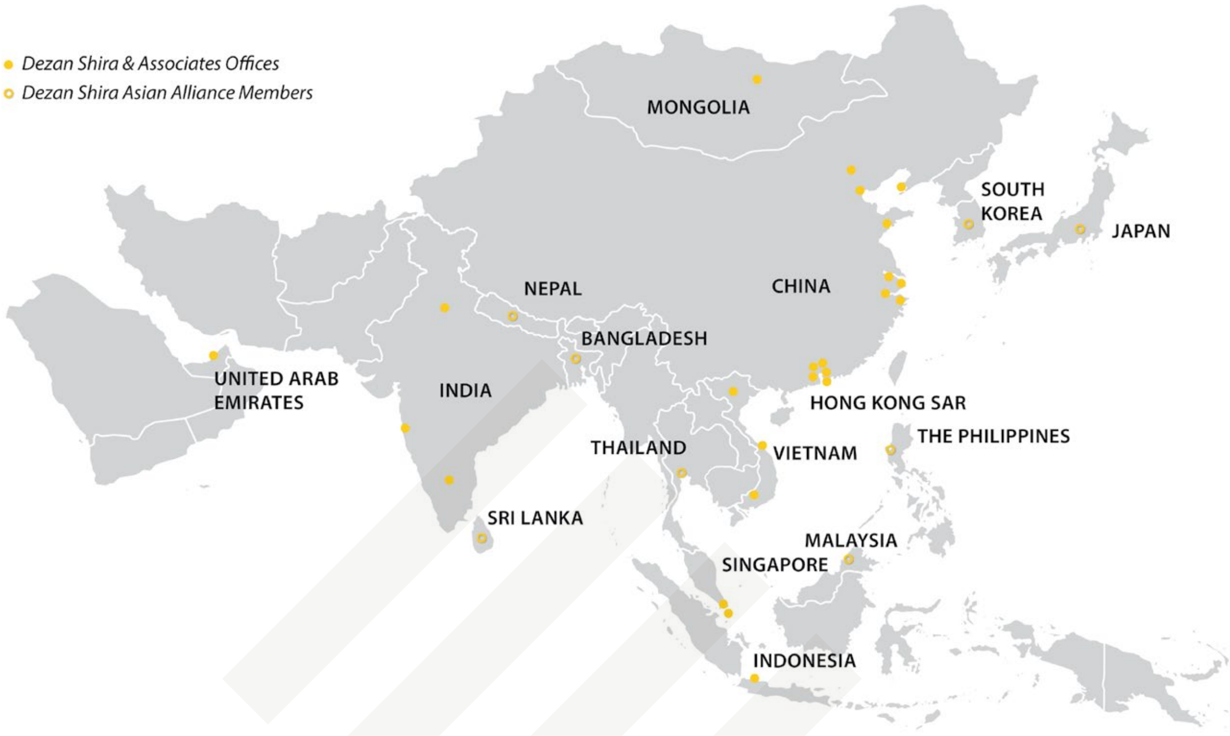

About Dezan Shira & Associates

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

Preface

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2022 turned out to be a difficult year for businesses operating in China. Unexpected lockdowns caused by COVID-19 outbreaks, weak consumption trends, a struggling real estate sector, and newfound geopolitical tensions caused serious disruptions to supply chains and damped global business confidence in the country.

Still, the actual use of foreign direct investment (FDI) in mainland China expanded in the first ten months of 2022 – growing 14.4 percent year-on-year to over US$152 billion from January to October. The whole year's FDI is expected to create double-digit growth.

Another silver lining has emerged out of the tough challenges overcome in 2022 – an easing of the zero-COVID policy is now in sight, with Beijing proposing a relaxation of the travel restrictions.

Economists expect China will fully reopen in the second half of 2023, pushing GDP growth to around five percent from three percent in 2022. Industries in line with Beijing's policy priorities, such as the healthcare sector, green sectors, consumer market, and sectors related to industrial automation, are expected to be the biggest beneficiaries.

Under these circumstances, it is vital that U.S. investors are familiar with the changes happening in China's business landscape – to identify areas of risk in advance and take steps to prepare for new market opportunities. This is the only way investors can stay nimble in an otherwise difficult time.

Designed to introduce the fundamentals of investing in China, this publication is compiled by experts at Dezan Shira & Associates, a specialist foreign direct investment firm providing corporate establishment services, 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 in Bangladesh and client liaison offices in the United States, Europe, and Russia.

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What’s New in This Guide?

Doing Business in China 2023 for US Companies introduces the fundamentals of investing in China. Compiled by the professionals at Dezan Shira & Associates in December 2022, this comprehensive guide is ideal not only for businesses looking to enter the Chinese market, but also for companies who already have a presence there and want to keep up to date with the most recent and relevant policy changes.

To be more specific, the below changes are noticeable for your attention:

Why China: A new section is added at the beginning to explain why China is still a market that cannot be overlooked by US companies. The section covers the country’s growth outlook, supply chain, workforce and labor market, market reforms and opening, trade and investment relations between the US and China and key sectors for US investment.

Business suspension: A new section is added in the “How do I make changes to my business” chapter, introducing the requirements and benefits for companies to acquire a dormant company status amid business difficulty, while retaining its legal standing for a period of up to three years.

Tax incentives: The tax incentive policies are updated for each tax in the “What are the major taxes in China” chapter, including corporate income tax, value added tax, stamp tax, surtaxes, resource tax, and property tax, and information is added on the vehicle purchase tax.

E-fapiao updates: The “fully digitalized e-*fapiao*” is introduced in the “Value-added tax (VAT)” section, providing the latest developments in 2022.

Accounting standards: Two other accounting standards have been added – the *Accounting System for Business Enterprises* and *the Accounting System for Non-governmental Non-profit Organizations* (NGOs) – in the “Accounting and bookkeeping” section. The Accounting System for NGOs applies to NGOs and the representative offices of NGOs in China. This chapter also examines the discrepancies between the Chinese accounting standards (CAS) and China’s tax laws, in addition to the differences between CAS and the *International Financial Reporting Standards* (IFRS).

Human resources and payroll: Brief introductions have been inserted on how to get approval for implementing the special work hour system and the calculation of severance pay in this chapter, both of which are among frequently asked questions by Dezan Shira & Associates clients.

Cybersecurity and data protection: This chapter is updated with developments under China’s major cybersecurity and data protection laws and regulations in 2022, explaining key compliance requirements for businesses and providing practical tips on preparing for these new obligations.

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Why China?

China's growth potential

Although China's economic growth rate is slowing after years of breakneck expansion, especially in 2022 amid multiple economic headwinds, the size of its economy dwarfs almost all others, be they developed or developing. Simply put, foreign companies cannot afford to ignore the world's second largest economy. With a population of 1.4 billion, China's GDP per capita was US$12,551 in 2021, about six times lower than that of the US. There is still significant room for economic activity and household wealth to continue to grow before leveling off at a saturation point.

The British Consultancy Centre for Economics and Business Research (CEBR) projects China's economy to continue growing at 5.7 percent per year through 2025 and then 4.7 percent to 2030, at which point it will surpass the US to become the world's largest economy. Although these growth rates are slower than in the past, the impact is still incredibly significant given the sheer size of the economy and reflects China's transition towards becoming a high-income country.

Why China Remains an Attractive Investment Destination

GDP Outlook

China's GDP per capita is about six times lower than the US, which means there is significant room for its economy to grow.

Workforce and Talents

China has the world's largest labor market, and workers in the manufacturing sector tend to be more experienced, more educated, and better resourced than their Asian counterparts.

Market Size

China's rising purchasing power, expanding middle class, and a population over a billion, positions it to become the largest retail market in the near future.

Market Reforms and Opening

China is continuously opening its market and improving the business environment. Between 2017 and 2019, China moved from 78th to 31st on the World Bank's Ease of Doing Business rankings.

Infrastructure and Supply Chain

China has a sophisticated manufacturing and logistics infrastructure set up.

China's tremendous domestic market

China's rising purchasing power, expanding middle class, and a large consumer base, all point to the fact China will likely become the world's largest retail market in the near future.

Despite the weaker than expected consumption performance observed in 2022, the domestic market will benefit from China's dual circulation strategy, which intends to spur domestic demand and simultaneously create conditions to increase foreign investment and trade, in the long run. The focus on tapping into China's internal consumption patterns and domestic markets will also buffer the impact of global economic headwinds on the country's economic and financial stability. While the policy emphasizes self-reliance, it does not exclude foreign companies. A successful implementation will depend on robust performance in both domestic and foreign markets.

Further, the focus on domestic consumption also creates new opportunities. Many foreign companies have started to produce goods specifically for local consumption in China, rather than use the country as a production and processing base for an export-led business model as in the past. For many companies, China is now their largest market for growth.

China's supply chain and infrastructures

China's advanced supply chain and logistics capacity ensures its significance in global trade: Its broad range of industrial capacities allows foreign firms to source goods easily; its well-connected infrastructure system also allows efficient transportation of products.

China's supply chain is also hastening its pace to become digitized, with increased use of robotics in warehouses to improve efficiency and security. Chinese companies recognize and embrace the potential benefits of IoT and AI to digitize the supply chain. This process is increasing the importance of technical skills and automation.

China's workforce and labor

China has the world's largest labor market even though its working age population is shrinking. The labor force of China, which refers to the population aged between 16 and 59 and capable of working, stood at around 880 million in 2020. And by the end of 2021, the number of employed people in China amounted to around 746.5 million people.

Despite the increasing concerns that China's labor cost keeps rising, China's labor force still earns considerably less than their counterparts in developed countries, while at the same being more experienced and efficient compared to lower-cost, emerging markets.

For example, in 2020, the average hourly cost for labor in the manufacturing sector was US$6.50 in China, compared to US$4.82 in Mexico and US$2.99 in Vietnam, two popular alternatives for manufacturing. However, while Vietnam's labor costs in manufacturing are less than half of China's, Vietnam's productivity per worker is about one-third of productivity levels in China.

Workers in China's manufacturing sector tend to be more experienced, more educated, and better resourced than in competing countries, often making China a more cost-efficient option.

The breadth of China's labor pool means that the country's human resources are highly adaptable to business needs, as companies will be able to find workers and technical specialists experienced in a wide variety of fields.

Further, China's labor market is becoming an asset not just for its size and cost efficiency, but for the quality of education. For instance, the Times Higher Education World University Rankings placed 10 Chinese universities in its 2022 top 200 list – the most ever – including two in the top 20.

China's market reforms and opening

China has endeavored to attract greater foreign investment by relaxing more market access restrictions and continuously introducing improvements to the business and regulatory environment.

Key among its reform actions, are changes to the negative lists. These lists indicate which industries are subject to special administrative measures for foreign investors, or in other words, are supervised by authorities when determining market entry, scope of operation, and access to local market.

The 2021 National Negative List removed two restricted items from its 2020 version, cutting it down from 33 to 31, while the new 2021 FTZ Negative List removed another three items, cutting it down to 27 from 30. Taking auto manufacturing as an example, the restrictions on the share ratio of foreign investment in passenger vehicle manufacturing has been liberalized. Before, the Chinese party shareholding percentage in passenger automobile manufacturing was to be no less than 50 percent, now foreign investors can hold the majority share.

In addition to the *Foreign Investment Law* and supporting regulations coming into effect in 2020, other reforms in the areas of company establishment, tax, finance, reporting and compliance management are enabling foreign investors to play on a more even ground with domestic competitors.

China has also repeatedly and publicly stated its intentions to accelerate market opening reforms, most recently in President Xi Jinping's televised speech to kick off the fifth edition of the China International Import Expo (CIIE) in November 2022. And in July 2022, a couple of well-known companies in the financial sector, including Goldman Sachs and ICBC Joint Venture, received the green light for further collaboration. Such policy orientation towards high-tech innovation and market opening – which was initially a key issue of US-China trade tensions – will pave the ground for future and sustainable patterns of growth and investment in China.

Innovation and emerging industries

Once known as an economy rife with copycats and counterfeits, China-based businesses are advancing to the leading edge of innovation and experimental business models. While this space may be more sensitive or tricky to navigate in the near-term given the current U.S. China relationship, companies that do not pay attention to China will not just miss out on the market, but also the country's increasingly dynamic innovation that is beginning to influence trends worldwide.

China's spending on research and development is equivalent to about 2.5 percent of GDP, which is far higher than other countries at similar levels of development. This spending has contributed to the growth of dynamic and innovative business models in areas like e-commerce, fintech, and artificial intelligence that are competitive with – or even lead – advanced economies like the US.

One unique advantage for data-fueled innovation in China is the size of its internet-using population. China has close to a billion internet users, which is more than the US and EU combined. About 800 million people in China use mobile payments on a daily basis – over eight times more than the US – resulting in a world-leading fintech industry. China also benefits from early adoptions of technology. China's digital payment development, for example, shows how applications can facilitate changes in lifestyle.

Beyond tapping into an enormous market, investing in China positions international companies to gain experience with innovative products that can make themselves more innovative and competitive in their home countries.

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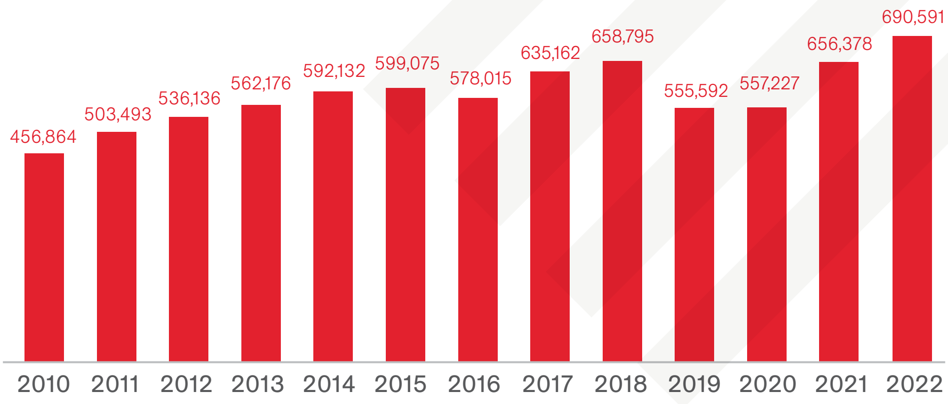
Overview of the US-China Bilateral Relationship

US trade with China has grown enormously in recent decades and is crucial for both countries. The US imports more from China than from any other country, and China is one of the largest export markets for US goods. However, the bilateral trade relationship has also experienced multiple ups and downs, especially in recent years with political differences and the pandemic.

The US and China's trade and investment ties

China is an important global market for the US. In 2022, China was the fourth largest US goods trading partner (after the European Union, Canada, and Mexico) with total trade at US$690.6 billion, the fourth largest US export market at US$153.8 billion, and the largest source of US imports at US$536.8 billion. The total bilateral trade in 2022 increased by 5.2 percent compared to 2021.

Total Goods Traded with China (in Millions)



Source: US Census Bureau

The two countries trade on a broad spectrum of sectors, including electronic devices, agriculture and food, medical devices, biotechnology, and energy. Top US exports include advanced technology products while imports include consumer goods and electronics. China also supplies key intermediary goods (e.g., auto components and active pharmaceutical ingredients). In comparison, current levels of services exports remain low. In 2020, China accounted for just six percent (US$40.4 billion) of all US services exports and three percent (US$15.6 billion) of US imports.

FDI flows are also significant. In 2021, US investors held US$1.15 trillion in Chinese stocks and bonds while Chinese investors held US$1.4 trillion in US debt and US$720 billion in US equities, according to US government and private estimates. Net US FDI flows to China were US$9.3 billion and US$4.3 billion from China in 2020. The stock of US FDI in China was US$123.9 billion, while China's FDI stock in the US was US$54.9 billion.

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Trade war, trade deals, and their impact

Trade between the two countries brings benefits to both markets. The US has profited immensely from access to China's market. Not only has the US household purchasing power been boosted by increased trade with China but exports to China supported millions of jobs in the US and vice versa.

However, the bilateral trade relationship is not always amicable. While occasional business disputes emerge from time to time, the tension recently reached its peak during the Trump administration. In 2018, following an investigation under the Section 301 of the Trade Act of 1974 (19 USC. §2411), the US Trade Representative (USTR) imposed tariffs on an estimated US$250 billion worth of US imports from China. China then countered with tariffs on US$110 billion worth of US products. Most of these tariffs remain in effect. Since the imposition of the Section 301 tariffs, the USTR has granted a number of product-specific exclusions based on each party's requests. Most recently, the exclusions were extended for COVID-related products until the end of 2022. Once the exclusions expire, US importers will have to pay section 301 tariffs of up to 25 percent on these products.

Amid the tensions, the US and China reached an agreement on a Phase One trade deal in 2020. The agreement, effective from February 14, 2020, to December 31, 2021, covered multiple sectors, including intellectual property, technology transfer, agriculture, financial services, and currency and foreign exchange. China committed to make substantial additional purchases of US goods and services, while the US agreed to modify some of its Section 301 tariffs actions. The agreement also established a strong dispute resolution system.

In the end, the Phase One deal was only a moderate success. According to the Peterson Institute for International Economics, China bought only 57 percent of the US exports it had committed to purchase, falling short of expectations. While it facilitated certain structural reforms to China's IP laws and provided greater market access to US exports, some limitations and shortcomings existed including a failure to make purchasing commitments. Since the deal ended in 2021, there has been no follow-up action.

While in Washington D.C. mention of the trade war has fallen out of the discourse, President Biden has largely maintained the tariffs on Chinese goods at an estimated US$40 billion each year. Although these tariffs hit Chinese imports hard, US consumers and manufacturers also bear the cost burden. The Biden administration is under increasing pressure from US businesses to lower the tariffs as one way to ease inflation, however, US Trade Representative Katherine Tai has suggested that the tariffs would not decrease until China adopts more structural changes.

Recent developments

2022 has added more complexities to the US-China bilateral trade relationship. In August 2022, President Biden signed the CHIPS and Science Act, intensifying the competition in technology. In a similar fashion, the US President signed an executive order in September to boost the domestic biotech industry which may limit the operations of Chinese biotech companies. Also in September, interest hikes in the US drove further RMB depreciation, breaching the 7:1 exchange rate at its peak. While raising dollar rates could cause capital outflows from China, it could also make Chinese products more appealing.

On a relatively positive front, top leaders of the two nations met in Indonesia in November 2022 at the G20 Summit, thawing an unusually long period of no interaction. Though politically the two countries both acknowledged the need to refrain from getting into a "new cold war," tariffs seem to remain frozen in place. In the meeting between USTR, Katherine Tai, and China's Minister of Commerce, Wang Wengtao, the two sides had "candid, professional and constructive exchanges" on US-China economic and trade issues.

Such interactions spurred more exchanges between the two countries. In November, a group of former Chinese officials and scholars visited New York, and China's National Development and Reform Commission (NDRC) also met with US business representatives, including ExxonMobil, Boeing, and Emerson Electric. In December, US regulators gained access to the audit documentation of public companies headquartered in mainland China and Hong Kong for the first time in history. This was a requirement to prevent the delisting of Chinese firms listed on the NYSE, but it marked a major step for bilateral cooperation in this area. Many also have hope for the mandated review of Section 301, four years after its first implementation in 2018. The review period will run through January 17, 2023 and will decide on whether and how the tariffs should continue, change, or be rescinded.

Looking into the future

The future of bilateral trade relations remains blurry and lacks a clear path forward. This uncertainty is further fueled by the political dynamic in the US. With a currently divided legislature, trade policies may be more difficult to predict, although being tough on China appears to be one of the few areas both US parties can agree on. The 2024 election may also completely change the narrative once again.

Owing to COVID restrictions, geopolitical tension, and economic competition, interactions between the two powers have been severely limited with almost no engagement in recent months. However, there is little doubt that the US-China relationship will remain competitive at one level or another going forward.

Yet competition in some areas does not preclude cooperation in others. A strong interwoven relationship between the two largest economies still benefits many. Though after years of a trade war and decoupling actions, the two countries will need to establish a new tone to future dialogues.

This quote by Secretary of the Treasury Yellen summarizes the current sentiment of many both in Washington and board rooms, “I expect, certainly hope and expect that there will continue to be very strong ties between China and the United States when it comes to mutually beneficial trade and investment”. While some industries may be more sensitive to geopolitics going forward, the two countries still have many opportunities to cooperate on transnational issues—climate change, nuclear nonproliferation, and global health, among others – and in business, particularly as China reopens to the world after dismantling its zero-Covid policy. The future at least, looks more optimistic now than it has in the previous five years.

Key Sectors for US Investment in 2023

Foreign direct investment (FDI) has played a crucial role in China's economic development. From 2010 to 2020, US investors put nearly US$150 billion into China. Annual investment flows peaked in 2012 at US$15.4 billion. However, growing geopolitical tensions and the COVID-19 pandemic have amplified concerns over the future of investment flows between the two countries. Despite the challenges, we identify some key sectors that still have potential opportunities for US businesses.

Energy / green energy

China is a global leader in the energy sector, especially in renewables. In recent years, China has opened its energy sector to foreign investment as it seeks to balance energy security with a carbon neutral pledge. The country has lifted investment restrictions on coal, oil, gas, and power generation. China's pledge to two carbon goals also created many new opportunities in renewables, clean production, waste management, sustainable infrastructure, and services that support green development.

The US still carries some advantages when it comes to clean energy, especially in terms of advanced technology and new industrial trends. For example, Tesla is the world's top electric vehicle company and very popular among Chinese middle- and upper-class consumers.

China's 2022 version of the encouraged catalogue for foreign investment lists around 100 items in the energy sector for foreign investment while energy techniques and equipment are major areas for investment.

Consumer products

The average purchasing power parity (PPP) of the Chinese people has increased rapidly in recent years. The Chinese consumer taste favors discretionary spending categories such as fashion, accessories, consumer electronics, and electric vehicles (EV). Upper- and higher-income consumers chase aspirational goods, such as luxury goods, premium beauty and personal care products, and high-end cars. In recent years, more emphasis has been placed on product quality and user experience, with a changing attitude towards domestic brands. Despite the large consumption base, there is still room for growth. China's household consumption is about 38 percent of its GDP, compared with 68 percent in the US. To boost consumption, China is promoting policies such as "consumption upgrading" and "dual circulation".

China's rebalancing to a more consumption-driven growth model should present opportunities for US companies in the e-commerce, logistics, and financial services sectors. According to Morgan Stanley Research, private consumption will reach US$9.7 trillion by 2030. Similarly, McKinsey's data show that despite downward pressure on economic growth in China, inbound FDI in China has been running at historical highs, having hit a record US$181 billion in 2021, a 21 percent increase compared with the previous year. This creates huge potential in this market for US companies to take advantage of.

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Health and biotech

As the world's second-largest healthcare market, China presents opportunities to US exporters in many healthcare and biotech sub-sectors. A variety of factors, including extended life expectancy, an aging population, and greater expectations about quality of life have driven the growth of China's healthcare market. Under the "Health China 2030" initiative announced in 2016, there has been significant investment in local healthcare infrastructure, market reforms, and support for innovation.

Medical devices remain the most dynamic and strategically important healthcare sales sector for foreign businesses. High-end and technology-heavy medical devices are primarily imported, while domestic products dominate the low to mid-market segments. The medical device market in China is expected to expand to US$38.4 billion by 2025, where imports may comprise over two-thirds of the market share. Within the market, diagnostics imaging and consumables constituted a large share.

Additionally, prospects in the pharmaceutical and biotechnology sectors are significantly large too. The industry is predicted to grow to US$111.76 billion in 2025. Opportunities for foreign investors include establishing incubators to foster early-stage innovation, opening technology platforms to Chinese innovators, and investing in R&D for commercialization. Some major acquisitions included Pfizer's purchase of Cstone Pharmaceuticals (US$200 million) and GGV Capital's purchase of Shenzhen Hepalink Pharmaceutical Group (US$50 million).

Food and agriculture

China is a main importer of U.S agricultural and food products. While not too common in the agricultural industry, FDI still exists and supports the sector in China. For example, in Jiangsu Province, FDI in actual use in the agricultural sector reached US$283 million in the first half of 2022. Since 2010, Jiangsu has introduced nearly 1,600 foreign-funded agricultural projects, to a total of US$1.82 billion. The investment projects have also expanded from farming and breeding to processing, tourism and other sectors involving the primary, secondary and tertiary industries.

The agriculture and food industry also received a critical amount of US investment, with US$1.4 billion in 2021. This was driven by larger acquisitions such as PepsiCo's purchase of Be & Cheery (US$750 million) and Sequoia Capital's purchase of Shijiazhuang Junlebao Dairy (US$171 million). Smaller greenfield investments include Beyond Meat, Yum China, Starbucks, and Popeye Restaurants.

Additionally, China's Rural Revitalization Strategy aims to promote more balanced economic and social development. Opportunities also exist for foreign companies in this strategy, especially in agricultural technology, food security, and environmental/waste management.

Service industry

FDI in the service industry has grown enormously over the past 15 years. The share of services in China's total FDI increased from 24.7 percent in 2005 to more than 80 percent in 2021. This trend is in part due to China's huge service sector demand, particularly in the field of high-tech and manufacturing services, such as in legal, consulting, insurance, and banking.

China is also keen on attracting foreign investment in the sector. At a press conference in September 2022, officials from the National Development and Reform Commission (NDRC) mentioned plans to build a national unified market to improve the overall domestic business environment. This initiative will reduce market segmentation and regional protectionism, and create a more transparent business environment for sustainable development. For US companies, this means fewer market entry barriers.

High-tech manufacturing

High-tech in China is an industry that receives both domestic and international attention – domestically, the crackdown has altered certain business behaviors; internationally, competition with the US, especially through the CHIPS and Science Act, have fueled tensions. For China, high-tech manufacturing is critical to its strategic development in the near future. China has also hastened its pace in setting international standards in this field. Thus, despite the domestic and international challenges, opportunities still exist for US investors.

From 2010 to 2021, the information and communications technology (ICT) sector received a total of US$25 billion US investment, which functioned as one the major sources of financing for Chinese technology startups. Facing growing uncertainties, particularly given geopolitical tensions, investors are suggested to remain agile and keep multifold strategies in place.

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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?

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"ROs are often used by foreign companies to facilitate activities in China, such as communicating and liaising with China-based agents and distributors."

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);
- Foreign invested partnership (FIP);
- Global staffing solutions (GSS);
- Mergers and acquisitions (M&A); and
- Variable interest entity (VIE).

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.

[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.*

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.

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 setup 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 ("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; 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. Previously, Chinese individuals were explicitly excluded from being shareholders in a JV with few exceptions. However, under the FIL, which took effect January 1, 2020, this limitation has been eliminated. Chinese individuals can 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 was enacted, there were two types of JVs in China, and they differed primarily in terms of how profits and losses get distributed:

Equity Joint Venture (EJV):

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

Cooperative Joint Venture (CJV):

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

With the 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.

RELATED READING

CHINA BRIEFING

China Joint Venture: 7 Considerations to Reach a Successful JV Agreement

China Briefing Article

August 5, 2021

A China joint venture is becoming the market-entry strategy of choice for many foreign investors since the COVID outbreak. We list some best practices.

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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).

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.

VIVIAN MAO
Partner
Shanghai Office

"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."

Global staffing solutions (GSS)

GSS is a market entry strategy that alleviates the stress on businesses to establish a corporate entity and outsources the burden of keeping up with the day-to-day management of an employee's payroll and the entity's tax compliance to a local firm. This frees up critical resources for the foreign firm to explore its options in a new or unfamiliar market.

In simple terms, the way GSS works is that it enables businesses to place boots on the ground, without needing to physically set up a local establishment. The service works with the third-party service provider signing separate contracts with both – the foreign company and the foreign employee. This means that while the normal day-to-day control and working employee relationship will exist between the overseas company and its outsourced hires, the local service provider in China will handle all the risk mitigation, compliance, payroll, and benefits on the ground.

Under the GSS service, foreign companies can enjoy the benefits of having full-time staff working in overseas markets and remaining compliant with local laws, without the time and investment required to set up and operate an overseas establishment.

It empowers foreign firms with the ability to look at alternatives within a specific sector and try out different strategies.

Investors can use this in a new market to gain first-hand knowledge of the local business environment and culture to determine market suitability, plan against supply chain disruptions, and establish sustainable long-term strategy.

RELATED READING

CHINA BRIEFING

Planning for Uncertainty: Global Staffing Solutions to Facilitate Your China Market Entry
China Briefing Article
July 6, 2020

For many businesses, setting up their own company, is the only known or viable way to enter a new market. In this article, we introduce an alternative market entry mode, called Global Staffing Solutions.

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Mergers and acquisitions (M&A)

In addition to greenfield investment in which a company makes foreign direct investment by building operations from the ground up, investors can also expand their business presence in China by acquiring existing assets or buying a controlling stake in an existing company, i.e., mergers and acquisitions (M&A).

In general, acquiring an existing company can simplify a lot of the tedious details involved in entering a new market, such as the lengthy setup processes. Also, it can help a company acquire capabilities it cannot or does not want to develop internally. By becoming the controlling stakeholder of the acquired company, the acquirer can obtain difficult-to-acquire licenses, such as the permit for running medical institutions, and also utilize the established experience and framework of the acquired company to better prepare for the market conditions they are about to face. More importantly, if an existing company holds a significant market share in the sector that the investor plans to enter, the extended time to market and competition for a greenfield investment may not be worthwhile.

However, the effectiveness of such an arrangement is largely dependent on the makeup of both the acquiring company and the acquired company. Companies have different work cultures, management styles, and operational procedures. It can be a difficult task to combine the best of both sides to achieve the desired synergies. The acquiring company can only gain a quick and strong foothold in the target market when the two parties are compatible with each other.

For this reason, it is imperative that thorough due diligence of both companies is done beforehand on the assets, contracts, credit and debt, employment relationships, and management of both firms, to expose sensitive areas, disputes, and weaknesses so that the transaction is made on the basis of fair, transparent, and reasonable evaluations.

Another factor to be noted is that the definition of foreign investment under the FIL includes a foreign investor acquiring shares and assets of a Chinese enterprise. Consequently, all FDI rules and regulations must be observed, including restrictions on investment, qualifications of investors, and scope of business. In addition, M&As in China are subject to antitrust review as required by the *Anti-Monopoly Law* and a potential national security review if the transaction could raise national security concerns.

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 FIL whether it is legitimate and whether it falls within the scope of 'foreign investment'. However, in a legislative draft released in 2020 regarding pre-school education, which was still a draft at the time of writing this guide, 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. On the other hand, the China Securities Regulatory Commission (CSRC) – the China security watchdog – confirmed that qualified companies with VIE structures can still go public on foreign stock markets. Foreign investors interested in this structure are recommended to closely follow the regulatory trends.

SIMON LAUBE
Senior Associate
International Business Advisory
Shanghai Office

"With global economic headwinds continuously affecting the business world, SMEs are suggested to reconsider M&A as a strategy that can help them survive and thrive in the post-pandemic era."

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)
GSS	• Market research • Supply chain management	• Having full-time staff working in overseas markets and remaining compliant with local laws without the time and investment required to set up and operate an overseas establishment	• Limited capabilities • Temporary arrangement rather than a long-term strategy
M&A	• Expanding business presence in a new market without establishing operations from the ground up	• Simplify the tedious details involved in a greenfield investment • Inherit the market share and established framework of the target company • Help the investing company acquire capabilities it cannot or does not want to develop internally	• Subject to all FDI restrictions and rules • Higher scrutiny from the authority • Antitrust review and potential security review • Post-merger integrations may require additional resources
VIE	• Getting access to sectors that are restricted or prohibited to foreign investment	• See common purpose	• Breach risks of the contractual arrangement • Vague attitude of the Chinese authority towards VIE structure

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 FIL on their plans is a business-critical task.

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

According to Article 31 of the 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 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 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 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 READING

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*.

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How do I establish a business?

FANNY ZHANG
Senior 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 State Administration for Market Regulation (SAMR)[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 National Negative List and the 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 trading company, regional headquarters, an R&D center, an investment company, or several others. Often, the capital requirements will differ depending on the type of company that is being incorporated.

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[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.

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. Registered capital contributions can be made cash or in kind, as a lump sum, or in installments. 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.

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.

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.

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 AMR. 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 few years.

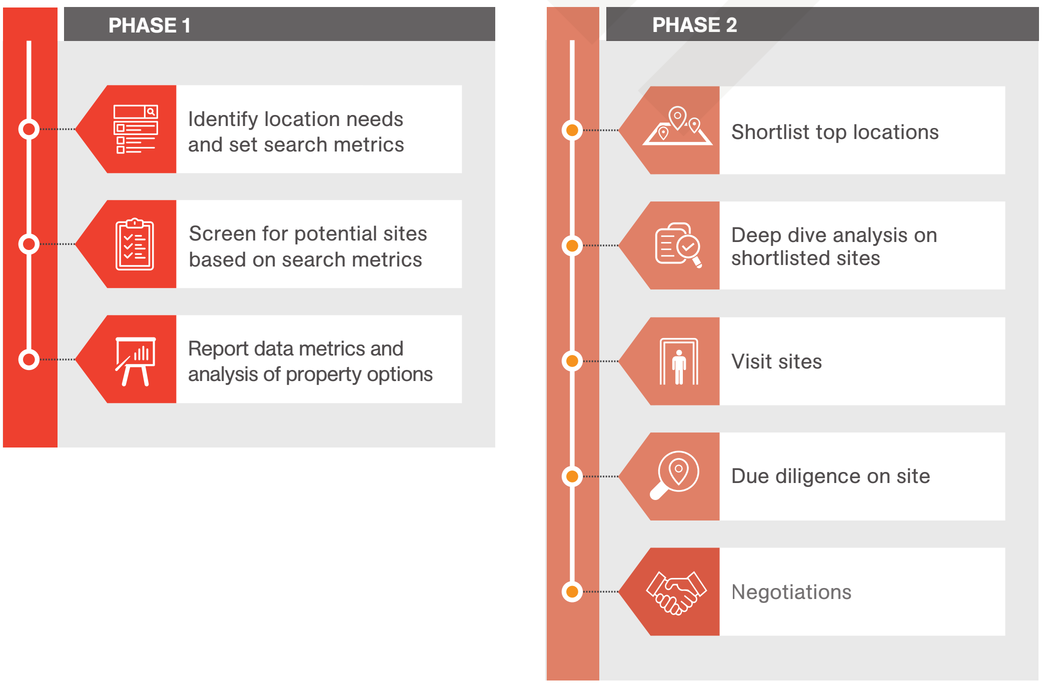
Location

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 Guangdong-Hong Kong-Macao Greater Bay Area (GBA), the Hainan Free Trade Port (FTP), Western China, and 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.

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*

Pre-licensing (2 - 3 months)

BASIC INFORMATION COLLECTION FROM CLIENT
(depends on client)

INCORPORATION DOCUMENTS PREPARED BY CLIENT
Including the proof on lawful use of the office premises
(depends on client)

ENVIRONMENT IMPACT ASSESSMENT*
Including report assessment, on-site environmental impact assessment, and report approval from authorities in charge
(3-6 months)

AMR BUSINESS REGISTRATION**
Including online incorporation information submission and pre-review, and on-site documentation submission to the authority in charge
(7-10 working days)

FOREIGN INVESTMENT INFORMATION REPORTING***
(real time)

COMPANY NOW LEGALLY EXISTS

CARVE COMPANY CHOP, FINANCIAL CHOP, INVOICE (“*FAPIAO*”) CHOP, AND LEGAL REPRESENTATIVE CHOP
(1-2 working days)

Post-licensing (2 - 3+ months)

RMB BASIC ACCOUNT
(2 weeks)

FOREIGN EXCHANGE REGISTRATION CERTIFICATE
(around 2 weeks)

FOREIGN CAPITAL ACCOUNT
(5-7 working days)

CAPITAL INJECTION
(in accordance with Articles of Association)

CAPITAL VERIFICATION ASSISTANCE
(2 weeks)

TAX REGISTRATION
Including tax identification authentication of the legal representative or financial employee in charge, VAT taxpayer status set-up, invoice set-up, and on-site submission of documentations
(3-5 working days)

CUSTOMS REGISTRATION****
(around 2 weeks)

E-PORT REGISTRATION****
(around 2 weeks)

SAFE IMPORT-EXPORT ENTERPRISE NAME FILING****
(2-3 working days)

** For manufacturing WFOE only.*

***In an effort to simplify company establishment procedures, the government has decided to cancel the foreign trade dealer/operator filing nationwide starting from December 30, 2022. The government also intends to integrate the customs registration with the AMR registration, but the reform hadn't been fully implemented in practice at the time of writing.*

**** 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 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, chief finance officer (CFO), 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 (general manger, deputy general manager, and chief financial officer) 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.

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."

Chief financial officer

Chief financial officer (CFO), or financial employee in charge, is a key personnel of a company that has primary responsibility for managing the company's finances, including financial planning, finance and accounting compliance, taxation, cash flow tracking, as well as financial reporting analysis.

CFO is senior management by nature and typically reports to the general manager of the company. This position may be concurrently filled by a member of the board of directors. CFO is of special importance in China during the company setup stage, where the CFO needs to go through real name authentication and be the contact person with the authority in charge.

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 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 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.

FIL's Impact on Key Positions in EJV

Items	Under the EJV Law	Under the 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

VIKTOR ROJKOV
Assistant Manager
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."

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, such as the Real Estate Ownership Certificate. If the office premises is leased from another individual or organization, the lease term of the original lease agreement should be no shorter than one year.

Generally, the AMR does not accept "residential" purpose real estates to be used for business registrations. The purpose of the premises as indicated in the Real Estate Ownership Certificate, (i.e., residential purpose, commercial purpose, or industrial purpose) must match the nature of the businesses. For example, the premises for a FICE should be for commercial use, while the premises for a manufacturing company should be for industrial use.

In most cases, 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 a number of providers in major cities across China. For recent start-ups or foreign companies wanting to test the waters first, having to lease office space can be a burdensome commitment. Serviced offices offer an option in which businesses can lease the required office space under flexible terms and at more accessible prices. Apart from simply being a cost-efficient way to meet the office space requirement, using a serviced office provider allows companies to use their on-demand services, such as IT packages, secretarial support and meeting rooms. While these often-tiny work places can offer a solution, it is important to realize that not all of them are in compliance with the AMR standards. Investors who consider this option are suggested to confirm with the serviced office as well as the authority in charge whether the serviced office address can be used as premises for business registration.

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

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, which is difficult to mange with the ongoing COVID-19 pandemic and the travel restriction policies implemented in China. Investors are suggested to contact the bank or consult with professional services for solutions.

MONICA LI
Manager
Business Advisory Services
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."

Intellectual property considerations

Intellectual property (IP) protection is a longstanding and critical concern for companies operating in China, which has also been a key point of contention in the US-China trade war. China has already made strides in recent years to improve IP protection as the government seeks to spur domestic Chinese innovation and improve the business environment for investment, such as revising its IP laws and establishing a new national IP appeals court. However, challenges remain, as counterfeiters and infringers are getting increasingly sophisticated. For example, infringers may take advantage of procedural loopholes and proactively seek to invalidate legitimate IP rights. Companies are thus suggested to develop a comprehensive strategy to identify and protect their IP in China. This includes enhancing internal controls and making the best use of external resources.

In China, IP is defined as a proprietary right enjoyed by a holder with respect to their works, inventions, trademarks, geographical indications, trade secrets, layout design of integrated circuits, new varieties of plants, etc. Among others, copyrights on works, patent rights on inventions, utility models, and designs, and trademark rights, are the most common IP rights.

China follows the principle of territoriality in IP protection, meaning IP rights acquired under the laws of a country can only be valid and protected within the territory of that country unless an international convention or bilateral or multilateral agreement is in place. What that means is that enjoying IP rights in a foreign country will not automatically secure the IP rights in China. A domestic IP registration/filing in China is necessary to effectively protect your IP in the country.

Besides, China mainly applies a "first-to-file" rule for IP registration, which means that the first entity or individual who registers IP rights will hold those rights exclusively, irrelevant of the original user, with limited exceptions. Thus, the first and foremost strategy we can offer is to register/file your IP rights in China as early as possible.

In addition to registration, businesses are also suggested to establish a thorough internal IP protection system, to adopt preventive measures to protect IP, and to confront IP infringements in business operations. This system can be set up with the help of external third-party professional services, especially for businesses that are new to China and have limited knowledge of China's trademark protection situation.

For businesses engaging in import-export, they are suggested to file their patent, copyright, or trademark, with the customs authorities. This is necessary because:

- It is a prerequisite for the customs to take active IP protection measures.
- It helps customs to find infringing goods.
- It can have a deterrent effect on the infringer.

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.

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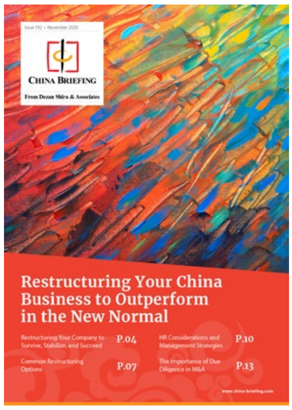

Restructuring Your China Business to Outperform in the New Normal
China Briefing Magazine
November 2020

In this issue of China Briefing magazine, we walk foreign investors through the different considerations when restructuring their China businesses.

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[1] *JVs that havn't adapt to the new governing structure based on the 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 file 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 is 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 for 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.

ALLAN XU
Director
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.”

“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 corresponding 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.

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 one 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, 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 an option. 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."

Business suspension

Business suspension, or company dormancy, refers to a policy that allows enterprises to cease business activities during a given period of time and return to the market when they are financially and operationally stable.

According to the *Administrative Regulation of the People's Republic of China on the Registration of Market Entities* (the Regulation) and its Implementing Rules that took effect on March 1, 2022, business suspension is applicable to those situations when the company's normal operation is challenged by factors like natural disaster, accident, public health incident, or public security incident. The company can decide to suspend its business for a certain period by its own assessment, but the suspension period cannot be more than three years. A business suspension filing with the local AMR is required to turn the company's status to "business suspension".

For the company to become dormant, the law in China currently does not impose many restrictions on applicant eligibility. Generally speaking, the company should not be included in the blacklist of abnormal operations or serious illegal and dishonest acts, and the business suspension filing should not endanger national security, public interests, the rights and interests of trading counterparties, etc.

During the business suspension period, the company shall be exempted from retaining physical premises, and the company can suspend their business operation legally, without getting their business license revoked. Besides, the dormant status may also bring the following benefits to the company:

- Reserve the company name;
- Reserve the special license or pre-approval, which is hard to apply for again in a special industry;
- Protect the company's branding or other intangible assets;
- Hold a particular type of physical asset, such as property; and
- Save the time and cost of winding down the company and opening a new entity in the future.

To be noted, however, the Regulation and its Implementing Rules provide clear guidance on how the dormant company should deal with its tax obligations, such as whether the company is still required to complete monthly/quarterly/annually tax filing or not. The corresponding tax responsibility during the suspension period, however, still needs to be clarified by the competent tax authority.

Moreover, the Regulation and its Implementing Rules do not state that business suspension can be used as a lawful reason for termination. The company can only use the business suspension situation as a strategic condition in the termination negotiation, rather than as a ground to unilaterally terminate its employees.

Deregistration

Companies in China may want to end their operations for various reasons, due to changes in their business scope, failure to adapt in the market, or external pressures like the US-China trade war. Irrespective of what factors might trigger this decision to shut down the business, investors cannot simply walk away without following proper closure procedures.

For one, not properly closing the company will attract stringent penalties from the government's tax and regulatory bodies. It could also do lasting damage to the reputation of the company – both in the eyes of the law and among consumers – as the business will be blacklisted.

Moreover, in case of improper closure, the legal representatives and financial associates of the entity will face difficulty in moving out of the country, starting another business, or even conducting ordinary banking and financial transactions if they are based in China.

The *Company Law* stipulates certain requirements before triggering the closure of a company. This includes organizing the liquidation of the company prior to the cancellation of its registration, followed by the announcement of the termination of the company. Overall, the company deregistration process requires dealing with multiple government agencies, including the respective industrial and commercial bureaus, market regulatory bureaus, tax departments, and banking authorities.

Take WFOE closure as an example, the following steps offer a rough guideline to the deregistration procedure:

- Form a liquidation committee and prepare an internal plan
- Liquidate the assets
- File a record with SAMR
- Newspaper announcement
- File a record with MOFCOM
- Begin terminating employees
- Tax clearance and deregistration
- SAMR deregistration
- Deregister with other departments
- Bank account closure
- Cancel company chops

CHENCHEN LIU
Assistant Manager
Business Advisory Services
Shanghai Office

"A WFOE will usually be subject to special attention during its closure procedure, involving more steps and authority involvement than that of its representative office and Chinese company counterparts."

While each case is unique, the whole process of deregistration can take up to a year or longer. The time taken to successfully close a business depends on the enterprise' preparedness, credit-debt record, level of compliance, and submission of information to various government departments. For example, it typically takes six months to one year to deregister a RO and even longer in case of irregularities. In the case of a WFOE, it typically takes between 12 to 14 months.

The STA has issued the *Notice on Further Optimizing the Procedures for Dealing with Enterprise Tax Deregistration* (henceforth Notice) to ease the difficulties of enterprise deregistration. The Notice takes measures to reduce enterprises' repeated errands and to issue tax clearance certificates on the spot even when some enterprises submit incomplete documents.

In particular, the newly introduced commitment system presumes the integrity of the enterprise, which may be reflected in a positive inspections record, high tax credit ratings, and no tax or fines owed. In such situations, the tax clearance time will be unaffected, and only a commitment is needed from the legal representative deregistering the company to provide all tax-related information within a stipulated time period.

Through the above measures, many expect that the cancellation time of enterprises can be reduced by at least one-third. At the same time, the government will strictly investigate business entities indulging in the evasion of debt. The names and information on enterprises that have lost credibility due to non-compliance or debt evasion will be jointly published by the respective government agencies.

Closing a business requires a holistic view of every aspect of the business – whether it be HR, tax, legal, accounting, IT, logistics, or stock and inventory. Many of these issues are intensified when a company is inactive or there has been insufficient preparation. When an investor decides to close a business, making a plan is essential to staying ahead at each stage of the closure process, and can mean avoiding lengthy delays, added costs, and serious consequences. Businesses should ensure they retain an experienced local advisor to avoid some of these common challenges and pitfalls.

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Tax, Audit, and Accounting

- What are the major taxes in China?
- What are some of the key compliance requirements?

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 CIT rate applied to all companies in China today, both foreign and domestic, is 25 percent. Reduced CIT rates are available based on the entity type, size, sector, or location. A reduced CIT rate of 20 percent is applied to small and low-profit enterprises (SLPEs) on 12.5 percent of the taxable income amount for the portion of taxable income not exceeding RMB 1 million (effective from January 1, 2021 – December 31, 2022) and on 25 percent of their taxable income amount for the portion of taxable income more than RMB 1 million but not exceeding RMB 3 million (effective from January 1, 2022 – December 31, 2024), which means the effective CIT rates are 2.5 percent and five percent, respectively. If a taxpayer qualifies as a high-tech enterprise or is 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 qualified enterprises. Besides lower CIT tax rates, other CIT incentives include CIT exemption on certain type of incomes, such as dividends, bonuses, and other equity investment income between qualified resident enterprises; CIT reductions on certain incomes, such as income derived from eligible technology transfer; additional pre-tax deduction of certain expenses, such as research and development (R&D) expenses; tax credits for certain costs, such as the investment in seed-stage or start-up technology enterprises; and accelerated depreciation or one-time deduction of the value of fixed assets.

RELATED READING

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October 2022

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Key Preferential CIT Incentives Checklist	
☐	CIT incentives for small and low profit enterprises (SLPEs)
☐	CIT incentives for high and new technology enterprises (HNTEs)
☐	CIT deductions on R&D expenditures
☐	CIT incentives for technology-based small- and medium-sized enterprises (TSMEs)
☐	CIT incentives for advanced technology service enterprises (ATSEs)
☐	CIT incentives for qualified enterprises established in certain regions, such as western China, Hainan FTP, Shanghai Lingang, Shenzhen Qianhai, Fujian Pingtan, and Zhuhai Hengqin
☐	CIT incentives for enterprises engaging in pollution control
☐	CIT incentives for hiring disabled employees or retired soldiers
☐	CIT reduction for enterprises investing in seed-stage or start-up technology enterprises
☐	CIT incentives for software enterprises and integrated circuit enterprises
☐	CIT incentive for 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) ≤30% of the sales revenue of the current year (the excess can be carried forward to future years for deduction) for enterprises manufacturing or selling cosmetics, enterprises manufacturing pharmaceuticals, and enterprises manufacturing beverages (excluding alcohol)* Not deductible for tobacco enterprises*

**Effective from January 1, 2021 to December 31, 2025*

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

China offers IIT incentives in certain regions, such as the GBA, the Hainan FTP, Shanghai Lingang New Area, and Zhuhai Hengqin. In such regions, the effective IIT rate for qualified talents could be lowered to 15 percent, though the eligibility and application method vary from each other.

RELATED READING

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.

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Turnover taxes

Value-added tax (VAT)

VAT is one of two major turnover taxes in China, the other being consumption tax. VAT is levied on the gross margin at every point on the supply chain where value is added to a taxable product or service. It is considered a neutral tax, allowing taxpayers to offset VAT that has already been paid for the cost of materials used in the product at a previous stage.

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 (RMB 5 million, approx.US$710,000) set for small-scale taxpayers must apply for general taxpayer status. 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 certain conditions.

Small-scale taxpayers are generally subject to a lower VAT levy 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.

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.

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.

Since April 2019, qualified taxpayers have been allowed to apply for uncredited VAT refunds in the current taxable period. In 2022, the full refund of incremental VAT credit on a monthly basis, which was previously only available to companies in the advanced manufacturing industry, was extended to micro and small firms in all industries as well as qualified enterprises in another twelve industries. Moreover, qualified enterprises will also enjoy a one-off refund of their remaining VAT credit in turn, following a timeline specified by the tax authorities.

JENNY LIAO
Director
Corporate Accounting Services
Shanghai 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."

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 multiple preferential VAT policies. During the period between April 1, 2021 and December 31, 2022, small-scale VAT taxpayers that are subject to a VAT levy rate of three percent will be exempted from VAT payment or prepayment. Meanwhile, during the same period, small-scale taxpayers shall also be exempted from VAT where their monthly turnovers do not exceed RMB 150,000 (approx. US$23,000) or quarterly turnovers do not exceed RMB 450,000 (approx. US$69,000).

Fapiao

In China, *fapiao* refers to VAT *fapiao* (invoices) in particular. It is a business voucher issued and received by all parties involved in the purchase and sale of goods or services. Different from the commercial invoices or receipts used in many other countries mainly to record transactions, *fapiao* in China serve as both the legal receipt and the tax invoice.

Fapiao can mainly be sorted into two categories – general VAT *fapiao* and special VAT *fapiao*. While special VAT *fapiao* can only be utilized by VAT general taxpayers, general VAT *fapiao* can be utilized by any company registered in China but cannot be used by the recipient for VAT deduction purposes.

These two types of *fapiao* have been in paper form for a long time. However, China has been trying to digitalize its *fapiao* system, first on general VAT *fapiao* since 2015, then expanding to special VAT *fapiao* since 2020. Next, from December 1, 2021, China kicked off another pilot program of fully digitalized e-*fapiao*, which is a completely new type of electronic invoice that is different from the previously introduced normal VAT e-*fapiao* but has the same legal effect. Initially piloted for selected taxpayers in Shanghai, Guangdong, and Inner Mongolia, the pilot program of fully digitalized e-*fapiao* was further expanded in 2022, with a broader scope of taxpayers being able to issue and accept fully digitalized e-*fapiao*.

E-*fapiao* imposes new compliance requirements on the financial and accounting processes and requires software installment and system upgrade. On the other side, it offers a great opportunity for enterprises to further automate and optimize their operations. CFOs and finance managers with responsibility for China operations are suggested to prepare for e-*fapiao*'s impacts on their existing systems and procedures as well as the benefits rooted in the digitalization of VAT invoice.

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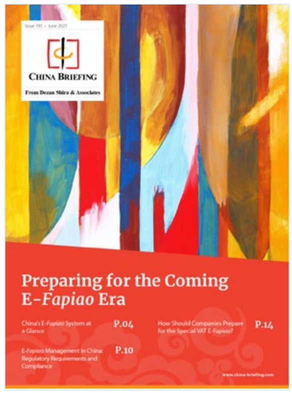

Preparing for the Coming E-*Fapiao* Era
China Briefing Magazine
June 2021

China has been quickly expanding the pilot program on electronic special value-added tax (VAT) *fapiao*. What is e-*fapiao*? How will it affect your business? In this issue of China Briefing magazine, we demonstrate the opportunities and risks associated with e-*fapiao* implementation.

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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, ranging from one percent to 56 percent. 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

c. Compound method:

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

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.

Surtaxes

Urban maintenance and construction tax (UMCT), in addition to the education surcharge (ES) and local education surcharge (LES), are the typical surtaxes levied in China, which means these taxes are levied on the basis of turnover taxes, rather than the total value of the business transactions. To be more detailed:

- UMCT, 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.

During the period between January 1, 2019 and December 31, 2024, taxpayers that fall into the scope of SLPEs, small-scale taxpayers, or self-employed individuals can enjoy a 50 percent surtaxes reduction.

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.

ADA ZHOU
Manager
Corporate Accounting Services
Shanghai Office

"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."

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 2022, China imposed export duties on 106 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.

Stamp tax

Stamp tax is levied on entities and individuals who make taxable documents and conduct securities transactions within the territory of China, or who make taxable documents outside the territory of China to be used within the territorial of China. Taxable documents refers to contracts, property transfer documents, and business account books. The tax rates vary between 0.005 percent and 0.1 percent. During the period between January 1, 2019 and December 31, 2024, taxpayers that fall into the scope of SLPEs, small-scale taxpayers, or self-employed individuals can enjoy up to 50 percent tax reduction, based on the decision made by provincial governments.

RELATED READING

CHINA BRIEFING

China's New Stamp Tax Law to Take Effect on July 1: What are the Changes?

China Briefing Article

June 29, 2022

China's new Stamp Tax Law takes effect July 1, 2022 – there are some updates to the previous system of taxation, such as the simplification of tax compliance, changes to some tax rates, and new exemptions.

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Property tax

Property tax in China is mainly levied on property for commercial purposes. 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, 2024, taxpayers that fall into the scope of SLPEs, small-scale taxpayers, or self-employed individuals can enjoy a tax reduction up to 50 percent of the tax amount.

It should be noted that China is also considering expanding the property tax to real estate for residential use. This has been piloted in Shanghai and Chongqing since 2011. In October 2021, China further decided to implement a pilot property tax scheme in certain regions. But no details have been revealed so far.

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, 2024, taxpayers that fall into the scope of SLPEs, small-scale taxpayers, or self-employed individuals can enjoy up to 50 percent tax reduction.

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.

RELATED READING

CHINA BRIEFING

China's Urban Maintenance and Construction Tax: New Regulations in Effect from Sept. 1, 2021

China Briefing Article

September 6, 2021

New regulations on China's urban maintenance and construction tax took effect September 1, 2021, which clarified the calculation and management of the country's urban construction and maintenance tax. This includes the Urban Maintenance and Construction Tax Law and two supporting regulations.

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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, 2024, taxpayers that fall into the scope of SLPEs, small-scale taxpayers, or self-employed individuals can enjoy up to 50 percent resource tax reduction.

Vehicle purchase tax

Vehicle purchase tax is a tax levied on entities and individuals that purchase automobiles, trams, car trailers, and motorcycles with engine displacement exceeding 150cc within the territory of the People's Republic of China.

"Purchase" refers to the act of obtaining a taxable vehicle for own use through purchase, import, self-manufacture, gift, prize-winning, or any other method. A one-off levying and collection shall be implemented for vehicle purchase tax.

Starting from January 1, 2018, the vehicle purchase tax has been exempted for purchase of new energy vehicles (NEVs). This policy is now extended to December 31, 2023.

Besides, the vehicle purchase tax will be halved for passenger cars with displacement of 2.0 liters or less, purchased between June 1, 2022 and December 31, 2022, and if the price of a single vehicle (excluding VAT) does not exceed RMB 300,000.

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

Environmental protection tax is levied on enterprises, public institutions, and other producers or operators that discharge taxable pollutants directly to the environment within the territorial areas of the People's Republic of China and other sea areas under the jurisdiction of the People's Republic of China.

On January 1, 2018, China's first Environmental Protection Law (EPT Law) came into effect, replacing the previous pollutant discharge fee (PDF) system in a bid to strengthen the enforcement of environmental regulations.

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 administration authorities significantly differ from the previous system.

What are some of the key compliance requirements?

AMBER LIU
Senior Manager
Corporate Accounting Services
Shenzhen Office

"To be noted, though closely related to each other, there are discrepancies between CAS and tax laws, which are referred to as book-tax difference."

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 Ministry of Finance (MOF) released ASBEs in 2006 and brought them into effect in January 2007. It experienced several amendments in the following years. Currently, the ASBEs consist of one basic standard, 42 specific standards, and several application guides. Most foreign invested enterprises (FIEs) established in China generally adopt ASBEs for their accounting and financial reports.

Entering into force on January 1, 2013, the ASSBEs are the counterpart of ASBEs for SMEs, providing unified standards for small-size enterprises. The ASSBEs use the ASBEs as a reference but are more similar to tax laws in terms of their tax calculation methods, which simplify the process of making adjustments between accounting standards and tax rules. Small-scale enterprises can choose to adopt either the ASBEs or ASSBEs.

In addition to the CAS framework introduced above, there are also some enterprises adopting the *Accounting System for Business Enterprises*, which was released by the MOF in 2000. The *Accounting System for Business Enterprises* applies to all types of medium and large companies except for listed companies and financial and insurance companies. With a growing number of companies voluntarily adopting the CAS framework, the *Accounting System for Business Enterprises* is becoming less common even if it is China-specific and easy to implement.

For social organizations, foundations, non-profit private schools, medical institutions, temples, Taoist temples, Mosques, churches, and other social service agencies, their accounting is regulated by the *Accounting System for Non-governmental Non-profit Organizations* (the "Accounting System for NGOs"), which was released by the MOF in 2004. A representative office established by an overseas NGO falls into this category. Different from CAS or the *Accounting System for Business Enterprises*, the Accounting System for NGOs imposes specific requirements on the accounting treatments of various kinds of asset donations and labor donations, the entrusted agency business where the NGO plays an intermediate role of handing over an asset to a designated beneficiary, the division of restricted and unrestricted net assets, the classification of cost of business activities, and the additional disclosure requirements on the explanatory notes on the financial situation. With more NGOs seeking to have an establishment in China, this standard has drawn more attention in recent years.

To be noted, though closely related to each other, there are discrepancies between CAS and tax laws, which are referred to as book-tax difference. To put it simply, book-tax difference means that for the same transaction, the tax treatment and timing of recognition as stipulated by the tax laws are different from the accounting treatment as stipulated by the accounting standards. Such differences mostly come from the different goals served by the accounting standards and tax laws. While the purpose of accounting is to accurately and truly reflect the financial situation of an enterprise, the tax laws mainly ensure the tax revenue of the jurisdiction. Thus, the two regulatory systems differ in accounting elements and measurement principles. For the sake of tax compliance, businesses are suggested to pay attention to the book-tax differences and deal with tax in an effective manner.

Besides, although CAS has substantially converged with IFRS, there are additional considerations due to the special circumstances in China. This leads to accounting treatments that are different from those derived from the principles and description in IFRS. For foreign entities that report under IFRS and consolidate their Chinese subsidiaries that report under CAS Standards, the information from the Chinese subsidiary needs to be carefully translated, mapped, and converted to fit into the overseas parent company's accounting books and policies. Knowing the differences between the two is a prerequisite for being able to do so.

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.

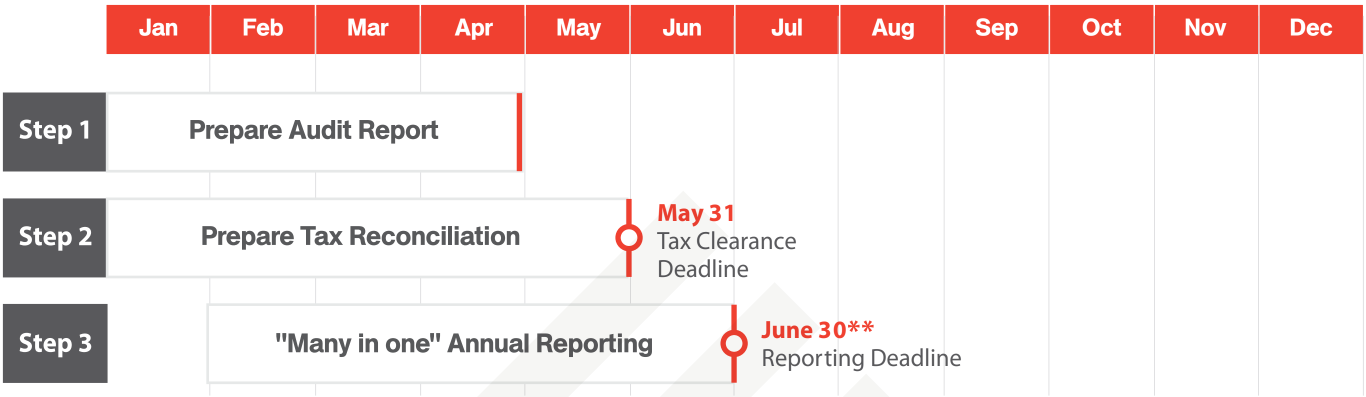
Enterprises in China should adopt the accrual basis of accounting in performing recognition, measurement, and reporting for accounting purposes. FIEs, including their legally responsible persons, must take full responsibility for the truthfulness, legitimacy, and completeness of financial statements.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

Books and records have to be retained for at least 30 years under Chinese law.

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 official 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. 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.

- **Step 2: Conduct CIT reconciliation**

Although the STA oversees all kinds of tax, only CIT 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 could be 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.

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.

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. 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.

Following the annual audit and completion of tax payment, a net profit figure can be derived. After allocating a portion of the profit (at least 10 percent for WFOEs) to a reserve fund account (until the reserve fund reaches 50 percent of the registered capital) and to a staff bonus welfare fund or an expansion fund (not mandatory), the remaining net profit can be repatriated or reinvested. With 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.

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

The third step of annual compliance is to conduct annual reporting to multiple government bureaus, 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 usually covers the basic information of the enterprise, investor profiles, equity change information, investment information, balance sheet of the company, warranties and guarantees, operation information of the enterprise, credit and debt information, tax breaks enjoyed, and the customs relevant information. Information regarding the credit and debt.

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.

RELATED READING

Annual Audit and Compliance in China: Get Ready for 2022
China Briefing Magazine
November 2021

With the scope and penalties of China's social credit system being further clarified in 2021, legal and regulatory compliance has become more important than ever. More attention should be given to the annual compliance procedures as mandated by various governmental departments. In this issue of China Briefing magazine, we walk foreign businesses through the annual audit and compliance process from start to finish.

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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.

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*

Failing to submit the annual report on time may lead to additional penalties, ranging from RMB 10,000 to RMB 30,000. An RMB 20,000 to RMB 200,000 penalty might be given if the report includes fraudulent information. Failing to make corrections as required or fraud could lead to license revocation.

Tips on managing annual compliance requirements

Tip 1: Paying attention to the procedural changes and corresponding requirements.

While the essential steps remain similar, in the context of China's business reform and opening up, the detailed procedures have been subject to frequent changes in recent years. Companies are suggested to pay special attention to the annual compliance updates, study the new requirements, and make necessary preparations to stay compliant.

Tip 2: Paying attention to the local variations

The detailed procedures and requirements of each step may vary from one place to another. It is not always right to assume the company is compliant by solely referring to the national laws and regulations.

Tip 3: Using qualified third-party services

It is not uncommon to see companies getting penalized for unnecessary mistakes or negligence, with business credit being affected. Such companies are suggested to use professional third-party service firms rather than managing the matter internally.

IVY GU
Manager
Audit and Corporate
Accounting Services
Shanghai Office

“Performing similar due diligence on other third parties, such as prospective distributors or joint venture partners, is advisable for doing business in China.”

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.

HANNAH FENG
Partner
Beijing Office

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

Internal control and financial review

To mitigate potential business management risks associated with frauds, companies in China are all advised to develop a thorough internal control mechanism, and periodically review their internal control procedures to ensure the effectiveness of the system over time. Especially when most businesses become vulnerable to acts of fraud in the era of COVID-19, where employees are troubled by travel restrictions and when working-from-home (WFH) is the new normal, it is more critical than ever for them to assess possible fraudulent risks within the organization and develop corresponding strategies in advance. 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;
  - Falsification of expense claims; 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.

As such, many foreign companies choose to engage an audit firm to perform periodic reviews of the internal control system or financial health check of their Chinese subsidiaries. Meanwhile, fraud prevention programs must also be developed. Below we offer some tips on reducing risk exposure:

- Segregation of duties properly among key personnels;
- Ensuring supervision by building an effective and clear reporting line;
- Re-assessing the corporate governance structure; and
- Developing a proper mechanism to safeguard and prevent misuse of company chops.

SHIRLEY CHU
Manager
Tax
Dalian Office

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 before 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.

"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).

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.

Depending on how the term is defined, labor contract could be divided into three groups:

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

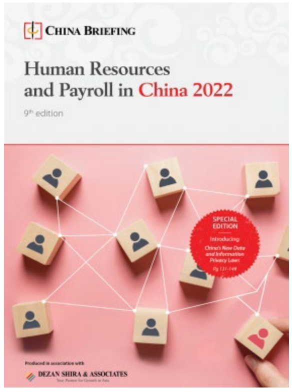
Fixed-term contract

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, including the employer and employee information, the term of the contract, the job description, the salary details, etc. Depending on the specific situation, a number of additional terms to the labor contract are recommended, including:

- Probation period;
- Non-competition clauses;
- Confidentiality clauses;
- Allowances and benefits (particularly for foreign employees); and
- Reference to the company rulebook or staff manual.

RELATED READING



Human Resources & Payroll in China 2022 (9th Edition)
February 2022

This special edition of HR and Payroll, updated for 2022, navigates China's newest laws and regulations related to HR and payroll management. Among others, we added a new section introducing the latest privacy and personal information protection requirements in human resources management.

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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 to 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
- Written contract is not mandatory for part-time employees.

Non-fixed term contract

Non-fixed term contract refers to a norm of labor contract between employer and employee that has no fixed term. The non-fixed term contract effectively guarantees the employee job security until retirement age. As there is no longer a contractual limit to the length of employment, companies will be unable to dismiss the employee upon the expiry of the labor contract. This means employers can only terminate the employee by mutual agreement or based on valid grounds.

Job contract

A job contract is defined by the task or project the employee is to work on, not the length of time. This type of contract allows a company to hire a person to implement a specific project. Once the project is completed, the employment relationship comes to an end. At that stage, the company needs to make a severance payment to the employee accordingly.

Job contracts are sometimes used for seasonal jobs where the scope of work can be defined very clearly. However, in most cases, defining the scope of work proves to be a challenge. It is often hard to adequately define the completion of a project. The relevant legal framework offers no guidance on what to do when a project is left uncompleted for whatever reason, or how employees should be compensated in such a case.

This lack of clarity makes job contracts relatively more prone to disputes and even litigation. In addition, the employer is not allowed to set a probation period for a job contract. For these reasons, most employers avoid this type of arrangement.

Dispatch

Labor dispatch is an important form of supplementary employment in China. Unlike direct hiring, labor dispatch has a triangular form of employment relations, in which a host company hires dispatch workers from a dispatch agency. While dispatched workers work for and are supervised by the host company, the dispatch agency, which usually have considerable experience and knowledge of hiring local workers, is the de facto legal entity that is responsible for the administrative management of the employees.

Compared to direct hiring, labor dispatch is particularly attractive where:

- the business is not allowed to hire employee directly, either because the business is in the process of setup and hasn't got its business license, or because the business is structured as a RO, which is legally required to recruit through dispatch agencies;
- business priority is given to revenue-generating activities over any other concerns, especially when the business is small-size and at its very early stage; or
- there is an inconsistent work flow for businesses in seasonal and project-based industries.

Despite the popularity of the labor dispatch among FIEs, China has been limiting companies from taking advantage of labor dispatch, to protect dispatched workers.

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.

RELATED READING

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August 2020

China has leapfrogged other countries by rapidly digitalizing its financial, tax, and HR compliance procedures. n this special issue of China Briefing, we examine how business leaders can get the most from simple, cost-effective solutions.

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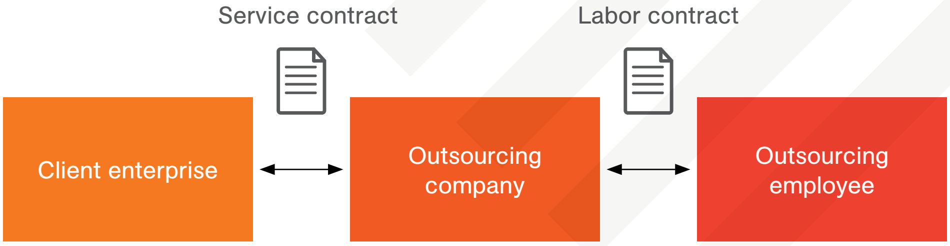
Outsourcing

Outsourcing is another form of supplementary employment in China. It's traditionally applied to tasks that require specialist skills, a high degree of confidentiality, or those that have a clear scope but incur major consequences if incorrectly implemented, such as IT development, accounting, tax filing, HR administration, and payroll processing.

With labor dispatch facing increasing scrutiny, many companies tend to use outsourcing as a substitute to dispatching, as another alternative to avoid directly hiring employees.

Similar to labor dispatch, outsourcing can help businesses in China circumvent tedious administrative processes and still match workforce needs. Under this model, the client enterprise has no direct employment relationship with the outsourcing employees.

Outsourcing



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.

HR & PAYROLL

For assistance with automating your HR processes or advice on drafting labor contracts, please contact us at hr.admin@dezshira.com

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*, 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.

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 State Administration of Foreign Expert Affairs (SAFEA) has released the detailed scoring criteria and other specific standards to evaluate expats , which could be found in the online service platform of the Ministry of Science and Technology (http://fuwu.most.gov.cn/).

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,* 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.

Renewal and deregistration of foreigner's work permit

The Foreigner's Work Permit in China is normally valid for one year. The validity period can be raised to two years for Tier B talents and five years for Tier A talents. It may not, however, exceed the validity of the employee's passport, the term on the company's business license, or the registration certificate of the employer. The Foreigner's Work Permit in China will also be subject to annual review.

Renewing the Foreigner's Work Permit in China is not as difficult or time-consuming as making the initial application. However, companies must be organized enough internally to know when each foreign employee's visa will expire. If the Foreigner's Work Permit in China is not renewed upon expiry, it will be deregistered automatically.

When the employment relationship between the employer and the foreign employee ends, the employer is bounded to deregister the Foreigner's Work Permit in China within 10 days of termination. And when the employer company no longer exists, the foreigner can apply to the local bureau in charge to deregister its Foreigner's Work Permit in China by themselves.

With the deregistration of the Foreigner's Work Permit in China, the Residence Permit shall be deregistered as well, and the foreigner need apply to the entry-exit bureau for a temporary visa that grants limited time of stay.

What obligations do I have as an employer?

DAVID NIU
Partner
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. However, China's minimum wage standards do include the social insurance premiums and housing fund contributions paid by employees in most regions. In fact, it is possible that the employee's take-home pay is lower than the corresponding minimum wage standard in these regions. Only a few regions, such as Shanghai, clearly stipulate in their local rules that their local minimum wage standards exclude social insurance premiums and housing fund contributions.

Work hour system and overtime payment

In China, overtime is paid differently depending on the work hour system adopted by the employer, i.e., standard work hour system, comprehensive work hour system, and non-fixed work hour system. The latter two systems are considered 'special work hour systems', which engage special approval and compliance requirements.

Overtime payments are subject to the below overtime rates:

Overtime Payment under the Standard Work Hour System	
Time of work	Percentage of hourly salary*
Extra hours worked on weekdays	150%
Hours worked on weekends	200%
Hours worked on public holidays	300%

**Basic hourly salary is calculated by taking the monthly pay of the employee and dividing it by 174 (average number of working hours in the month).*

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. Overtime is applicable for hours worked above the standard set per cycle. However, no rest day is outlined under this system.

Overtime payments are subject to the below overtime rates:

Overtime Payment under the Comprehensive Work Hour System	
Time of work	Percentage of hourly salary
Extra hours worked outside of normal shift	150%
Extra hours worked on public holidays*	300%

**This higher rate applies even if the standard shift for the worker is scheduled on a public holiday.*

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.

How to get approval for the special work hour system

Before implementing a special work hour system, be it comprehensive or non-fixed work hour system, the employer must apply to the local labor bureau for approval.

It usually takes around 20 working days for the labor bureau to examine and decide whether to grant an approval. Once approved, the company can implement the special work hour system for one to three years, as stipulated by the approval document issued.

To be noted, the requirements to be eligible for the special work hour system may vary from city to city. For example, Beijing allows senior management to undertake the non-fixed working hour system without the need for approval. Shanghai, on the other hand, requires permission prior to allowing any staff to engage in the non-fixed work hour system. In this case, we advise companies to contact the relevant labor bureau in charge for applying for the special work hour systems.

Social security

China's social insurance system consists of five different types of insurance – pension, medical, unemployment, work-related injury, and maternity insurances. These five insurances plus a housing fund scheme form China's social security system.

In China, 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. However, since social security is managed at regional level, a range of inconsistencies exists among cities. Moreover, foreign employees are eligible for social insurance exemptions if they come from countries that have social insurance exemption agreements with China. To date, China has signed social security agreements with 12 countries, but only 11 such agreements have been implemented, including Germany, South Korea, Denmark, Canada, Finland, Switzerland, the Netherlands, Spain, Luxembourg, Japan, and Serbia.

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.

China's Social Security System			
Category	**Contribution***		**Description**
	Employer rates	**Employee rates**	
Pension insurance	Around 16%	Around 8%	Designed to provide necessary financial support to individuals after their retirement
Unemployment insurance	0.5%-1%	Around 0.5%	Designed to provide financial support to individuals who faultlessly lost their job within certain period
Medical insurance	5%-12%	Around 2%	In the event of illness/non-occupational injury, an employee can have part of the treatment cost covered by medical insurance
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 part of 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 workers save to purchase housing

** 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.*
***Depending on what kind of work is beign carried out by the employee*
****Maternity insurance has been merged into medical insurance in most cities. The contribution rate of the employer shall be the sum of their original contribution rates to the medical insurance and the maternity insurance. The contribution rate of the employee shall be their original contribution rate to the medical insurance, considering employees don't need to contribute to the maternity insurance.*
*****In certain cities, employer and employee are allowed to contribute more than 12 percent.*

Leave and vacations

Under Chinese labor laws and regulation, employers in China are obliged to provide corresponding paid leaves and vacations to qualified employees.

Statutory annual leave

Statutory annual leave in China is generally granted based on an employee's work tenure, as demonstrated in the below table:

Statutory Annual Leave	
Work tenure	**Days leave**
Less than one year	No leave
1-10 years	5
10-20 years	10
Over 20 years	15

To be noted, work tenure is not limited to the length of time that an employee has worked for their current employer, but rather refers to their cumulative work years with all previous and current employers. Also, paid annual leave does not include the country's statutory rest days, public holidays, and other additional holidays (e.g., maternity leave and paternity leave).

In the case where an employee has not taken all of their paid annual leave in that year, and does not agree to carry over the untaken leave to the next year, the employer must compensate this employee with 200 percent of the employee's average daily wage for each day of unused annual leave, in addition to their regular daily wage.

National holidays

Besides statutory annul leave, employees are entitled to paid leave for the below national holidays:

- New Year – 1 day;
- Spring Festival (Chinese New Year) – 3 days;
- Tomb Sweeping Day – 1 day;
- Labor Day – 1 day;
- Dragon Boat Festival – 1 day;
- Mid-Autumn Festival – 1 day;
- National Day – 3 days.

Employees are entitled to triple pay for working on national holidays.

Child-related leaves

Child-related leaves in China include prenatal check-up leave, maternity leave, breast-feeding leave for female employees, paternity leave for male employees whose wife has given birth, and childcare leave for those whose child is under a certain age. The exact number of days of child-related leaves vary from one province to another. By law, employees are entitled to be paid as normal for these leaves, or even higher in the case of maternity leave.

Sick leave

Employers usually have considerable autonomy in deciding how many paid sick days it would like to give employees in a year. However, there are stricter rules when it comes to the recuperation period, a specific type of sick leave in which the employer cannot terminate the employee suffering from non-occupational sickness or injury and is responsible for paying a proportion of salary by law. The regulations on recuperation period are made at the local level, which vary from one province to another.

Marriage leave

In China, newly-wed employees are entitled to marriage leave – extra days of paid leave. Although there is no clear law on how many days of marriage leave an employee can get on the national level, every region in China offers employees who get married at least three days of leave, by referring to the marriage leave requirements to the state-owned enterprises. Many regions in China tend to offer extra marriage leave, with Gansu and Shanxi – which offer 30 days – the most generous.

Termination

DONFIL HUANG
Manager
Business Advisory Services
Guangzhou Office

"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.

Severance payment

The formula of calculating the severance payment is:

SEVERANCE PAYMENT = AVERAGE MONTHLY SALARY x YEARS OF SERVICE

- For the average monthly salary: It is calculated as the employee's average monthly salary during the last 12 months preceding the termination. If the employee worked for less than 12 months, the average monthly salary shall be calculated according to the actual work time.
- Three-time restriction: Where the employee's average monthly salary is more than three times the average monthly salary in the location of employment, the latter will be used to calculate severance pay.
- For counting the years of service: For a working period that is less than six months, it shall be counted as half a year, and half a month's salary must be paid as severance payment. If a working period is over six months but less than one year, it shall be counted as one year, and one month's salary shall be paid as severance payment.
- Total amount restriction: For an employee whose average monthly salary is more than three times the average monthly salary in the location of employment, the severance is limited to a maximum of 12 month's average salary, even if they worked for a company for over 12 years.

The calculation method provided above is only the minimum amount an employer is required to pay by law. In practice, however, employers often pay a higher amount than the statutory minimum amount.

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.

4

Cybersecurity and Data Protection

- What are the major cybersecurity and data protection laws?
- What are some of the key compliance requirements?

THOMAS ZHANG
Partner
Shenzhen Office

“Cybersecurity and data protection are becoming increasingly important in China. Building compliance into IT infrastructure and systems is key to achieving the goals set in the laws and regulations.”

Cybersecurity and data protection are becoming increasingly important in China, as in most major economies. With the release of the *Cyber Security Law* (CSL), the *Data Security Law* (DSL), the *Personal Information Protection Law* (PIPL), together with some other relevant data security regulations and guidelines, China is fleshing out its extensive legal realm of cybersecurity and expands and clarifies requirements for companies to protect data and networks in several areas.

In this chapter, we introduce China's major cybersecurity and data protection laws and regulations, explain the key compliance requirements for businesses, and provide practical tips on preparing for these new obligations.

What are the major cybersecurity and data protection laws?

So far, the three sweeping laws – the CSL, the DSL, and the PIPL, together with some other relevant data security regulations, department rules, standards, and guidelines, form the legal framework for cyberspace governance, information security, and data (privacy) protection in China.

The CSL, effective from June 1, 2017, is a milestone for cybersecurity legislation in mainland China and serves as a “Basic Law” in its field. The Law is an evolution of the previously existent cybersecurity rules and regulations from various levels and fields, assimilating them to create a structured law at the macro-level. The Law also offers principle norms on certain issues that are not immediately urgent, but are of definite long-term importance. These norms will serve as legal reference when new issues arise. The CSL has a wide influence over all enterprises that employ networks or information systems in their operations. According to related articles of the CSL, enterprises are roughly categorized into “network operators” and “critical information infrastructure (CII) operators” based on the enterprise's types and their business scopes.

On September 14, 2022, the Cyberspace Administration of China (CAC), China's top cybersecurity body, released draft amendments to the 2017 CSL. The amendments are designed to make the law consistent with several new laws that have been released since the 2017 CSL came into force. The seeking-opinion stage ended on September 29, 2022. At the time of writing, the amendments haven't been formally passed.

The DSL, effective from September 1, 2021, contains a wide range of provisions that stipulate how data is used, collected, developed, and protected in China. It emphasizes on top-down coordination of data security implementation among governments and differentiated fines based on severity of violations.

Among others, the most important part is probably the dealing of the “important data”, which generally refers to data related to “national security, national economy, and the people’s livelihood”. The DSL as well as some other regulations have repeatedly stipulated that transferring “important data” overseas are subject to a security review. While DSL does not elaborate on what constitutes “important data”, it requires government departments to formulate the catalogue of “important data”. The MIIT had become the first central authority to follow the directive. After two rounds of public comments in September 2021 and February 2022, the *Management Measures for Data Security in the Field of Industrial and Information Technology Sectors (for Trial Implementation)* was finally released on December 13, 2022, which divides the data in the fields of industry and information technology into three categories and clarifies the criteria for distinguishing “general data”, “important data”, and “core data”.

The PIPL, in effect since November 1, 2021, is China’s first law specifically regulating the protection of personal information, which has a far-reaching impact on data privacy compliance of enterprises. Similar to European Union’s *General Data Protection Regulation* (GDPR), the PIPL defines what is considered personal information in China and lays principles and rules on processing general personal information and sensitive personal information. One particular important point is that for firms processing personal data of more than a certain amount as well as CII operators, personal information collected or generated within the territory of China are required to be stored within China. If it’s necessary to provide the data overseas, the firm must undergo a security review conducted by the CAC in advance.

In addition to the three sweeping laws, the CSL, the DSL, and the PIPL, China formulated a string of other data regulations in 2021 and 2022, including:

- On August 30, 2021 – the State Council unveiled the *Regulations on the Security and Protection of Critical Information Infrastructure*. It defines which companies are most likely to be defined as CII operators and what are their compliance obligations.
- On November 14, 2021 – the CAC released the *Network Data Security Management Regulation (Exposure Draft)*, which unifies data security rules introduced by the CSL, the DSL, and PIPL and rolled out review requirements for companies pursing IPOs in Hong Kong.
- On December 28, 2021 – the CAC released the revised *Cybersecurity Review Measures*, after seeking public comments in July 2021. It stipulates that any Chinese companies that hold the personal information of one million or more users would need to seek a government cybersecurity review before listing abroad. The new Measures took effect on February 15, 2022.
- On June 30, 2022 – the CAC released the draft *Standard Contract Provisions on the Export of Personal Information*, clarifying how companies can transfer personal information overseas by using a streamlined “standard contract” procedure – a much simpler procedure that does not require an external audit. The draft provisions also provide a standard contract template for transferring personal information overseas, which will be a strong reference for companies after it comes into force. Under the PIPL, companies are restricted from exporting personal information outside of China without prior approval or signing a contract with the

overseas recipient. The new provisions will greatly facilitate cross-border data transfer for foreign companies and multinationals handling small amounts of data.

- On July 7, 2022 – the CAC released the *Measures for Data Export Security Assessmen*t, following the release of the draft version for public comment on October 29, 2021. The document details specific requirements for security reviews for cross-border data transfer and clarifies what procedures companies must undergo to get clearance to transfer data overseas. The Measures took effect on September 1, 2022. Foreign companies and large multinationals have been eagerly awaiting such measures ever since China issued legislation requiring companies that want to export certain types of data to undergo a security assessment by the cybersecurity authorities.
- On August 31, 2022 – the CAC released the *Guidelines for Data Exit Security Assessment and Declaration (First Edition)*, which explain the procedures and processes for companies to apply for permission to export data out of China and include complete lists of required documents, templates for documents such as security assessment declarations, and application forms.
- On December 13, 2022 – the MIIT released the *Management Measures for Data Security in the Field of Industrial and Information Technology Sectors (for Trial Implementation)*. The document makes provisions on the hierarchical and classified data management in the fields of industry and information technology, the data lifecycle security management, the data security monitoring, early warning and emergency management, and the data security testing, certification, evaluation, and management. The Measures will take effect on January 1, 2023.

China Solicits Opinions on Amendment to *Cybersecurity Law*

On September 14, the CAC released new amendments to the *2017 China Cybersecurity Law*. The amendments were released along with a brief explainer, which stated that the amendments seek to make the law consistent with several new laws that have been released since the *Cybersecurity Law* came into effect in 2017.

Almost all of the amendments change the scope and severity of penalties for violating certain provisions. If passed, the amended law will increase fines for violations of cybersecurity obligations and prohibitions for network operators to up to RMB 50 million.

The amendments do not make any changes to the legality of various types of behavior or activity prohibited by the *Cybersecurity Law*. It also do not reduce the responsibilities of network operators to protect their networks, data, and users.

The amendments to the *Cybersecurity Law* may raise stakes for smaller companies, making compliance all the more critical.

What are some of the key compliance requirements?

Personal information protection

As a special legislation in the personal information protection field, the PIPL puts forward detailed obligations on businesses– as personal information processors – by incorporating special chapters and clauses.

The role of companies in personal information protection

Under the PIPL, businesses are "personal information processors", because they "independently decide the purpose and method of processing and other personal information processing matters" of the employees' or clients' personal information. This concept is similar to the "data controller" under the GDPR.

Personal information, which is referred to as "personal identifiable information" in the US or "personal data" in the EU, pertains to various kinds of information that is related to any identified or identifiable natural persons as recorded by electronic or other means.

The processing of personal information refers to types of behaviors in relation to personal information, including the collection, storage, use, processing, transmission, provision, publication, and erasure of personal information.

To be noted, even if the businesses process domestic natural person's personal information outside of China, the entity may still be subject to the PIPL in the below two circumstances:

- Where the company provides products or services to individuals inside China; and
- Where the company analyzes and evaluates the activities of individuals inside China.

This stipulation is similar to the "long-arm jurisdiction" under the EU's GDPR.

Principles of personal information processing

When processing personal information, companies must follow the basic principles:

- The principle of legality: Personal information must be handled in accordance with the law and shall not be handled by misleading, fraud, coercion, or other means.
- Principle of legitimacy: The processing of personal information of natural persons shall have legitimate purposes, not for snooping personal privacy or other illegal purposes.
- Principle of necessity: The processing of personal information should have a clear and reasonable purpose and should be directly related to the purpose of processing, and the entire exercise must be based on a certain necessity.
- Principle of good faith: "Good faith" is the basic principle of all civil activities, and the employer should pay more attention to the principle of good faith when dealing with employees' personal information.

RELATED READING

CHINA BRIEFING

GDPR Versus PIPL – Key Differences and Implications for Compliance in China
China Briefing Article
May 18, 2022

China's PIPL shares similarities with Europe's GDPR, but the two do not perfectly overlap. Foreign companies in particular must be aware of the differences between the respective regulations to ensure cyber data compliance. We compare the PIPL vs GDPR and discuss the steps that companies should take to be compliant.

AVAILABLE HERE

- Minimum principle: The processing of personal information shall be limited to the minimum scope for the purpose of processing and excessive collection of personal information shall not be allowed. Personal information processor should adopt a processing method that has least impact on the rights and interests of individuals. For the personal information obtained, the scope of knowledge or the scope of dissemination should be limited to the minimum. Especially in the employment management, the scope of knowledge should be limited to the relevant management level and cannot be extended to other employees.
- Principle of openness and transparency: The rules for personal information processing rules shall be disclosed, and the purpose, method, and scope of personal information processing shall be clearly stated.
- Quality assurance principle: In handling personal information, the quality of personal information shall be guaranteed to avoid adverse impact on personal rights due to inaccurate and incomplete personal information.
- Security principle: The use and processing of personal information must be established on the basis of ensuring information security.

Among all the principles, businesses are suggested to pay special attention to the principle of necessity and the principle of minimum, which are easier to be challenged in practice.

Consent management

The PIPL has provided differentiated consent management rules based on the kind of personal information and the processing activity of the personal information, as stipulated in Article 13, Article 23, Article 29, and Article 39 of the PIPL.

For general personal information, obtaining individual's explicit and informed consent is the principle, but there are circumstances where consent can be waived, as provided in Article 13 of the PIPL. To be noted, however, such exemption has strict conditions.

In the case where the information falls into the scope of sensitive personal information, or where the company shares personal information to a third party or transfers personal information it processes to an overseas party, a separate consent from the individuals is required, in addition to the general consent.

In addition to the above circumstances, Article 15 of the PIPL requires the personal information processor to "provide a convenient way to let the user withdraw their consent".

Consent Management Under the PIPL	
Circumstances	**Consent requirement**
Processing general personal information	Yes, with exceptional circumstances
Processing sensitive personal information	Yes, separate consent is required
Providing personal information to other PI processors	Yes, separate consent is required
Providing personal information to overseas	Yes, separate consent is required

Processing sensitive personal information

The PIPL sets stricter requirements on data processors to protect sensitive personal information.

Under the PIPL, sensitive personal information refers to the personal information that is likely to result in reputational damage or serious personal or proprietary endangerment, including such information as biometric identification, religious belief, specific identity, medical health, financial account, and whereabouts, as well as the personal information of minors under the age of 14 years. A personal information processor may process sensitive personal information only for a specific purpose and with sufficient necessity, and strict protection measures are in place to prevent abuse or misuse.

Besides, the processing of sensitive personal information of an individual shall be subject to the individual's separate consent. Where laws and administrative regulations provide that the processing of sensitive personal information shall be subject to the written consent, such provisions shall prevail. To process personal information of a minor under the age of 14 years, the personal information processor shall obtain the consent of the minor's parents or other guardians.

In addition, for the sensitive personal information of an individual, the personal information processor shall inform the individual of the necessity of processing and the impact on their personal rights and interests, in addition to the normal notification matters, except for the circumstances that may be exempted from informing the individual of such information in accordance with the PIPL.

Providing personal information to third party

In the daily operations of businesses in China, there are many occasions that may require sharing the personal information that they possess with a third party, such as if the company outsources its payroll processing to a third-party service firm. Another example is when a company shares personal information with a business partner who may decide to process the received personal information for purposes other than the original one.

Article 21 and Article 23 of the PIPL sets rules for providing personal information to a third party. Accordingly, where the company entrusting a third-party firm to process personal information within the original scope and purpose, no separate consent is required. However, where the cooperation of the company with a third-party firm involves personal information processing beyond the original purpose and scope, the company should comply with its notification obligation and obtain separate consent from employee. Besides, the company should conduct careful due diligence of a third party to guarantee its security and compliance before cooperating with it. Moreover, the company should make corresponding provisions in the commercial contract with the third party to clarify the matters related to personal information processing.

Automatic decision-making

Article 24 requires the data processor to provide users with an alternative option or the ability to refuse the use of their personal characteristics for marketing and push information through automated decision-making mechanisms.

This means the system needs to be able to receive the recipients' feedback and exclude certain users from automatic decision-making mechanisms, which requires special consideration when designing the system.

Providing personal information to overseas stakeholders

The PIPL stipulates various requirements on the cross-border transmission of personal information, which shall be paid special attention to by relevant enterprises.

Under the PIPL, in addition to obtaining separate consent from individuals mentioned earlier, Article 39 also requires the personal information processor to inform the individual of such matters as the name of the overseas recipient, contact information, purpose and method of processing, type of personal information, and the way and procedure for the individual to exercise the rights against the overseas recipient.

Article 38 of the PIPL offers the following procedures for companies to receive clearance to transfer the PI of China-based subjects overseas:

- Undergo a security review organized by the CAC, except where exempted by relevant laws and regulations.
- Undergo PI protection certification by a professional institution in accordance with the regulations of the CAC.
- Sign a contract with a foreign party stipulating the rights and obligations of each party in accordance with standards set by the CAC.
- Meet other conditions set by the CAC or relevant laws and regulations.

According to the *Measures for Data Export Security Assessmen*t, data processors providing "important" data overseas, CIIOs and data processors that process PI of more than 1 million people providing PI overseas, and data processors that have transferred the PI of over 100,000 people or the "sensitive" PI of over 10,000 people overseas since January 1 of the previous year, need to undergo a security review.

Personal Information Protection Impact Assessment

Article 55 of the PIPL requests the company to carry out Personal Information Protection Impact Assessment (PIPIA) when "processing sensitive personal information, making automatic decision-making for the use of personal information, entrusting other parties to process the personal information, and providing personal information to overseas parties". Article 56 further specifies the PIPIA requirements, which should include assessing the purpose of personal information processing, the impact it may have on personal rights and interests, and whether the protection measures currently in place are adequate.

PIPIA and cross-border data transfer

A fact that is easily overlooked is that PIPIA is actually a prerequisite for cross-border data transfer, regardless of whether the company chooses to transfer data overseas through security review or standard contract.

Where a company can utilize the standard contract to make cross-border data transfer, a PIPIA is an obligation defined in the draft *Standard Contract Provisions on the Export of Personal Information.*

Where a company's cross-border data transfer activity requires a security review, a signed standard contract with the overseas party needs to be submitted to the CAC for review and approval, which means PIPIA is also necessary in cases of security review.

ROY WANG
Assistant Manager
IT Service
Shanghai Office

"In order to comply with the PIPL, companies not only need to understand the law itself but also require strong technological expertise."

The requirements of conducting a PIPIA are similar to conducting a DPIA under the GDPR. Both processes require companies to identify the purpose for processing PI, the potential risks to individuals, and whether the company has taken the appropriate control measures for protecting the PI.

Once the PIPIA process is completed, the below information should have been gained (and saved for at least three years as required by Article 56 of the PIPL):

- Description of the processing and its purpose.
- The legitimate interests within the processing.
- An assessment of the necessity and proportionality of the processing.
- An assessment of the risks to individuals (or data subjects in the GDPR context).
- The measures envisaged to address the risks.
- All of the safeguards and security measures to demonstrate compliance.

Ensuring the rights of individuals for their personal information

Articles 45 to 47 of the PIPL stipulate the rights of individuals to inquire about what personal data is being collected and stored by the data processor. They also allow the users to request a copy of their personal data, correct any inaccurate personal information, and delete their personal information when withdrawing consent or terminating the use of the product or service.

Companies therefore need to consider how to quickly locate each user's personal information within the IT system and predefine a way of exporting a copy and delivering it to the user. Companies also need to consider ways of making each user's record 'independent' to ensure that the deletion of one user's record will not impact other existing or in-use data.

The right to deletion requires the company to consider the deployment of a universal platform for saving related personal data, so that the data can be easily located and deleted from all locations. Companies also need to plan for a reasonable authentication mechanism to accurately recognize the user who makes an inquiry or requests a copy, update, or deletion. As Article 49 of the PIPL also stipulates that the rights of an individual shall be exercised by his or her next of kin when the natural person dies. This presents an even bigger challenge for personal information processors, who also need to be able to recognize and authenticate a user's next of kin.

Cybersecurity and security review

China's cybersecurity laws and regulations stipulate obligations of data processors to establish and maintain data security protection systems and implement measures such as backup, encryption, and access control to guarantee data security, detailing as provisions on necessary security measures to prevent the loss, damage, theft, or tampering of data and emergency response measures to take in the event such criminal activity or negligence occurs.

Data processors are also required to strengthen the security of data processing systems, data transfer networks, and data storage environments in accordance with the security level of the data they are handling.

This refers to a set of measures stipulated in the *Management Measures for Data Security in the Field of Industrial and Information Technology Sectors (for Trial Implementation)*, which classifies data into three categories, "general data", "important data", and "core data", and specifies different levels of security requirements depending on the type of data being handled. This three level classification was first proposed in the first draft of the Management Measures in September 2021 and was continued in the second draft of the Management Measures in February 2022.

The *Network Data Security Management Regulation (Exposure Draft)*, released on November 14, 2021, further requires that systems that process important data must in principle meet the security requirements of 'level three' cybersecurity protection or above and critical information infrastructure operators. Systems processing core data must be strictly protected in accordance with the relevant regulations.

The *Network Data Security Management Regulation (Exposure Draft)* also requires that data processors inform any persons or organizations implicated in a data breach within three days of the incident occurring and report the incident to the public security authorities if any criminal activity is suspected. In addition, if a security breach implicates the personal information of over 100,000 users, the data processor must inform the local cyberspace authorities and submit an investigation and evaluation report within five days of the incident occurring.

MLPS 2.0

The Multi-Level Protection Scheme (MLPS) is a set of national standards first introduced by China in 2004, then adopted into the CSL in 2017 and few national standards in 2019, and updated within what is now the MLPS 2.0 framework.

MLPS 2.0 gives more pressure to companies to maintain compliance, with five levels of regulated security protections. Level 1 is the least sensitive, while Level 5 is the most sensitive. Companies, as the network operators, are expected to verify their own systems to understand which of those levels they fall into, and which corresponding security control measures they are expected to adhere to.

For level 2 or above for example, an on-site evaluation of in-place security control measures must be performed by a government-designated "security auditing" firm.

Multi-Level Protection Scheme 2.0			
Object of infringement	**Extent of infringement**		
Assessment	General	Serious	Particularly serious
Chinese citizens, legal persons, and other organizations concerned	Level 1	Level 2	Level 3
Social order or public interest	Level 2	Level 3	Level 4
National security	Level 3	Level 4	Level 5

Security review

Security review requirements have been extensively covered in previous regulations and legislation, including the PIPL, the CSL, and the DSL. Building upon these requirements, the revised *Measures for Cybersecurity Review* was released on December 28, 2022, which stipulated that companies with over one million Chinese users seeking to list overseas must undergo a security review.

The *Measures for Data Export Security Assessment* details the requirements for security reviews for cross-border data transfer. This set of regulations clarifies what procedures companies must undergo to get clearance to transfer data overseas.

The *Network Data Security Management Regulation (Exposure Draft)* proposes to expand the security reviews to data processors that process 'important data' or go overseas for listing. Besides, companies supplying cloud computing services to state agencies and CII operators must also undergo a security review. Moreover, Internet platform operators who use artificial intelligence, virtual reality, deep synthesis, and other new technologies to conduct data processing activities shall conduct security review in accordance with relevant state regulations.

'Important data' management

Handling and possessing important data come with a lot of added responsibilities. Data processors are required to report the data that they possess to the authority and are subject to stricter security requirements. There are also additional requirements if the companies wish to export the data overseas, which has been stipulated in relevant legislations.

The *Network Data Security Management Regulation (Exposure Draft)* includes the most extensive definition of what is classified as important data, expanding upon the definition outlined in previous regulations. It defines important data as data that "may endanger national security and public interest in the event it is tampered with, destroyed, leaked, illegally obtained or illegally used" and enumerates a list information that may fall under the scope of important data.

Reporting important data

The *Network Data Security Management Regulation (Exposure Draft)* requires all districts and government departments to oversee the data processors within their own district or department, as well as related industries and fields, to identify any important core data and organize it into a catalogue, which should be reported to the national cyberspace authorities.

Companies are therefore required to report to the cybersecurity departments if they are in possession of important data and are required to provide a report within 15 days of identifying the data.

Security responsibilities for important data

The regulation requires data processors of important data to assign an experienced member of staff to be in charge of the security of the important data, and to establish a data security agency overseen by this person. The data security agency must be responsible for:

- Researching and making recommendations for decisions related to data security.
- Formulating and implementing data security plans and emergency response plans.
- Carrying out risk monitoring and dealing with security incidents.
- Carrying out data security training, education, risks assessment, emergency drills, and other such preventative measures.
- Handling complaints and reports.
- Reporting to the cybersecurity departments.

Other responsibilities include, but are not limited to:

- Formulating security plans and conducting annual data security training and education for staff. Data security-related technical and managerial personnel must receive at least 20 hours of training per year.
- Prioritizing the purchasing of secure and reliable network products and services.