Doing Business in China

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The law is as stated at 1 January 2007. Whilst every effort has been made to ensure the accuracy of this publication, it is for general guidance only and should not be treated as a substitute for specific advice. If you would like advice on any of the issues raised, please speak to one of the contacts named on page 24.

Introduction

Before 1978, China's economic policies were mainly aimed at self-reliance. As a result, the country was virtually shut off from world economic developments. In 1978, China opened its doors to foreign investment with the goal of modernising its economy and raising the living standard of its people. The country has since established the necessary legislative basis for foreign investment and has actively sought to acquire modern foreign management and technical skills.

China adopted a Constitution in 1982 which has been amended various times since. The national legislative organ is the National People's Congress (**NPC**), which convenes annually for two weeks. When the NPC is not in session, its permanent organ, the Standing Committee, exercises most of its powers. The primary executive organs of state power are the President, who is the head of state, and the State Council being the government. The Chinese Communist Party remains the main political force in China and controls all appointments to key state organs. The PRC is a unitary state which has delegated certain legislative and executive powers to regional or local authorities.

Visas and Work Permits

General

Foreigners who wish to enter, pass through or reside in China must obtain a visa from a Chinese embassy, consulate, visa office or other agency authorised by the Ministry of Foreign Affairs. Visas must generally be obtained before entering China, although visas may be obtained at the border in some circumstances.

Business visits

Foreigners who wish to travel to China for business, to attend seminars or participate in scientific or cultural exchanges are required to apply for a business “F” visa. This visa can be for single, double or multiple entries. An F visa is valid for stays of one to six months and may be renewed up to three times in China for a maximum period of one year.

In order to apply for an F visa, an applicant must obtain a formal invitation letter, setting forth the entry purpose and date, from an authorised Chinese entity. This letter can normally be obtained by an authorised travel agent or through a Chinese sponsoring organisation in the relevant location. The applicant must then present the invitation letter together with other necessary documents to the local Chinese embassy or consulate to apply for the visa.

Types of Business Entities

General

China recognises a wide range of business vehicles, some of which are only open to domestic investors. The principal business entities available to foreign investors are:

1. representative offices;
2. branch offices;
3. equity joint ventures;
4. cooperative joint ventures;
5. wholly foreign-owned enterprises;
6. companies limited by shares with foreign investment; or
7. holding companies.

Special regulations have been adopted to govern the establishment and operation of each of these foreign investment vehicles. China's *Company Law* mainly regulates two types of business entities: limited liability companies and companies limited by shares.

Companies

Limited liability company

A limited liability company may be set up by between one and 50 shareholders. The words "limited liability company" or "limited company" must be included in the name of the company. A limited liability company's constitutional documents are its articles of association. A minimum capital of RMB 30,000 is required for the establishment of a limited liability company. Capital contributions may be made in the form of cash and of non-currency assets that can be appraised and denominated in currency and are legally transferable such as in kind contributions, industrial property or land use rights.

A limited liability company is liable for its debts to the extent of its assets, while the liability of its shareholders is limited to the amount of their respective capital contributions.

The highest decision-making authority in a limited liability company is vested in the shareholders' meeting. A limited liability company may choose to establish a board of directors and a supervisory committee.

Company limited by shares

A company limited by shares may be established by promotion or share offer. A number of promotors between two and 200 is permitted. If the company is established by promotion, the promoters must hold all of the shares. If it is established by a share offer, the promoters must subscribe to at least 35% of the shares and offer the rest to the public. Establishment by share offer is subject to the approval of China's securities regulator. The minimum capital of a company limited by shares is RMB 5 million.

A company limited by shares is liable for its debts to the extent of its assets, while the liability of its shareholders is limited to the amount of their respective shareholdings.

Foreign-invested business entities

Representative office

Many foreign enterprises have established representative offices in China as the first step of their market entry strategy, as they are fairly easy and inexpensive to establish. A representative office is not an independent legal entity and does not have its own capital.

A foreign enterprise can engage in a limited range of activities through a representative office. In general, a representative office is only permitted to engage in indirect business operations in China. It may represent the foreign enterprise in carrying on activities such as business liaison, product and service introduction, trade name promotion, market surveys and research, and warranty and after-sale service management. A representative office is not permitted to engage in direct business activities.

A representative office cannot employ Chinese employees directly. Local employees must be employed through a designated Chinese labour service agency. A representative office must have a chief representative, who may be foreign or local.

Branch office

Currently, only foreign companies in a limited number of business sectors, such as banking and insurance, have been permitted to set up branches in China. Although the Company Law authorises the establishment of branch offices by foreign companies generally, the competent authorities have yet to issue the necessary implementing rules that would allow a wider range of foreign companies to set up branches in China. A branch of a foreign company does not have independent Chinese legal person status. As a result, the foreign company is directly liable for the obligations undertaken by the branch office.

Equity joint venture

An equity joint venture (**EJV**) is a corporate legal entity established by two or more foreign and Chinese parties. An EJV is a limited liability company with its own registered capital and a legal identity distinct from its investors. As an independent legal person, an EJV is capable of contracting and bearing liability on its own behalf.

The business scope of a joint venture must be clearly set out in the project documentation. An EJV may only conduct business within its approved business scope and the approval of the original approval authority is required to amend an EJV's business scope. Each EJV will have registered capital that represents the equity investment contributed by the parties to the joint venture. The parties' contributions to the registered capital may be made in cash or in kind pursuant to a contribution schedule approved by the Chinese examination and approval authorities.

Foreign investment must normally account for at least 25% of the registered capital of an EJV. However, foreign investment in an EJV may be less than 25% of the registered capital provided that it is established in accordance with the mandatory establishment procedures. An EJV with less than 25% foreign investment will not be eligible to benefit from the preferential policies generally applicable to a foreign investment enterprise (**FIE**).

The highest authority of an EJV is its board of directors. The board of directors must have a chairman and a vice-chairman, one of whom is generally appointed by the Chinese party and the other by the foreign party.

Cooperative joint venture

A cooperative joint venture (**CJV**) is a business arrangement established by two or more foreign and Chinese parties pursuant to a cooperation agreement. There are two types of CJVs: those that have legal person status (a separate corporate existence) and those without legal person status. Legal person status is the norm and there are special requirements that apply to CJVs that do not have legal person status. CJVs with legal person status are limited liability companies. Limited liability does not apply to CJVs without legal person status.

Limited liability CJVs share many characteristics with EJVs and, in particular, they have a registered capital and the liability of the joint venture partners is limited to their respective contributions to the registered capital. A feature that distinguishes CJVs from EJVs, however, is that the parties may agree to a profit and loss sharing arrangement that does not correspond with the ratio of the parties' capital contributions (as is required in the case of EJVs). Greater flexibility is also allowed in the form of permitted capital contributions and the distribution of assets in the event of dissolution.

As in the case of EJVs, foreign investment in a CJV must normally account for at least 25% of its registered capital. If foreign investment accounts for less than 25% of the registered capital, the CJV will not be eligible for the preferential treatments generally applicable to FIEs.

A CJV may be managed by a board of directors or a joint management body. A CJV without legal person status must be managed by a joint management body. A CJV's board of directors or joint management body must be composed of at least three members.

Wholly foreign-owned enterprise

A wholly foreign-owned enterprise (**WFOE**) is an investment vehicle established and operated by a foreign investor without the participation of a Chinese partner. WFOEs are prohibited in certain industry sectors. While more industry sectors are being opened to wholly foreign-owned investment following China's accession to the World Trade Organisation (**WTO**), certain sectors will remain off limits to this type of investment for the foreseeable future.

A WFOE is usually a limited liability company although, subject to approval, other liability structures are theoretically permitted. A WFOE with limited liability status has its own registered capital and a legal identity distinct from its foreign investor. It is an independent legal person capable of contracting and bearing liability on its own behalf. The foreign investor may make its capital contributions to the WFOE in cash or in kind.

Company limited by shares with foreign investment

The establishment of a company limited by shares with foreign investment (**CLSFI**) must comply with the industrial policies and requirements generally applicable to foreign investment in China. A CLSFI may be formed by way of promotion or share float. If established by promotion, more than half of the promoters must be domiciled in China and at least one of the promoters must be a foreign shareholder. When the share float method is adopted, at least one of the promoters must have been profitable in the three years preceding the share float and the promoters must subscribe for at least 35% of the shares. The required minimum registered capital of a CLSFI is RMB 30 million, which is three times higher than that for a domestic company limited by shares. Foreign investment must represent at least 25% of the registered capital of a CLSFI.

Existing EJVs, CJVs and WFOEs may apply to their original approval authority to convert into a CLSFI provided that they were profitable in the three years prior to the application. The original investors shall act as the promoters of the CLSFI, although they may be joined by new promoters. The application must also be approved by the Ministry of Commerce.

A CLSFI may be listed on stock exchanges in China as well on overseas stock exchanges. Such listings are subject to certain requirements in terms of capitalisation, business performance and number of shareholders.

Holding company

Holding companies are sometimes also referred to as "investment" or "umbrella" companies. They are FIEs established for the specific purpose of holding the equity interests in the various FIEs established by a single foreign investor in China. A holding company may be wholly foreign-owned or a joint venture with a domestic investor. The requirements in terms of capital contribution and existing investments for setting up a holding company are relatively high. There are two ways in which an overseas investor can qualify to establish a holding company. Under the first method, the investor must have a total capitalisation of at least US$400 million, and have contributed a minimum of US$10 million to the registered capital of its subsidiaries in China. Alternatively, the investor must demonstrate that it has established at least 10 FIEs in China with an aggregate paid-up registered capital of US$30 million or more.

A holding company may engage in a wide range of activities. In addition to investing in areas open to foreign investment, a holding company may provide enterprises that it has invested in (**invested enterprises**) with a wide range of services relating to foreign exchange balancing, procurement of machinery and equipment, loan applications, market information, investment advice, technical support, staff training and human resource management. A holding company may also establish research and development centres and provide financial support to its invested enterprises.

Provided that a holding company satisfies certain requirements, it may provide its invested enterprises with specified additional services such as acting as a distributor for their products on Chinese and overseas markets, transportation, warehousing, leasing of machinery and office equipment, etc. It may also provide after-sales services, carry out systems integration of products manufactured by its invested enterprises and sell (but not retail) inside China the products it has imported from its overseas parent.

A holding company satisfying specified criteria may be recognised as the regional headquarters of a multinational company (**regional headquarters**). Such a regional headquarters may engage in an even wider range of services including import and wholesale in China of the products of the multinational company and its affiliates, import of raw materials, components and spare parts necessary for the provision of maintenance services for the products of its invested enterprises and the multinational company, entrust other enterprises to manufacture or process its products or the products of the multinational company and sell the same on the domestic and overseas market etc.

Holding companies should charge for services rendered to their subsidiaries on an arm's length basis and are taxed accordingly. They are prohibited from offsetting investment costs or losses from their pre-tax income or allocating these costs to their subsidiaries.

Business Environment

General

On 11 December 2001, China joined the WTO following negotiations which lasted over a decade. In order to become a WTO member, China agreed to fundamentally change the organisation of its economy. China's commitments are contained in the Protocol on the Accession of the People's Republic of China (**Protocol**) and relate, amongst others, to the removal of various restrictions on foreign direct investment, the lowering and removal of tariff and non-tariff barriers as well as an improvement of the transparency of the legal structure for investment and business. In addition, by becoming a member, China is also required to comply with the general framework of the WTO which includes agreements on intellectual property protection, anti-dumping mechanisms, subsidies, trade-related investment measures (such as local content requirements, foreign exchange balancing requirements, etc.) and a mechanism for the resolution of trade disputes.

To implement the Protocol, China is gradually removing or reducing foreign investment restrictions in most industrial areas. The Protocol contains detailed schedules for the opening up of various industry and service sectors to foreign investment. In some economic sectors, foreign investors will be permitted ultimately to establish WFOEs thus doing away with the need for a Chinese partner. In other sectors, they will still be required to have a Chinese party but will be allowed to have an increased investment share.

China has removed or reduced a number of non-tariff measures which restrict trade, such as quotas, import licensing requirements, certification requirements, health and quarantine measures and technical standards. In addition, China is implementing a schedule of progressive reduction of the import tariffs on many imports.

China has committed to making the legal environment for foreign investment and trade more transparent. Since December 2001, the country has adopted a wide range of new and amended laws compatible with its WTO membership. In line with its transparency obligations, China has established a WTO Notification Inquiry Centre to which foreign parties may address inquiries about WTO and trade-related issues.

Intellectual property

Trade marks

The *Trade Mark Law* and its *Implementing Regulations* govern the trade mark application procedure and the protection of registered trade marks. Both trade marks and service marks may be registered in China. Trade mark registrations are the primary means for protecting trade mark rights in China. With the exception of well-known trade marks, China does not recognise trade mark rights acquired through use. The first person to register a trade mark in China is regarded as the owner of that mark. Registration of trade marks is therefore essential to secure protection.

The trade mark registration procedure includes examination as to formality and for prior conflicting marks. The procedure is characterised by short deadlines and the lack of opportunities for formal negotiations with the Trade Mark Office as to the terms on which a mark may be accepted for registration. There are also strict rules regarding the form in which

registered marks may be used. Matters such as the selection, use and registration of Chinese character equivalents to marks in Roman letters must also be considered when registering a trade mark in China.

Patents and designs

Under China's *Patent Law*, three kinds of patents are available, namely invention patents, utility model patents and design patents. The three requirements for granting a patent are novelty, utility and inventiveness. A granted invention and utility model patent is infringed by anyone who, without the consent of the patent owner, makes, uses, offers for sale or sells products directly obtained through the patented process for production or business purposes. An owner of any kind of patent right also has the right to prevent any other party from importing, without its authorisation, the patented products or product obtained through the patented process for production or business purposes. Similarly, a granted design patent is infringed by anyone who, without the consent of the design owner, makes or sells products incorporating the patented design for production or business purposes.

Copyright

The *Copyright Law* and its *Implementing Regulations* govern the protection of copyright works. Works include written literary works, musical, dramatic, folk art and dance works, artistic and photographic works, film, television and video works, engineering design and product design blueprints and maps. Registration is not, in general, necessary in order to acquire copyright. Registration of computer software is separately regulated under the Computer Software Protection Rules. Acts of copyright infringement include copying and publishing a copyright work without the consent of the copyright owner, falsely claiming authorship of a copyright work and adapting, translating, annotating or editing a copyright work without the consent of the copyright owner.

Enforcement

The IP regime in the PRC is subject to unique and specialised considerations, given its reliance on administrative enforcement procedures. Dedicated administrative authorities have power under the relevant IP laws to control the misuse of specific IP rights. Under the PRC Trade Mark Law, the relevant Administrative Authority is the Administrative Authority for Industry and Commerce (**AIC**). The AIC also has power to enforce the PRC Anti-Unfair Competition Law which bans certain types of intellectual property infringement. The Administrative Authority for Patent Affairs is the relevant authority under the PRC Patent Law and the National Copyright Administration is the appropriate authority under the PRC Copyright Law.

Although the ultimate forum for upholding IP rights in the PRC is the People's Court (IP Division), the most efficient and cost effective way of enforcing IP rights in the PRC is often by way of administrative enforcement action. Administrative enforcement actions can be taken very quickly, sometimes within days of infringing products being found, and can be disposed of completely within 2/3 months. If infringing products are found they can be seized and destroyed. Fines are imposed upon infringers and they may be ordered to pay compensation. In serious cases, if the quantity of infringing products is large, criminal proceedings may be instituted against the infringer, thereby increasing the deterrent effect on others.

Franchising regulations

PRC domestic and foreign franchises are governed by the Measures for the Administration of Commercial Franchise Operations (**Franchise Measures**). For foreign franchises, the Franchise Measures operate in conjunction with the Measures for the Administration of Foreign Investment in the Commercial Sector (**Commercial Enterprise Measures**).

The Franchise Measures set out a number of stringent requirements which a franchisor and franchisee must meet before they may enter into franchise agreements in the PRC. In particular, a franchisor must have two directly owned stores in the PRC for at least one year before it may lawfully grant franchises. The effect of this is to prohibit franchises from coming directly from overseas without establishing an operations company in China.

The Commercial Enterprise Measures govern the establishment with foreign investment of enterprises which engage in distribution activities (including wholesale, retail and franchising) in China. The Commercial Enterprise Measures require that companies engaging in distribution activities satisfy certain capital investment requirements and approval requirements and impose restrictions on the involvement of FIEs in the distribution of certain types of goods.

Foreign Investment Policy

General principles

The Chinese government has issued a wide range of rules and regulations to govern foreign investment in the country. Their purpose is to direct foreign investment into certain priority industry sectors while restricting or prohibiting investment in other sectors. The key national regulations for implementing China's foreign investment policy are the Regulations for Guiding the Direction of Foreign Investment (**Guiding Regulations**). The Guiding Regulations classify all foreign investment projects into one of four categories: encouraged projects, permitted projects, restricted projects and prohibited projects. The classification of an investment project under the Guiding Regulations determines the feasibility and establishment method for the project. The principal difference between encouraged and permitted projects is that encouraged projects may be eligible for tax breaks on the import of capital goods under existing foreign investment promotion policies. Restricted projects must be examined and approved by the relevant provincial-level departments. A record of the projects must also be filed with the higher level competent authorities and with the authorities in charge of the industry invested in. If a restricted project exports 70% of its output, it may be treated as a permitted category project with the approval of the relevant state or provincial-level authorities.

The Guiding Regulations provide for the publication of two catalogues, the Catalogue for Guiding Foreign Investment in Industries (**Foreign Investment Catalogue**) and the Catalogue of Priority Industries for Foreign Investment in the Central and Western Regions (**Central and Western Region Catalogue**). The Foreign Investment Catalogue lists specific industries in which foreign investment in China is encouraged, restricted or prohibited whereas the Central and Western Region Catalogue lists the industries in which foreign

investment is specifically encouraged in the central and western regions of China. Projects not included in the Foreign Investment Catalogue are considered permitted. The two catalogues constitute the basis for the applicable policies regarding the examination and approval of foreign investment projects and FIEs.

Following its accession to the WTO, China has been gradually removing restrictions on foreign investment in a wide range of industries, although investment limits in certain sectors are expected to continue in existence for the time being.

Foreign exchange controls

China's currency, the Renminbi, is not currently a freely convertible currency. Foreign exchange controls are applicable to currency transactions in China. Under the foreign exchange controls currently in place, FIEs are required to treat their foreign exchange transactions differently depending on whether the transaction relates to a current account item or a capital account item.

A current account item is a transactional item which is of a recurrent nature and includes payments in the context of foreign trade, cross-border supply of services and the overseas remittance of profits and dividends. Foreign exchange revenue from current account items must be sold to or deposited in a foreign exchange account with a designated foreign exchange bank. In order to pay for current account items in foreign exchange, an FIE can use its foreign exchange savings or purchase foreign exchange at a designated foreign exchange bank. The FIE will need to show the bank relevant supporting materials of the underlying transaction for which the payment is made. For instance, if the payment is made for the import of goods, the purchase contract, invoice, etc. must be produced.

A capital account item refers to a transactional item which either increases or reduces the capital or liability from the inflow or outflow of capital in the course of international receipts and payments. Items include direct investment, all kinds of loans, securities investments, etc. As opposed to current account transactions for which verification by a designated bank suffices, capital account transactions often require prior approval or verification by the foreign exchange authorities. In recent years, there has been a moderate relaxation of controls over capital account items.

Government Initiatives and Incentives

Government incentives to encourage foreign investment

National and local governments offer a wide range of incentives to attract foreign investment. The preferential treatments include income tax incentives, exemption from certain import and export duties, simplified customs procedures, facilitation of visa and residence applications for overseas personnel, reduced land use fees and simplified establishment procedures. Additional benefits are available in specified locations as set forth below. The type and extent of the preferential treatment available also differ depending on the industry. Most of these preferential treatments are only available to FIEs with at least 25% foreign equity ownership.

CEPA

Mainland China has entered into a separate Closer Economic Partnership Arrangement (**CEPA**) with its two special administrative regions, Hong Kong and Macau. Each CEPA is a free trade agreement that offers respectively Hong Kong and Macau products, companies and residents preferential access to the mainland Chinese market. Many of the preferences go beyond China's WTO concessions. CEPA is not a closed agreement and both sides hold regular meetings on further concessions and implementation details.

CEPA covers three areas:

1. the removal of tariffs and other barriers on trade in goods;
2. the opening of the mainland Chinese market to Hong Kong and Macau service companies; and
3. measures for the promotion of trade and investment.

Trade in goods

CEPA permits the duty free import of all Hong Kong products into the Mainland provided the goods meet the specified rules of origin and are not subject to import prohibitions or restrictions in the Mainland.

Trade in services

CEPA provides for liberalised market access in a wide range of services sectors ahead of the liberalisation schedule under the Protocol and facilitates the recognition of Hong Kong professional and technical qualifications. The sectors include:

- management consulting
- convention and exhibition services
- legal services
- accounting, auditing and bookkeeping
- real estate
- construction
- engineering and integrated engineering
- building design
- urban planning and landscaping
- distribution and retail services
- logistics
- freight forwarding agency
- transport
- airport services
- storage and warehousing
- patent agency services
- trade mark agency services
- information technology services
- telecommunications
- tourism and travel-related services
- audiovisual services
- cultural and entertainment services
- banking and financial services
- securities
- insurance
- job referral agency and job intermediary
- advertising
- medical and dental

The CEPA service benefits are of four main types:

1. earlier market access: Hong Kong and Macau service suppliers can enter China market between one to five years earlier than under the WTO timetable;
2. higher equity shares: Hong Kong and Macau service suppliers are permitted to hold a higher equity share (in certain service sectors even up to 100%) in mainland China service companies;
3. lower capital thresholds: capital requirements to establish a business in mainland China have been substantially reduced thus opening the market to smaller players; and
4. recognition of Hong Kong and Macau qualifications: Hong Kong and Macau professionals such as legal practitioners, accountants and medical personnel are permitted to practise in the PRC, subject to passing any relevant local professional exams and satisfying any local traineeship requirements.

Hong Kong and Macau service providers can be individuals or juridical persons. Except in the legal sector, a juridical person must satisfy the following criteria to qualify as a "Hong Kong or Macau service supplier":

1. it is incorporated or established in Hong Kong or Macau in accordance with the relevant laws and regulations;
2. it has obtained any licences or permits required by law to provide such services;
3. the nature and scope of its business in Hong Kong or Macau corresponds to the services to be provided in mainland China;
4. it pays profits tax in Hong Kong or Macau;
5. it has had substantive operations of at least three to five years (depending on the sector) in Hong Kong or Macau (no such requirement for real estate services);
6. it owns or leases business premises in Hong Kong or Macau commensurate with the scope and the scale of its business; and
7. 50% of its staff in Hong Kong or Macau are Hong Kong or Macau residents without limit of stay and persons (from the Mainland) permitted to reside in Hong Kong or Macau.

An overseas service supplier can take advantage of CEPA through a merger with, or acquisition of, a Hong Kong or Macau service supplier. It must acquire at least 50% of the Hong Kong or Macau entity and is required to wait one year after the merger or acquisition before it will be eligible for any of the CEPA benefits.

Trade and investment facilitation

The two sides have agreed to further strengthen economic and trade cooperation through trade and investment facilitation in the following areas:

1. trade and investment promotion;
2. customs clearance facilitation;
3. commodity inspection and quarantine, food safety, quality and standardisation;
4. electronic business;

5. transparency in laws and regulations;
6. cooperation on small and medium enterprises;
7. cooperation in the Chinese traditional medicine and medical products sector; and
8. protection of intellectual property.

Tax incentives

General

China has introduced a wide range of tax incentives to attract foreign investment. The incentives are available to FIEs and foreign enterprises. Tax incentives may take the form of and be a combination of:

1. reduced tax rates;
2. tax exemption and reduction periods; and
3. tax refunds.

The major factors which determine the availability of tax incentives are:

1. the location;
2. the industry;
3. the amount of investment;
4. the technological level;
5. the export rate; and
6. the duration of operations.

As a general principle, production-oriented FIEs with an operation period of over 10 years (regardless of location) are eligible for an exemption from foreign enterprise income tax during the first two profit-making years and a reduction by half during the following three years. Further, FIEs exporting more than 70% of their output are eligible for a 50% reduction on the enterprise income tax. Where technologically advanced FIEs still qualify as technologically advanced after the expiration of the two and three year period for exemption and reduction of enterprise income tax, they may be granted a further three year extension of the 50% reduction. A foreign investor in an FIE which directly reinvests its profit derived from the FIE to increase its registered capital or who uses the profit as capital investment in another FIE is eligible for a refund of 40% of the income tax already paid on the reinvested amount, provided that the term of operation of the FIE is not shorter than five years.

China has also signed a number of tax treaties and arrangements to avoid double taxation which may offer residents of the countries or regions concerned certain tax benefits in addition to those available to FIEs or foreign residents generally. A recent arrangement with Hong Kong, for example, allows for lower withholding taxes in addition to the exception of personal income tax for Hong Kong residents.

Special zones

In order to attract foreign direct investment, China has established various types of special zones throughout the country. Foreign investors who establish FIEs in these zones can take advantage of a host of preferential policies, including tax incentives. The tax incentives vary widely depending on the type of zone and are in certain instances only available to investors that satisfy specified preliminary conditions.

The major types of investment zone are listed below:

1. Special Economic Zones (**SEZ**);
2. Economic and Technological Development Zones (**ETDZ**);
3. Open Coastal Economic Zones (**OCEZ**);
4. High-tech or New Technology Industry Development Zones (**HNTIDZ**);
5. Border Open Cities; and
6. Other types of special zones or regions.

The tax incentives available in the various zones are summarised below:

Special Economic Zones

Production-oriented FIEs and foreign enterprises with establishments engaged in production or business operations in the zone area are subject to a flat tax rate of 15%. A production-oriented FIE located in an SEZ is further eligible for the 50% reduction of tax for the third to fifth year from its first profit-making year. As a result, after the first two years of tax holidays, such FIE is taxed for three years at a rate of 7.5%.

A production-oriented FIE located in the old urban district of a city in which an SEZ is located is eligible for a reduced 24% income tax rate. This rate may be further reduced to 15% if the FIE is engaged in any of the following types of project:

1. a technology-intensive or knowledge-intensive project;
2. a project with a total foreign investment of at least US$30 million with a long payback period; and
3. an energy, transportation or harbour construction projects.

A service FIE in an SEZ may be eligible for a one year tax exemption followed by a 50% reduction of the applicable income tax rate for two years provided that:

1. its term of operation is at least 10 years; and
2. it has foreign investment of over US$5 million.

Foreign financial institutions established in SEZs with a registered capital in excess of US$10 million and a term of operation of at least 10 years may be eligible for a 50% reduction on the applicable tax rate for a period of two years after their first profit-making year.

Foreign enterprises without an establishment in China are taxed at a reduced withholding tax rate of 10% on income sourced from within an SEZ such as dividends, interests, rental payments, royalties.

Economic and Technological Development Zones

The enterprise income tax rates and eligibility conditions applicable to production-type FIEs located in ETDZs are the same as those applicable to such FIEs established in SEZs.

A non-production type FIE established in an ETDZ may also be eligible for the 15% reduced tax rate if the ETDZ is located in an open coastal city and is engaged in energy, transportation or harbour construction.

Open Coastal Economic Zones

The enterprise income tax rates and eligibility conditions applicable to production-type FIEs located in OCEZs are the same as those applicable to such FIEs established in the old urban districts of cities in which SEZs are located.

Foreign enterprises without an establishment in China are taxed at a reduced withholding tax rate of 10% on income sourced from within an OCEZ such as dividends, interests, rental payments, royalties.

High-tech or New Technology Industry Development Zones

A high or new technology FIE established in an HNTIDZ is subject to a reduced enterprise income tax rate of 15%.

If a high or new technology FIE established in an HNTIDZ is not eligible for the standard two-year exemption and three-year reduced tax rate and has a term of operation of at least 10 years, the enterprise may be eligible for a two-year tax exemption commencing from the first two profit-making years.

Border Open Cities

Production-oriented FIEs may be eligible for a 24% reduced tax rate.

Shanghai Pudong New Area

Production-oriented FIEs benefit from a reduced tax rate of 15%.

Singapore Suzhou Industrial Park

This Park offers the same tax advantages as are available in ETDZs.

Central and Western Regions

The term Central and Western Regions refers to all China's non-coastal provinces together with Guangxi.

FIEs established in the Central and Western Regions of China which fall under the "encouraged" category are eligible for a reduced income tax rate of 15% for three years following the expiry of the two-year exemption and three-year 50% reduction.

It is possible that many of these tax incentives in the various zones described above will be phased out as China converges the tax treatment of FIEs and domestic enterprises.

Taxation

Tax collection system

Over the past decades, China has made efforts to establish a modern, rational and efficient tax system that keeps pace with the transformation of a command economy into a market-oriented economy. China has developed a two-tier system for levying taxes whereby certain taxes are collected by State Tax Bureaus and others by the Local Tax Bureaus. Every tax levied in the PRC can be classified as a central tax, local tax or a shared tax. Generally speaking, the State Tax Bureau is responsible for the levy and collection of the central taxes which constitute the revenue of the central government and the shared taxes which are revenue shared between the central and local governments. The Local Tax Bureau is responsible for the collection of local taxes which constitute the revenue for the local governments concerned. The State Tax Bureau will directly pay the portion of taxes shared by the local governments collected by it into the local government treasury.

Foreign enterprise income tax

FIEs, foreign enterprises with an establishment in China and foreign enterprises without an establishment in China which derive income from China are required to pay foreign enterprise income tax. Generally speaking, FIEs and foreign enterprises with an establishment in China are taxed on their net income whereas foreign enterprises without an establishment in China are taxed on a withholding basis on gross income receipts.

FIEs and foreign enterprises with an establishment in China

Foreign enterprise income tax of FIEs and foreign enterprises with an establishment in China is calculated and payable based on the balance of the income (including income that is exempt from business tax, as discussed below) received by an FIE or a foreign enterprise with an establishment in China, after deduction of costs, expenses and losses. Income includes income generated from production and business operations as well as income derived from dividends, interest, rental and assignment of property, royalties and non-operating revenue.

The applicable tax rate is 33% which is made up of 30% state tax and 3% local tax. These components are to be dealt with separately as special tax incentives may apply. The current tax structure allows local governments the discretion to maintain the full amount of the local tax even when the national tax is either exempted or reduced under the various tax incentive schemes. Local governments may also waive the local tax in order to attract foreign investment to their locality.

It should be noted that the Chinese authorities have submitted plans to consolidate the tax regime applicable to FIEs and enterprises with domestic investment. A few reports have put the likely consolidated tax rate at 24%.

Foreign enterprises without an establishment in China

If a foreign enterprise with no establishment in China derives income from China or a foreign enterprise with an establishment in China derives income from China, which is not related to its establishment in China, enterprise income tax will be levied on a withholding basis on gross income receipts at the rate of 20%. The tax withholding rate may be reduced to 10% under relevant bilateral tax treaties and in certain investment zones.

Individual income tax

Chinese and foreign individuals are subject to the same individual income tax (**IIT**) regime. ITT is computed at different tax rates depending on the type of taxable income. Income from salaries and wages is taxed at progressive rates with a highest rate of 45% whereas the tax rate for income from production and business activities of individual industrialists and business people ranges from 5% to 35%. Other taxable income such as from author's remuneration, personal services remuneration and royalties, etc. is generally taxed at a flat rate of 20%.

Individual tax payers are allowed a standard deduction of RMB 1,600 per month for the ITT on wages and salaries. Expatriates enjoy a higher deduction of RMB 4,800 per month.

Table. Scale of IIT Rates for Expatriates

Monthly Taxable Income (after deduction of RMB 4,800)	Tax Rate (%)
Not exceeding RMB 500	5
Part from 501 to RMB 2,000	10
Part from 2,001 to RMB 5,000	15
Part from 5,001 to RMB 20,000	20
Part from 20,001 to RMB 40,000	25
Part from 40,001 to RMB 60,000	30
Part from 60,001 to RMB 80,000	35
Part from 80,001 to RMB 100,000	40
Part over RMB 100,000	45

Although IIT is payable by the employee, the employer generally has the obligation to withhold the IIT amount and pay it to the tax authorities. If the employer fails to withhold part of the income for IIT purposes, the employer will be liable for such payment.

An essential element in determining IIT liability is whether an individual is domiciled or resident in the PRC. Persons who habitually reside in China due to family or business relationships or registration of permanent residency are considered to be taxpayers domiciled in the PRC. They are subject to IIT on their worldwide income. In most cases, a foreigner working in China is not deemed to be domiciled in China but only resident.

Tax treatment of non-domiciliary individuals varies depending on the duration of their residency in China in a calendar year. Individuals who are not residents in China or residents in China for less than one year are subject to tax only on their income derived within China. Residents who reside in China for at least one year are taxed on their worldwide income just as domiciled individuals. However, residents who have resided in China for more than one year but less than five years are exempted from IIT on foreign source income paid outside China. Residents for more than five years are subject to their worldwide income irrespective of whether derived in or outside China. It should be noted that for the five-year residency rule, any absence from China of 30 days or more on a single trip or for a cumulative period of 90 days or more on a number of trips within the same tax year will break the five year period.

Directors and senior managers of FIEs in China are taxed on the income related to their employment at the FIE even if the work is performed outside China and regardless of the length of their residence in China.

An expatriate who is physically present in China for more than 90 days (or 183 days in the case of a resident of a country or region with which China has entered into a double taxation avoidance treaty or arrangement) in a particular calendar year will be subject to IIT on the portion of the wages and salaries which is deemed China-sourced.

A foreign representative of a representative office is taxed as a resident in China irrespective of whether the representative actually resides in China. Therefore, the representative is taxed on the salary attributable to the services rendered in China.

Business tax

Business tax is normally payable on the income derived from the provision of certain types of labour services, the assignment of intangible assets or the sale of immovable property. FIEs and foreign enterprises which engage in these taxable activities in China are also subject to business tax. The tax is levied on gross turnover with deduction of expenses or costs only permitted in limited instances.

The applicable tax rates are as follows:

5%-20%	Applicable to entertainment business.
5% or 8%	Applicable to financial and insurance services.
5%	Applicable to services and assignment of intangible assets and sale of immovable property.
3%	Applicable to transportation, construction, post and telecommunications and cultural and sports activities.

An exemption from business tax is granted to foreign enterprises without an establishment or place of operations in China, which derive interest income or rental income from the lease of tangible and movable properties from sources inside China. Amongst others, there are also exemptions available for:

1. nursing services provided by nurseries, kindergartens, homes for the aged and welfare institutions for the handicapped;
2. medical services provided by hospitals, clinics and other medical institutions;
3. educational services provided by schools and other educational institutions and services provided by students participating in work-study programmes;
4. agricultural services such as mechanical cultivation, irrigation and drainage, etc.;
5. admission fees for certain cultural activities such as those organised by memorial halls, museums, cultural centres, art galleries, etc.; and
6. admission fees for cultural and religious activities conducted at places of religious worship.

Reductions or exemptions from business tax are not dependent on the location of the FIE or its business activities.

Value-added tax

Value-added tax (**VAT**) is levied on the sale of tangible movable property, the provision of processing or repair and replacement services and the import of taxable goods inside China.

The principal applicable tax rates are as follows:

17%	The standard rate.
13%	Applicable to general daily necessities, publications, agricultural materials, machinery and products, though generally not for the purchase of fixed assets.
6%	Applicable to goods sold by small taxpayers and projects involving natural resources taxed on value added at each stage of a production cycle.
5%	Applicable to oil and gas produced by Sino-foreign joint exploration projects.
0%	Applicable to agricultural products sold directly by producer, imported equipment for processing, assembly or compensation trade, equipment used for scientific research, exports, etc.

VAT is levied and collected on the basis of the value added to the taxable goods and services at each stage of the production cycle. The seller can generally deduct the VAT that has been paid on the purchase of materials and certain overheads that are used for the taxable sales (input tax) and account for the difference to the authorities.

VAT may be refunded in a number of circumstances. VAT paid on the inputs to manufacture goods which are subsequently exported may be partially refunded. A VAT refund is also available when goods are returned by the buyer.

Capital goods imported by FIEs may be exempt from import stage VAT if the investment project is listed as "encouraged", involves a technology transfer and is not listed in the Catalogue of Import Commodities for Foreign Investment Projects Not Eligible for Tax Exemption. FIEs may also be entitled to a full VAT rebate on the purchase of domestically-manufactured equipment within their total investment amount on condition that the project is listed as "encouraged" or included in the Catalogue of Industries, Products and Technologies Currently and Particularly Encouraged by the State for Development and that the equipment is not listed in the Catalogue of Import Commodities for Foreign Investment Projects Not Eligible for Tax Exemption or the Catalogue of Import Commodities for Domestic Investment Projects Not Eligible for Tax Exemptions.

Consumption tax

Consumption tax is imposed upon manufacturers and importers of luxury or non-essential goods, as well as businesses which entrust third parties to process such goods. The tax also applies to FIEs and foreign enterprises which engage in these taxable activities in China. The consumption tax is levied on 11 categories of goods, including tobacco, liquor and alcohol, cosmetics, skin and hair-care products, jewellery, fireworks, gasoline, diesel oil, automobile tires, motorcycles and motor cars. The rate of the tax varies and is sometimes expressed as a percentage of the sales value (with rates ranging from 3% to 45%) or as a fixed amount per volume of the product. For instance, the tax rate applicable to cosmetics is 30% whereas the tax amount payable on diesel oil is RMB 0.1 per litre.

Unlike VAT, consumption tax is levied only when goods are sold to the wholesaler, retailer or directly to the end-user and not on any further on-sale of the goods thereafter. Taxable consumer goods used in the continuous production of other taxable consumer goods are exempt from consumption tax. Goods manufactured for exports are generally exempted.

Workplace Relations

General

The principal statute governing employment and labour issues in China is the 1994 Labour Law. The Ministry of Labour and Social Security promulgates from time to time rules and regulations which supplement the law. Apart from the national legislation, foreign investors are also subject to the local labour regulations of the area in which they are located.

Employment conditions

Employers are required to enter into labour contracts with their employees. The contract must set forth the employment terms and conditions.

Enterprises are allowed great autonomy in determining the wage levels of their employees provided they comply with the minimum wage requirements determined by the local government.

China has a mandatory 40-hour work week, based on an eight hour working day and a five day work week. Overtime work is possible within certain limits. Employees who work overtime are entitled to overtime pay, ranging from 150% to 300% of the normal wage, depending on whether the overtime is done on weekdays, weekends or statutory holidays.

Employment by FIEs

FIEs can recruit employees through various channels:

1. direct recruitment through advertisement, head hunters or other agencies such as a foreign service corporation;
2. recommendation of local staff by the Chinese joint venture partner; and
3. recommendation by the local labour authorities or local employment centres.

Recruitment of, or even execution of labour contracts with, employees who are still employed by another employer is prohibited in China. The recruiting employer has to wait until an employee has left the previous employer before it may enter into a new labour contract.

FIEs should preferably recruit Chinese nationals. If there is a demonstrated need, an FIE must secure the approval of the local labour authority to employ a foreign national except if the foreign national occupies a senior management position specified in the constitutional document of the FIE.

Under anti-discrimination and equal opportunity legislation enacted by the PRC, employees should be employed without regard to their nationality, race, gender, religion or disability.

Women below the age of 16 may not be employed. Subject to this exception, women have the same employment rights, terms and employment opportunities as their male counterparts.

Remuneration packages paid to local staff by FIEs in China typically include basic salary, allowances, subsidies and benefits. In addition to salary, some foreign employers have introduced performance-related bonuses.

Employment by a representative office

A representative office in China may be staffed with expatriate and local Chinese personnel. In both cases, certain requirements must be satisfied to employ the personnel.

Expatriate personnel seconded from overseas to work at a representative office are required to obtain a foreigner's employment permit before they may commence employment in China. However, the chief representative and other representatives are exempt from this requirement.

A representative office of a foreign enterprise may only employ Chinese citizens through a government designated service company. The representative office is required to sign a "service contract" with this service company. Under the contract, the representative office pays the service company a management fee for its services for the period during which the service company makes the Chinese employee available to the representative office. The representative office makes the final decision on whether or not to recruit the employee. In practice, the representative office may sign a separate agreement with the employee to specify the employment conditions such as the employees' duties and benefits and pay the salary and other benefits to the employee directly.

Leave entitlements

Local employees in FIEs are entitled to annual leave, home leave, sick leave, marriage leave and maternity leave.

Employees who have worked continuously for more than one year (but not necessarily with the same employer) are entitled to paid annual leave. Currently, there are no binding national laws on the length of the annual leave. The duration of annual leave may vary according to the employee's period of service and other factors.

An employee who does not live in the same locality as his or her parents or spouse is entitled to home leave. The employee will receive 30 days' home leave annually in order to visit a spouse and either 20 days per year or 20 days every four years (depending on whether or not the employee is married) to visit parents. In addition, employees are not only entitled to their normal wages during home leave but are also entitled to a refund of travel expenses. There remains disagreement among the various local labour bureaus as to whether home leave and annual leave are mutually exclusive.

The period of sick leave ranges from three to 24 months, depending on the age and the period of service of the employee. Sick employees are entitled to 60% to 100% of their salary during the first six months and 40% to 60% after that, depending on the length of the service.

Female employees are entitled to no less than 90 days of maternity leave, commencing 15 days before the estimated date of delivery. In special circumstances, the maternity leave can be extended by another 15 days.

Welfare benefits

All FIEs are required to contribute a portion of their profits to the social welfare of their employees. This includes payments towards funds covering pensions, unemployment, basic medical insurance, work-related injury insurance, maternity insurance and housing.

These contributions are part of the total compensation package of local employees and are typically expressed in terms of a percentage of after-tax profits. National labour legislation establishes the basic requirements concerning welfare payments but the specific amounts of contribution vary greatly among different localities.

Termination of employment

The labour contract should set out the circumstances in which the employer and employee may terminate the contract.

The employer may, in general, only terminate an employer without notice if there is sufficient "cause". Cause is generally limited to instances where an employee fails to satisfy conditions during probation, commits a serious violation of labour discipline or the rules and regulations of the employer, causes substantial harm to the interests of the employer due to serious dereliction of duty or is under criminal investigation in accordance with the law.

The employer can dismiss an employee with 30 days of notice in the following circumstances:

1. the employee's disability because of non-work related illness or accident,
2. lack of qualification for work, even after a change of job or retraining, or
3. change in the objective circumstances of employment.

There are strict procedural requirements for redundancy, including submission of the redundancy plan for government review.

Trade unions

Employees of FIEs, like employees in other types of enterprises, have the right to establish a trade union organisation to carry out labour union activities. The establishment and activities of the labour unions are governed by relevant laws such as the Trade Union Law. All trade unions need to be member of the All China Federation of Trade Unions.

Labour unions in FIEs may assist employees in signing individual labour contracts and negotiate collective contracts with the enterprise. They may participate in the mediation and arbitration of labour disputes and provide legal consultancy services and support and assistance to employees in legal actions against their employers.

Dispute Resolution

The courts

The PRC has established a four-tier judicial system which includes district people's courts, intermediate people's courts, higher people's courts and the Supreme People's Court in Beijing. Each province or directly administered municipality of China has its own district, intermediate and higher people's court. The jurisdiction of these court(s) varies between

different provinces and municipalities. In Shanghai, for example:

1. a district people's court has jurisdiction to hear civil and commercial cases with a dispute amount of less than RMB 5 million if it only involves domestic interests and of less than RMB 1 million if it involves foreign interests;
2. an intermediate people's court has jurisdiction to hear civil and commercial cases with a dispute amount of between RMB 5 million to RMB 100 million if it only involves domestic interests and of between RMB 1 million to RMB 80 million if it involves foreign interests; and
3. a higher people's court has jurisdiction to hear civil and commercial cases with a dispute amount of more than RMB 100 million if it only involves domestic interests and of more than RMB 80 million if it involves foreign interests.

The Supreme People's Court is the highest court in the land. In addition to its role as the court of final appeal, it is also empowered to conduct first instance hearings in cases of great significance to the whole nation or in cases which the Supreme People's Court deems should be tried and adjudicated by itself.

The civil procedure in PRC courts is governed by the Civil Procedure Law. A plaintiff may commence a civil case by filing a written complaint with the people's court that has jurisdiction over the dispute. A court may order property preservation measures to protect the interests of the plaintiff. A litigant who disagrees with the judgment or ruling of the first instance court may lodge an appeal with a higher court. Under a limited number of circumstances, a litigant may petition the appeal court or the court above for a re-trial or review of the appeal court's decision if he is dissatisfied with the appeal court's decision. The Supreme Court's judgments or rulings are final and cannot be appealed.

Pursuant to *An Arrangement on Reciprocal Enforcement of Judgments in Civil and Commercial Matters by the Courts of the Mainland and of the Hong Kong Special Administrative Region pursuant to Choice of Court Agreements between Parties Concerned*, money judgments in commercial cases given by specified courts of the Mainland and Hong Kong may be enforced in each others' courts. Legislative changes are yet to be made in both jurisdictions in order to implement this Arrangement.

Arbitration in the PRC

Previously, many foreign parties to contracts in China have chosen to resolve their disputes with Chinese parties by arbitration in an overseas location such as Stockholm. Overseas arbitration rewards are enforceable in China under the New York Convention framework. In recent years, owing to the relatively higher costs involved, Stockholm has been a less popular choice and foreign parties have increasingly been willing to refer such disputes for arbitration to China's leading arbitration institution, the China International Economic and Trade Arbitration Commission (**CIETAC**).

CIETAC is one of the busiest international business arbitration institutions in the world. Located in Beijing, CIETAC has established sub-commissions in Shanghai and Shenzhen. It has adopted two sets of arbitration rules, one governing general disputes and the other governing financial disputes. CIETAC is served by panels of PRC and foreign arbitrators but parties may also appoint arbitrators outside the panels.

Another international arbitration tribunal which is popular for resolving China-related disputes is the Hong Kong International Arbitration Centre (**HKIAC**). The HKIAC recommends the use of the UNCITRAL Arbitration Rules to govern international arbitrations but this is not mandatory. Pursuant to the "Arrangement Concerning Mutual Enforcement of Arbitral Awards between the Mainland and the Hong Kong Special Administrative Region" (**Arrangement**), an arbitral award made by the HKIAC may be enforced in a PRC court according to the provisions of the Arrangement.

Deacons

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Whilst every effort has been made to ensure the accuracy of this publication, it is for general guidance only and should not be treated as a substitute for specific advice. If you would like advice on any of the issues raised, please speak to the above contacts.

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