



DEZAN SHIRA & ASSOCIATES

Your Partner for Growth in Asia

CHINA LEGAL AND TAX UPDATE

Presented by Sabrina Zhang, Partner, Beijing office
March 2014, Boston



AGENDA



- Where is China Today
- Opportunity For Growing
- Establishing China Business
- Recent Key Regulatory Updates
- Profit Repatriation
- Cross Boarder Transaction and PE Risk



Where Is China Today?



Fact Numbers

- No. 1 Country Population: 1.35 Billion
- No. 2 Total GDP in 2013: USD7.3 Trillion
- No. 1 United Nations FDI Attraction Index Rank
- No. 1 Total Exports: USD1.9 Trillion
- No. 2 Total Imports: USD 1.66 Trillion

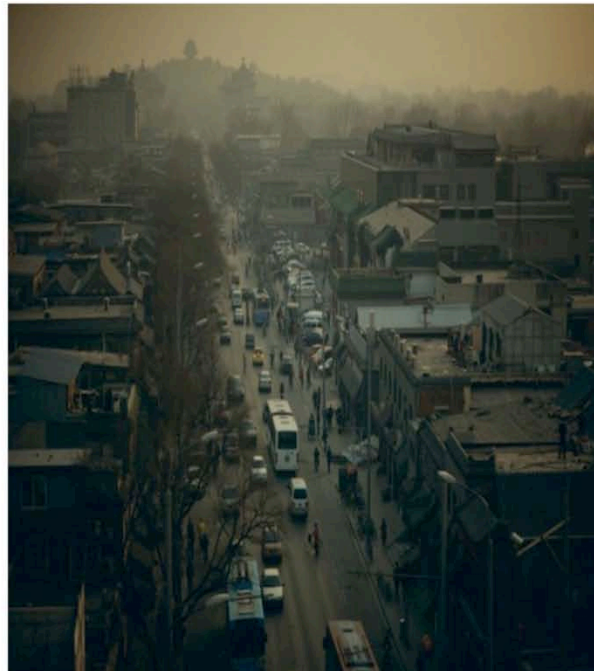
Where is China today?



1911



1981

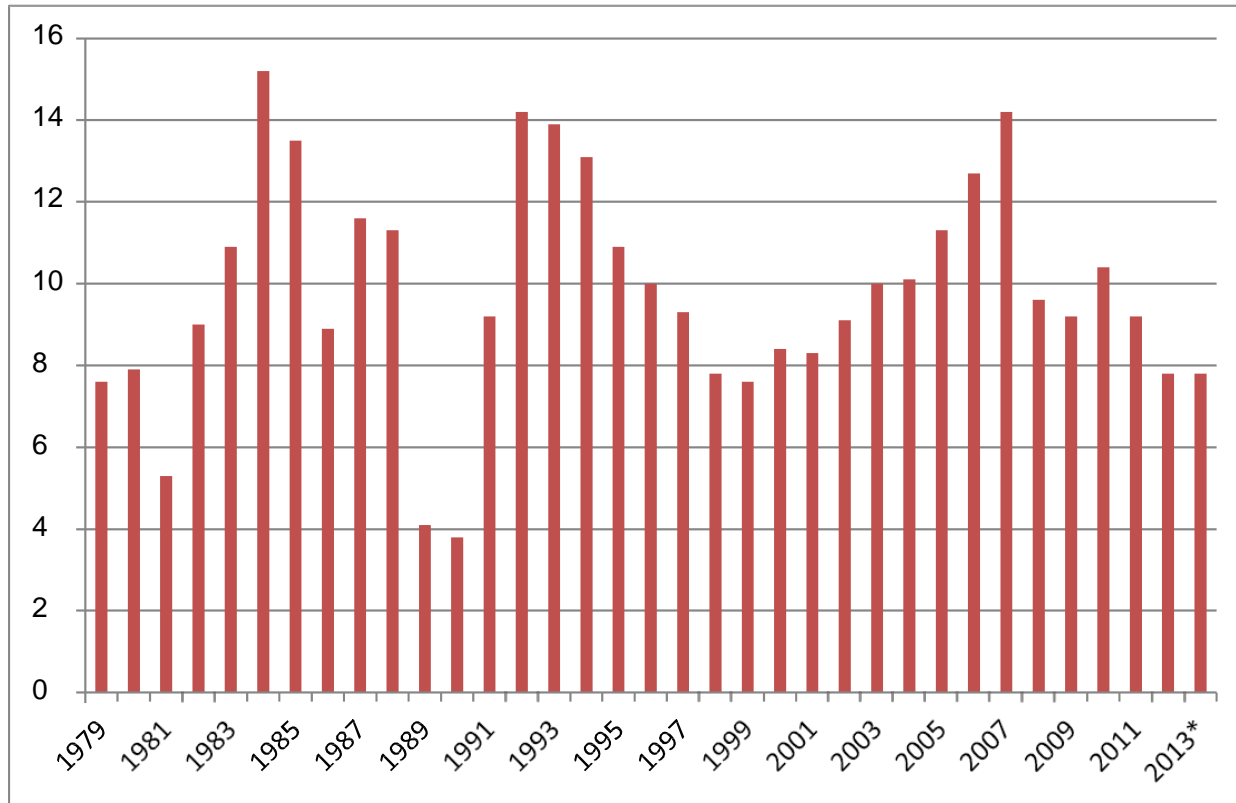


2011





Chinese Real GDP Growth: 1979-2013

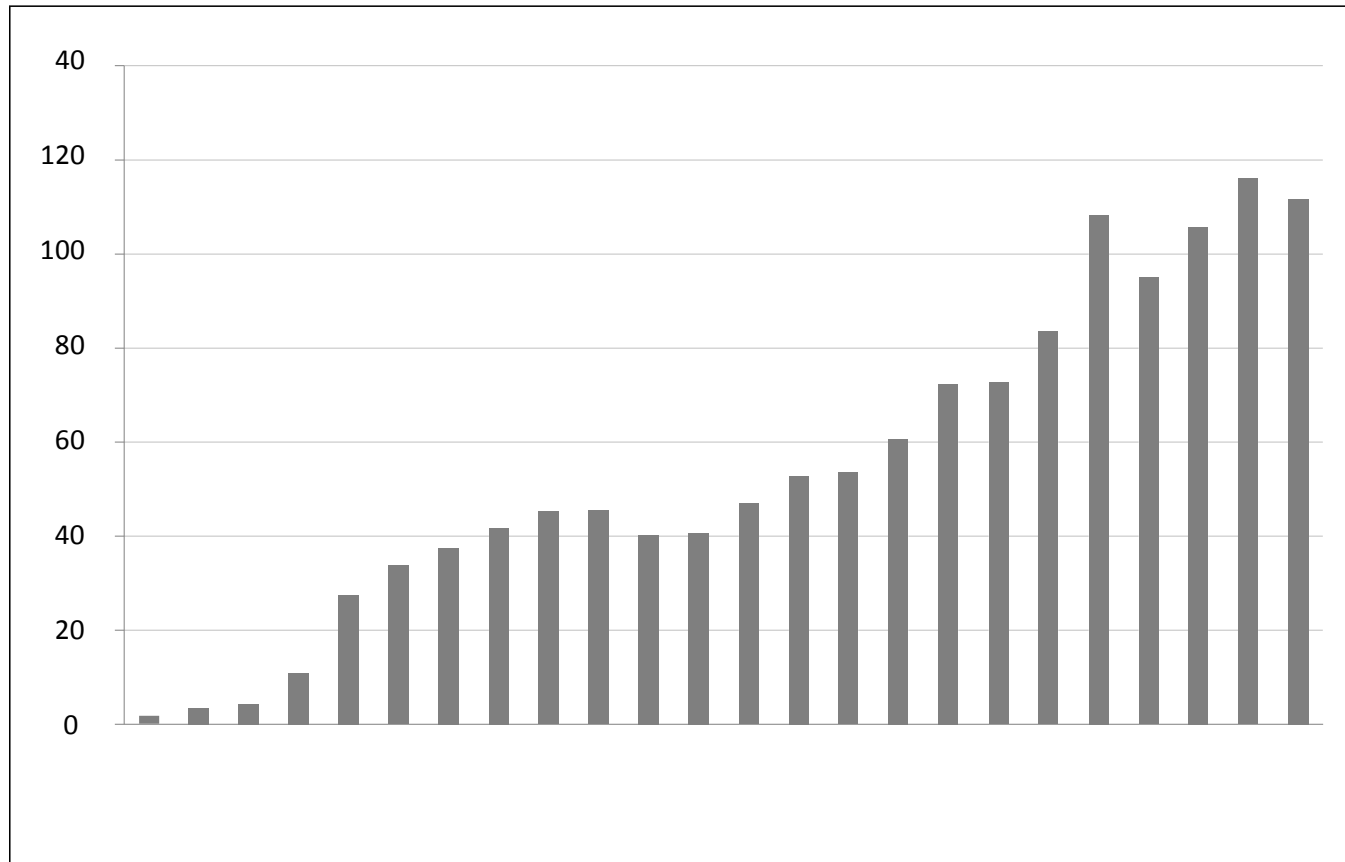


Source: IMF.

Note: * Data for 2013 is the IMF's projection made in July 2013.



Annual FDI Flows to China: 1985-2012
(\$ billions)



Source: United Nations Conference on Trade and Investment and Invest in China.
Note: Excludes FDI in financial services.



Major Recipients of Global FDI Inflows in 2012 (\$ billions)

Source: United Nations Conference on Trade and Investment.
Note: The United Nations' data on China's FDI inflows differ from China's official data



China: Projected growth pattern assuming steady reforms and no major shock

| Indicator | 1995–2010 | 2011–15 | 2016–20 | 2021–25 | 2026–30 |
|---|-----------|---------|---------|---------|---------|
| GDP growth (percent per year) | 9.9 | 8.6 | 7 | 5.9 | 5 |
| Labor growth | 0.9 | 0.3 | –0.2 | –0.2 | –0.4 |
| Labor productivity growth | 8.9 | 8.3 | 7.1 | 6.2 | 5.5 |
| Structure of economy (end of period, %) | | | | | |
| Investment/GDP ratio | 49 | 42 | 38 | 36 | 34 |
| Consumption/GDP ratio | 47 | 56 | 60 | 63 | 66 |
| Industry/GDP ratio | 46.7 | 43.8 | 41 | 38 | 34.6 |
| Services/GDP ratio | 43.1 | 47.6 | 51.6 | 56.1 | 61.1 |
| Share of employment in agriculture | 36.7 | 30 | 23.7 | 18.2 | 12.5 |
| Share of employment in services | 34.6 | 42 | 47.6 | 52.9 | 59 |

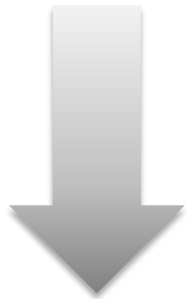
Sources: NBSC and DRC.

An Aging Population...



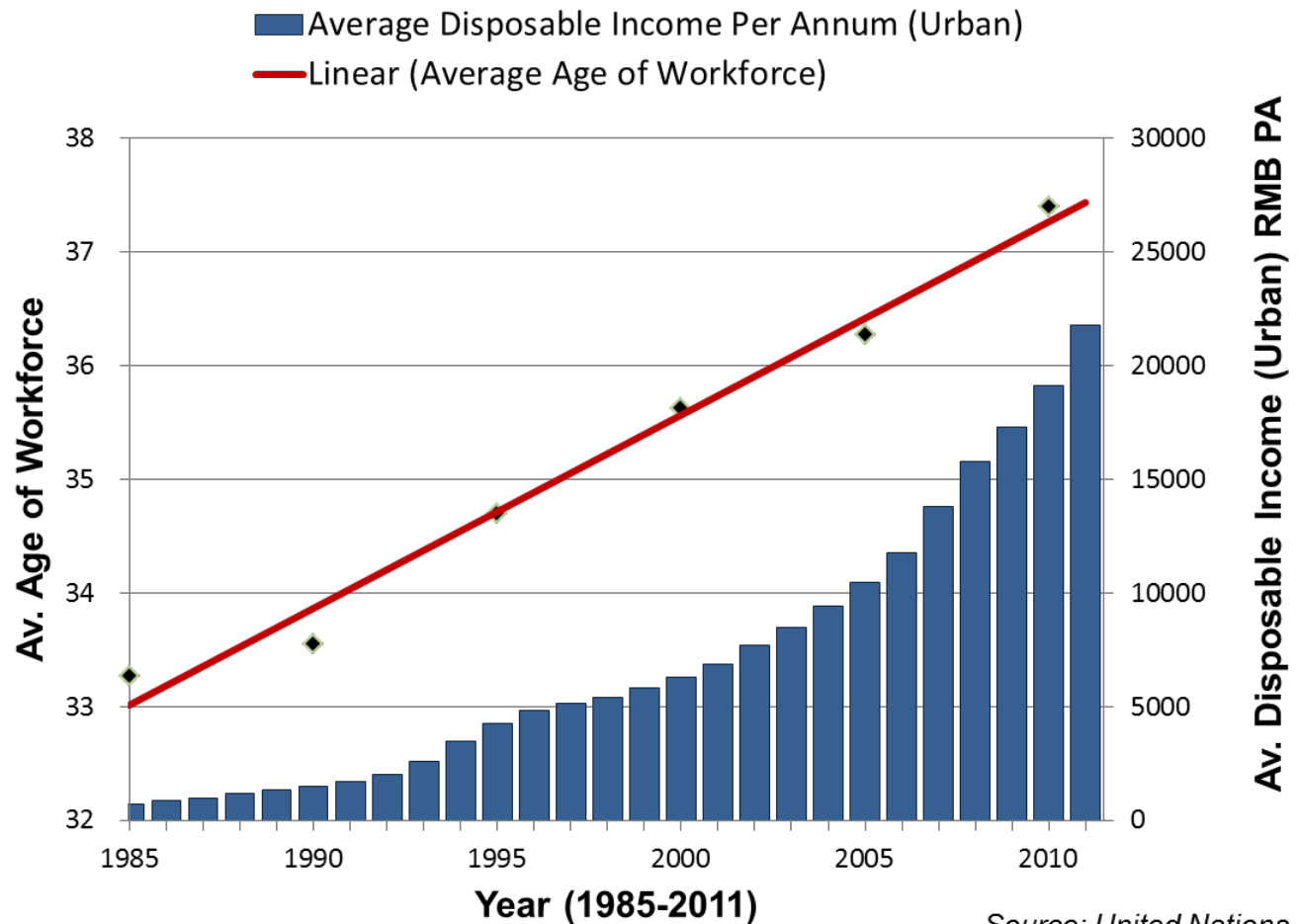
China in 1992

Av. age of worker: **23**
GDP growth rate: **12-14 %**
Employment by SOEs: **>60%**
Ranking by Nominal GDP: **11th**



China in 2012

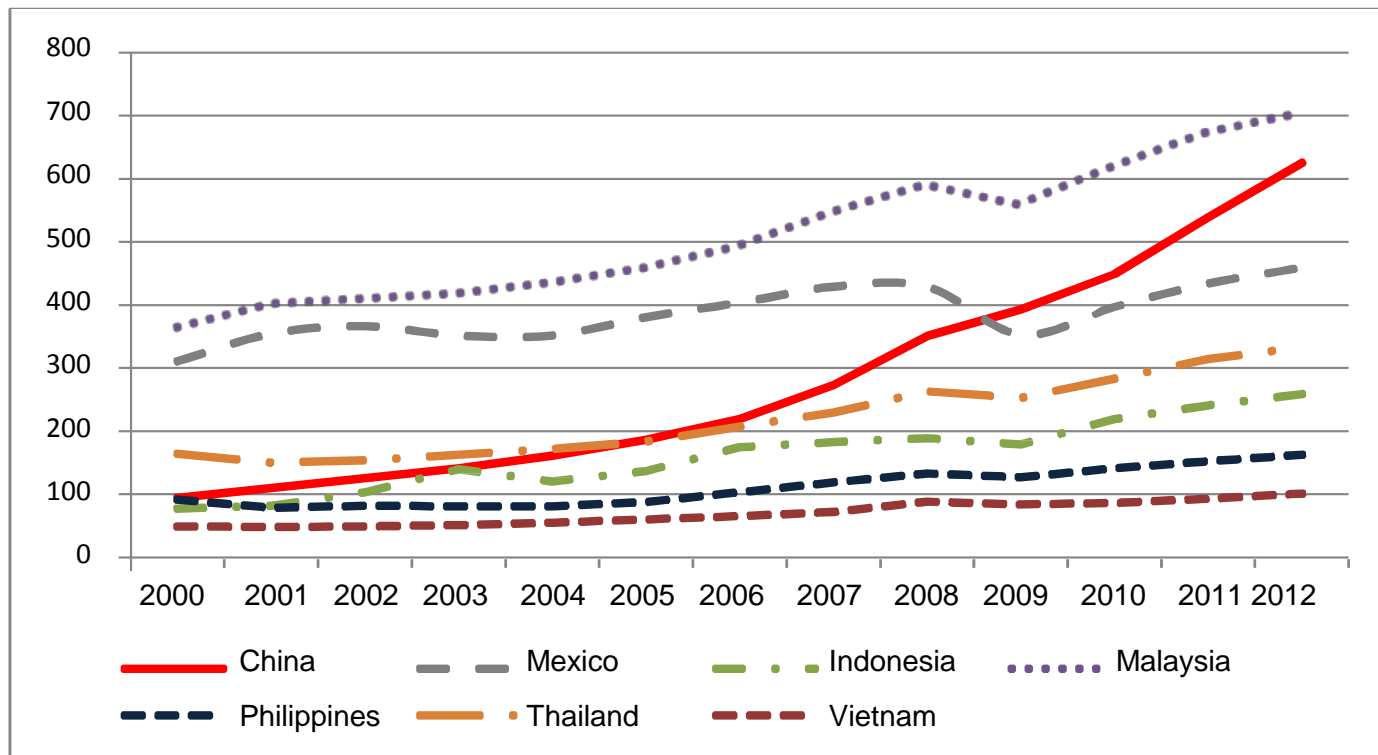
Av. age of worker: **37**
GDP growth rate: **7.9%**
Employment by SOEs: **<20%**
Ranking by nominal GDP: **2nd**



Arising Labor Cost



Average Monthly Wages for Selected Countries: 2000-2012
(U.S. dollars)



Source: Economist Intelligence Unit.

Arising Labor Cost



Senior managers in 1st tier cities reaches HK level

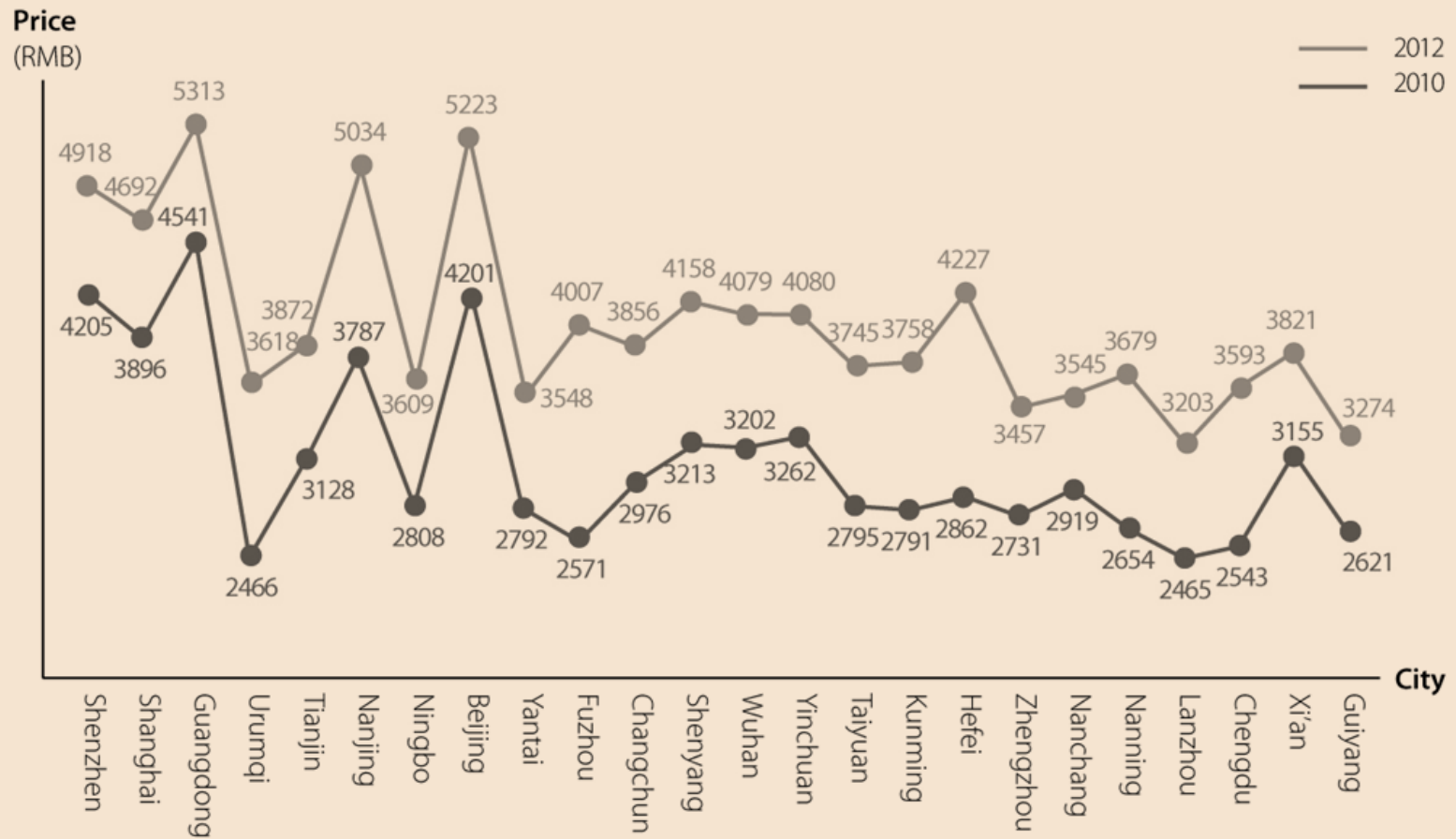
2013-2014 Salary levels for Asia-Pacific



Arising Labor Cost



China's Average Wage Comparison 2010 vs. 2012





Opportunity For Business Growing

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Opportunities For Growing



- Industry restructure and upgrade
- Increase the middle class and acceleration of urbanization
- Move into 2nd & 3rd tier cities and inland

Opportunities For Growing



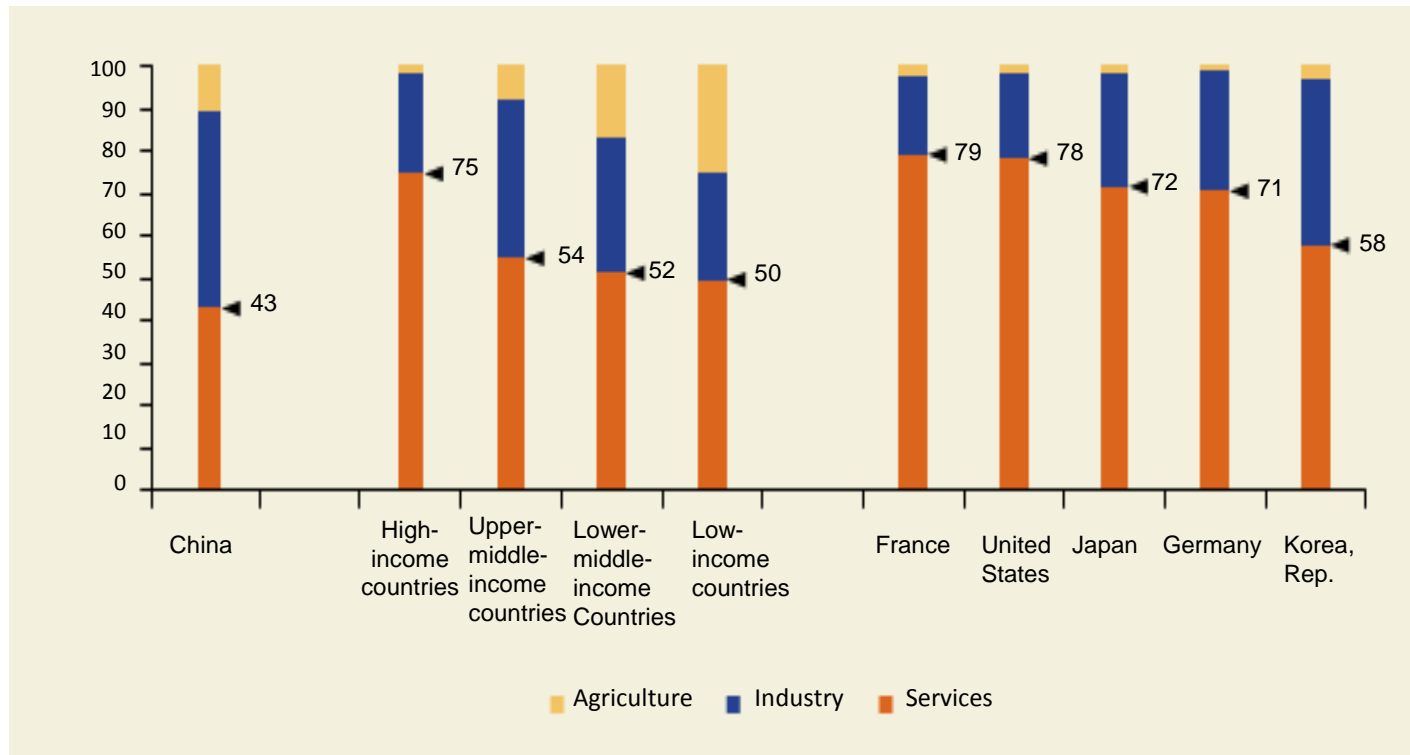
New Drivers in the 12th Five-Year Plan



Opportunities For Growing



Services, value added, as a share of GDP (2010)

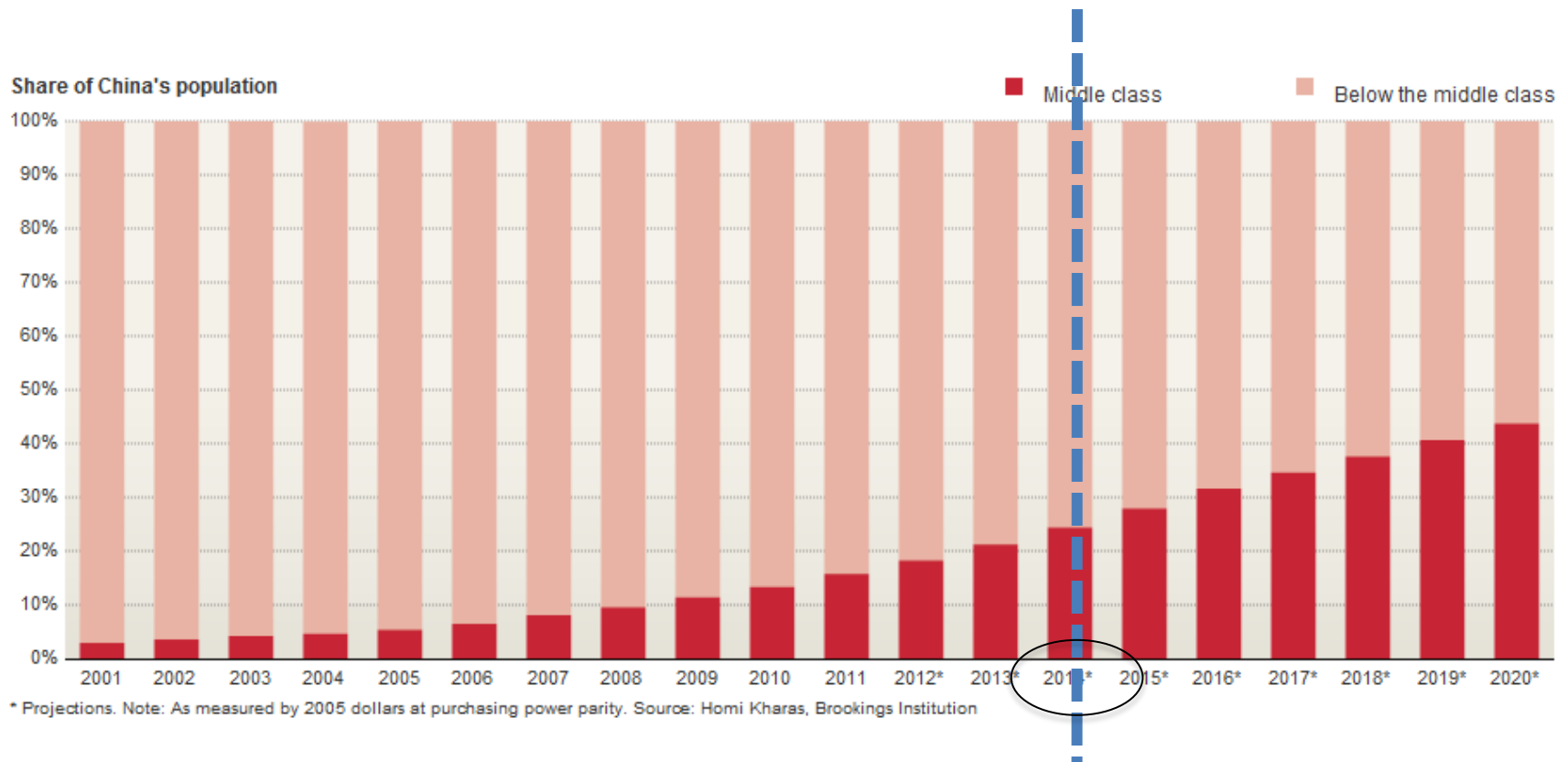


Source: World Bank World Development Indicators 2011.

China's Rising Middle Class...



Differs widely between cities, but middle class is generally defined as **income** of over RMB30,000 to RMB50,000 **per annum** (5-8,000 \$ pa)



Move into 2nd & 3rd tier cities and inland



Growth Moving Inland

2013 H1 Results

| Top 5 Cities | H1 GDP Growth |
|--------------|---------------|
| Tianjin | 14.1% |
| Xining | 14.1% |
| Chongqing | 14.0% |
| Lanzhou | 13.4% |
| Xiangyang | 13.2% |





Establishing China Business

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The traditional legal form of foreign direct investment

- Representative Offices (ROs)
- Equity Joint Ventures (EJVs)
- Cooperative Joint Ventures (CJVs)
- Wholly Foreign Owned Enterprises (WFOEs)
- Branch under WFOEs



Representative Office (RO)

Typical function

- Marketing, Research, Liaising, Sourcing
- Hiring of employees in China (visa, residence permit, working permit)
- No commercial activity

| Advantages | Disadvantages |
|--|---|
| √ Incorporation quick and easy to setup (2-3 months) | × Cannot receive revenue RMB |
| √ Inexpensive | × No possibility to issue invoices in RMB (Fapiao) |
| √ Easy to be funded by HQ | × Must go through HR agency to employ local staff; direct hiring of expates, but limited to 4 |
| | × High tax implications for growing operations |



Wholly Foreign Owned Enterprise (WFOE)

Typical function

- Can engage in manufacturing, processing & assembly, services & consulting and/or trade

| Advantages | Disadvantages |
|--|---|
| √ Direct hiring of employees possible (unlimited expat hire) | × Application & incorporation procedure: 3-6 months (depending on WFOE type) |
| √ Can receive revenue RMB | × Equity-Debt ratio limited to 70:30 |
| √ Can issue VAT invoices (Fapiao) for clients | × Cash flow management and funding |



Foreign Invested Commercial Enterprise (FICE)

Typical function

- Special type of WFOE used for trading
- Import, export, distribution and domestic retailing (both wholesale and retail)

| Advantages | Disadvantages |
|--|--|
| √ Direct hiring of employees possible (unlimited) | × Application & incorporation procedure: 4-5 months (at least) |
| √ Can issue invoices in RMB (Fapiao) | × Equity-Debt ratio limited to 70:30 |
| √ Can import/export as well as sell to the domestic market | × Operation complicated due to Custom and VAT issues |
| √ VAT refunds available for export | × Cash flow management and funding |

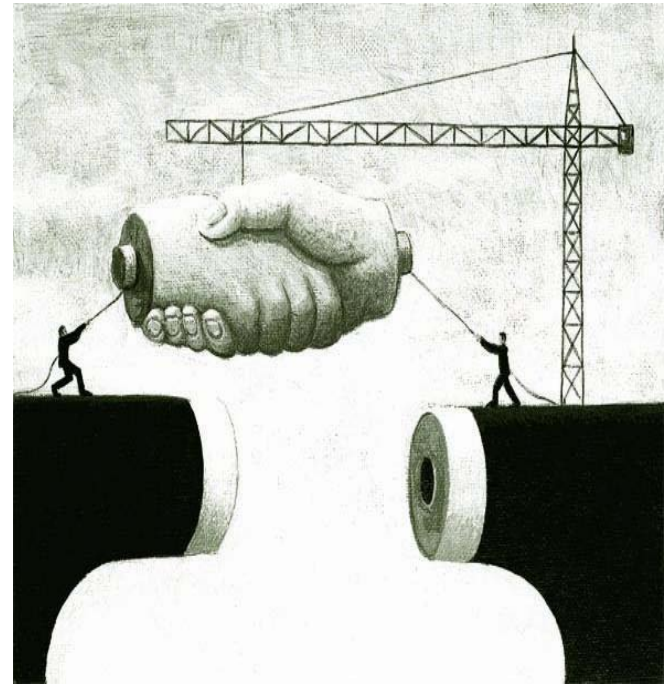


Joint Venture (JV)

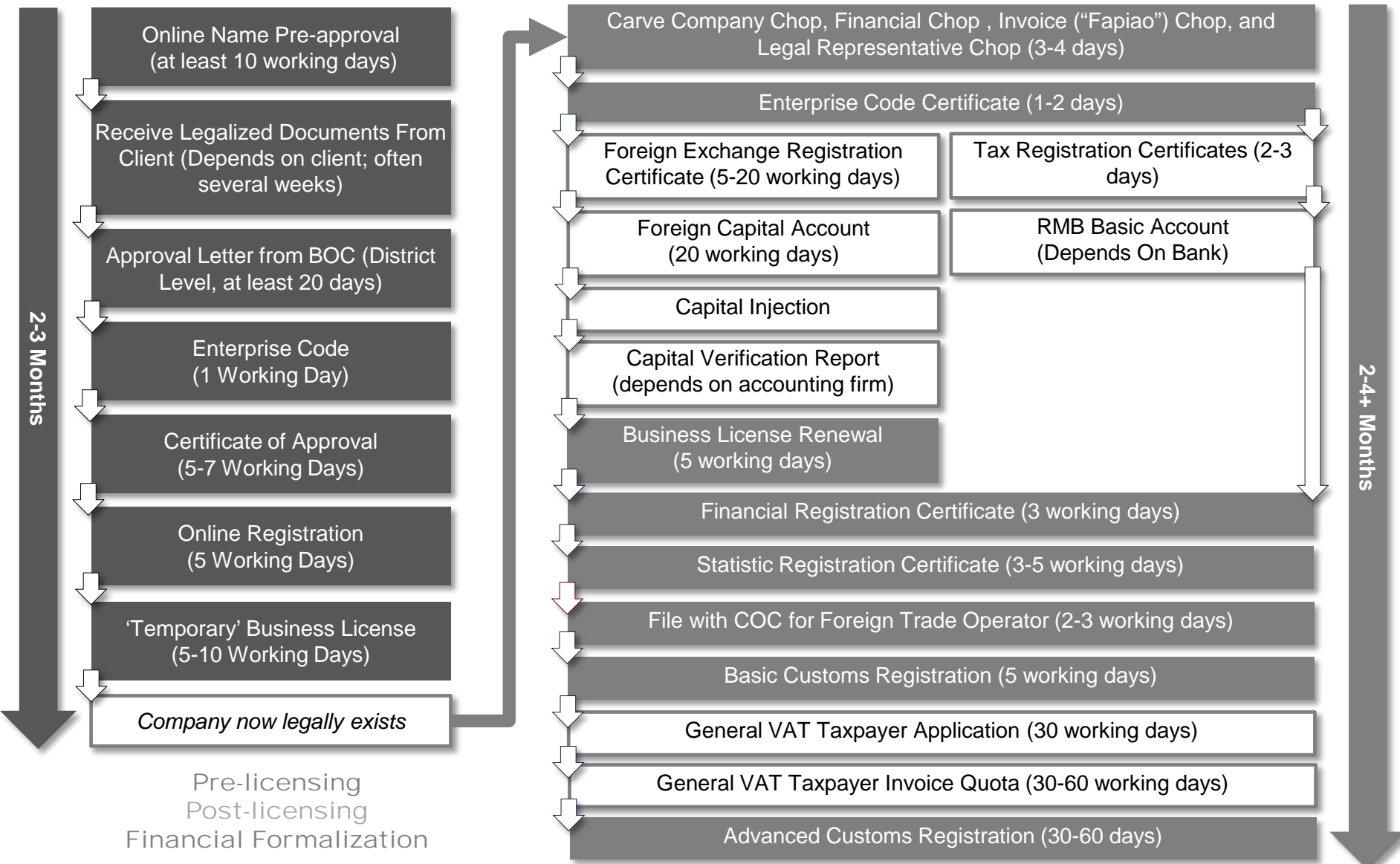
A Joint Venture in China is an entity involving a Chinese and a foreign party

Why do I need a partner?

- Legally required
- Other advantages: network, sales channels, infrastructure facility
- “Same bed, different dreams”!
- Proper evaluation of your partner
- Difficult to exit



WFOE Establishment Procedure



Business License



| | | |
|---|--|----------------|
|  | | 编号: N9 1318767 |
| 企业法人 营业执照 | | |
| 注册号: 110000450206684 | 名称: [REDACTED] (北京) 有限 | |
| 成立日期: 2012年05月28日 | 住所: 北京市海淀区蓝靛厂东路2号院金源时代商务中心B区2#B座5F室 | |
| 登记机关 | 法定代表人: [REDACTED] | |
| 2012 年 08 月 日 | 注册资本: 美元40万元 | |
| | 实收资本: 美元40万元 | |
| | 公司类型: 有限责任公司(中外合资) | |
| | 经营范围: 许可经营项目: 无 一般经营项目: 医疗设备、器械维修和保养, 提供技术服务、技术咨询、技术培训。 | |
| | 股东(发起人): [REDACTED] | |
| | 营业期限 自 2012年05月28日 | |
| | 至 2022年05月27日 | |

Company Name:

Address:

Legal Representative:

Registered Capital: USD 400,000

Paid-in Capital: USD 400,000

Company Type: Limited Liability Company (Sino-foreign equity joint-venture)

Business Scope:

Repair and Maintenance of medical equipment, medical apparatus & instruments. Technical Services, Technical Consulting and Technical Training

Shareholder (the Initiator): ---



Key Taxes for Foreign Invested Enterprises

| Tax | Rate |
|-----------------------------|-----------------------------------|
| Corporate Income Tax (CIT) | 25% of profit |
| Individual Income Tax (IIT) | 3% - 45% |
| Withholding Tax (WHT) | 5% - 10% |
| Value Added Tax (VAT) | 3%, 6% - 17% |
| Business Tax (BT) | 3 or 5% |
| Surcharges | 1 - 7% on turnover tax (VAT & BT) |



Changes in investment vehicles

- Restructure of investment in China: RO vs. WFOE
- On-shore/Off-shore holding company of multiple subsidiaries
- Regional headquarters
- Re-investment in China through existing China operation
- Foreign Invest Partnership (FIP)



Recent Key Regulatory Updates

Recent Key Regulatory Updates

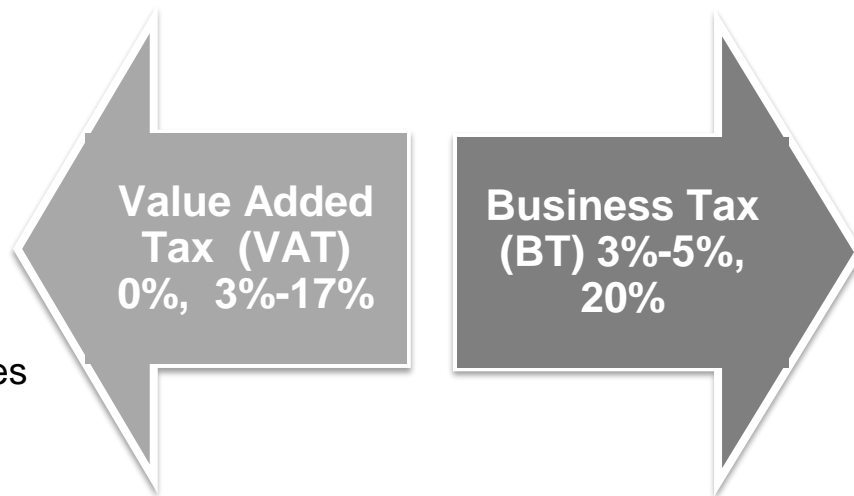


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- Aug 13** **BT/VAT reform expanded to the rest of China**
Approval of massive FTZ in Shanghai
 - July 13** **New Exit-Entry Administration Law**
Stricter punishments for foreigners illegally employed/staying in China
 - July 13** **Revision on Labor Contract Law**
tightens loopholes on hiring dispatched workers and offers better protection to the interests of such workers
 - Dec 12** **Procedures Further Relaxed for Outbound Investments**
Non-resource related investments <USD10m no longer requires approval from NDRC, just from MOFCOM and SAFE
 - Feb 14** **State Council Relaxes Registered Capital Restrictions**
State Council released Announcement on Publishing the Registered Capital Registration System Reform Scheme

VAT Reform – Original Two Turnover Tax System



- Domestic supply of goods and services
- Trading tangible goods
- Processing & repair & replacement
- Export-related activities
- Input VAT may be deductible
- Export exemptions or refunds



- Provision of services and non VAT-taxable services
- Transfer of intangible assets
- Some immovable properties
- No input deductions (“sunk costs”)
- Usually 3-5% / up to 20% for entertainment sector

Consumption Tax

Goods harmful to health, social order and the environment - 5% on alcohol in general, 40% on large vehicles, etc.

Stamp Tax

Documents - .005% to 0.1%.

Surcharges

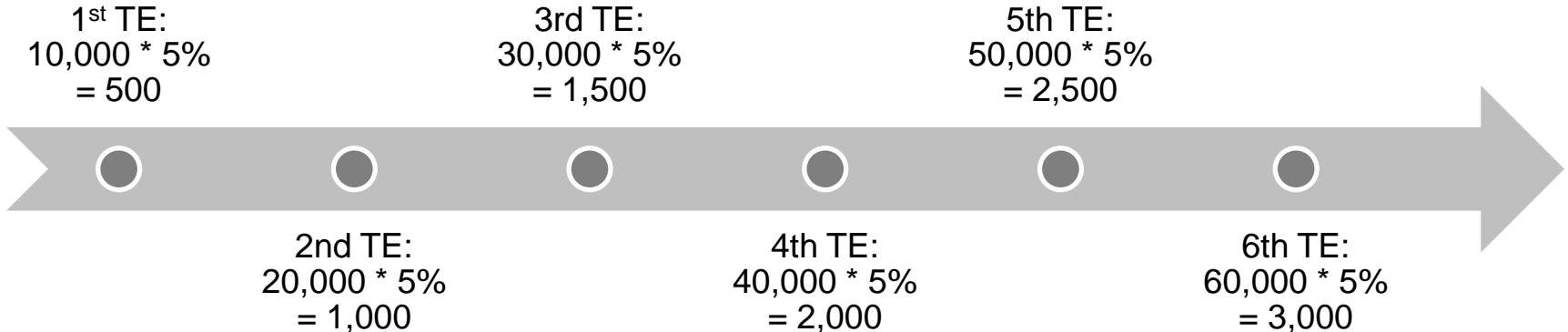
On indirect taxes themselves (Urban Construction and Maintenance, Education Surcharge, Riverine, etc.) – 1%-7%

VAT and BT Burden On Supply Chain



Double Taxation

Assume the value added is 10,000 at each taxable event (TE)



Total BT Costs = $500 + 1,000 + 1,500 + 2,000 + 2,500 + 3,000 = 10,500$

Price = $10,000 * 6 = 60,000$

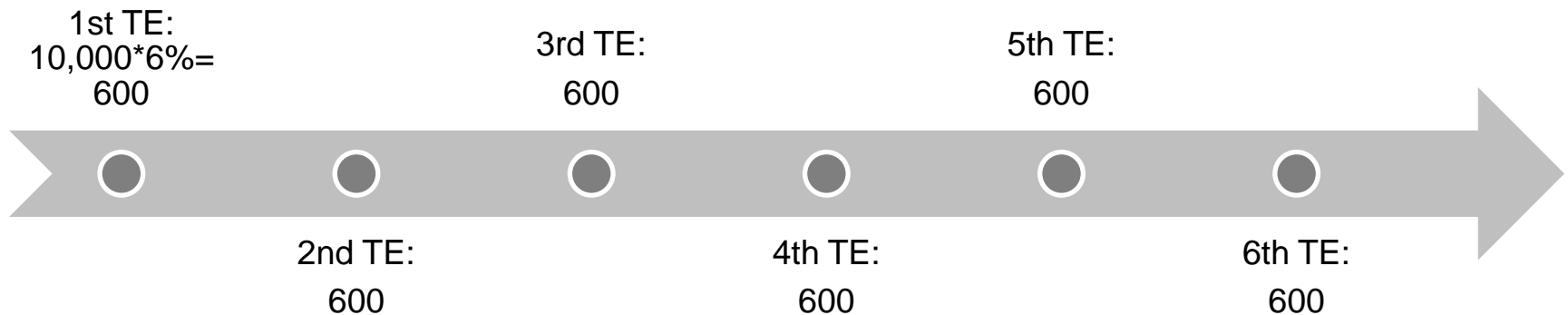
Effective Tax Rate = $10,500 / 60,000 = 17.5\%$

VAT and BT Burden On Supply Chain



Pass-on Tax

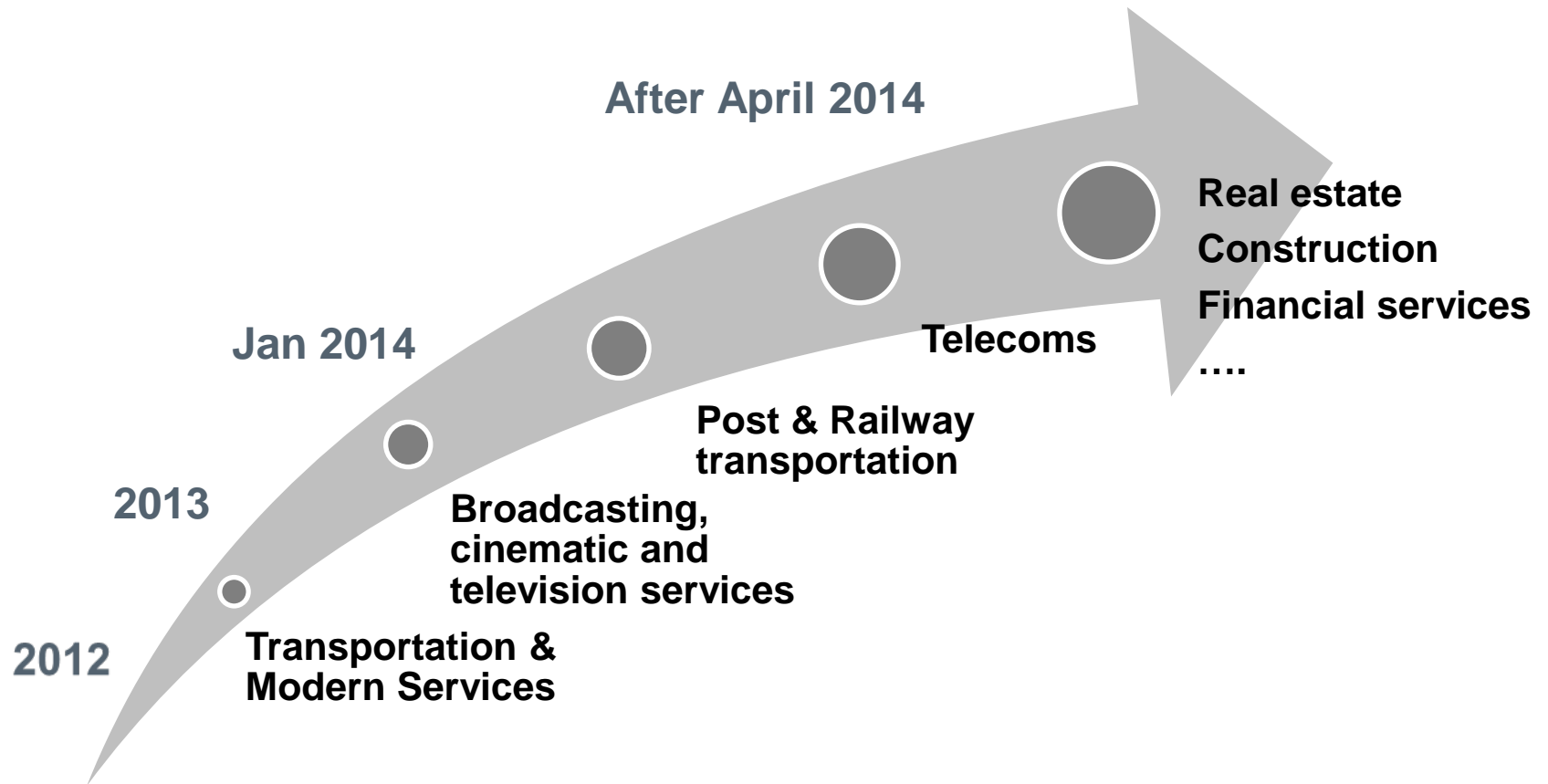
Assume the value added is 10,000 at each taxable event (TE).
Under the current VAT regime:



Total VAT Costs = $600 \times 6 = 3,600$
Price = $10,000 \times 6 = 60,000$

Effective Tax Rate = $3,600 / 60,000 = 6\%$

VAT Pilot Program Industry Implementation



Circular 106 - VAT Taxable Services and Rates



| | VAT | Old BT Rate |
|---|-----|--|
| Tangible movable property leasing services (including finance lease and operation lease) | 17% | 5% |
| Transport Services <ul style="list-style-type: none"> – Land transport services – Waterway transport services – Air transport services – Pipeline transport services – Railway transport services | 11% | 3% on a net basis |
| Postal Services provided by the China Post Group | 11% | 3% on a net basis |
| Modern Services (excluding tangible movable property leasing services) <ul style="list-style-type: none"> – Research and development and technology services (including technology consulting service, technology service, etc.) – Information technology services (including software services, electric circuit design and testing service, etc.) – Cultural and creative services (including design service, IPR service, advertising service, conference and exhibition service, etc.) – Logistics support services (including port service, cargo transport agency service, etc.) – Authentication consulting services (including certification service, tax and legal services, etc.) | 6% | 5% without allowable deductions |
| Certain taxable services stipulated by the SAT and MOF | 0% | 0% or 5% |

Reform On Investment Administration System



Key Changes

- Capital contribution requirements removed
- Except for special restricted industry, there is not minimum registered capital requirement
- Capital verification report is not required, and the shareholder can subscribe the capital flexible
- Total investment rules still apply to FIEs – *unclear to be removed or not*
- The annual inspection procedure has been changed to annual report filing

- No paid-in capital
- No annual inspection file form
- No shareholder information
- QR code is printed



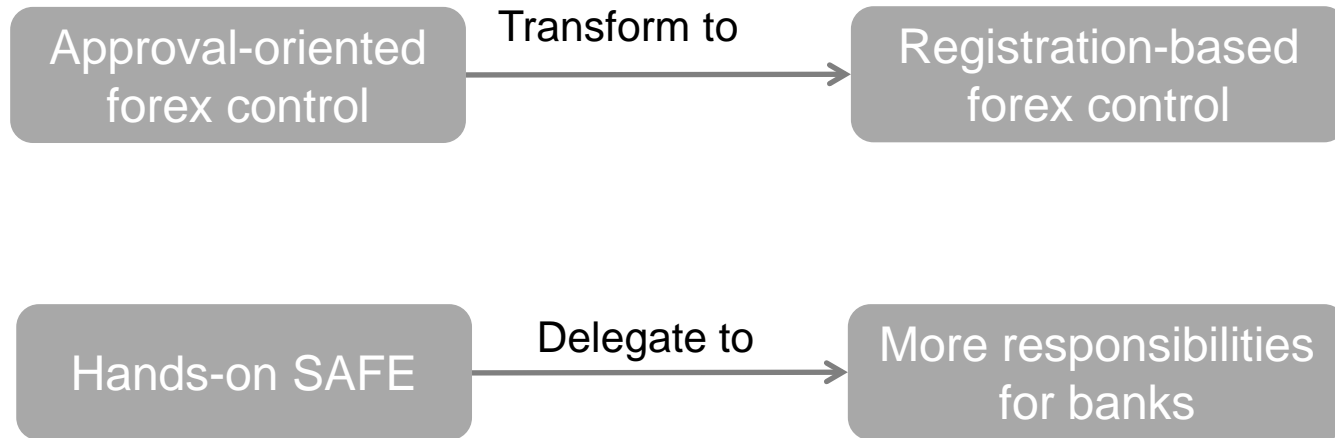
Shanghai Free Trade Zone



Established 29 September 2013 with total coverage 28.78 km²

- Pre-establishment national treatment
- Negative list: Imposes 190 restrictions in 18 sectors of foreign investment
- The List is effective through December 31, 2013
- Simplified registration
- No minimum registered capital requirement
- Outbound investment
- Liberalized interest rates and exchange rates
- Opening of service industry: banking, financial leasing, shipping, medical service, education...

Simplified Forex Regulations



➤ New Rules

- SAFE: A series of rules on foreign debts, FDI, trade services
- PBOC: Investments in financial institutions using offshore RMB, simplifying cross-border RMB procedures



Profit Repatriation

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When The Profit Is Allowed To Be Repatriated?

- The WFOE's registered capital has been injected within the time limits as set out in the Article of Association;
- The WFOE's prior year's loss has been fully made up;
- The WFOE has drawn 10% of the rest after-tax profits as the company's statutory common reserve;
- The WFOE's relevant taxes have been fully paid up;
- The WFOE has sufficient cash for dividend distribution;
- The WFOE's board of directors approved the distribution through a board resolution.

Profit Repatriation – Document Requirement



| Document | Required by Banks | Required by Tax Authorities |
|--|-------------------|-----------------------------|
| Audit Report for Profit-making Years | √ | √ |
| Annual CIT Returns and quarter and annual tax receipts for profit-making years | | √ |
| Financial Statement in the Year of Profit Distribution | | √ |
| Capital Verification Report | √ | √ |
| Articles of Association of and All Amendments | | √ |
| Board Resolution for Dividend Repatriation and Chinese translation | √ | √ |



Cross-board Transactions & PE Risk

Taxes Involved With Cross – Border Transactions



➤ Sale Goods Into China

- Import Value Added Tax (VAT)
- Custom Duty (CD)
- Consumption Tax (CT)
- Payment term decides who takes tax burden

➤ Provide Service or Charge Passive Income to Chinese Customer

- Value Added Tax (VAT) or Business Tax (BT) and its surcharges
- Corporate Income Tax (CIT)
- Individual Income Tax (IIT)
- Withholding Tax (WHT)
- If no specification on payment terms, normally foreign company shall bear the tax burden

CIT Liabilities Of Foreign Enterprises



- A non-resident enterprise (NRE) with an establishment or place of business in china shall pay corporate income tax on its china-sourced income derived by such establishment or place of business.
- An establishment or place of business includes but are not limited to:
 - *A management establishment, a business establishment or an office*
 - *A factory, farm, or place of extraction of natural resources*
 - *A place where services are provided*
 - *A place where a project of construction, installation, assembly, repair, exploration, etc, is carried out*
 - *Other establishments or places of business where production and business operations are carried out*
- An establishment or place of business is equivalent to the concept of a **Permanent Establishment (PE)** in tax treaties.



- “For a period or periods aggregating more than 6 months / 183 days within any 12-months period” relevant to service PE
- 6 months within any 12-months period *GUOSHUIHAN [2007] NO.403*
 - from the first month arrived until the last month of service
 - do not necessarily have to be six full months, one day in a month could be also counted
 - if no expatriate in China for performing service within consecutive 30 days, one month is deducted
- 183 days within any 12-months period *GUOSHUIFA [2010] NO.75*
 - from the first day arrived until the last day of service
 - more than one employee is counted as one day

How are PEs Taxed – Deemed Taxation



- Scope of profits taxable in source country: only profits of an NRE attributable to its PE in China are taxable in China.
- If A PE does not keep separate accounts and profit apportioning is not customarily used, profits of A PE will be determined on A deemed basis.

Taxable Income = Gross Revenue X Deemed Profit Rate (DPR)

- DPR range

| | |
|---------|--|
| 15%-30% | Project engineering, designing and consulting services |
| 30%-50% | Management services |
| ≥ 15% | Other services |

Taxes Involved With Cross – Border Transactions



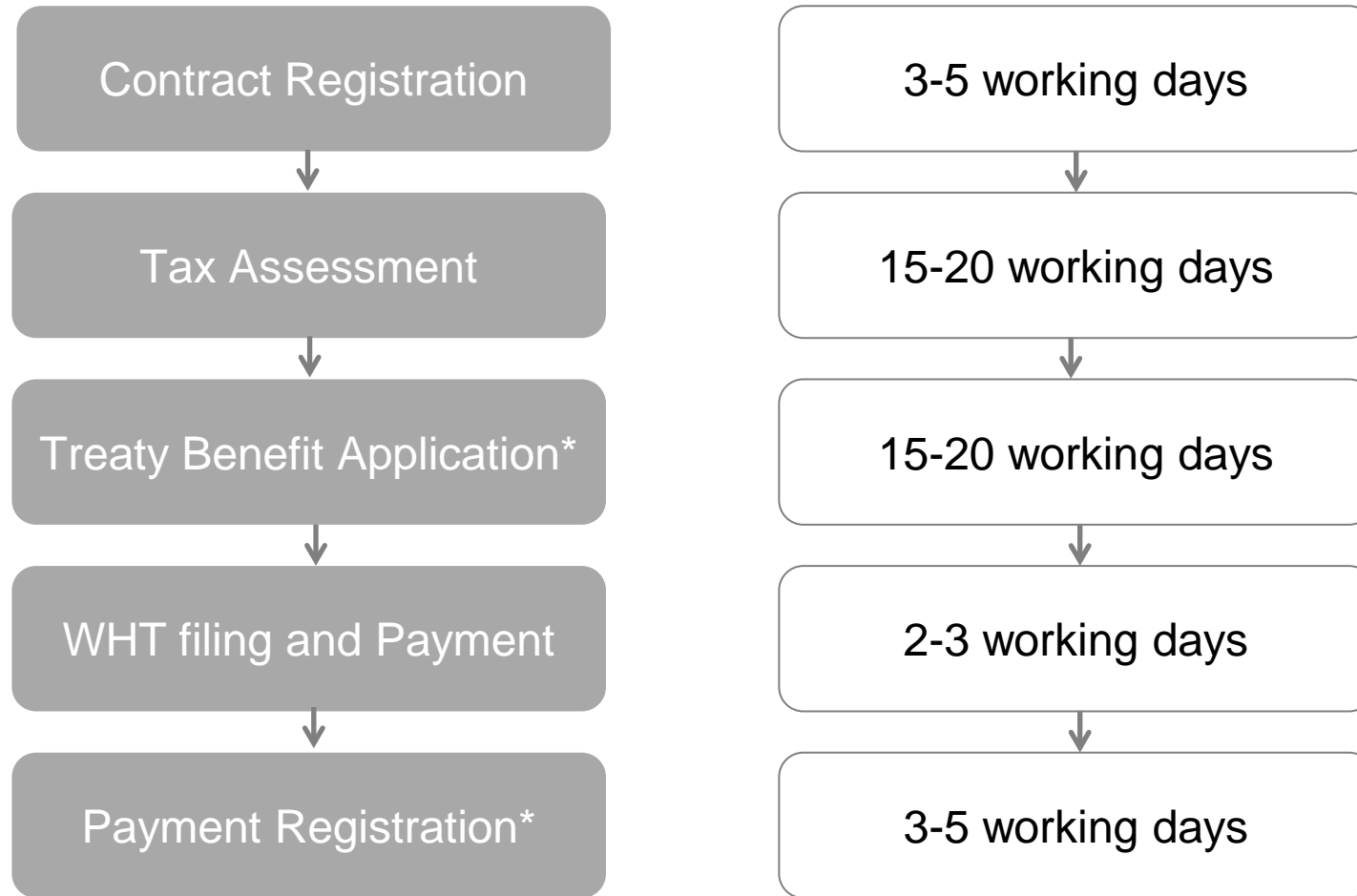
| Tax | Service Fees | | Royalty/ Interest | Dividend |
|---------------------------|--------------|--------|----------------------|----------|
| | PE | Non-PE | | |
| VAT / BT & surcharges | Y | Y | Y | N/A |
| 25% CIT (Based on DPR) | Y | N/A | N/A | N/A |
| 10% or less WHT | N/A | N/A | Y | Y |



Where a non-resident enterprise has entered into a sale contract for machinery and equipment or goods with a Chinese resident enterprise, and concurrently provides labor services such as installation of equipment, assembly, technical training, guidance, supervision services, etc, and the sale of goods contract does not list the fee amount for the aforesaid labor services, or the pricing is unreasonable, the tax authorities in charge may:

- Assess the income from provision of labor services based on the actual circumstances and with reference to the pricing standards for identical or similar business.
- Or there are no reference standards, the non-resident enterprise's income from provision of labor services shall be determined in accordance with the principle of not less than **10%** of the total price in the sale of goods contract.

Procedures For Outward Payment On Overseas Transactions



Our Global Presence



- 11 China offices, 2 India offices, 2 Vietnam offices, Hong Kong and Singapore
- Liaison offices in Italy and the United States

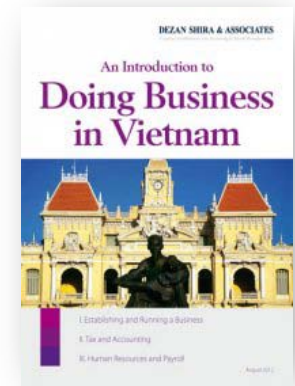
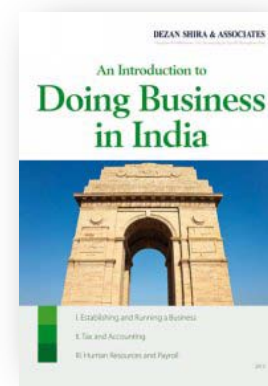
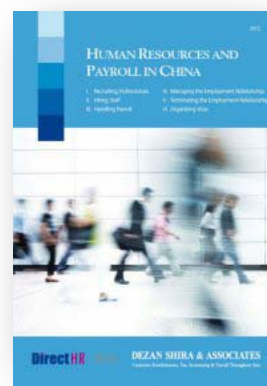
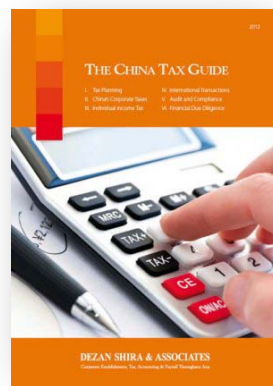
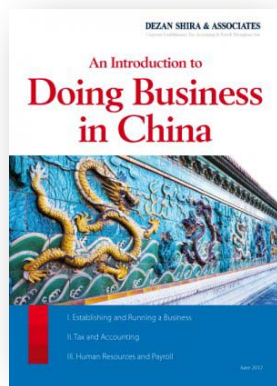


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