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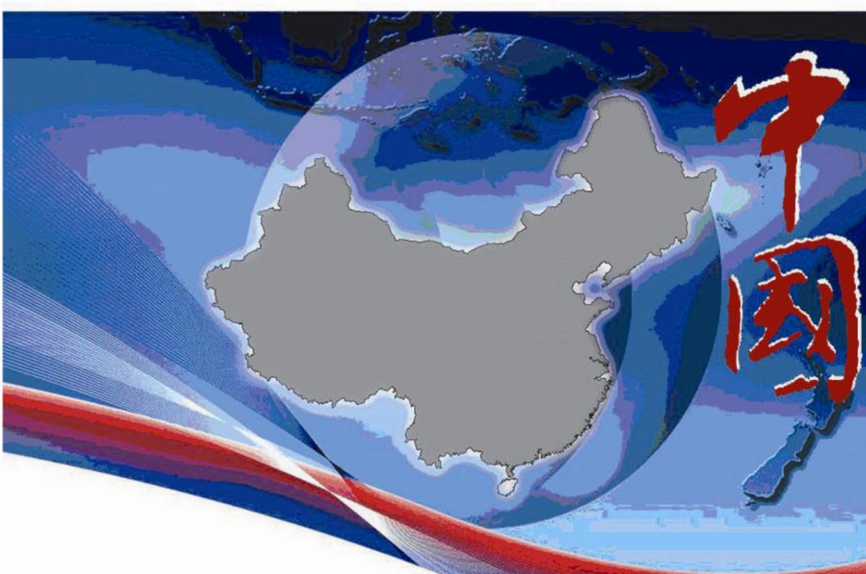
NEXIA TS (SHANGHAI) CO., LTD

Doing Business in China: A Brief Guide for Foreign Investors



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OPTIONS FOR DOING BUSINESS IN CHINA

I. Introduction

Foreign companies that wish to make direct investments in China have several options available, ranging from gaining a simple presence as a representative office in China to establishing a wholly foreign owned company to forming a joint venture with a Chinese partner company. Each option has its own unique advantages and disadvantages, and each option has its own set of rules for establishment or setup. Likewise, some types of businesses are completely open regardless of which option is chosen, and some types of businesses are restricted to only one type or another. In some special cases, a business type may by completely disallowed to foreign owned enterprises. In the final analysis, it is the decision of the foreign investor which type of operation best fits their needs, thus the investor must consider carefully all of the implications of the various options available.

We provide here a brief introduction to the three main direct investment vehicles available to foreign companies opening their business in China. The advantages and disadvantages of each option are discussed, as are the general procedures and requirements for setting up. This introduction is by no means comprehensive. The laws and regulations in China are in a constant state of change, and one business type may encounter a different set of rules than another. Likewise, laws and regulations are subject to the interpretation of the local presiding government agencies. Thus, what is true one day literally may not be true the next day, or what is true in one locality may not be strictly true in another. In our experience in setting up foreign-owned companies in China, it has become clear that each situation or set of circumstances is different from the next, even though there is an underlying consistency in all of it. In this introduction, it is our intent to provide the general and most consistent details of setting up a business in China; details that do seem to hold true over time, from one locale to the next, and from one business type to another. We hope that you find the material useful in making your decisions.

II. Representative Offices of Foreign Owned Companies

According to China's foreign-invested company rules, a representative office is not considered a separate legal entity within China, thus all legal liability for the activities performed by the representative office are assumed by the overseas head office of the company. For instance, only the head office may sue or be sued in the courts of law, and only the head office may engage in direct profit making activities.

A representative office is commonly set up by a foreign company to test the market prior to establishing full operations in China. The office may not engage in any direct profit-making activities. Typically, the representative office will only engage in indirect business activities on behalf of its parent company. Indirect business activities are fairly restricted and include business liaison activities, negotiations with Chinese clients of the parent company, oversight of projects that the parent company is engaged in, training, product introduction, market surveys and technology exchange. The general rule is, while the representative office may perform negotiations on behalf of the parent company, the representative office cannot enter into or execute any contractual agreements on its own behalf or on behalf of the parent company.

A representative office may employ People's Republic of China ("PRC") nationals only through a state-approved agency. A representative office is considered a permanent establishment of a foreign enterprise for tax purposes and is treated as a taxable entity. Because there is no profit made by a representative office, enterprise income taxes and business taxes are calculated based on the costs of operating the office each year.

Advantages of the Representative Office

Even though a representative office may not engage in any direct profit-making activities, there are still advantages to opening such an office as follows:

1. For a company unfamiliar with doing business in China, this type of setup allows a company to explore markets, check on competitive advantages and disadvantages, and to begin direct communications with potential Chinese clients or business partners.

2. Companies exploring China for long term business, or that are already engaged in business with Chinese clients, can make use of a representative office to handle negotiations, provide oversight to projects, market products, find suppliers and potential business partners, etc.

3. The representative office provides an inexpensive means to open and maintain a business presence in China. No capital investment is required, and since there is no cash earned by the office, the parent company just needs to provide the funds for the ongoing operational expenses month to month.

4. Registration times are typically short and the procedures are relatively simple.

Disadvantages of the Representative Office

1. Since the representative office is not considered a separate legal entity in China, all legal liability passes through to the head office of the parent company without limitation.

2. The representative office cannot issue any invoices, perform any direct profit-making activities on behalf of the parent company, cannot charge clients for any products or for services rendered (such as training), etc. Thus the parent company must handle all profit-related business matters within China from its overseas location.

3. The registration period for a representative office is typically short, so subsequent frequent registration processes may be required.

4. As with any business, meticulous records must be maintained, especially with respect to operational expenses, payment of debts, enterprise income tax payments, individual income tax payments etc. This is especially important when it comes time to deregister the representative office for any reason. Without good records and on-time payment, deregistration can be a quite lengthy and laborious process.

5. If it is desired, conversion of a representative office to a wholly foreign owned enterprise can be a lengthy process, even longer than registering a WFOE on its own. The only way around this is to open a second office for the WFOE while the representative office is undergoing deregistration.

6. In some cases, since annual taxes are based on the cost of operations in the representative office, taxes may be higher than for a WFOE where annual taxes shall be based on profits.

III. Wholly Foreign Owned Enterprises (WFOE)

The Wholly Foreign Owned Enterprise (WFOE) is likely the least restrictive and most popular direct investment vehicle currently in use by foreign companies opening their businesses inside China. Certainly, the WFOE offers the investor the most direct control of how business is conducted, as well as offering the most comprehensive capabilities for handling and managing the business according to the investor's business plan.

A WFOE is a limited liability company (separate legal entity) that is established in China under PRC Company Laws, and is wholly owned by one or more foreign investors. The liabilities of the investors in a WFOE are usually limited to the amount of their contributions to the WFOE's registered capital. As such, the WFOE will only be liable to creditors to the extent of its registered capital. Legal liability does not pass through to the overseas parent company.

The business scope of a WFOE company is limited to that described in the business license, and thus cannot be expanded or amended without the approval of the original examination and approval authority. It is therefore essential to ensure that the business scope is drafted as broadly as possible, especially in order to ensure coverage for any future plans that may not be immediately implemented upon registration completion.

As a rule of thumb, the registered and paid up capital required for opening a WFOE is USD $150,000, although this amount may be more or less, as the registered capital requirements vary from industry to industry and also on a regional basis. The registered capital is the total equity investment contributed by the investor(s), as distinguished from funds borrowed or otherwise raised. The cash contributions may be drawn down against post establishment operational costs. Investors are required to register the proposed constitutional documents of the WFOE with a subordinate agency under the Ministry of Commerce ("MOFCOM"), and make capital contributions in accordance with the relevant laws and regulations, as well as the terms of the company's articles of association.

Advantages of a WFOE

A WFOE, because it is a separate legal entity in China, may carry out all business functions within the approved business scope of the company. That is, the company may sue or be sued, and the company can enter into contracts with clients, suppliers and cooperating companies. The company can also issue invoices to clients for goods and services, and thus can claim profits. The company may hire and contract with local Chinese for the workforce on its own, without using any government approved agencies. The major advantages of opening a WFOE include:

1. The foreign owners have full control over the management of the company. Thus there is independence and freedom to implement the worldwide strategies of the parent company

without having to consider the involvement of the Chinese partner.

2. Ability to formally carry out full business functions in China rather than just function on a contracting basis or as a representative office. For example, the WFOE may sell goods directly to customers (or distributors) and issue invoices (and VAT invoices) to customers in RMB and receive revenues in RMB. Additionally, with an import/export license, these activities can be carried out locally in China on behalf of the WFOE company.

3. Profits in RMB may be converted to foreign currency for remittance to the foreign company's parent company outside China (subject to corporate income tax and in accordance with the PRC rules on foreign exchange).

4. The trade secrets or proprietary technology of the foreign investors can be well protected, as there is no involvement of a Chinese partner or others.

5. Employment of staff may be done within China or staff may be imported from abroad. The WFOE has full control of human resources.

6. As opposed to a Joint Venture or to contracting third parties, the WFOE is not required to share profits with any Chinese counterpart or partner. Profits may be remitted to the parent

company as dividends, or may be used to expand the business in China or buy property.

7. WFOEs are relatively quick and inexpensive to establish.

8. The company can register and be approved for any operational time period without need for frequent re-application.

9. If a WFOE qualifies as a high technology enterprise, the company may enjoy the benefit of reduced enterprise income taxes.

Disadvantages of the WFOE

1. For a new foreign company doing business in China, there is potential for many mistakes related to intended market etc. If not familiar with doing business in China, a foreign company may consider opening a representative office or establishing a joint venture.

2. Generally, registered and paid up capital of at least RMB 1,000,000 (USD $150,000) is required.

3. Unless the business scope of the company is listed as real estate investment, the WFOE may not buy real estate other than for business use (unless using profits generated by the WFOE).

4. WFOE set up and registration time is approximately 4 months. If immediate business needs to be done in China, a contract with a local Chinese firm will be required.

WFOE Structure and Other Considerations

1.1. Every foreign company that establishes a WFOE limited enterprise in China must meet certain staffing requirements at the senior level. For example, it is required that the company appoints a legal representative who will have most of the legal powers and liabilities related to the company operation. From the beginning of the setup process, foreign invested enterprises must understand the various staffing requirements and appoint personnel to the positions appropriately to ensure that the company is protected and that operations run smoothly. The individuals also should understand their legal liability in the various roles.

IV. Joint Ventures

Joint ventures between foreign companies and Chinese partner companies are common and have been a popular foreign investment vehicle for many years. This is especially true in the cases where the business is restricted by authorities to only Chinese companies or their joint ventures, as well as in the cases where the foreign company has little to no experience doing business in China and does not want to risk a start up on their own.

There are two major types of joint venture open to foreign investors, including the equity joint venture (EJV) and the cooperative joint venture (CJV). Except in the case of a simple contractual joint venture (a type of CJV), joint ventures are limited liability companies where the investors are liable only to the extent of their share of the total registered capital of the company. While the application and approval process is somewhat similar to that of WFOEs, the time investment from beginning to end of the process is generally longer because of the due diligence and contract negotiations that must be performed. A simple introduction to the various forms of joint venture is given below.

Equity Joint Venture (EJV)

In an EJV limited liability enterprise, the foreign partner holds at least 25% share, with up to 20% of the total registered capital offered as industrial property rights or technology know-how. The requirements for total investment in an EJV are the same as for a WFOE. The EJV is a self-managed enterprise, with the top level of management staffed as a board of directors. The number of appointed board members by each JV partner roughly corresponds to the percent share held by the investor. Profits and losses are also distributed to each investor according the investor’s equity share. Profits may only be distributed in cash. Generally, the EJV contract must specify the life term of the EJV.

Cooperative Joint Venture (CJV)

Cooperative joint ventures (CJV) can take two forms. One form is to create a limited liability company as in the case of the EJV above. The second form is to create a contract for a specific project, without actually setting up a separate legal entity. In the first case, a board of directors will be appointed to manage the company, and they can only serve a maximum of three years. In the second case, the contract may call for a board of directors or for a management team to manage the project. In both cases, profits are paid to the investors according to the contractual agreement rather than according to the percent of investment share. Likewise, profits may be distributed in cash or products or a combination of both. The investment and setup rules for a CJV are similar to those for an EJV.

Advantages of a Joint Venture

1. Foreign companies can invest in businesses that are restricted by the government to Chinese companies.

2. The Chinese partner already has experience handling business in China, so there should be few, if any, surprises in managing the business.

3. If a good business relationship already exists with the Chinese partner, negotiations and company setup should be smooth and relatively quick.

4. For handling a specific project of fixed duration, there is no need to go through the procedures involved in forming a WFOE and later deregistration.

5. The Chinese partner can handle all application and registration matters on behalf of the JV.

Disadvantages of a Joint Venture

1. In the absence an already established business relationship, the process of finding and negotiating with a Chinese partner can be lengthy and costly.

2. The JV is self-managed, so the business plan of the company may not be carried out in accordance with the wishes of the foreign investor.

3. Proprietary technology or trade secrets provided by the investors to the JV are not well-protected.

4. Profits of the JV are shared with the Chinese partner company.

V. Summary of Options for Doing Business in China

In the previous sections, we have discussed the three main vehicles open to foreign investors wanting to extend their businesses into China. These include the representative office, a wholly foreign owned enterprise, and the variations of joint venture that are possible. As mentioned, the descriptions are general only. Each situation is different. Each business type is different. And there may be variations in process or regulations from one area to another. A consultant who is fully equipped to assist foreign investors to investigate the potential or to set up their business in China is important. In further consideration of setting business in China, foreign investors want to know what to expect with respect to taxation in China. We now take a look at the tax implications for doing business in China.

TAXATION IN CHINA

As previously mentioned, the tax holidays regime for foreign companies doing business in China ended with the implementation of the new corporate income tax code on 1 January 2008. All new foreign companies set up in China, as well as all domestic enterprises, now follow the same flat rate for corporate income tax. Some tax relief is still offered for those companies engaged in and approved as high technology, and some relief is still found in certain special locations for certain business types, but generally, tax relief is no longer the major consideration for setting up business in China.

Foreign-invested enterprises inside China, foreign enterprises doing business in China without a permanent establishment, and individuals working in China are all liable for one or more China taxes to include: corporate income tax (CIT), value added tax (VAT), consumption tax (CT), business tax (BT), surcharge tax for education and infrastructure, individual income tax (IIT), vehicle and vessel license tax, stamp tax, native farming and forestry produce tax, animal slaughter tax, city real estate tax and land value added tax in China. In the case of import and export businesses, applicable customs duty is also levied on goods and equipment. Due to constant changes and updates in the taxation regulations in China, as well as the fact that different local tax bureaus interpret laws in different ways, it would be impossible here to offer a comprehensive report. However, the general descriptions and rates offered below should provide the foreign investor with sufficient information to make initial assessments about what to expect in taxation when moving the business into China.

1. Corporate Income Tax

All foreign enterprises doing business in China (including Sino-foreign joint ventures, wholly owned foreign enterprises, representative offices, non-resident companies offering services on a contractual basis, etc.) are subject to the same CIT rates as their domestic Chinese counterparts, which is currently 25%. If a company is approved by authorities as a high technology company, the rate may be reduced to 15%. Some encouraged businesses in western provinces may also enjoy a CIT rate of 15%.

2. Value Added Tax, Business Tax and Consumption Tax

Generally speaking, since January 1, 1994, industrial and commercial consolidated taxes for foreign invested companies were abolished. These taxes were replaced by the use of value added tax (VAT), consumption tax (CT) and business tax (BT). In turn, the VAT and BT have both undergone many changes since that time, and continue to do so. Thus, below we offer a brief description of each of these taxes. For the most current details related to your particular case, please don't hesitate to ask us.

Value Added Tax (VAT)

Enterprises or individuals who sell commodities, provide specified services such as processing, repair and maintenance services or import commodities into the territory of China are subject to value added tax in line with Chinese laws. The standard rates for VAT generally fall between 6% and 17%. The actual rate is dependent upon the particular products that are sold as well as whether the enterprise is considered a general taxpayer or a small-scale taxpayer.

In the case of exporting goods outside of China, VAT is not collected. Thus companies may later apply for VAT rebates. Note that VAT rebates do not allow companies to recover the entire input VAT.

Business Tax (BT)

Enterprises or individuals with businesses that provide services, such as transportation, postal services and telecommunication, finance and insurance, construction, art, sports, entertainment and general services are all subject to BT. BT also applies to transfer of incorporeal properties and sales of immovable assets, as well as to those who provide labour services. Generally, the BT rates fall from 3% to 6%, with the tax rate for the entertainment sector topping 20%. Exemptions do apply.

3. Stamp Tax

Business activities involving purchases and sales, processing, contracting, leasing, transportation, storage, financing, property insurance, technology contracts, property transfer vouchers, business account books, licenses and other specific documents that have been drawn up or obtained by both Chinese and foreign parties, and that have a legal effect in China, are subject to stamp tax. The minimum rate of stamp tax is 0.03% and the maximum is 0.5% of the taxable value of a given transaction. Stamps shall be affixed on the specific documents.

4.City Real Estate Tax

Upon a deduction of 20% of the original value of the real estate, the city real estate tax is levied at an annual rate of 1.2% on the remaining amount. The tax rate is 10% if it is levied on the rental income. The newly constructed houses, which are built or purchased by the relevant foreign-invested enterprises in Pudong New Area and Economic and Technological Development Zones, shall be exempted from real estate tax for 5 years as of the month of completion of construction or purchase.

5. Vehicle and Vessel Licence Tax

All the vehicles owned and used by foreign-invested enterprises are subject to this tax according to the "Interim Regulations on the Vehicles and Vessels Operation Licence Tax". The tax rates are as follow:

6. Individual Income Tax (IIT)

All persons working in China, including foreigners, shall be subject to payment of individual income taxes (IIT) in China. Some time limitations apply, and these should be checked with your tax consultant prior to commencement of employment. Generally it is the responsibility of the employer to file and pay income tax on behalf of the employee each month. If this is not done, it shall be the responsibility of the employee to file their IIT each year. Currently for foreigners working in China, the first 4,800 RMB are deducted from the monthly income to calculate the taxable amount. The individual income such as wages and salaries of foreigners working in China shall be taxed at progressive rates from 5% to 45%.

7. Deed Tax

When transferring the ownership of land and houses in the territory of the People's Republic of China, any organization or individual on the receiving end is subject to deed tax. The transfer of ownership of land and houses refers to: 1) the grant of land use right by the state (not including the transfer of management right of the rural collective land); 2) transfer (including selling, bestowal and exchange) of land use right; 3) sale and purchase of houses; 4) bestowal of houses; 5) exchange of houses.

The tax rate of 3 - 5% is determined by the provincial, autonomous regional or municipal governments according to the situation and is registered with the State Finance Ministry and the State Council for filing.

FOREIGN EXCHANGE CONTROLS

All foreign monies flowing into and out of China are controlled by the State Administration of Foreign Exchange. This holds true for both individuals and enterprises. Foreign currencies must come through approved banks, and it is the bank that must assure that monies are sent or received according to the regulations. Generally, the individual or enterprise must provide the bank with supporting documentation for each transaction, including evidence that the payment or remittance is "genuine and consistent" and that all applicable taxes have been paid.

Upon setup of an enterprise in China, foreign invested enterprises will register with the State Administration of Foreign Exchange and open one or more foreign currency bank accounts at an approved bank. Incoming funds are held and may not be converted to RMB until all supporting documentation is submitted and approved by the bank. Likewise, monies intended for remittance to another country are held until the supporting documentation is completed and approved.

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www.nexia.com

CONTRIBUTORS

Contributed by Consultants from Nexia China Pte Ltd and Nexia TS (Shanghai) Co., Ltd, Nexia International:

HENRY TAN

CHAIRMAN, NEXIA CHINA

BAcc, First Class Honours, National University of Singapore

Chartered Accountant, Australia

FLORA LUO

INTERNATIONAL BUSINESS MANAGER, SHANGHAI OFFICE

BA Degree, Guangxi University

Masters of Science (Business and Marketing), University of Wales

NEXIA CHINA

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Nexia China Pte Ltd is the umbrella company set up for the Chinese firms in China. Nexia China Pte Ltd is headed by Mr Henry Tan who is also a director of Nexia International and Managing Director of Nexia TS Public Accounting Corporation, Singapore. The China Secretariat is at Nexia TS (Shanghai) Co., Ltd in Shanghai.

Nexia TS, together with its China associates offers professional and quality management consultancy, audit and tax services. We have been assisting foreign firms to set up in China for the past years and have accumulated much experience in this area. Our expertise has successfully helped many foreign firms set up wholly foreign-owned enterprises, equity joint ventures, contractual joint ventures and representative offices in China. Nexia TS has its own office in Shanghai to ensure personalized services for our clients all the way.

Nexia TS also works with many local associates in China with offices in Shanghai, Nanjing, Shandong, Suzhou, Fuzhou, Xiamen, Guangzhou, Shenzhen, Dongguan, Zhuhai, Ningbo, Kunshan and Beijing.

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Nexia TS, in alliance with its China associates, can offer the following services:

- Set up of Private Limited company

- Set up of representative office
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- Investment opportunities
- Market research of viability of business or products
- Assist as a one-stop shop to set up manufacturing plants
- Audit
- Tax
- Asset valuation
- General business consultancy
- Application of work permits and visas
- Locating of office space and accommodation
- Recruitment
- Trade enquiries
- Sourcing of suppliers or agents

- Arrangement of sale of products into China

One-stop set up of office on production facilities from inception, office, production, layout, recruitment of staff to operation.

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Doing Business in China

Nexia China Pte. Ltd
Tel: (8621) 6390 6000
Fax: (8621) 6390 6300
Email: china@nexiats.com.sg
Website: www.nexiats.com.sg

Nexia member firms
Nexia HDDY (Shanghai) CPAs Co. Ltd
Beijing Yongtuo Certified Public Accountants Co. Ltd
Zhonglei Certified Public Accountants Co. Ltd
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