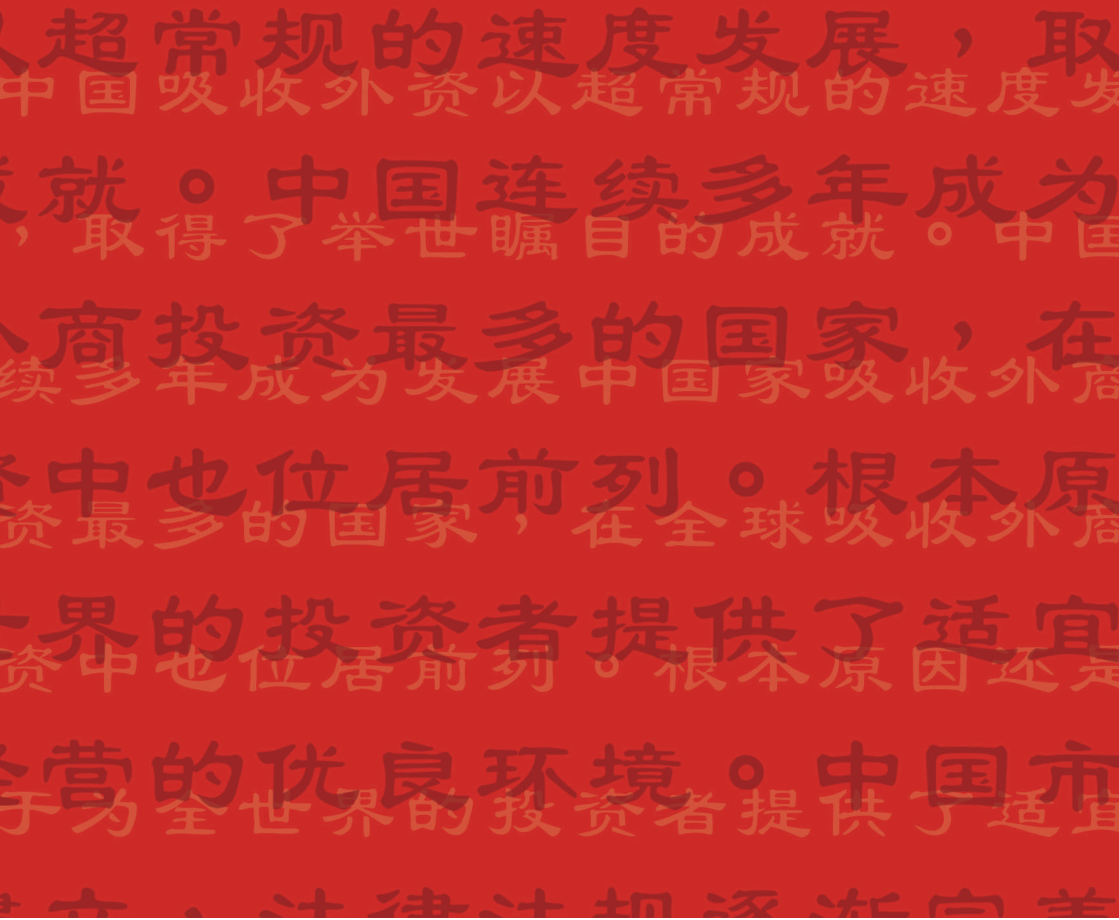

Herbert Smith

China investment guide

2012

China investment guide

We are pleased to present this fourth edition of the Herbert Smith China investment guide. The guide has continued to assist clients and contacts to successfully navigate China's complex legal environment.

This fourth edition of the Herbert Smith China investment guide continues to draw upon our many years of experience in China to present an overview of China's legal environment as it relates to foreign direct investment, M&A and various business arrangements that do not involve establishing an entity in China. Except in passing, this guide does not address sector-specific requirements (of which there are many) for investing in China.

China's formation of a basic national socialist legal system was declared complete at the 11th National People's Congress held in March 2011 in Beijing. This is good news for foreign investors seeking certainty and stability following significant changes to labour laws, corporate income tax rules and competition law in recent years. However, incremental changes will continue as China adjusts its regulatory system in response to changing economic conditions.

We trust you will find this fourth edition of the Herbert Smith China Investment Guide to be a useful tool in planning new, and managing existing, investments in China. Quality legal advice in relation to each specific investment is essential.

Herbert Smith LLP

May 2012

Herbert Smith LLP

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Defined terms

See Section 57 "Common abbreviations" at end of this Guide.

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The content of this Guide, current as of 16 April 2012, is for general information only. It does not constitute legal advice and should not be relied upon as such. Specific advice should be sought about your specific circumstances.

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1. China today

Since opening up in 1979, China's economy has grown rapidly and its commercial law system has developed almost from scratch. In March 2011, the 11th National Peoples' Congress declared that the construction of a basic socialist legal system was complete.

A developing legal system

In 1979, publicly available laws and regulations were few and administrative discretion was paramount. Although the legal system has developed significantly over the last 30 years, its development appears to have been ad hoc in many respects. For example, different laws and regulations regulate different types of companies available for foreign investment. Experimental (though binding) regulations are also issued pending the issuance of "final" regulations. From time to time, steps are taken to unify some aspects of China's foreign investment regime. The issuance of the Enterprise Income Tax Law in 2007 unified the tax regimes applicable to FIEs and domestic companies (see Section 40 "Corporate taxes & incentives"). The Anti-Monopoly Law, effective August 2008, also brought domestic and foreign investors under the same set of rules (see Section 38 "Competition law: merger control" and Section 48 "Competition law: behavioural provisions").

The court and arbitration systems in China have made significant progress toward becoming independent and impartial. Since 2002, judges and prosecutors have been required to pass the state bar exam.

The environment

The first couple of decades of China's development saw economic development take priority over environmental concerns. The result has been polluted air, water and soil on an unprecedented scale.

In recent years, however, China has sought to encourage environmentally-friendly investment and to actively discourage pollution-heavy industries. The Ministry of Environmental Protection was formed in March 2008, and enforcement of environmental regulations and standards continues to improve.

With China taking a more visible role in international environmental forums and with its citizens becoming more concerned about environmental issues, China's attention to the environment is set to continue.

Outbound investment

The rapid growth of outbound investment has been one of the key features of the Chinese economy over the last few years. Although not directly the concern of this publication, the outbound investment trend demonstrates the desire of many Chinese companies to become globally competitive. In turn, this is likely to make successful Chinese companies even more competitive in China, their home market.

WTO

China joined the WTO on 11 December 2001. Since then, China has become a more integrated member of the world's trading system. While anti-dumping and anti-subsidy actions have been increasing, the resolution of these disputes is now subject to WTO processes. Foreign investors have also benefitted from the opening of many sectors to foreign investment and China's commitment to reform its legal system relating to trade in goods and services, intellectual property and foreign exchange control.

CEPA

The Closer Economic Partnership Arrangements with Hong Kong and Macau give Hong Kong and Macau businesses greater access to China's markets. Goods of Hong Kong or Macau origin can benefit from reduced tariffs in China. Hong Kong and Macau businesses have also been given greater access to various service sectors.

While the main text of CEPA was signed in 2003, annual supplements from 2004 to 2011 have progressively opened up investment opportunities for Hong Kong and Macau investors.

Issues

China's economy remains in transition from being centrally-planned to having market status. Many of the issues that foreign investors encounter in China can be traced to this transition.

The following areas are generally recognised as in need of ongoing reform:

- Intellectual property rights – Despite substantial WTO-related reforms of China's intellectual property laws and some successful enforcement action (for instance, in 2009 Microsoft obtained jail terms for software pirates in Shenzhen and Suzhou), issues remain with the enforcement of intellectual property rights. Counterfeiting, piracy and theft of know-how are particular concerns.
- Regionalism – Economic and political differences can exist between central and local authorities, and between local authorities in different areas. Inconsistent national and local regulations are also not uncommon. The Anti-Monopoly Law seeks to address anti-competitive administrative action by regional authorities (see Section 48 "Competition law: behavioural provisions"); however, although various implementing regulations have been issued, no significant action has been taken to date.
- Judicial and arbitral processes – The enforcement of judgments and arbitral awards, both foreign and Chinese, remains challenging. The Supreme People's Court is giving increasing attention to improving procedures and enforcement.

Prospects

China has made great progress in establishing a legal system, particularly in relation to foreign investment, corporate and commercial matters. However, implementation of the law can be uneven and in many areas there remains a need for implementing rules that give guidance as to the practical details.

Foreign investment opportunities are likely to exist for a long time to come. However, the foreign investment restrictions outlined in this guide are also likely to continue.

Relationships

It is often said that relationships (in Chinese, "guanxi") are particularly important in China's business context. However, relationships are never a substitute for a solid legal structure and operations that are compliant with Chinese law.

2. Your options in China

China's foreign investment regime recognises several types of companies that can be set up by foreign investors. These companies are commonly called foreign investment enterprises (FIEs). Other common business arrangements are also available. The various alternatives are summarised below.

Investing

Investments in China may be through the establishment of green-field operations or through the acquisition of equity interests in, or assets of, an existing company. The resulting business operations must be registered in China.

The main types of investment vehicle available to foreign investors are:

- Wholly foreign-owned enterprise (WFOE) – A limited liability company with 100% foreign ownership (see Section 5 "Wholly foreign-owned enterprises (WFOEs)").
- Equity joint venture (EJV) – A limited liability company with both foreign and Chinese investors (see Section 6 "Equity joint ventures (EJVs)").
- Cooperative joint venture (CJV) – A joint venture with both foreign and Chinese investors. A CJV may be incorporated as a limited liability company or may exist as an unincorporated venture (see Section 7 "Cooperative joint ventures (CJVs)").
- Foreign investment company limited by shares (FICLS) – A share issuing company with limited liability (see Section 8 "Foreign investment companies limited by shares (FICLS)").
- China holding company – A qualifying FIE that can invest in, and coordinate the activities of, the investor's China subsidiaries (see Section 9 "China holding companies").
- Regional headquarters – A qualifying FIE that can provide management and support services to the regional subsidiaries of an investor (see Section 10 "Regional headquarters").
- Partnership – A partnership with either general or limited liability; foreign investment in partnerships has been allowed since 1 March 2010 (see Section 11 "Partnerships").

Various considerations relating to the setting up of FIEs are addressed in Sections 13 to 28 below.

WFOEs are the investment vehicle of choice for many foreign investors. WFOEs, however, are not permitted to engage in all activities and sectors. Reference should be made to China's Foreign Investment Industrial Guidance Catalogue and to sector-specific regulations to determine whether a WFOE is permitted for a particular business, or if a joint venture is required (see Section 4 "Open & prohibited sectors").

Other arrangements

The following arrangements may also be suitable for foreign companies wishing to carry out activities in China:

- Representative offices – These are set up in China to represent foreign companies (and their affiliates). A representative office itself is not a company. Significantly, representative offices are not permitted to engage in direct business activities (see Section 49 "Representative offices").
- Manufacturing arrangements – These can be structured as processing and assembly arrangements, compensation trade, or manufacturing arrangements. The main idea with each of these is that someone else manufactures your products. Protecting your intellectual property and maintaining quality control are key considerations in manufacturing arrangements (see Section 50 "Manufacturing in China").

- Management contracts – A foreign company may provide certain management services in return for a fee (see Section 51 "Management contracts").
- Distribution arrangements – A foreign company may appoint Chinese companies to distribute the foreign company's products in China. Protecting intellectual property is a key consideration in distribution arrangements.

3. Selecting your investment vehicle

Your preferred business model will largely drive your choice of investment vehicle.

A joint venture may be an obvious choice if you are a developer of major projects that frequently have local partners. On the other hand, a WFOE may be preferred if you are a manufacturer with confidential processes and full control over operations in other parts of the world.

Having a Chinese joint venture partner who knows the market can be an advantage. However, Chinese and foreign parties often have different objectives and management styles. Disputes are not uncommon.

Before making your choice, however, you will first need to know which type of company is allowed in your industry.

Regulatory environment

China's legal environment may require changes to your business model. Multi-level marketers, for instance, have been required to remodel their sales teams and establish branches and service outlets in each provincial-level area in China in which they conduct business. Numerous other investments, including in telecommunications, publications printing and securities firms, are required to be in the form of joint ventures.

Restrictions on available investment vehicles are set out in China's Foreign Investment Industrial Guidance Catalogue (see Section 4 "Open & prohibited sectors"). Industry-specific regulations can also restrict the forms of foreign investment.

Governmental approvals are needed for setting-up of FIEs (see Section 17 "Approvals & registrations").

Key features

Understanding the key features of the main foreign investment vehicles may also help determine which one is appropriate.

The main differences are summarised in the following table:

	WFOE	**EJV**	**CJV**	**FICLS**
Ownership	Wholly foreign-owned	In proportion to equity contributions	As set out in the CJV contract	At least 25% foreign-owned; Chinese shareholders required
Separate legal entity?	Yes	Yes	Your choice	Yes
Limited liability?	Yes	Yes	Yes, if set up as a separate legal entity; No, if not	Yes
Management control	Complete managerial and operational control	Subject to proportion of ownership; Unanimous board resolutions on certain matters required by law	Subject to contract and proportion of ownership; Unanimous board resolutions on certain matters required by law	Subject to shareholding; Board decisions by majority vote

Key features

	WFOE	EJV	CJV	FICLS
Profit-sharing	As set out in articles of association or shareholders' agreement	In proportion to equity contribution	As set out in the CJV contract	In proportion to shareholdings
Capital recovery	Share net assets upon liquidation; Sale of interest; Capital reduction only in special circumstances	Share net assets upon liquidation; Sale of interest; Capital reduction only in special circumstances	Early capital recovery permissible; Share net assets upon liquidation; Sale of interest; Capital reduction only in special circumstances	Share net assets upon liquidation; Sale of interest; Share buy-backs only in special circumstances
Ease of set up	High	Low – negotiations can take some time	Low – negotiations can take some time	Low – negotiations and approvals can take some time
Intellectual property	More control	IP and confidential information potentially at risk	IP and confidential information potentially at risk	IP and confidential information potentially at risk
Local resources	Could be high, if foreign investor has necessary experience and personnel	Chinese party may assist with business contacts, market knowledge and know-how	Chinese party may assist with business contacts, market knowledge and know-how	Chinese party may assist with business contacts, market knowledge and know-how

Tax

FIE tax incentives are no longer available, and the previous FIE incentives are being phased out. However, new tax incentives have been introduced for companies operating in certain sectors (see Section 40 "Corporate taxes & incentives"). The standard rate of corporate income tax is 25%.

Dividends paid by FIEs to their foreign investors are subject to a withholding tax of 10% or 5% for investors (with some exceptions) from certain jurisdictions (see Section 40 "Corporate taxes & incentives").

You are recommended to seek expert tax advice in planning your investment.

Offshore holding companies

Use of an offshore holding company can optimise taxation and make a future sale of the FIE more straightforward (see Section 32 "Offshore transactions"). However, in some circumstances, the sale of an offshore holding company can still be subject to capital gains tax in China (see Section 40 "Corporate taxes & incentives"). The acquisition of an offshore holding company can also be subject to Chinese merger control filing and national security review where the conditions are met (see Section 38 "Competition law: merger control" and Section 38 "National security reviews").

The British Virgin Islands and Cayman Islands continue to be popular jurisdictions in which to set up a vehicle for holding foreign investors' interests in FIEs. Hong Kong, Singapore and Mauritius are also common due to their favourable double-taxation agreements with China (see Section 40 "Corporate taxes & incentives").

Nominee investors

The Supreme People's Court has indicated that nominee investor arrangements are enforceable. That is, in the event of a dispute between the actual investor and the nominee investor regarding ownership of the investment, the People's courts should rule in favour of the actual investor.

The main limitation of a nominee-investors arrangement, however, is that it will not be enforced if entered for the purpose of circumventing mandatory requirements of Chinese law. Accordingly, the use of a nominee-investor arrangement to avoid foreign investment restrictions is not a prudent investment strategy.

What's everyone else doing?

As the chart below indicates, WFOEs are typically the investment vehicle of choice. However, depending on your business model and relevant legal restrictions, joint ventures or FICLS may also be suitable.

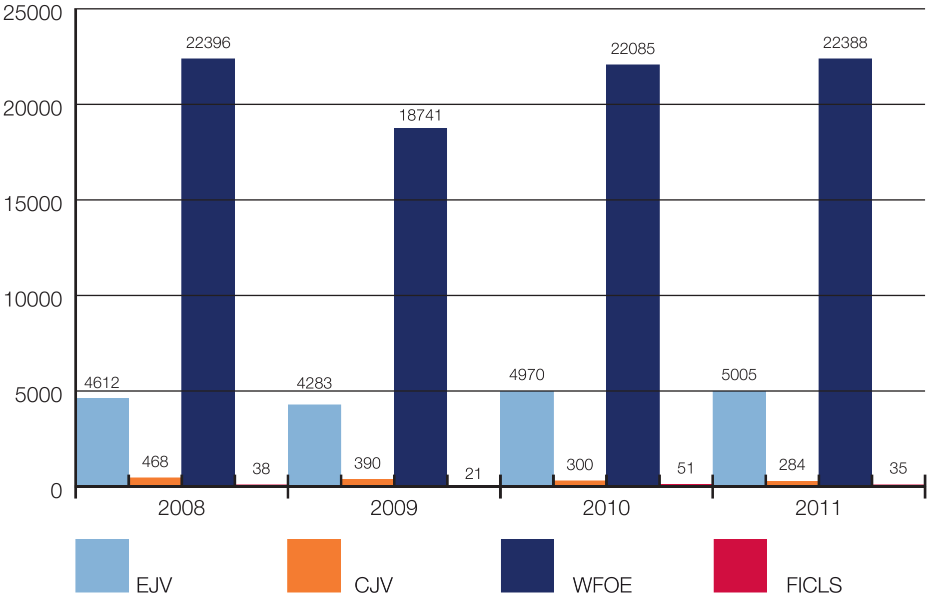

Figure 1 – Number of FIEs established by type (published MOFCOM data)

[1] China's central and western regions comprise the following provinces and areas: Chongqing Municipality, Gansu Province, Guangxi Province, Guizhou Province, two 13counties of Hunan Province, Inner Mongolia Autonomous Region, Ningxia Province, Qinghai Province, Sha'anxi Province, Sichuan Province, Tibet Autonomous Region, Xinjiang Autonomous Region and Yunnan Province.

4. Open & prohibited sectors

Foreign investment projects in China are classified for approval and incentive purposes as "encouraged", "restricted", "prohibited" or "permitted".

Projects that are encouraged benefit from simpler approval procedures and can also benefit from customs incentives. Restricted activities and sectors must generally be approved at higher levels of government, which means that approvals can be harder to obtain.

Foreign Investment Catalogue

The Foreign Investment Industrial Guidance Catalogue (Foreign Investment Catalogue) is issued by China's National Development and Reform Commission (NDRC) and the Ministry of Commerce (MOFCOM). The most recent revision was promulgated on 24 December 2011.

The Foreign Investment Catalogue sets out encouraged, restricted and prohibited activities and sectors. Any activity or sector not included in the Foreign Investment Catalogue is permitted.

Referring to the Foreign Investment Catalogue is often the first step when determining which foreign investment vehicle to use, as it identifies activities and sectors for which a Chinese partner is required. In some instances it also states that the Chinese partner must have either a controlling interest or a relative controlling interest.

The Chinese party (or parties) must hold at least a 51% interest if a controlling interest is required. A relative controlling interest requires the cumulative interest of the Chinese parties to be greater than that held by any one foreign investor.

The Foreign Investment Catalogue is supplemented by a Central and Western China Foreign Investment Catalogue which lists additional encouraged activities and sectors for projects in Central and Western China.[1] Investment encouraged in Central and Western China includes certain types of manufacturing, value-added telecommunication services, tourism and environmentally-friendly investment. High-pollution industries and investments using outdated technology are discouraged.

Set out below are examples of activities and sectors that are encouraged, restricted and prohibited under the most recent Foreign Investment Catalogue.

Encouraged

Encouraged activities and sectors largely involve energy- and raw material-saving technology, promote agriculture or are needed for China's economic development.

The Foreign Investment Catalogue sets out over 350 encouraged activities and sectors. The examples below give some indication of the coverage and specificity of these encouraged activities and sectors:

- Development of various agricultural technologies
- Venture prospecting and exploitation of petroleum and natural gas projects (limited to EJVs and CJVs)
- Development and production of certain food products
- Productions of chlorofluorocarbon substitutes
- Production and engineering of certain plastics and plastic alloys with a volume of at least 60,000 per annum
- Development and production of new types ofenvironmentally-friendly materials
- Manufacture of digitally controlled tooling and high-performance welding robots
- Production of certain precision dies and moulds

- Manufacture of certain key motor vehicle parts and components
- General design, manufacture and maintenance of civil aircraft (limited to EJVs and CJVs)
- Design, manufacture and maintenance of aircraft engines (limited to EJVs and CJVs)
- Manufacture of solar air-conditioning, heating and drying systems
- Manufacture of flat-screen televisions, digital camcorders and digital audio equipment
- Integrated circuit design and large-scale production of integrated circuits with a line width of 0.18 micron or less
- Manufacture of systems for computer assisted design (three-dimensional CAD)
- Development and production of software products
- Design and manufacture of civil satellites (Chinese party to hold a controlling interest)
- Construction and management of renewable energy power plants, and sea water desalination plants
- Construction and operation of hydropower stations
- Operation of nuclear power plants (Chinese party to hold a controlling interest)
- Construction and operation of water supply plants
- Wholesale, retail and logistics (restrictions exist on some products)
- Research and development centres
- Air transportation (Chinese party to hold a controlling interest)
- Development of technologies to monitor and treat environmental pollution
- Services to the elderly, disabled and children (not including compulsory education)
- Tertiary education institutions (limited to EJVs and CJVs)

Restricted

Activities and sectors restricted to foreign investment are largely those that use outdated technology, are harmful to the environment or are in protected sectors of the economy.

Restricted activities and sectors include:

- Selection and cultivation of new varieties of crops, and the production of seeds (Chinese party to hold a controlling interest)
- Exploration and mining of precious metals (gold, silver and platinum)
- Production of rice wine and famous brands (Chinese party to hold a controlling interest)
- Printing of publications (Chinese party to hold a controlling interest)
- Production of certain psychotropic drug ingredients (Chinese party to hold a controlling interest)
- Water transportation (Chinese party to hold a controlling interest)
- Value-added telecommunication services (foreign investor limited to 50% interest)
- Mobile and data telecommunication services (foreign investor limited to 49% interest)
- Direct selling, mail-order and internet selling
- Insurance (foreign investor limited to 50% interest for life insurance)
- Insurance brokerages
- Securities companies (which may only underwrite A-shares, and underwrite or trade B-shares, H-shares and government bonds and corporate bonds; foreign investor limited to one-third interest)
- Securities investment fund management companies (foreign investor limited to 49% interest)

- Futures companies (Chinese party to hold a controlling interest)
- Production of radio and television programmes and movies (limited to CJVs)

Prohibited

Activities and sectors prohibited to foreign investment are largely those that endanger national security, harm the public interest, cause harmful pollution, damage natural resources, use large tracts of agricultural land for non-agricultural purposes or threaten military installations.

Prohibited activities and sectors include:

- Production and development of transgenic organisms and transgenic crop seeds
- Processing of green teas using traditional Chinese processes
- Arms and munitions manufacturing
- Construction and management of certain conventional coal-fired power plants
- Gaming industry
- Institutions for compulsory education
- Radio and television broadcasting

Permitted

These include all activities and sectors not included in the Foreign Investment Catalogue.

5. Wholly foreign-owned enterprises (WFOEs)

Key features of a WFOE include:

- 100% foreign ownership. Multiple foreign investors are permitted, though it would typically create more flexibility to consolidate multiple interests offshore (see Section 32 “Offshore transactions”). In some instances, a Chinese partner may also be taken offshore (see Section 33 “Taking your Chinese partner offshore”).
- 100% management control. This helps to avoid corporate culture conflicts that can affect EJVs and CJVs.
- Limited liability. An investor’s liability is limited to its share of the registered capital (equity) of the WFOE.
- No shares. Investors hold a proportion of the registered capital rather than shares as such.
- Limited investors. WFOEs are limited to a maximum of 50 investors.
- Board of directors. While a WFOE typically has a board of directors, a WFOE with comparatively few investors or small in scale may have one executive director (and no board of directors).

Although WFOEs can engage in a wide range of sectors, restrictions still exist. These restrictions are set out in the Foreign Investment Catalogue (see Section 4 “Open & prohibited sectors”) and various industry-specific regulations.

Not a listing vehicle

WFOEs do not issue shares and, therefore, cannot be listed directly. You may, however, be able to list a WFOE’s offshore holding company (see Section 30 “Planning your exit”). Alternatively, it may be converted into a FICLS in preparation for listing (see Section 8 “Foreign investment company limited by shares (FICLS)”).

Business scopes

A WFOE can generally engage only in activities that are within its business scope (see Section 14 “Business scopes”).

Setting up

The establishment of a WFOE is subject to governmental approval (see Section 16 “Documentation” and Section 17 “Approvals & registrations”). Funding and a variety of specific considerations are set out in Sections 13 to 28.

6. Equity joint ventures (EJVs)

Key features of an EJV include:

- Foreign and Chinese joint ownership. Consolidation of foreign investors' interests into one offshore company may create more flexibility (see Section 32 "Offshore transactions").
- Limited liability. An investor's liability is limited to its share of the registered capital (equity).
- No shares. Investors hold a proportion of the registered capital rather than shares as such.
- Profit distribution, board of director representation and distribution of surplus assets on liquidation (unless otherwise agreed) must be in proportion to registered capital holdings.
- Board of directors is the highest authority of the company.
- Certain decisions (including increases or reductions of registered capital, termination and dissolution) need unanimous board consent.
- Early withdrawal of capital is difficult.
- Equity transfers are subject to the consent and pre-emptive rights of EJV partners.
- Foreign investment must typically be greater than 25%, although foreign investments of less than 25% may still be approved.

EJVs can engage in a broader range of activities and sectors than WFOEs. However, some restrictions still exist. These restrictions are set out in the Foreign Investment Catalogue (see Section 4 "Open & restricted sectors") and industry-specific regulations.

Not a listing vehicle

EJVs do not issue shares and, therefore, cannot be listed directly. You may, however, be able to list an EJV interest through an offshore holding company (see Section 30 "Planning your exit"). Alternatively, it may be converted into a FICLS in preparation for listing (see Section 8 "Foreign investment company limited by shares (FICLS)").

Business scopes

An EJV can generally engage only in activities that are within its business scope (see Section 14 "Business scopes").

Setting up

The establishment of an EJV is subject to governmental approval (see Section 16 "Documentation" and Section 17 "Approvals & registrations"). Funding, negotiations and a variety of specific considerations are set out in Sections 13 to 28.

7. Cooperative joint ventures (CJVs)

Key features of a CJV include:

- Foreign and Chinese joint ownership. Consolidation of foreign investors' interests into one offshore company may create more flexibility (see Section 32 "Offshore transactions").
- Can be either incorporated or unincorporated. Liability of partners in an incorporated CJV is limited to their respective share of registered capital (equity), unless the CJV contract provides otherwise. Partners of an unincorporated CJV have unlimited liability.
- No shares. Investors hold a proportion of the registered capital rather than shares as such.
- Board of directors (or management committee) is the highest authority of a CJV.
- Early recovery of capital is permitted on the condition that the Chinese party takes title to all fixed assets upon expiration of the CJV term and upon certain other conditions. Agreed profit distribution formulas need not reflect the parties registered capital holdings.
- Transfers of rights to third parties are subject to the written consent and (if incorporated) the pre-emptive rights of other CJV partners.

CJVs are not common. However, they can be useful for infrastructure projects and certain other projects. Restrictions on foreign investment in CJVs are set out in the Foreign Investment Catalogue (see Section 4 "Open & restricted sectors") and industry-specific regulations.

Not a listing vehicle

CJVs do not issue shares and, therefore, cannot be listed directly. You may, however, be able to list a CJV interest through an offshore holding company (see Section 30 "Planning your exit"). Alternatively, it may be converted into a FICLS in preparation for listing (see Section 8 "Foreign investment company limited by shares (FICLS)").

Business scopes

A CJV can generally engage only in activities that are within its business scope (see Section 14 "Business scopes").

Setting up

The establishment of a CJV is subject to governmental approval (see Section 16 "Documentation" and Section 17 "Approvals & registrations"). Funding, negotiations and a variety of specific considerations are set out in Sections 13 to 28.

8. Foreign investment companies limited by shares (FICLS)

Key features of a FICLS include:

- Important decisions need a two-thirds majority (not unanimous) shareholder vote.
- Shareholder meetings are required.
- FICLS are required to have a board of directors of between five and nineteen members, and a board of supervisors with a minimum of three members.
- A minimum share capital of Rmb30 million divided into shares of equal value is required.
- Foreign investors should hold at least 25% of share capital.
- May be established by means of promotion or share offer.
- Between 2 and 200 promoters are needed. At least one must be foreign and half or more must be PRC-resident. For establishment by share offer, at least one promoter must have been profitable for the preceding three years.
- For establishment by share offer, promoters must subscribe for at least 35% of the shares and their holding is subject to a three-year lock-up period.
- For establishment by promotion, promoters must subscribe for all the shares.
- A joint venture or a WFOE that has been profitable for three years may be converted into a FICLS.

FICLS are typically set up for listing purposes. Fifty-one is the largest number of FICLS approved in any one year.

Shares & listings

Subject to approval, FICLS can issue shares to the public. They may also list on the Shanghai or Shenzhen stock exchanges or on an overseas stock exchange (see Section 30 “Planning your exit”).

Business scopes

A FICLS can generally engage only in activities that are within its business scope (see Section 14 “Business scopes”).

Setting up

The establishment of a FICLS is subject to governmental approval (see Section 16 “Documentation” and Section 17 “Approvals & registrations”). Funding, negotiations and a variety of specific considerations are set out in Sections 13 to 28.

9. China holding companies

A China holding company can invest in other FIEs and provide services to affiliates that would be difficult or impossible for an ordinary FIE to provide.

A China holding company may be set up as either a joint venture or a WFOE. A holding company will only be attractive to foreign investors with substantial operations in China.

Investor qualifications

To establish a China holding company, a foreign investor is required to either:

- have a total asset value of at least US$400 million and have established FIEs in China with a cumulative paid-up registered capital of at least US$10 million; or
- have more than 10 FIEs in China with a cumulative paid-up registered capital of more than US$30 million.

In addition, the foreign investor must be in good financial standing and have the financial capacity to establish and fund a China holding company.

The Chinese party to any joint venture China holding company must also be in good financial standing and have the requisite financial capacity. In addition, a Chinese party is required to have total assets of at least Rmb100 million.

Registered capital & debt

The minimum registered capital of a China holding company is US$30 million. The first US$30 million must be paid in within two years of issuance of the business licence; any amount in excess of US$30 million may be paid in within five years.

A China holding company may borrow up to four times its paid-up registered capital. However, if its registered capital is US$100 million or more, it may borrow up to six times its paid-up registered capital. This is a higher debt/equity ratio than allowed for other FIEs (see Section 18 “Equity funding”).

Permitted investments

China holding company investments must comply with the Foreign Investment Catalogue (see Section 4 “Open & prohibited sectors”) and various other foreign investment regulations.

A China holding company is required to:

- Invest at least US$30 million in other FIEs or R&D centres anywhere in China (not including acquisitions of equity from its parent company or affiliates, but including the payment of any unpaid registered capital)
- Invest at least 25% (by itself or together with other foreign investors) of an FIE’s registered capital to qualify for tax incentives (subject to the phasing-out of the tax incentives; see Section 40 “Corporate taxes & incentives”)
- Invest in at least 10% of an FIE’s registered capital to provide group services to that FIE

A China holding company may also:

- Act as a promoter for the establishment of or buy the shares of a FICLS
- Open branches in China, provided that it either has a minimum of US$30 million paid-up registered capital or has invested in 10 or more FIEs and the branch is to be opened in a region in which its investments or sales are concentrated
- Acquire "G" shares as a strategic investor (see Section 35 "Buying China-listed companies")

A China holding company may not invest in companies in China with money borrowed in China. That is, only registered capital, loans from overseas, or retained earnings may be used for equity investments in China.

Permitted services

A China holding company may provide a range of services to each FIE in which it has invested at least 10% equity. However, each such FIE must first entrust the China holding company to provide such services pursuant to a unanimous board resolution.

Permitted services that a China holding company may provide to its invested FIEs include:

- Purchasing agent for machinery, equipment, raw materials, and parts and components for production purposes
- Product sales agent and after-sales service provider
- Subject to SAFE supervision, foreign exchange balancing between its invested FIEs
- Staff training and assistance with production, sales and marketing
- Assistance to obtain loans and guaranteeing loans (direct financial assistance remains subject to CBRC approval)

A China holding company may also:

- Establish and support R&D centres for new products and high technology
- Provide consultancy services to both its investor(s) and invested FIEs
- Provide outsourcing services to overseas entities (including, but not limited to, its parent and affiliated companies)

In addition, a China holding company may provide the following services, provided the China holding company has at least US$30 million paid-up registered capital and has obtained MOFCOM's consent (some services also require a unanimous board resolution of the invested FIE):

- Distribute products of its invested FIEs in China and abroad
- Distribute goods in China by way of "commission agency" (except by way of auction) or "wholesale" (specific MOFCOM approval may be needed for certain restricted goods)
- Transport and warehouse products of its invested FIEs
- Export domestic products (including those of its invested FIEs)
- Effect limited systems integration on its invested FIEs' products and sell those products in China and overseas
- Provide technical training to domestic distributors of its invested FIE's products
- Provide technical training to any enterprise that has entered a technology transfer contract with the China holding company, its parent or affiliate
- Import and sell its parent company's products to "test" the market for new products of an invested FIE
- Establish a financial leasing company (separate thresholds apply), or lease machinery and equipment to its invested FIEs

- Sell (excluding retail) in China its parent company's products
- Provide after-sales services in respect of its parent company's products
- Contract with qualified Chinese companies with respect to overseas projects
- Entrust any company in China (not only its invested FIEs) to make group company products; the products may be sold in China or exported

Prohibited activities

A China holding company cannot engage in direct production, except limited systems integration as noted above.

Tax

Holding companies are taxed at the full corporate income tax rate of 25% (see Section 40 "Corporate taxes & incentives").

Rmb re-investments

For much of 2011, China holding companies could not re-invest Rmb income earned in China without first increasing their registered capital. This had the effect of making the Rmb earnings subject to a 10% withholding tax on a deemed distribution to the shareholders.

From December 2011, however, the requirement for first increasing registered capital was removed, and China holding companies can again re-invest Rmb income without the shareholders being subject to a 10% withholding tax. However, the re-investment of Rmb in China by a China holding company remains subject to SAFE approval.

10. Regional headquarters

A regional headquarters may be set up to coordinate and provide services to group companies in the region, both in China and elsewhere.

The benefits of a regional headquarters depend largely upon which rules are used to set it up. There are various options: national, Beijing, Shanghai, Guangdong, Guangzhou, and Shenzhen.

National regional headquarters

Under the national rules, a regional headquarters must be a China holding company and must also have:

- paid-up registered capital of not less than US$100 million; or
- paid-up registered capital of not less than US$50 million, total assets of not less than Rmb3 billion and profits of not less than Rmb100 million in the financial year immediately preceding the year of the application.

In addition, a China holding company must have invested at least US$30 million in FIEs (including in at least one R&D centre in China) before it may be designated as a regional headquarters under the national rules.

A regional headquarters under the national rules may enjoy the benefits of a China holding company (see Section 9 “China holding companies”). A regional headquarters under the national rules may also engage in various additional activities, including:

- Import and sell (not retail) the products of its parent company’s affiliates
- Engage in “commercial leasing” or “financial leasing” upon MOFCOM approval
- Engage in processing trade in which all products are to be exported
- Subject to SAFE approval, centralise foreign exchange management for its affiliated companies (both in China and abroad); intra-group lending via an authorised foreign exchange bank is permitted

Beijing regional headquarters

Under Beijing municipal rules, a China holding company set up in Beijing may be designated as regional headquarters. Alternatively, and subject to the investor satisfying various criteria, a management company with a registered capital of at least US$2 million may be designated as a regional headquarters.

Beijing regional headquarters may operate group treasury services. China’s foreign exchange restrictions, however, can make China treasury operations difficult in respect of affiliates outside China. Moreover, regional competition within China may result in difficulties for treasury operations if authorities from another locality object to cash being pooled in Beijing.

Beijing regional headquarters may also engage in:

- Domestic distribution and import and export
- Research and development
- Logistics operations
- Shared services among group companies and outsourcing services for offshore companies

Specific incentives available include:

- Three-year subsidies to newly-established or relocated RHQs that either (i) have a registered capital of Rmb100 million or more (subsidy can be up to Rmb10 million), or (ii) rent offices in Beijing. Newly-established or relocated RHQs that purchase or build offices in Beijing may enjoy a one-off subsidy.
- A financial award (of up to Rmb10 million) for RHQs whose annual revenue, for the first time, reaches Rmb100 million or more.

Shanghai regional headquarters

Similar to Beijing, a China holding company, or a management company with a registered capital of at least US$2 million, may be designated as a regional headquarters in Shanghai.

Shanghai regional headquarters may engage in:

- Group treasury services (see comments above in relation to Beijing regional headquarters)
- Research and development, and technical support
- Commodity purchase, distribution, and marketing services
- Logistics operations
- Shared services among group companies and outsourcing services for offshore companies

Preferential policies for a Shanghai regional headquarters include:

- Rmb5 million establishment subsidy
- Rental subsidies
- Financial awards if the annual turnover exceeds certain thresholds for the first time
- Financial awards to certain senior management

A procurement centre or a logistics centre established by a Shanghai regional headquarters may receive special assistance with customs clearances.

Guangdong regional headquarters

To enjoy the benefits extended to Guangdong regional headquarters, a foreign investor is required to have total assets of not less than US$300 million and at least US$30 million already invested in China. The registered capital of a Guangdong regional headquarters is required to be at least US$1 million.

A Guangdong regional headquarters, like those in Beijing and Shanghai, may provide group treasury operations (see comments above in relation to Beijing regional headquarters).

Guangdong regional headquarters may also benefit from:

- Various tax incentives for its R&D facilities
- Import and export rights for the materials and products of its group companies
- Government assistance to obtain working rights and residence permits for its employees

Guangzhou regional headquarters

Guangzhou regional headquarters may be in the form of a China holding company, a management company, an R&D centre, or a production enterprise that functions as regional headquarters.

To be certified as foreign-invested regional headquarters, an FIE must:

- be registered in Guangzhou with an independent legal-person status
- have invested in or provide management for three or more enterprises (either in China or elsewhere)
- satisfy one of following conditions:
  - meet the industrial standards listed in the Certification Conditions and Standards of Guangzhou Headquarters Enterprises
  - be established by a Fortune 500 company
  - be officially recognized as a top-500 enterprise (or a top-100 chain store)
  - be a top-10 leading enterprises in certain strategic new industries, such as new energy, internet, new materials, and life sciences

Shenzhen regional headquarters

To be certified as a foreign-invested regional headquarters in Shenzhen, an FIE must:

- be registered in Shenzhen with an independent legal-person status
- comply with Shenzhen industrial development policy
- receive no less than 30% of its revenue from its subsidiaries and branches;
- have three or more subsidiaries or branches out of Shenzhen
- satisfy other requirements that may be specified by the Shenzhen authorities

Revised regulations regarding Shenzhen regional headquarters are expected to be released in 2012.

11. Partnerships

Foreign investment in the form of a partnership has been allowed since March 2010. Specific rules are expected for foreign private equity partnerships; however, when the new rules will be issued is unclear.

Key features of a foreign-invested partnership include:

- May be established by two or more foreign entities or individuals with or without a Chinese partner; an FIE, though not a China holding company, may be a partner in a partnership.
- General partnerships (ie, partners have joint and several liability) and limited liability partnerships (ie, a combination of one or more general partners and one or more partners with liability limited to their capital contribution) are permitted.
- Limited liability partnerships may not have more than 50 partners, and must have at least one general partner.
- Capital must be contributed in foreign currency or Rmb from lawful sources.
- Establishment and any subsequent change requires registration with the local AIC.
- Profits and losses are distributed according to the partnership agreement.
- Income tax is assessable on each partner, and not on the partnership; this allows individual partners to offset losses from certain other businesses.
- Transfers of partnership interests to third parties are subject to the consent and pre-emptive rights (unless the partnership agreement says otherwise) of partners.

Not a listing vehicle

Partnerships are not legal entities and do not issue shares; therefore, they cannot be listed directly. A corporate reorganisation would be needed before listing (see Section 30 “Planning your exit”).

Business scopes

A partnership can generally engage only in activities that are within its business scope (see Section 14 “Business scopes”).

Setting up

The establishment of a foreign-invested partnership requires registration with the local AIC (see Section 17 “Approvals & registrations”). Governmental approval is not needed for the establishment of a foreign-invested partnership itself. However, if the partnership engages in a project that requires approvals, then the necessary approvals must be obtained.

12. Branches & liaison offices

Except in some industries, foreign companies are usually not permitted to set up branches in China. FIEs and partnerships established in China, however, may set up branches if they wish to conduct activities in a different location in China.

Branches are not separate legal entities, and liability for the branch is borne by the company that established it. The name of a branch must begin with the name of the enterprise to which it belongs.

FIE branch registration

Except for certain restricted projects, the establishment or closing of an FIE's branch typically no longer requires approval from the FIE's approval authority. The establishment of an FIE or partnership branch, however, must be registered with the relevant local branch of the SAIC in the place where the branch is to be established. The relevant local branch of the SAIC will issue a business licence to the branch.

FIE branch operations

Branches of FIEs may engage in business operations. However, the scope of business of a branch may not exceed the business scope of the company setting up the branch.

FIE liaison offices–deregister or convert

FIE liaison offices no longer need to be registered and, upon expiry of any liaison offices established prior to April 2006, liaison offices must either be deregistered or converted into branches. Deregistered liaison offices may continue to exist, although they may not engage in any direct business activities.

Branches are permitted to undertake liaison and consultancy activities previously undertaken by liaison offices.

Branches of foreign companies

Foreign companies in certain industries, such as commercial banking and oil exploration, are permitted to set up a branch in China. Other foreign companies are generally not permitted to set up branches in China.

A branch of a foreign company is similar in nature to a representative office (see Section 49 "Representative offices"). However, unlike a representative office, a branch of a foreign company is permitted to engage in direct business activities.

13. Where?

With 9.6 million square kilometres of land, there is a lot of space in China for your business. But, of course, not all locations in China offer the right infrastructure or are close enough to your suppliers and clients.

Your business

Business concerns are likely to be most important in determining where to set up. Relevant factors include:

- Availability of required infrastructure
- Proximity to suppliers and customers
- Real estate costs
- Availability of appropriately qualified staff
- Location of your joint venture partner, if any
- Attitude of relevant governmental authorities

Setting up in a special zone can give rise to additional incentives and benefits.

Free trade zones

Free trade zones (also known as "bonded areas") are considered to be outside the customs area of China. This means that customs duties and import VAT are not payable on goods imported into the zone from overseas. Goods subsequently transferred into China from a free trade zone will generally be subject to customs duties and import VAT.

Free trade zones have been popular with trading companies and export-oriented manufacturing companies.

Special economic zones

Shenzhen, Xiamen, Zhuhai, Shantou and Hainan were set up as special economic zones in the 1980s. Authorities in these zones were able to experiment with reforms and tax incentives to attract foreign investment.

Nowadays, however, the special economic zones provide few special benefits with only Shenzhen emerging as a first-tier investment destination.

Other zones

Other zones include:

- Economic and Technological Development Zones – Economic and technological development zones target technology-intensive investments.
- High-tech Development Zones – High-tech development zones also target technology investments. However, many of these zones have reportedly failed to live up to expectations.
- Shanghai Pudong New Area – The Shanghai Pudong New Area was designated as a State-level financial and commercial centre in 1990. It offers excellent infrastructure and a range of incentives for foreign investors.
- Export processing zones – Export processing zones allow goods to be imported for processing and exported without customs declarations or the payment of duties upon importation.

From time to time China's national authorities shut down unapproved zones. Before relying on incentives offered by a zone, you should be confident that the zone is properly authorised to offer the incentives. The alternative is to risk losing the incentives earlier than expected.

Central & Western China

The late 1990s saw China begin to encourage foreign investment in Central and Western China with the "Go West" policy (see also Section 4 "Open & prohibited sectors"). Central and Western China infrastructure was improved and continues to be improved.

Benefits of setting up in Central and Western China include:

- Lower costs of land and labour
- Significant populations – over 50% of China's total population
- Good education levels in some areas
- Additional tax incentives

Central and Western China, however, remain significantly poorer than many areas along China's Eastern coastline.

14. Business scopes

Unlike in many other jurisdictions, FIEs may only engage in activities that are within their business scope. The business scope of an FIE must be set out in its articles of association, and is also included in its business licence.

Acts outside a company's business scope may be invalid, or may result in the company being fined.

Limited activities

Although local practice can vary, business scopes must generally be limited to defined activities within the same or related industries. By way of example:

- Unless its business scope was broad enough, an FIE set up to manufacture starter motors for motor vehicle engines may not be able to manufacture gear boxes for motor vehicles.
- The human resources department of a manufacturing FIE would not be able to provide recruitment services to another FIE within the same group. An FIE can nevertheless do its own recruiting as an activity incidental to its operations.

Business scopes might not be approved if they are too broad. At the same time, however, a business scope that is too narrow may unnecessarily restrict future business opportunities. Preliminary discussions with the approval authority and the local Administration of Industry and Commerce (AIC) can help to identify an appropriate business scope.

Business scopes may be amended after a company is set up, but it is clearly better for the business scope to be carefully planned before an FIE is set up.

Acting outside your business scope

If an FIE acts outside its business scope, the AIC may issue warnings, impose fines, confiscate illegal income, order the suspension of business for rectification, or confiscate or revoke the FIE's business license. Fines for activities that are encouraged or permitted under the Foreign Investment Catalogue can be up to Rmb100,000. Fines for activities that are restricted or prohibited can be up to Rmb200,000.

Liability may also arise for breach of contracts that can no longer be performed. Acting outside an FIE's business scope does not automatically invalidate a contract. However, an FIE may not be able to perform a contract if is directed to stop engaging in the activities required under the contract. Damages arising from such breaches can exceed the amount of fines levied.

Business scopes and M&A

Business scopes can be important in M&A transactions, particularly when determining the deal structure. If an FIE intends to acquire additional business assets, for instance, its business scope should be broad enough to permit it to operate those assets.

An FIE can, nevertheless, make investments in China without requiring "investment" in its business scope.

15. Negotiations

Negotiations in China can be more time consuming than in developed jurisdictions. This, in part, can be caused by cultural and language barriers.

Things to keep in mind

Here are a few points that are worth keeping in mind when negotiating in China:

- It is not uncommon for the Chinese party to have a large negotiating team.
- While there will be a chief negotiator, decision-making power will often rest with various other people further up the hierarchy.
- A request to defer a contentious point until a later stage may reflect a need to consult with a superior on that point. Sometimes an apparently contentious point will cease to be a problem following such consultations.
- Discussions about drafting will often appear to focus on whether legal requirements and governmental policy are satisfied. You should seek independent advice as to the interpretation of laws and policies, and associated risks.
- The Chinese party may want a greater commitment from you in relation to export sales, training, technical support, management expertise and other matters.
- It is usually acceptable to break negotiations for the purpose of meeting separately with your own team members.
- You should require the Chinese party to get your consent before any relevant registrations are made. Difficulties may arise if, for instance, the Chinese party unilaterally reserves an unwanted business name or if the Chinese party reserves your business name and negotiations subsequently break down.
- It is usually best if you (or your legal counsel) take control of document preparation (see “Duel of the languages” below).

Where to negotiate?

The informal opinion of an approval authority can be needed during negotiations. Accordingly, choosing a location with access to the relevant approval authority can be of some benefit.

Duel of the languages

It is not uncommon for foreign investors to read only English. Contracts often provide, however, for the Chinese text of a document to control, or for the English and Chinese texts to have equal status. Moreover, even if the English text controls in theory, governmental authorities in China will likely only read the Chinese text. In this context, it is very important to ensure that both language texts say the same thing.

Compared to the Chinese party, you may well have better access to bilingual professionals. Accordingly, better documentation will likely result for all involved if you (or your legal counsel) take control of document preparation.

Contracts do matter

China has a history of short contracts that leave the details to be worked out in the future in the spirit of cooperation. A hastily concluded agreement, however, can result in problems for years to come.

To arrive at a “meeting of the minds” can require significant negotiations. The agreement, once reached, is best expressed in writing. Issues not addressed up front can present difficulties later.

16. Documentation

Certain documents are required for the setting up of all FIEs.

Additional sector-specific documentation may also be required. For instance, setting up a foreign-invested securities joint venture requires the foreign investor to submit a range of additional documentation, including audited financial statements for the last three years and a statement, certified by the foreign investor's home-country regulatory authority, that the investor has not been penalised during the past three years.

The below table sets out various documents that are typically needed to set up a WFOE or a joint venture. These documents must be in Chinese. If the original is in another language, then a Chinese translation must be submitted. Approval authorities also have the right to ask for any material that they think may be relevant to an application. Differences exist between different localities.

("–" = not needed; "√" = generally required; "O" = may be useful or needed in some circumstances)

Document	WFOE	JV
Letter of intent – Sets parameters for contract negotiation. Often only confidentiality and exclusivity obligations are legally binding.	–	O
Project proposal – Sometimes required by local authorities. A more formal project proposal will often be required for large infrastructure projects.	O	O
Feasibility study – A formal business plan setting out nature of operations, corporate information of investors and financial expectations. This document serves to "sell" the project to the approval authorities.	√	√
Joint venture contract – Sets out the relationship between the parties, covering business scope, amount and timing of capital contributions, parties' responsibilities, board of directors, management, liquidation, transfers of equity and dispute resolution. Must be governed by Chinese law.	–	√
Shareholders' agreement – May be needed if a WFOE has multiple investors. Similar to a joint venture contract but does not need to be governed by Chinese law.	O	–
Articles of association – The constitutional document of the FIE. A joint venture's articles of association will mirror the joint venture contract.	√	√
Bank reference letter – A letter from the investor's bank (or group bank) indicating that the investing entity is of good financial standing.	√	√
Investor's certificate of incorporation – Certificates showing name changes and other important changes may also be required. Notarisation and authentication is usually required.	√	√
Lease or land use right certificate – The address of the lease or land use certificate will be the registered address of the FIE. A lease (with a novation clause) may be entered by the investor. The approval authorities will sometimes accept a letter of intent to lease or buy.	√	√
Asset valuation report – Required where state-owned assets are being acquired or injected as capital contributions. Certain other assets may also need to be valued.	O	O

Document	WFOE	JV
Name reservation – A corporate name (in Chinese) must be reserved before the application to set up the FIE is submitted. The name must comprise four parts: the business or trade name (using at least two Chinese characters); the industry; form of organisation; and name of administrative area.	√	√
Application letter – Sets out the basic information of the investor and the intended FIE. Should be on investor's letterhead.	√	√
Application forms – Standard forms require basic corporate information, including names of proposed directors, and related project information.	√	√
Appointment letter(s) for chairperson and directors – Should be on investor's letterhead.	√	√
Copy of passport for chairperson and each director – The personal information and photograph page(s) usually suffice.	√	√
Resume for chairperson and each director – A resume can be brief. Marital status can be required.	√	√
Power of attorney – Authorisation for a Chinese agent to deal with governmental authorities on behalf of the investor.	O	O
Power of attorney – For service of domestic legal documents.	√	√

Various application documents, many of which are similar to those listed above, are also required for the establishment of a foreign-invested partnership.

The following documentation should also be considered at the set-up stage. In many respects, these documents will lay the foundation of your business after set-up:

- Trademark, trade name, technology & know-how licences – Such licences should increase your control over IP used by the FIE and may also generate royalty payments (see Section 27 "Technology transfers & licensing" and Section 28 "Protecting your IP"). Withholding taxes on royalty payments are generally less than corporate income tax levied on the FIE (see Section 40 "Corporate taxes & incentives").
- Employment agreements – Required for both Chinese nationals and foreign nationals (see Section 24 "Foreign national employees" and Section 25 "Chinese national employees").
- Environmental impact assessments – Required for construction and renovation projects (see Section 46 "Environmental issues").
- Consultancy, sales, marketing & distribution agreements – May be needed depending on your business model.

17. Approvals & registrations

Most forms of foreign investment in China are subject to governmental approval and registration. The main exception is foreign-invested partnerships, which may be established by registration with the local AIC (see Section 11 "Partnerships").

Which approval authority?

MOFCOM and the NDRC are the main approval authorities. Except for certain large projects, however, most approval powers are exercised by local and provincial COFTECs.

Industry-specific approvals are also required in various sectors. For example, a joint venture securities company requires CSRC approval and a telecommunications joint venture requires Ministry of Industry and Information Technology approval.

Generally, local COFTECs can approve encouraged FIEs (see Section 4 "Open & prohibited sectors") with a total investment of less than US$300 million and restricted FIEs with a total investment of less than US$50 million.

MOFCOM's provincial-level branches (and, in some cases, lower-level branches) may also approve the following foreign investment:

- Establishment of and any subsequent changes to foreign-invested companies limited by shares if total investment is (i) US$300 million or less in "permitted" and "encouraged" sectors, or (ii) US$50 million or less in "restricted" sectors.
- M&A transactions in (i) "permitted" and "encouraged" sectors, if the total transaction amount is up to US$300 million, and (ii) "restricted" sectors, if the total transaction amount is up to US$50 million.
- Venture capital enterprises and venture capital management enterprises with total capital of up to US$100 million.
- China holding companies with registered capital of up to US$100 million.
- Establishment of new enterprises in "encouraged" sectors and which are not subject to national comprehensive balancing.
- Additional investment in an FIE if (i) MOFCOM originally approved the establishment of the FIE, and (ii) the newly-added investment is below US$300 million for "encouraged" or "permitted" categories and US$ 50 million for the "restricted" category.

Encouraged FIEs with a total investment of US$300 million or more and restricted FIEs with a total investment of US$50 million or more are required to be approved at the central level.

Approval authorities at the central level include the NDRC and MOFCOM. State Council approval is required for encouraged projects with a total investment of US$500 million or more and for restricted projects with a total investment of US$100 million or more.

Approval reply & certificate

COFTEC or MOFCOM will issue an approval reply and an approval certificate if an application to set up an FIE is approved. A joint venture contract and articles of association are only effective upon approval.

MOFCOM and COFTEC generally have 90 days to approve (or not approve) the establishment of an FIE.

The approval time limits run from the receipt of all application materials. Requests for additional documents recommence the time periods for the relevant authority to make a decision.

Business licence

You must register an FIE with the State Administration of Industry and Commerce (SAIC) or its local branch within 30 days of receipt of the approval certificate for the FIE. The SAIC or its local branch is required to issue the FIE's business licence within 15 days.

The date of issuance of the business licence is the date of establishment of the FIE or partnership.

Post-establishment registrations

A number of additional registrations should be completed within 30 days of the issuance of the FIE's business licence. These registrations include:

- Tax registration – An FIE is required to register with the State and local tax authorities. A tax registration certificate will be issued.
- Customs registration – An FIE is required to register with the local Customs Bureau before it can import any equipment or other items.
- Foreign exchange registration – Foreign exchange registration takes place with the local Foreign Exchange Bureau. This registration must be in place before a foreign exchange bank account can be opened (although you will need to tell the Foreign Exchange Bureau which bank you intend to use).
- Corporate seals – An FIE is required to obtain the local Public Security Bureau's approval before its corporate seals are made.
- Enterprise ID Code & IC Card – The Enterprise ID Code and the IC Card (an electronic copy of the Enterprise ID Code) are issued by the Technology and Supervisory Bureau.
- Financial registration – An FIE is required to register with the finance department of the relevant local government.
- Labour bureau registration – Registration with the relevant labour bureau is needed in connection with social security payments for employees (see Section 25 "Chinese national employees").
- Statistics registration – An FIE is required to register with the local Statistics Bureau.

18. Equity funding

The required amount of registered capital (equity) is fixed as a percentage of total investment. In practice, this limits the amount of foreign debt that a WFOE or a joint venture can incur (see Section 19 "Debt funding").

Registered capital & total investment

Registered capital represents the equity that an investor holds in a WFOE or a joint venture. Registered capital and debt together represent a WFOE's or joint venture's total investment, an amount that should correspond to the planned scale of its business operations.

Appropriate amounts of total investment and registered capital must be determined before applying to set up a WFOE or a joint venture. These amounts will be subject to approval.

How much?

It is best to set the registered capital at a realistic amount from the beginning. Subsequent increases are subject to approval, can be time consuming and can also result in a comparatively lower ability to borrow (see below). However, too much registered capital can result in cash being trapped in the FIE (see Section 42 "Foreign exchange & cash traps"). The circumstances under which registered capital may be reduced are limited (see below). SAFE has indicated that it will take steps to ensure that registered capital is not being used for speculative purposes.

By law, the minimum registered capital for a limited liability company is as low as Rmb30,000, or Rmb100,000 for a single-investor WFOE. In practice, however, approval authorities typically require a higher amount of registered capital. Higher amounts of registered capital may also be required by regulations governing specific industries.

The ratio of registered capital to total investment is fixed by regulation. The ratios are:

Total investment	Registered capital (as percentage of total investment)
Up to US$3 million	At least 70%
Over US$3 million up to US$10 million	At least 50% (minimum of US$2.1 million)
Over US$10 million up to US$30 million	At least 40% (minimum of US$5 million)
Over US$30 million	At least one-third (minimum of US$12 million)

This means, for instance, that:

- A WFOE or joint venture set up with a total investment of US$500,000 is required to have a registered capital of at least US$350,000 and can only incur foreign debt up to an amount of US$150,000.
- A WFOE or joint venture set up with a total investment of US$51 million is required to have a registered capital of at least US$17 million and can only incur foreign debt up to an amount of US$34 million.

Registered capital may be set in Rmb or a freely convertible foreign currency.

Holding companies in China are permitted to have greater proportions of debt (see Section 9 "China holding companies").

What can I contribute?

Registered capital may be contributed in the form of:

- Currency – Currency can be contributed in foreign currency or lawfully obtained Rmb (eg, dividends from another entity in China). Registered capital contributions in cash must generally comprise at least 30% of the FIE's registered capital.
- Industrial assets – The value of industrial assets (including machinery and equipment) must be appraised and verified. The value of imported equipment must also be verified by an authorised commodity inspection institution upon importation.

  State-owned assets being contributed to registered capital must be valued by an authorised valuation institution, and that value generally must be filed with the SASAC (or its local branch). For certain significant assets, governmental approvals may also be required. Explanations are required if the contribution value is less than 90% of the valuation.
- Land use rights – Land use rights (see Section 45 "Real estate") being contributed as registered capital are also subject to appraisal and verification. Foreign investors should take care that the land use rights are registered in the name of the FIE subsequent to the establishment of the FIE.
- Intellectual property – Intellectual property contributions are required to be appraised and verified. Intellectual property contributions to a WFOE cannot generally exceed 20% of its registered capital. For other FIEs it may be possible to contribute up to 70% of registered capital as intellectual property. A capital contribution of intellectual property, however, means that the FIE takes ownership of the intellectual property. Many foreign investors prefer to license (and not transfer) their intellectual property (see Section 27 "Technology transfers & licensing").
- Equity – The equity of one company may be contributed to the registered capital of another company (including FIEs), provided that the registered capital is fully paid up and unencumbered, and valued by a licensed valuation institution. As with other non-cash contributions, equity contributed as registered capital cannot exceed 70% of the registered capital of the company into which it is contributed.
- Shareholder loan conversion – Investors may increase registered capital by converting shareholder loans to equity (see "Increasing registered capital" below).

Title to non-cash contributions must be transferred to the FIE.

Timing

Registered capital may be paid in one lump sum or in instalments. Full lump sum payments of registered capital must be made within six months of issuance of an FIE's business licence.

The initial payment for registered capital being paid in instalments may be as low as a 15% of the registered capital. The initial payment must be made within three months of issuance of the FIE's business licence. The balance of registered capital paid in instalments must be paid within two years.

An investor in a China holding company has up to five years to pay the balance of registered capital exceeding US$30 million.

If a foreign investor in a WFOE fails to pay the initial instalment of registered capital within time, then the WFOE's approval certificate automatically becomes void. Failure to pay for an EJV renders the foreign investor liable to pay interest. Failure to pay for a CJV may result in both the approval certificate and the business licence becoming void.

Any failure to pay registered capital on time (except for the initial payment of registered capital for a WFOE) can result in a fine of between 5% and 15% of the registered capital.

Capital verification

Each payment of registered capital is required to be verified by a duly qualified accountant registered in China, who will issue a capital verification report. The report should be filed at the relevant local AIC.

Increasing registered capital

A joint venture's registered capital may be increased subject to the unanimous consent of the board of directors, the approval of the approval authority and registration at the relevant local branch of the SAIC.

A WFOE's registered capital may be increased subject to the approval of the approval authority and registration at the relevant local branch of the SAIC.

An increase in registered capital allows a corresponding increase in total investment. However, in some localities, the maximum increase in total investment might be limited to the amount calculated by using the ratios set out above on the amount of the increase only. The effect is to encourage greater initial amounts of registered capital, although, in deciding how much to initially contribute, care must also be taken to avoid a cash trap (see Section 42 "Foreign exchange & cash traps").

After approval, an increase in registered capital must be registered with the relevant local branch of the SAIC. An amount of 20% of the increased registered capital must be paid before the application to register the increase is submitted to the relevant local branch of the SAIC. The articles of association (and any joint venture contract) will need to be amended. A capital verification report will need to be issued and registered. Various governmental registrations will also need to be updated.

In certain circumstances in-kind contributions of increased registered capital may be imported tax free.

Reducing registered capital

Registered capital may only be reduced in certain circumstances, including if there have been changes in the scale of operations or production. Reductions in registered capital are subject to the approval of the governmental authority that originally approved the FIE. Creditor notification is required, and a capital verification report will need to be issued and registered.

Improper withdrawal of capital

Affected Chinese parties are encouraged to take legal action against foreign investors that improperly depart from China. Foreign investors may also be liable beyond their capital contributions if their failure to properly liquidate an investment results in losses for creditors.

The liquidation or transfer of any investment is not affected if conducted strictly in accordance with Chinese law.

Share capital – FICLS

FICLS may be established by means of promotion or share offer. Under establishment by promotion, the promoters subscribe for all the shares issued by the FICLS. Under establishment by share offer, the promoters subscribe for at least 35% of the total share capital and the balance is offered to the public or specified targets.

The minimum share capital of a FICLS is Rmb30 million, of which at least 25% must be held by foreign shareholders. Share capital may be paid in currency or in kind, provided that at least 30% is paid in currency.

Payments of share capital of a company established by means of promotion may be paid in instalments, and the initial payment must be at least 20% of the share capital. The balance of the share capital must be paid in full within two years or within five years if the FICLS is a China holding company (see Section 9 "China holding companies"). More specific timing requirements may be set out in the articles of association.

Share capital payments are required to be verified by a duly qualified accountant registered in China.

19. Debt funding

WFOEs and joint ventures may be funded by debt. However, the amount of foreign debt that may be incurred is limited.

Debt limits

The amount of foreign debt incurred by a WFOE or joint venture may not exceed the difference between its total investment and registered capital. The maximum permitted foreign debt levels are fixed by various ratios between total investment and registered capital (see Section 18 "Equity funding").

An FIE that exceeds its foreign debt limits must either reduce its debt or increase its registered capital. Debt in excess of the limits may be capitalised.

Foreign exchange loans

Foreign exchange loans (including shareholder loans) are permitted. Foreign exchange loans are required to be registered with the State Administration of Foreign Exchange (SAFE) or its local branch. Failure to register may give rise to repayment difficulties.

SAFE will not register foreign exchange loans that cause an FIE to exceed its total investment limits.

Rmb loans

FIEs may borrow Rmb from a bank or financial institution that is licensed to lend Rmb. Rmb loans may be secured by foreign exchange provided that the Rmb funds are used for the purpose that they are borrowed and not simply deposited with the loan being repaid by pledged foreign exchange.

Intra-group lending in Rmb is not generally permitted, although lending in the form of an entrustment loan through a financial institution is a relatively common practice.

A China holding company can assist its invested FIEs with loans (see Section 9 "China holding companies"). A group finance company may also be set up in some circumstances.

Corporate bonds

China's corporate bond market is underdeveloped. CSRC approval is required for the issuance of corporate bonds, and the company intending to make the issue must satisfy various criteria. Whether corporate bonds become a common form of debt funding for FIEs remains to be seen.

20. Remitting profits

China has a restricted foreign exchange regime (see Section 42 "Foreign exchange & cash traps"). However, while the expatriation of capital amounts requires approval, remittances of profits (and the payment of current account items) are relatively straightforward. The payment of taxes and allocations to statutory funds are required before profit can be distributed.

Determining profit

Distributable profits are determined in accordance with China's accounting regulations. The financial year, for accounting and tax purposes, is 1 January to 31 December. An FIE's financial statements should be audited by an accountant duly registered in China.

If needed, a second set of financial statements may be prepared in accordance with the accounting standards used in the investor's home jurisdiction. However, an FIE may only maintain one set of underlying accounts.

A FICLS' financial statements are required to be presented to and voted upon by shareholders.

Paying taxes

Taxes are required to be paid before profits may be distributed.

Fund allocations & previous losses

Profits cannot be distributed before previous years' losses are made up and allocations are made to various funds.

There are three funds, two of which are required for WFOEs and joint ventures and the third of which is applicable to EJVs only:

- Employee bonus and welfare fund – Used for collective welfare expenditure for employees, such as funding employee bonus schemes and housing subsidies.
- Reserve fund – Used mainly to cover an FIE's losses, increase production and business operations and, subject to governmental approval, to increase registered capital.
- Enterprise expansion fund (for EJVs) – Used mainly for expanding an EJV's operations.

An FIE should generally allocate 10% or more of after-tax profits to its reserve fund. Allocations to the reserve fund are not required once the aggregate amount of the reserve fund exceeds 50% of registered capital. Allocations to the employee bonus and welfare fund are discretionary.

Allocations to the reserve fund contribute toward FIE cash-trap problems (see Section 42 "Foreign exchange & cash traps").

Distributions

Profits may be distributed after the payment of taxes and fund allocations. Profits may also be retained. Any distributions made before making up previous years' losses must be returned to the company.

EJVs are required to distribute profit in proportion to their parties' respective equity holdings.

Wiring the money

The following documentation should be submitted to a foreign exchange bank to remit profits abroad:

- Tax payment certificates
- Audit report relating to the most recent financial statements
- Board resolution concerning the distribution of profits
- The FIE's foreign exchange certificate
- The FIE's capital verification report
- Other documents that may be requested by SAFE

Other options

Remittances of royalties and service fees can be more frequent than the remittance of profits. Payments of royalties and service fees will also usually be tax deductible to the FIE. Fees charged should be reasonable.

- Royalties – Royalties may be collected for trademarks, trade names, technology and know-how licensed to an FIE. These royalties may be subject to withholding tax. Various registrations are required (see Section 27 "Technology transfers & licensing").
- Service fees – An investor may charge fees for management services or other types of services provided to an FIE. Service fees may be subject to withholding tax.

21. Board of directors & supervisors

FIEs (excluding unincorporated CJVs) are typically governed by a board of directors and various senior management personnel (see Section 23 "Management").

An unincorporated CJV is governed by a management committee with similar powers to a board of directors.

Board membership

A WFOE or joint venture board of directors is required to have between three and thirteen members. An executive director is also possible for companies, such as WFOEs, with relatively few shareholders. A FICLS is required to have between five and nineteen directors.

Board membership for both EJVs and CJVs is required to reflect the parties' respective capital contributions. If the chairperson is selected by the foreign party, the vice-chairperson is to be selected by the Chinese party (and vice versa).

Changes of board members must be registered at the relevant local branch of the SAIC.

Chairperson and legal representative

A chairperson should be appointed for a board of directors. A vice-chairperson is optional.

The chairperson is typically the legal representative of an FIE, although an executive director or a general manager may also be appointed as legal representative.

Legal representatives can bind the company. He or she also bears significant responsibility for the acts and omissions of the FIE. For instance, the legal representative is personally responsible for failures of the company to complete its annual SAIC inspection within time.

Board meetings and quorums

Joint venture board meetings are required at least once a year. A joint venture quorum is two-thirds of the directors. Unanimous consent is required if an EJV is considering amendment of the articles of association, termination and dissolution of the joint venture, an increase or reduction of the registered capital, or merger or division of the EJV.

WFOE board meetings and quorum requirements are governed by the WFOE's articles of association.

FICLS board meetings are required at least twice a year, with at least 10 days notice for each meeting. A FICLS quorum is one-half of the directors. Special board meetings are to be held if requested by shareholders holding 10% or more of the share capital or by one-third or more of the directors or supervisors.

Board powers

The powers and functions of a board of directors are largely spelled out in the articles of association and, for a joint venture, in the joint venture contract as well.

The board of directors is the highest authority of an EJV.

Supervisors

Joint ventures, WFOEs and FICLSs must have supervisory boards with at least three members. If a joint venture or WFOE has comparatively few investors and is comparatively small in scale, then the appointment of one or two supervisors is sufficient.

Supervisors are mainly expected to monitor the financial affairs of the company and to supervise the performance and regulatory compliance of directors and senior personnel.

The specifics of the supervision system, such as the selection method for the supervisor(s), the term of appointment of the supervisor(s), and the duties and powers of the supervisor(s), may be set out in an FIE's articles of association. The provisions in the articles of association should, however, be consistent with the Company Law. Of particular note in the Company Law is that at least one-third of a board of supervisors must represent and be democratically elected by the staff and workers.

A WFOE or joint venture board of supervisors must meet at least once a year. A FICLS board of supervisors must meet at least once every six months.

Changes of supervisors must be registered at the relevant local branch of the SAIC.

Although the supervisor requirements are set out in the Company Law, which was effective 1 January 2006, the provisions were initially not consistently applied to joint ventures and WFOEs. As a result, some FIEs were set up after 1 January 2006 without a supervisor system. Depending on the approach of local authorities, such FIEs may be required to subsequently set up a supervision system.

FIEs set up before 1 January 2006 may decide whether or not to adopt a supervision system, although some local authorities have required a supervision system if, and at the same time as, any other changes are being made.

22. Director, supervisor & officer liability

Director, supervisor and officer liabilities are not as well developed in China as in many Western jurisdictions. Nevertheless, foreign investors should be aware of various specific provisions.

Civil liability

Civil liability includes:

- Directors, supervisors and senior management personnel may be liable if they violate laws or provisions of the articles of association and thereby cause loss to the company.
- FICLS directors bear liability for any board resolution that violates laws or provisions of the articles of association, and loss is thereby caused to the company; FICLS directors may escape liability if their dissent is noted in board meetings.
- Legal representatives are personally liable if their company does not complete its annual SAIC inspection within time.

Criminal responsibility

The "person-in-charge" of an FIE may be held criminally responsible for the acts of the FIE in a number of circumstances, including:

- Up to five years imprisonment and fines from Rmb20,000 to Rmb200,000 for those in charge of a company that defrauds creditors
- Up to three years imprisonment (seven years for especially serious cases) if serious industrial accidents occur due to lack of safety measures
- Up to three years imprisonment (seven years for especially serious cases) for failing to report or falsely reporting serious industrial accidents
- Up to three years imprisonment (between three and seven years for especially serious cases) for serious environmental incidents
- Up to three years imprisonment (between three and ten years for serious cases) for forcing another person to work by violence, threats or restrictions to personal freedom

An employee (which may include a director) of an FIE who takes advantage of his or her position or accepts money or other benefits may be sentenced to up to five years imprisonment if the amount involved is "considerably large".

Persons-in-charge may include directors. The chairman of the board is often considered to be the person who is ultimately in charge.

D&O insurance

The market for D&O insurance is not well-developed in China.

23. Management

EJVs are required to appoint a general manager, at least one deputy general manager and a finance manager. It is common for other FIEs to also appoint a general manager, deputy general manager(s) and a finance manager.

General manager

The general manager, who may be a Chinese national or a foreign national, is typically responsible for the day-to-day operations of the FIE. His or her particular responsibilities should be set out in the FIE's articles of association.

The Company Law gives the general manager a range of responsibilities, including:

- To be in charge of production, operations and management of the company
- To implement board resolutions, business plans and investment plans
- To formulate a management system for the company
- To decide on the employment and termination of staff, other than those that may only be employed and dismissed by the board of directors

Deputy general managers

An FIE may appoint one or more deputy general managers. If the Chinese party nominates the general manager of an EJV, then typically the foreign party will nominate the deputy general manager (and vice versa).

Finance manager

An EJV is required to employ one or more accountants to assist the general manager with the EJV's finances. It is also typical for other FIEs to employ an accountant.

24. Foreign national employees

FIEs may employ foreign nationals only for roles with special requirements and only if there is a shortage of suitable Chinese nationals. Many foreign investors have nationalised all but select senior management and senior technical positions. This helps to maintain control over the FIE while at the same time minimises cost.

In addition to the points outlined below, foreign nationals may also be subject to China's labour laws. See Section 25 "Chinese national employees" for an outline of Chinese labour law.

Registering in China

Foreign nationals must hold work permits and appropriate visas to be employed in China. Work permits will only be issued for positions with special requirements and if there is a shortage of Chinese national candidates for such position.

Obtaining a work permit and a visa can take several months. Generally, the required steps will be:

- Application for and issuance of a permit to employ a foreign national
- Application for a "work" visa in foreign national's home country
- Registration with Public Security Bureau within 24 hours of arrival in China
- Medical examination in China
- Application for and issuance of a work permit
- Application for and issuance of a residence permit
- Registration with the relevant tax bureau
- Registration with customs, if personal items are being shipped from abroad

Foreign nationals seconded to China, or doing business in China, for relatively short periods of time may apply for an "F" visa.

Split contracts?

Foreign investors contemplating the splitting of employment contracts for foreign personnel should ensure that they have a substantive reason for doing so. Splitting a contract for the purpose of reducing exposure to tax in China may result in unwanted consequences. Expert China tax advice should be sought.

Social security

Employers must contribute to various social security funds on behalf of foreign nationals. Foreign nationals are also expected to contribute to the funds. The funds include:

- Aged pension fund
- Medical insurance
- Workers' compensation
- Maternity insurance
- Unemployment insurance
- Housing fund

Although the obligation to contribute officially commenced on 15 October 2011, local governments in some areas are yet to issue implementing rules that would allow the contributions to be paid.

Tax year

The tax year for individual income tax purposes is 1 January to 31 December.

90/183 day rule

A foreign national residing in China for less than 90 days in any one tax year is exempt from tax on income paid by an employer outside China, the cost of which is not borne by an entity in China. A foreign national residing in China for more than 90 days in any tax year will be liable to tax on income derived from within China (even if the actual payment is made outside China). Double tax treaties with China typically extend the 90-day period to 183 days. Countries with double tax treaties with China include the United States of America, the United Kingdom, France and Australia.

The 90/183 day rule does not apply to chief representatives of representative offices (see Section 49 "Representative offices"). This means that chief representatives will be subject to individual income tax on income derived during their stay in China from day one.

Taxing your worldwide income

Foreign nationals residing in China for more than five years are, from the sixth year, subject to tax on their worldwide income.

To legitimately avoid being taxed on worldwide income, a foreign national can exit China for more than 90 cumulative days during their fifth tax year. Alternatively, a foreign national can exit China for more than 30 consecutive days.

Withholding tax

An FIE is required to withhold individual income tax from the salaries of its employees, including for any foreign national employees who have their salary paid offshore.

The amount of income tax withheld and paid to the tax bureau is final, although annual tax returns are required for various taxpayers, including those who earn more than Rmb120,000 per year.

25. Chinese national employees

Chinese labour law, which is summarised below, is more pro-employee than some investors would like. The below rules may also apply to foreign nationals working in China.

Recruiting and retaining the right Chinese national employees is a challenge for many foreign investors.

Written contracts

Each employee should enter into a written labour contract. If a written labour contract is not entered into within one month of commencement of employment, then the employer is obligated to pay the employee twice the monthly wages/salary for up to a period of 12 months. If a written labour contract is still not signed, then the labour contract becomes a contract without a fixed term.

Labour contracts will typically set out the term of employment, nature of the job, safety and working conditions, remuneration, discipline procedures and termination provisions. A labour contract should also include provisions protecting intellectual property (see Section 28 “Protecting your IP”). Labour contracts in China are governed by Chinese law.

Collective contracts may also be negotiated with the labour union or employee representatives. Collective contracts are aimed at improving the working conditions for all employees. A collective contract may specify minimum wages for a workplace.

Term of labour contracts

The term of labour contracts may be:

- fixed (ie, terminates at the end of a certain time period);
- not fixed (ie, has no fixed date of termination); or
- assignment-based (ie, terminates after completion of a certain assignment).

A labour contract without a fixed term is required in any of the following three situations (unless the employee proposes a fixed-term contract–something that may be hard to prove):

- the employee has worked for the employer for at least 10 consecutive years;
- the employee is within 10 years of retirement (and a number of other conditions are satisfied); and
- if the employee has already signed two consecutive fixed-term labour contracts with the employer.

If a contract without a fixed term is required, but the parties cannot agree to the terms, then the terms will be implied by law. That is, failure to agree on the terms of a contract without a fixed term does not excuse an employer from entering such a contract with an employee.

An employer that transfers an employee to a new employer (for instance, within a group) must also carry forward the employee’s term of service with the first employer to the new employer.

As set out below, contracts without a fixed term are more difficult to terminate.

Probation

China has maximum probationary periods as follow:

Term of labour contract	Maximum probationary period
Less than 3 months & assignment-based terms	0 months
3 months or more but less than 1 year	1 month
1 year or more but less than 3 years	2 months
3 years or more (incl. contracts without a fixed term)	6 months

The same employer and employee may only agree upon a probationary period once.

Child labour

Child labour is prohibited. For the purposes of Chinese labour law, a child is anyone under the age of 16 years. A very limited number of exceptions, including for artistic and athletic endeavours, are available.

Discrimination

Various laws and regulations include non-discrimination rules. Specifically, employers may not discriminate on the basis of the following when recruiting employees:

- ethnicity
- race
- gender
- religious belief
- disability

Moreover, employers may not discriminate against workers coming to cities from rural areas, and testing cannot generally be undertaken for certain infectious diseases (including Hepatitis B).

Job advertisements may not contain discriminatory content.

Data protection

An employer must maintain the confidentiality of personal information relating to its employees. In particular, an employer must obtain the consent of an employee before disclosing his/her personal information to a third party.

China's Tort Law, effective 1 July 2010, has also reinforced the need for employers to keep personal information confidential by providing a general right to privacy.

Work, health & safety

Workplace occupational health and safety programmes are required. This includes regular physical examinations for employees working under hazardous circumstances.

Employees between the ages of 16 and 18 years are protected under special occupational health and safety measures.

Vicarious liability

China's Tort Law confirms pre-existing judicial practice that employers should be liable to other parties for any harm caused by their employees during the course of their duties. Furthermore, if an employee is seconded to another workplace, the party to which the employee is seconded will be liable to third parties for any harm caused by the secondee in the course of his/her performance of work duties while he/she is on secondment. The party dispatching the secondee will be jointly liable only where it is at fault.

Working hours & overtime

The standard working week is five days at eight hours per day. The average working week may not exceed 40 hours. Overtime penalties must be paid if an employee works overtime.

Overtime may not generally exceed one hour per day. Under special circumstances, and with the consent of the trade union and employees, overtime hours may be extended up to 36 hours per month. Overtime penalty rates of between 150% and 300% apply.

Flexible work systems are subject to the approval of the local labour bureau.

Non-payment of wages criminalised

Employers, and senior managers of employers, may be criminally responsible for failing to pay wages to labourers. The criminal offense will be committed if labourers are not paid due to:

- A transfer of the employer's property
- An absconding manager
- A refusal to pay a relatively large amount when the employer actually has the funds to pay, and the employer refuses to comply with an order by the relevant governmental department

The penalties are imprisonment of up to three years and/or fines. If the consequences of the offense are serious, then offenders may be imprisoned for up to seven years and fined. An incorporated employer may be fined.

Annual leave

Employees are entitled to paid annual leave after one year of service with the same employer. The amount of paid annual leave entitlement varies according to the length of an employee's entire working history (not just the length of service with the current employer):

- Up to 1 year – 0 days annual leave
- More than 1 year, and up to 10 years – 5 days annual leave
- More than 10 years, and up to 20 years – 10 days annual leave
- More than 20 years – 15 days annual leave

Individual labour contracts, collective labour contracts or the employee handbook may provide for greater annual leave entitlements.

Employers may schedule an employee's leave according to business needs. An employer may also require an employee not to take his/her annual leave entitlements, but must pay the employee at 300% of his/her daily rate for each day of statutory leave requested not to be taken within the year of entitlement.

Paid annual leave is in addition to public holidays, though entitlements may be cancelled if certain other leave has been taken.

Other leave entitlements

China allows leave in a number of circumstances in addition to annual leave. The amount of leave can vary between different localities. Leave additional to annual leave may include:

- Medical leave – Covers an employee for a certain period during their recovery from illness or injury.
- Matrimonial leave – Leave for between one and three days following marriage. Extra leave may be available to those who marry late.
- Family planning leave – Leave for birth control purposes, with duration at the discretion of the employer.
- Maternity leave – Leave following child-birth, generally for a period of 90 days. Extra leave may be available to those who have children late.
- Funeral leave – Leave for between one and three days following the death of a parent, spouse or child.

Wages & salaries

Minimum wages are set each year at the provincial or municipal level. Minimum wages currently in force in Beijing, Shanghai and Guangzhou are:

Beijing:	Rmb1,260 per month for full-time employees (excluding social insurance premiums) or Rmb14 per hour for part-time employees (including social insurance premiums).
Shanghai:	Rmb1,450 per month for full-time employees (excluding social security premiums) or Rmb12.5 per hour for part-time employees (excluding social insurance premiums).
Guangzhou:	Rmb1,300 per month for full-time urban employees or Rmb12.50 per hour for part-time urban employees.

Professional and skilled workers command wages and salaries at significantly higher rates.

An employee's rights (including minimum wages and other matters) must be determined in accordance with the standards applicable in the location where the employee actually works. The employer and employee may adopt the standards applicable at the employer's registered location only if those standards are higher than the standards in the location of employment.

Salaries must be paid at least once a month.

Social security & housing

In addition to wages and salaries, employers must pay charges for various social security funds. Chinese nationals are also expected to contribute to the funds. These funds include:

- Aged pension fund
- Medical insurance
- Workers' compensation
- Maternity insurance
- Unemployment insurance
- Housing fund

The cost of these payments can be significant, in practice sometimes exceeding one-third an employee's monthly salary.

Staff meetings

In certain places, employees in the form of staff meetings or staff representative meetings are given responsibilities and powers under local rules. Staff meetings (or staff representative meetings if total employees exceed 100) in Shanghai, for instance, may:

- review, recommend changes to and approve special collective contracts
- approve matters relating to employees' vital interests
- examine and supervise the enforcement of labour contracts and collective contracts
- select staff representatives for board meetings and supervisory boards

A workplace labour union effectively operates as a secretariat for staff meetings (or staff representative meetings).

Termination

China's employment regime does not accommodate employment at will. Rather, termination of employment can only take place on specific grounds. Moreover, labour contracts may not include any grounds for termination that are not provided for by law. In addition, the opinion of the workplace labour union must be sought before an employee is dismissed.

Causes for dismissal without notice include dismissal for:

- Failure to satisfy the recruitment conditions during the probation period (reasons must be given to the employee)
- Serious violations of workplace rules
- Dereliction of duty causing serious loss
- Corruption causing serious loss
- Holding multiple jobs, which severely impacts on job performance
- Criminal offences

Grounds for dismissal of an employee with 30 days notice, or an additional one month's wages in lieu of notice, include:

- Being unable to take up his or her original job or any newly assigned work upon returning from non-work-related medical treatment for illness or injury
- Being incapable of performing in the job and remaining incapable even after receiving training or a transfer to another work post
- Being unable to agree with the employer, after mutual consultation, on a modification of his or her labour contract when the purpose for which he or she was originally hired has significantly changed or no longer exists

Certain financial or operational difficulties may also give rise to a right to dismiss employees upon 30 days notice. However, employers should give priority to such laid-off employees if they recruit for the same or similar position within six months after a layoff.

Employers may not dismiss an employee if:

- He or she has become wholly or partially unable to work and such inability is medically determined to have been caused by a work-related sickness or injury
- He or she is in a period of treatment for illness or injury
- She is pregnant, on maternity leave or within the specified nursing period
- He or she has served 15 or more consecutive years and is within five years of retirement

Employees may resign at any time with at least 30 days' notice (three days if within their probation period). No notice is required under a number of circumstances, including:

- If an employer uses coercion (including violence, threats or illegal restrictions on personal freedom) in the workplace
- If an employer fails to pay wages or social security premiums, or fails to provide working conditions as agreed under the labour contract

Severance pay

Severance pay may be payable upon termination of employment, including in situations in which an employer does not offer to renew a fixed-term labour contract.

Severance pay typically accrues at the rate of one month salary for each year of service, up to a maximum of 12 months' salary. Actual calculations for severance pay differ from area to area. However, the amount of monthly salary payable for severance pay is limited to three times the local monthly average wage announced by the relevant local government.

Double severance pay is required in cases of wrongful dismissal.

Withholding tax

An FIE that employs Chinese nationals is required to withhold individual income tax from the salaries or wages of each such employee. The amount of tax withheld and paid to the tax bureau on a monthly basis is final, although annual tax returns are required for various taxpayers, including those who earn more than Rmb120,000 per year.

26. Labour unions & the Party

Employees in China have a right to set up a workplace labour union. If the employees request the establishment of a labour union, the employer is required to offer assistance. Assistance may also be required for the establishment of a Chinese Communist Party organisation in the workplace.

Labour union activities

Many labour unions mainly organise social functions for staff. Labour unions, however, can also:

- Advise on and help negotiate individual labour contracts (including remuneration), collective contracts and termination of employees
- Facilitate communication and mediate conflicts between management and staff
- Advise on downsizing of an FIE's operations and assist retrenched staff to find new employment
- Participate in the development and oversight of an employer's social insurance policies

The consent of labour unions is required in certain M&A transactions (see Section 37 "Human resources").

Some HR departments find labour unions to be a positive influence within the workplace.

Labour unions at or above the county level may provide free legal services to certain employees and workplace labour unions.

Employees have no legal basis upon which to strike.

Labour union organisation & funding

Labour unions are required to be subordinated to the All-China Federation of Trade Unions. Independent labour unions are not permitted.

FIEs with a total staff of over 200 are obligated to support a full-time labour union representative. Additional full-time representatives may be required for any workplace with a total staff of over 500.

FIEs are required to allocate 2% of the monthly payroll to the workplace labour union.

Management participation

Labour union representatives have the right to attend board meetings, although they do not have the right to vote. Moreover, labour union representatives should be invited to attend board meetings if labour issues are to be discussed.

Chinese Communist Party (CCP) organisations

The Company Law, read together with the CCP charter, requires a basic-level CCP organisation to be set up in any workplace that has three or more CCP members.

The employer should provide the "requisite conditions" for the operation of a basic-level CCP organisation set up in its workplace. How much support is actually required, however, is not prescribed by law and will usually depend on the size of the workplace, the number of CCP members and a range of other factors.

27. Technology transfers & licensing

Foreign investors commonly license technology and IP (including know-how, trademarks, patents and copyright material) to the FIEs they establish. Technology may also be licensed to unaffiliated Chinese companies, and this is often the case in manufacturing or management arrangements (see Section 50 “Manufacturing in China” and Section 51 “Management contracts”). Licence contracts are typically governed by foreign law.

Licences facilitate control over the technology and (subject to registration) allow the payment of royalties. Sensitive technology, however, is rarely licensed to an entity over which the foreign company does not have control.

Technology transfers are less common than licences, and are mainly limited to the contribution of technology as registered capital.

Prohibited & restricted technology

PRC regulations recognise three categories of technology: prohibited, restricted and permitted.

Technology will generally be prohibited if it endangers State security, public interests or public morals, if it places people’s lives or health at risk, or if it destroys the environment. Prohibited technology may not be imported into China.

The catalogue of restricted technology sets out various specific technologies that are restricted from importation. The restricted technologies are mainly related to the biological, chemical, petroleum refining, petrochemical and bio-chemical industries.

Technology that is neither prohibited nor restricted is permitted.

Technology licence approvals & registrations

Restricted technology is required to be approved by and registered with COFTEC before importation. There is a two-stage approval process. The first step requires an application for a Technology Import Licence Proposal. COFTEC has 30 working days in which to decide upon the application. A licence contract may only be signed after COFTEC issues a Technology Import Licence Proposal. The second step is to apply for the Technology Import Licence. COFTEC has ten working days in which to decide upon the application. If COFTEC approves, certain details of the licence contract must be registered over the internet.

Licences for permitted technology are not subject to approval but are still required to be registered with COFTEC. The licence contracts may be registered over the internet.

The transfer of permitted technology, however, is still subject to approval and registration with MOFCOM if the transfer relates to certain major projects.

Technology improvements

A foreign company may not prohibit a licensee from making improvements to the licensed technology. Moreover, the relevant regulations state that improvements belong to the party making the improvement, and that the licensor may not require a gratuitous transfer of improvements.

Trademarks

Trademark licences are required to be filed with the China Trademark Office within three months of execution. This filing will be needed if royalties are to be remitted out of China.

Foreign trademarks should also be recorded at the China Trademark Office if royalties are to be remitted out of China. The recordal of trademarks can take longer than 18 months.

Protecting your technology

See Section 28 “Protecting your IP”.

Capital contributions

Technology may be contributed as part of an FIE’s registered capital. However, this means that the FIE will be the owner of the technology and that the foreign investor, if it wants to use the technology, should license the technology from the FIE. This is not attractive to most foreign investors.

Limitations on the amount of technology that may be contributed as registered capital also exist. In particular, a WFOE may not generally have more than 20% of its registered capital contributed in the form of technology (see Section 18 “Equity funding”).

28. Protecting your IP

Protecting intellectual property (IP) in China requires a multi-faceted approach including registrations, workplace security, employee contracts, commercial contracts and enforcement.

Registrations

China's various IP registration regimes are generally consistent with international standards.

- Trademarks – Trademarks are protected on a first-to-file basis. An exception exists for well-known trademarks, though demonstrating that a particular trademark is "well-known" can be difficult. Rights to priority may also arise from international treaties. If a trademark uses any words, the Chinese language equivalent should also be registered.

  China has adopted the international Classification of Goods and Services under the Nice Agreement. International registrations may be made under the Madrid system for the international registration of trademarks.

- Business names – A business name is required to be reserved with the relevant local AIC before an application to set up an FIE. A business name must be in Chinese (see Section 16 "Documentation"). Registration, however, will only give rights to the Chinese language business name within the particular administrative area. China does not have a national register of business names. Trademark registrations offer better protections in this respect and should, therefore, form part of any China investment strategy.
- Patents & designs – Patents and designs are protected on a first-to-file basis. Filings in another member country of the Paris Convention within certain time limits may also gain priority in China.

  Patents for inventions that are made in China may be filed outside of China before being filed in China; however, an applicant must first apply to China's patent office for confidential examination and approval prior to filing for a patent outside of China. Failure to obtain approval from the State Council patent administration department will preclude subsequent filing of the same patent in China.

  Compulsory patent licences may be granted if: (i) the patent holder fails to exploit or fully exploit its patent within three years from the granting of the patent or within four years from filing for the patent; or (ii) the patent holder's exercise of its patent rights is determined to constitute a "monopoly" and the anti-competitive effects need to be eliminated or reduced. Compulsory licences may also be granted in the event of a national emergency.

  Many foreign companies choose not to register patents for sensitive technology in China.

- Copyright material – Copyright material may be registered with the China National Copyright Administration. Registration may be helpful evidence of ownership rights in a copyrighted work, but it is not a precondition to copyright enforcement.
- Software – Software may also be registered with the China National Copyright Administration. Registration, however, requires the filing of source code (albeit with some code blacked out or removed). Many foreign companies do not register their software in China as the risk of leakage is considered greater than the benefits of registration.
- Domain names – Domain names are registered in China on a first-to-file basis.

Workplace security

Maintaining systems to control IP leakage from the workplace is necessary. Access to confidential information should be restricted to only those who require access. IT systems and any hard copies of IP should be secure.

Confidential material should be marked "Confidential Information" in Chinese to enhance its usefulness as evidence in Chinese courts.

Encryption

The use of encryption products in China is subject to approval by the State Encryption Administration.

Employees

Employee contracts should be prepared with a view to protecting IP. In particular, you should consider including the following in all relevant employment contracts:

- Confidentiality obligations – A wide range of workplace information can be contractually protected as confidential information.
- Non-compete clauses – Post-termination non-compete clauses may only be entered with senior management personnel, senior technical personnel and other personnel with confidentiality obligations. Reasonable compensation is required to be paid on a monthly basis during the non-compete period. The term of a non-compete obligation cannot exceed two years.
- IP assignments – The ownership of IP created in the course of employment should be clearly assigned.

Without such provisions, it can be difficult (if not impossible) to enforce IP rights against a non-cooperative employee.

Product selection

Careful thought should be given as to which products to manufacture in China. For instance, some foreign investors may prefer not to manufacture in China products that require new and sensitive technology. Alternatively, the components requiring new and sensitive technology may be imported into China as "sealed" units for integration with the rest of the product.

Commercial contracts

Sourcing materials and components can involve the exchange of IP, as can many other commercial arrangements. Adequate IP protections should be included in the contractual documentation.

Administrative enforcement action

Various governmental authorities have the power to take administrative action against infringers. Such actions are typically more efficient and less costly than litigation. The standards of proof are also lower.

Publicising successful administrative enforcement actions can generate goodwill with the relevant governmental authorities and may deter future infringers.

The relevant governmental authorities are:

- SAIC – The SAIC and its local AICs have a reputation for efficient trademark enforcement action, including investigations and raids. The SAIC can also handle disputes relating to business names, registered trademarks, passing-off activities and trade secrets.
- China Patent Office – The China Patent Office may assist with patent enforcements through investigations, mediation and raids.
- National Copyright Administration – The National Copyright Administration has a wide range of enforcement powers. They may order cessation of the infringing activities, confiscate illegal income, confiscate and destroy illegal copies and impose fines.
- Customs – Customs has the power to confiscate products that infringe trademarks, copyrights and patents.
- General Administration of Quality Supervision, Inspection and Quarantine – This authority may be involved if production quality and human health issues are in question.

Litigation

Although administrative actions are typically preferred, court action can be useful if injunctions are being sought or damages claimed. In addition, trademark owners have generally preferred to bring court actions against domain name registrants that pirate their trademarks. Domain name disputes may also be heard by a panel established by the China Internet Network Information Center.

Criminal prosecution

Criminal sanctions, including imprisonment in serious cases, can be imposed for IP infringements. Prosecutions, however, are relatively rare. In part, this is because it can be difficult to prove that the relevant financial thresholds for prosecution have been met.

The thresholds for criminal prosecution include:

- Rmb50,000 turnover or Rmb30,000 in profits, if trademarks are applied to goods without authorisation
- Rmb50,000 turnover for knowingly selling goods with counterfeit registered trademarks

Overseas actions

Many Chinese companies are keen to export. Products that infringe IP rights, however, can be blocked by customs in the port of destination. Such action requires close cross-border coordination.

It may also be possible to seize the overseas assets of infringers located in China.

29. M&A legal environment

The following sections outline the key types of transactions contemplated under China's M&A legal environment.

M&A and foreign direct investment

Foreign investors are generally not permitted to operate businesses in China without setting up an FIE in China. As a result, an M&A transaction will result in an FIE whether you are buying assets, equity or both. Accordingly, many of the considerations discussed in Sections 2 to 28 above are applicable to M&A activity in China.

Restrictions apply

Foreign investors cannot circumvent restrictions on foreign investment through M&A transactions. In particular, the acquisition of a domestic enterprise, or even assets, in a prohibited sector will be prohibited (see Section 4 "Open & prohibited sectors"). Competition law rules and national security review requirements must also be considered (see Section 38 "Competition law: merger control" and Section 39 "National security reviews").

Slow transactions

The complexity of China's legal environment often slows the pace of cross-border M&A transactions involving assets or issues in China. Not only are governmental approvals required for many types of transactions, but transfer fees may need to be paid before title is acquired. In short, China's legal environment does not allow for transactions to be carried out as efficiently as in many developed jurisdictions.

Social stability

Social stability is a key driver in China's M&A legal environment. This can be seen in the range of rights given to employees and in China's continued control over key sectors of its economy.

Certainty & predictability

Various legal reforms have resulted in a legal environment that provides a degree of certainty and predictability.

30. Planning your exit

Planning your exit before you enter can significantly improve your exit options and increase the value of the transaction. Investments should still be chosen wisely.

Public listings are typically the first exit choice for private equity investors. Private sales are more common for other investors.

Private sales

Private sales to industry players or financial investors are less susceptible to the ups and downs of the capital markets. Industry players and financial investors often prefer controlling interests. Governmental approvals are required for sales of FIE equity, although not (except for competition law requirements) for sales of offshore holding companies (see Section 32 "Offshore transactions").

See also Sections 29, 34, 36 and 40 for more information regarding the sale of China investments.

Listing in China

The Shanghai and Shenzhen stock exchanges have A share and B share markets. A shares can only be purchased by Chinese persons, qualified foreign institutional investors (QFII) and qualified strategic investors (see Section 35 "Buying China-listed companies"). B shares may be purchased by Chinese or foreign persons.

A WFOE or a joint venture would first need to convert into a FICLS before being able to list. For a WFOE this conversion requires the introduction of Chinese investors and governmental approvals. Various listing criteria must be satisfied and CSRC approval is required.

Very few FIEs have been listed on the A share markets. The issuance of B shares has been easier, although B share liquidity has been historically low with B shares being undervalued in comparison with A shares. Moreover, the promoters of companies listed in China are subject to a one-year lock-up on the shares they own prior to listing.

Listing in China has not, to date, been an attractive exit option.

Listing offshore

The shares of a FICLS or the China holding company of an FIE may be listed offshore. CSRC approval is required before a FICLS can apply for an offshore listing.

Hong Kong and New York have been the most attractive destinations for China operations listing offshore. Hong Kong markets are not subject to the stringent requirements of the US Sarbanes-Oxley regime. London, Singapore and Tokyo are also options.

A careful assessment of the various listing requirements and post-listing obligations will be needed before a particular stock exchange is chosen.

Structuring

Once you know how you want to exit, it is generally possible to structure the acquisition so that restructuring upon your exit is minimal.

The optimal structure may involve one or more offshore holding companies, with the choice of offshore holding companies being largely driven by tax issues and corporate considerations.

31. Due diligence

Due diligence is key to determining whether you know your potential partner sufficiently and whether you will get what you agree to buy. Due diligence, however, can be challenging and time-consuming due to factors such as the inadequate availability of information and some Chinese parties' lack of familiarity with due diligence.

Financial due diligence

Financial accounts presented by a Chinese target company are often not prepared by one of the international accounting firms. Adjustments may well be needed in order to align the accounts with the foreign purchaser's standards.

Determining the value of a target based on its financial accounts can be challenging. Expert assistance should be sought.

Independent investigations

Some foreign investors carry out independent assessments of the business reputation and connections of a potential partner and its key employees. This can often be a threshold question – do I want to be doing business with this potential partner?

You would want to know, for instance, if the proposed general manager of your joint venture has competing businesses in the neighbourhood. Those subject to the United States Foreign Corrupt Practices Act (or equivalent home country legislation) may also want to know whether a potential Chinese partner has a reputation for corrupt dealings with government officials. Moreover, knowing whether your intellectual property rights will likely be respected will be fundamental for many foreign investors.

These and similar questions are very difficult to address through traditional financial and legal due diligence.

Legal due diligence

Legal due diligence focuses on a range of issues, including corporate authority, ownership of assets, regulatory compliance, contractual rights and liabilities, and claims against the target. Such issues can radically affect the value of a deal.

Some of the issues that are not uncommonly found in legal due diligence include:

- Trademarks (and other intellectual property) are owned by another company within the target's group
- Constitutional documents have not been amended to account for changes that have occurred
- Insufficient documentation to show who owns land and buildings or other assets
- Land and buildings on that land are owned by different entities
- Security and debts are not sufficiently documented
- Buildings are constructed without appropriate permits and approvals
- Underpayment of employee withholding tax and social security premiums
- Outstanding labour disputes
- Significant contracts are poorly documented, with the arrangements lacking clarity

Some issues can be resolved. Others may be more fundamental. Whichever the case, most investors would prefer to know before they commit capital to a project.

Environmental due diligence

The environmental standards of some sites in China may fall below those required by a foreign investor. If you are planning to develop land, you will need to undertake an environmental impact assessment and have it approved before beginning your development work. Environmental impact assessments are also needed if you are planning to refurbish existing facilities (see Section 46 “Environmental issues”).

Accordingly, you will need to know the environmental status of any land before completing the deal.

32. Offshore transactions

One of the ways to acquire an FIE is to buy its offshore holding company. The acquisition of an offshore holding company is typically more straightforward and allows greater flexibility due to the absence of governmental approvals in China. Competition law filings may still be required.

Approvals not required

Except for competition law and national security review requirements (see Section 38 “Competition law: merger control” and Section 39 “National security reviews”), governmental approvals in China are not required for the purchase of an offshore holding company with subsidiaries in China.

If the offshore holding company holds equity in a joint venture, the consent of the Chinese party to that joint venture is also not required by law (although consent may be contractually required). However, even if no approvals or consents are required in China, cooperation is recommended.

Offshore transactions can also avoid some of the restrictions under the Chinese M&A rules (eg, timing of payments) and thus offer greater flexibility in transaction structures.

Capital gains tax

Sale of equity in an FIE is subject to capital gains tax. The sale of an offshore holding company may also give rise to capital gains tax within China (see Section 40 “Corporate taxes & incentives”).

Scarce targets

FIE targets are not always neatly held by offshore holding companies. If that is the case, then you may want to work with the seller to restructure the target before acquisition. Restructuring can also involve taking a Chinese partner offshore (see Section 33 “Taking your Chinese partner offshore”).

It is not always possible, however, to structure a deal as an offshore transaction. Investments in some sectors, for instance, require the investor itself to be experienced in that sector. Offshore holding companies (even if wholly-owned) do not always qualify.

33. Taking your Chinese partner offshore

Keeping a transaction offshore can be more straightforward than buying (or selling) equity or assets in China (see Section 32 "Offshore transactions"). This applies to WFOEs, joint ventures and FICLS. It can, however, have particular relevance for joint ventures. Partnering with your Chinese partner offshore can significantly increase flexibility and exit options. Going offshore, however, may not be as straightforward for your Chinese partner.

Tax advantages from being classified as an FIE are no longer available for new investments, and tax preferences already in place are being phased out (see Section 40 "Corporate taxes & incentives").

Your partner

The ease with which you can take a Chinese partner offshore will depend on whether they are an individual or a company, a private company or a government company and whether they already have an offshore investment vehicle or offshore funds.

Flexibility

Assuming it is possible, partnering offshore can result in a number of advantages. For instance:

- Depending on your choice of jurisdiction, board representation for the offshore holding company need not reflect share ownership in the holding company
- The partnership arrangement may be governed by non-Chinese law
- Financing options may be greater

SAFE registration

Exchanges of equity or assets for shares in overseas companies have been relatively common for private equity investments.

As of late 2005, Chinese nationals, Chinese enterprises and foreign nationals resident in China are required to register with SAFE any overseas investments before establishment or before taking control. Overseas investments required to be registered include those by way of:

- Exchange of equity in a Chinese enterprise
- Contribution of assets into an FIE
- Increase of registered capital of a domestic enterprise

Overseas investments set up before 2005 were required to register with SAFE before 31 March 2006.

Quasi FIEs

Since 8 September 2006, companies set up in China by a domestic enterprise (or individual) using an offshore special purpose vehicle no longer qualify as FIEs unless a "legitimate" foreign investor holds 25% or more of the equity.

Moreover, if a Chinese investor uses an offshore company to acquire an affiliate in China, then the acquisition must be disclosed to and approved by MOFCOM.

In some circumstances offshore companies may be taxable as Chinese-resident companies (see Section 40 "Corporate taxes & incentives").

34. Buying equity in China

Buying an existing entity in China is an alternative to setting up a new FIE. However, existing entities can come with unknown liabilities.

Due diligence is key to determining whether a particular target is suitable for your purposes (see Section 31 "Due diligence").

Complying with foreign investment restrictions

Whether you are buying an existing FIE or buying an existing domestic enterprise, you will need to comply with China's foreign investment laws and regulations. In particular, you will only be able to buy a company operating in open sectors (see Section 4 "Open & prohibited sectors").

Buying a WFOE

The consent of more than half the investors in a WFOE is required by law for the transfer of equity. Most WFOEs, however, have only one investor so this requirement does not generally create any problems. The transfer agreement and amendments to the articles of association are subject to governmental approvals.

Buying an interest in a joint venture

The non-selling party(ies) to an EJV have a pre-emptive right to acquire the equity share of the seller. Their consent to any transfer is also required. The acquisition agreement and amendments to the articles of association are subject to governmental approvals. Additional requirements exist if the transferred equity is held by a state-owned Chinese party.

Buying an offshore holding company that holds the joint venture interest could avoid pre-emptive rights and the need for the formal consent of your joint venture partner(s) (see Section 32 "Offshore transactions"). However, you will still need the cooperation of your joint venture partner(s) to operate the business thereafter.

Buying a Chinese enterprise

Chinese entities may be acquired by way of an equity transfer or a capital increase. Governmental approvals for the acquisition and change of articles of association are required. The resulting entity will be an FIE.

The newly-established FIE will be responsible for the debts and liabilities of the domestic enterprise. A number of special procedures apply to the acquisition of SOEs. State-owned asset valuations may also be required.

Human resource issues will often be of particular importance during negotiations for the acquisition of a domestic enterprise (see Section 37 "Human resources").

The acquisition vehicle

If the WFOE or joint venture interest does not have a dedicated offshore holding company, it may be best to set up such a holding company to make the acquisition. Alternatively, you may require the seller to restructure prior to the acquisition. This may make a future disposal more straightforward (see Section 32 "Offshore transactions").

Corporate documentation

Any transfer of registered capital in an FIE requires amendments to the articles of association. At the very least, the identity of the new investor needs to be stated in the articles of association. It is also an opportunity for a new investor to conform the articles of association to its particular requirements. Joint venture contracts may also need renegotiation or amending (see Section 15 "Negotiations").

Approvals & registrations

Any transfer of registered capital in an FIE requires approval by the authority that originally approved the establishment of the FIE (see Section 17 "Approvals & registrations"). Transfers are also required to be registered with the relevant local AIC.

Timing of payment

A foreign-investor buyer of a domestic entity in China must pay in full for the equity within three months from the date of issuance of the new business license to the resulting FIE. With governmental approval, more than 60% of the total consideration may be paid within six months and the remainder payable in full within one year.

Share swaps

Foreign investors may issue qualifying shares in payment for equity in China. A number of criteria must be satisfied, including:

- the shares used for payment in China must be listed on an overseas stock exchange (except in respect of certain special purpose vehicles controlled by Chinese residents);
- the trading price of the shares must have been stable during the most recent year; and
- a financial adviser qualified in China must investigate and report on the overseas listed company.

35. Buying China-listed companies

China is slowly opening its stock exchanges to foreign investment.

Types of shares

Shanghai and Shenzhen stock exchanges have both A and B share markets. A shares can only be purchased by Chinese persons, qualified foreign institutional investors (QFII) and qualified strategic investors. B shares may be purchased by Chinese or foreign persons.

Acquisitions of state-owned shares and legal person shares are subject to MOFCOM approval and compliance with CSRC requirements. However, the conversion of state-owned and legal person shares into tradable shares that began in 2006 is likely to mean that very few (if any) such shares will remain.

QFII

QFIIs may trade A shares on the Shanghai and Shenzhen stock exchanges. CSRC approval is required to become a QFII. SAFE is responsible for allocating a foreign exchange quota.

To qualify, a foreign institutional investor is required to have at least US$10 billion assets under management (for securities companies and commercial banks) or US$5 billion assets under management (for fund management companies, insurance companies and other institutional investors). Other criteria include having sound corporate governance, risk monitoring systems and qualified personnel. The securities regulator of the investor's home jurisdiction must have entered a memorandum of understanding with the CSRC and must be cooperative with the CSRC.

Strategic share investors

From 30 January 2006 qualifying foreign investors (in addition to QFII) can invest in A shares. To qualify certain criteria must be met, including the investor having total non-China assets of at least US$100 million (or having at least US$500 million of non-China assets under management).

Strategic share acquisitions must generally be for at least 10% of the shares and are subject to MOFCOM approval. Acquisitions of 30% or more may trigger general offer obligations (see below). Any cumulative decrease of 5% or more in shareholdings held by foreign investors will require the listed company's approval certificate to be updated.

A shares held by a strategic investor cannot be traded within three years of their purchase (except with MOFCOM approval under special circumstances).

Takeovers

A company that acquires 30% of the shares of a listed company is required to make a general offer. Partial offers are also allowed in two circumstances: voluntary offers, and when the offeror acquires more than 30% through "on market" purchases. Partial offers must be for a minimum of 5% of the shares of the target. Shares must be acquired proportionately.

The CSRC may, upon certain grounds, exempt an investor from making a general offer.

An offer price may not be lower than the highest price paid by the offeror during the six-month period prior to the date of the offer announcement. If the offer price is lower than the mean of the daily weighted average price during the 30-day period prior to the offer announcement, the financial adviser must determine if the price is reasonable or if the price has been subject to manipulation or other irregularity.

A company that takes a controlling interest in a listed company is not permitted to engage in the same or similar business as the listed company. This restriction also applies to affiliates of the investing company.

The takeovers code emphasizes the advisory and monitoring functions of financial advisers qualified in China.

Chinese securities law does not provide for a “squeeze-out” of minority shareholders like in many Western countries. Privatisation of listed companies is very difficult given the large numbers of shareholders.

36. Buying assets in China

China assets acquired by foreign investors must generally be owned and operated by an FIE. Asset acquisitions, in contrast to equity acquisitions, generally give rise to fewer unknown liabilities. Asset deals, however, will not be appropriate in some circumstances, for instance, if the buyer wants to retain the operating licences of the target company.

Complying with foreign investment restrictions

Asset acquisitions are required to comply with China's foreign investment laws and regulations. In particular, foreign investors will not be able to buy assets if those assets can only be used in prohibited sectors (see Section 4 "Open & prohibited sectors").

FIE needed

Foreign companies (except in certain financial sectors such as banking) cannot generally operate business assets in China without setting up an FIE in China.

State-owned asset valuations

State-owned assets must generally be valued by a qualified institution, and that value will typically need to be filed with the SASAC (or its local branch). For certain significant assets, governmental approvals may also be required. Explanations will be required if the transaction price is less than 90% of the valuation.

It can be best to work with an internationally-recognised valuation company to moderate valuations before they are finalised, even though asset valuation institutions are required to use an internationally-accepted valuation method.

Approvals

Governmental approval will be required to set up an FIE to operate the assets post-acquisition (see Section 17 "Approvals & registrations"). Additional governmental approvals will be required if a transfer of assets to a foreign investor might cause the State to cease being a controlling shareholder in the transferring entity.

Closings

In some circumstances, it is not possible for payment for an asset and the transfer of title to take place simultaneously. A transfer of land use rights, for instance, is subject to registration and such registration may take days to complete. A seller, however, may well be reluctant to complete such registration before full payment is received. A buyer, on the other hand, may be reluctant to pay before being assured of title.

Escrow arrangements may be used, although many third parties would require full indemnification before agreeing to hold money in escrow.

37. Human resources

Unemployment is a sensitive issue for the Chinese government. As a result, employees of targets are given considerable influence during acquisition negotiations. The integration of workforces post-acquisition or merger should also be considered in the planning stages.

Settlement of excess staff

Applications for the acquisition of a domestic enterprise must be accompanied by an employee arrangement plan. Many SOEs are over-staffed and foreign investors will typically not want to take on all an SOE's employees. However, employment contracts may only be terminated upon certain grounds (see Section 25 "Chinese national employees"). Termination of contracts can also be subject to consultations with an employee congress or labour union. Obtaining consent for redundancies from an employee congress or labour union can be challenging.

Confidentiality & non-competes

Staff taken on from a target may be subject to confidentiality and non-compete obligations. These obligations should be considered carefully if the employees are being transferred to a different entity. A release should be sought if appropriate.

Integrating workforces

The speedy integration of workforces can contribute to a successful M&A outcome. Unified staff manuals and individual employment contracts prepared well in advance can be particularly helpful in the integration process. Care should be taken that staff manuals are compliant with legal requirements in China.

38. Competition law: merger control

The Anti-Monopoly Law (AML), effective 1 August 2008, introduced a merger-control regime that applies to both foreign-invested and Chinese-invested concentrations. A merger that must be notified cannot be completed prior to clearance or deemed clearance by MOFCOM.

The AML also includes various behavioural provisions (see Section 48 "Competition law: behavioural provisions").

In addition, transactions in China may also be subject to national M&A security reviews and national economic security reviews (see Section 39 "National security reviews").

Concentrations

Mergers, or in technical terms "concentrations of undertakings", must be reported to MOFCOM if certain thresholds are met. These thresholds are set out below.

The AML defines "concentration of undertakings" as any of the following:

(i) merger of undertakings;

(ii) acquisition by an undertaking of control over one or more other undertakings by acquiring their equity or assets; or

(iii) acquisition by an undertaking of control over one or more other undertakings, or of the ability to exercise a decisive influence over one or more other undertakings, by contract or otherwise.

"Undertaking" includes an individual, legal entity or other organisation that engages in the production of or trading in goods or the provision of services.

The establishment of a Greenfield joint venture is a concentration of undertakings for the purpose of merger control requirements.

However, undertakings need not notify in either of the following cases:

- If one undertaking involved in the concentration holds 50% or more of the voting shares or assets of every other undertaking involved in the concentration
- If an undertaking not involved in the concentration holds 50% or more of the voting shares or assets of every undertaking involved in the concentration

Filing thresholds

The general thresholds for merger control notification are:

- the aggregate global turnover of all undertakings participating in the concentration exceeded Rmb10 billion during the previous financial year, with at least two undertakings each having a turnover of Rmb400 million or more within China during the previous financial year; or
- the aggregate turnover within China of all undertakings participating in the concentration exceeded Rmb2 billion during the previous financial year, with at least two undertakings each having a turnover of Rmb400 million or more within China during the previous financial year.

MOFCOM may also review any other concentration that in its opinion has the effect or potential effect of eliminating or restricting competition.

Calculating turnover

The turnover of a single undertaking is defined broadly as the sum of the turnovers of all its affiliates. However, the turnover between or among affiliates is not double-counted. Moreover, in an acquisition, only the turnovers of the buyer, its affiliates and the target (and not that of the seller and its other affiliates) will be counted.

Separate regulations exist for the calculation of turnovers of financial institutions.

Pre-notification consultations

Undertakings that are in doubt about whether a filing is required can request a meeting with MOFCOM to discuss whether filing is necessary. Applications for such a meeting must be in writing and must include certain prescribed information.

Notification

The merger-control filing must be submitted by all undertakings in the case of a merger, or by the acquiring party, with assistance from the other undertakings, in other types of concentration. The documents required in a merger-control filing include:

- A notification report setting out prescribed information and such other information as may be requested
- A statement regarding the expected impact of the concentration in the relevant market (this statement must include certain information and an analysis regarding the concentration)
- The concentration agreement (including supplemental agreements and other related documents)
- Audited financial reports of each undertaking for the previous financial year
- Other documents that may be required by MOFCOM

These documents must be submitted in hard copy and in soft copy on optical disk. Chinese translations are required for original documents that are not in Chinese.

If the parties have confidential information, then they should submit two versions of the notification, one with the confidential information and one without. MOFCOM is required to maintain the confidentiality of confidential information.

Preparation of a merger-control filing may take some time, and should be commenced early.

A filing may only be withdrawn with the consent of MOFCOM.

Review phase 1 – 30 days

The initial review period is 30 days from acceptance by MOFCOM of a complete filing. MOFCOM may request additional materials, and seek opinions from relevant governmental authorities, trade associations, competitors, other undertakings, consumers, and individuals. Hearings may be convened.

Within the initial 30-day review period MOFCOM must decide whether to (i) proceed to review phase 2 for more in-depth investigations, or (ii) approve the concentration. If it fails to notify the parties within the 30-day period, then the concentration is deemed to have been cleared.

Review phase 2 – 120 to 180 days (cumulative)

If MOFCOM decides that an in-depth investigation is needed, and gives notice of this decision within the initial 30-day review period, then it automatically has another 90 days in which to investigate and decide whether or not to permit the concentration. The 90-day period may be extended by an additional 60 days in certain circumstances, including where the relevant conditions under which the concentration was agreed have materially changed.

MOFCOM is required to give written notice of its decision, together with reasons being given for any prohibition. Failure to make a decision within the 120-day period (30 days + 90 days) is deemed to be a clearance. If notice is given of a 60-day extension, then failure to make a decision within the 180-day period (30 days + 90 days + 60 days) is also deemed to be a clearance.

Review factors

Factors that may be considered during an in-depth examination include:

- The relevant market shares held by the undertakings participating in the concentration, and their degree of control over the relevant market
- The degree of concentration in the relevant market, as determined by the Herfindahl-Hirschman Index and/or the Industry Concentration Index
- The impact of the concentration on (i) market entry and technological advancement, (ii) consumers and other undertakings, (iii) China's national economic development, (iv) public interests and economic efficiency

MOFCOM will first review whether a concentration creates or strengthens an undertaking's ability, incentive and likelihood to eliminate or restrict competition. If the undertakings participating in the concentration are not actual or potential competitors in the same relevant market, MOFCOM will focus on whether the concentration is likely to exclude or restrict competition in the upstream, downstream or affiliated markets.

Restrictive conditions

During the examination process, the undertakings may propose restrictive conditions that eliminate or mitigate any anti-competitive effect of the concentration. Restrictive conditions may include:

- structural conditions (eg, divestitures of assets or businesses)
- behavioural conditions (eg, opening up networks, platform or other facilities, or licensing technology or intellectual property)
- combinations of structural and behavioural conditions

Published decisions

Decisions to grant conditional approvals must be published. MOFCOM will supervise subsequent compliance with the restrictive conditions.

Decisions to prohibit a concentration must also be published.

Flowchart of notification and review processes

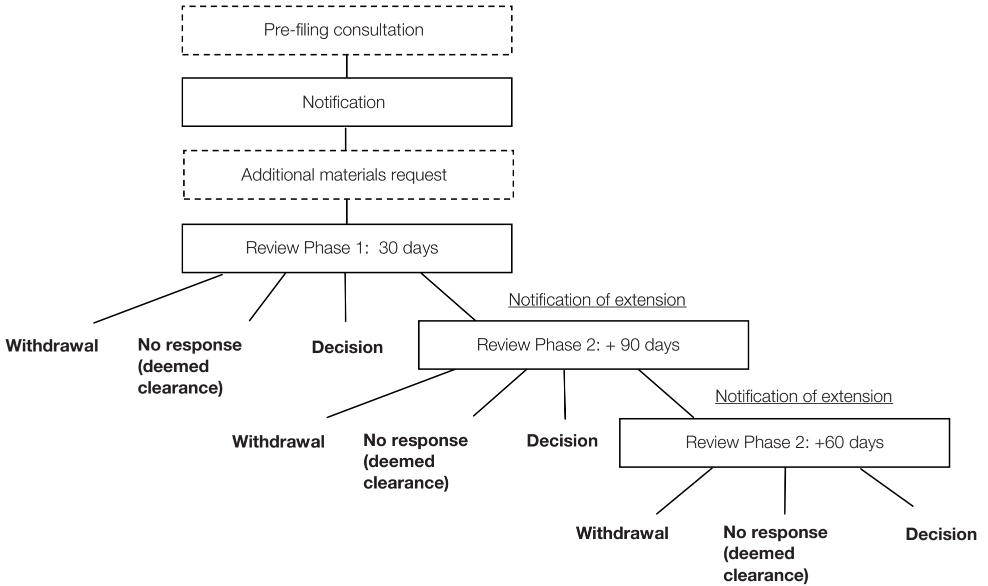

Figure 2 – Flowchart of notification and review processes

Investigations

MOFCOM must start an investigation once it has preliminary evidence that an undertaking has failed to declare a concentration. MOFCOM may obtain such preliminary evidence by its own initiative or from third parties. The involved undertakings must be notified upon commencement of an investigation.

Upon receiving notice, the undertakings under investigation have 30 days within which to submit relevant materials to MOFCOM. MOFCOM then has 60 days to give notice to the undertakings in writing as to whether MOFCOM will: (i) proceed to a more in-depth investigation; or (ii) withdraw the investigation. If MOFCOM decides to proceed with a further investigation, the undertakings must stop implementing the concentration.

If MOFCOM decides to conduct a further investigation, then the undertaking(s) have an additional 30 days to submit relevant documents and materials. MOFCOM must then complete the investigation within 180 days from the receipt of the documents.

Penalties

If a concentration is completed before clearance or deemed clearance, then depending on the circumstances of the transaction MOFCOM may:

- impose a fine of up to Rmb500,000 (approx. US$73,500) on the parties; and
- order the transaction to be unwound.

39. National security reviews

In addition to merger control requirements (see Section 38 "Competition law: merger control"), a transaction may also be subject to a national security review if the Chinese government considers that the concentration involves state security.

Chinese law also provides for "national economic security reviews" (see below); however, in practice, it is unlikely that a national economic security review process will be separately conducted.

National M&A security reviews

- Scope of transactions. M&A security reviews are required for foreign-invested acquisitions of military enterprises and foreign-invested acquisitions that result in the foreign investor(s) gaining "control" over "key domestic enterprises". Both equity and asset deals are covered. Acquisitions of foreign-invested enterprises are also covered.

  Military enterprises are those that are:

  - owned by or support the military
  - involved in national defence
  - located near key and sensitive military facilities

  Key domestic enterprises include those in the following industries:

  - agriculture
  - energy and resources
  - infrastructure
  - transportation
  - technology
  - major equipment manufacturing

  The Notice does not specify criteria for determining whether a particular enterprise is "key".

  Foreign investors will be considered to have control over a domestic enterprise if (i) one or more foreign investors hold an aggregate equity stake of 50% or more, (ii) a foreign investor has sufficient voting rights to have a major impact on shareholder or board decisions, or (iii) a foreign investor has the ability to exert actual control in any other way.

- Structuring. Foreign investors may not circumvent M&A security reviews via indirect investments or other approaches such as nominee holdings, trusts, multiple levels of re-investment, leases, loans, agreements granting control, or off-shore transactions.
- Notifications. Foreign investors engaging in M&A deals within the above scope of transactions must give notice to MOFCOM. MOFCOM will then decide whether to initiate an M&A security review.

  Foreign investors should consider discussing each transaction with MOFCOM to determine whether an M&A security-review notification is actually required in the circumstances.

The materials required in a notification include:

- an application, and a description of the M&A deal
- foreign investor's incorporation certificates
- statements setting out the status of both the foreign investor and the target
- proposed articles of association of the resulting FIE, and related documentation
- any equity transfer agreement, capital subscription agreement or asset transfer agreement, and related documentation

other documents that may be required by MOFCOM

Local approval authorities may refuse to approve transactions that should have been, but were not, notified for an M&A security review.

- Ministerial Panel. An inter-ministerial panel will be established to conduct M&A security reviews and issue decisions. The Ministerial Panel will be run principally by the NDRC and MOFCOM, with the State Council providing overall leadership.
- Review factors. Factors to be considered by the Ministerial Panel during an M&A security review include the impact of the M&A transaction on:
  - national security, including manufacturing and service capacity in the defence sector
  - stability of the state economy
  - social order
  - R&D capacity for key technologies relating to national security
- Timing and process. The main steps and the timing of each are outlined in Figure 3 below.

  Although the foreign investor may terminate or modify the transaction during an M&A security review hearing, the Notice does not grant any right to be heard by, or to present additional materials to, the Ministerial Panel.
- Decisions. If the Ministerial Panel concludes that an M&A transaction has exerted, or is likely to exert, a major impact on national security, then it is required to order MOFCOM (and other relevant departments) to either terminate or appropriately modify the transaction. Unlike merger control decisions, there is no obligation for the Ministerial Panel to publish conditional approvals or prohibitions.

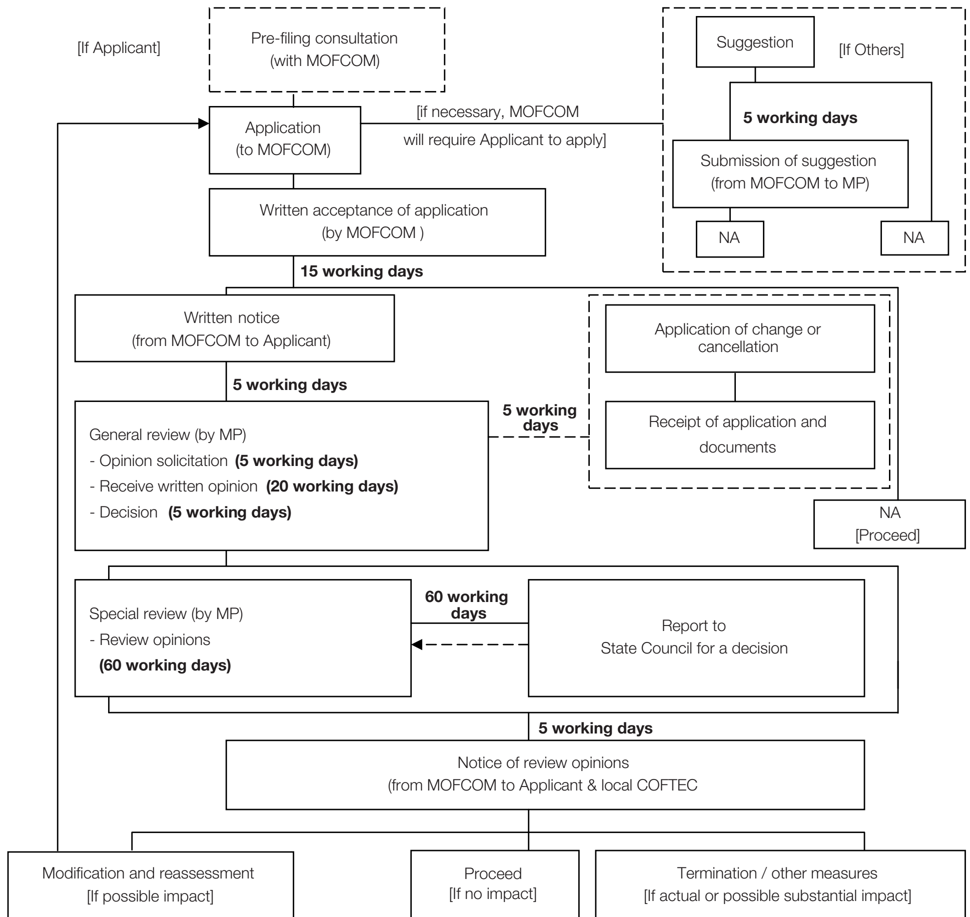

Figure 3 – National M&A Security Reviews

National economic security reviews

In addition to competition law reporting requirements (see Section 38 "Competition law: merger control") and national M&A security reviews (see above), Chinese law also provides separately for national economic securities reviews if a transaction results in a change of control of a domestic company and:

- the transaction involves a "key" industry;
- the transaction has or may have an impact on national economic security; or
- the domestic company owns a well-known trademark or a "time-honoured Chinese brand".

To the extent of overlap between national M&A security reviews and national economic security reviews, it is likely that only a national M&A security review will be conducted.

- Time-honoured brands – MOFCOM recognises various traditional brands as being “time-honoured”. From time to time, MOFCOM publishes lists of time-honoured brands.
- Key industries – The NDRC has named seven industries it considers key to national security and national economic stability. The seven industries are: armaments; power generation and distribution; oil and petrochemicals; telecommunications; coal; aviation; and shipping. While these seven industries were not identified by the NDRC in the context of special MOFCOM reviews, the importance attached to these industries suggests that a special MOFCOM review may be required for any foreign acquisition involving these industries. Other industries may also be considered to be key industries.

Although a review mechanism is not spelled out, MOFCOM may use its general powers to block or modify a transaction. Foreign investors tempted to overlook reporting, should note that MOFCOM may terminate a transaction that is not reported and which it considers has a major impact on national economic security.

40. Corporate taxes & incentives

FIEs established after 16 March 2007 are no longer entitled to FIE tax preferences. FIE tax incentives enjoyed by FIEs that were established on or before 16 March 2007 are being phased out. Various other incentives for both FIEs and domestic companies are now available.

We recommend you seek expert tax advice in the early stages of your investment planning. Tax advisors can also assist in structuring offshore holding arrangements so that tax on dividends flows are minimised.

Unified tax law

The Enterprise Income Tax Law (EIT Law), effective 1 January 2008, provides a unified tax regime for FIEs and domestic companies. In doing so, it aims to promote fair competition and apply international practices to China's taxation regime. The law also reinforces China's policy shift away from low-technology manufacturing toward high-technology and environmentally friendly projects.

The law does not apply to either sole proprietors or partnerships.

Tax preferences phased out

FIEs in China enjoyed preferential tax treatment from when China began to open its economy to foreign investment. Now FIE income tax preferences are no longer available and those previously in place are being phased out over a five-year transitional period that started 1 January 2008.

The phasing-out period applies to FIEs which are in two different situations:

- FIEs previously enjoying income tax rates of 15% or 24% – those previously taxed at 15% will be subject to rates of 18%, 20%, 22%, 24% and 25% from 2008 through 2012 respectively; those previously taxed at 24% will be taxed at 25% from 1 January 2008
- FIEs enjoying tax holidays – these FIEs may continue to enjoy the remaining tax holiday; however, if the tax holiday has not started due to the absence of profits, it will be deemed to have started in 2008

If the new unified preferential policies (see below) are more favourable to an enterprise than the phasing-out rules, then it may elect to be subject to the new policy; such election cannot be changed.

Unified tax rate

The standard tax rate for both FIEs and domestic companies is 25%; prior to 2008 the rate was 33% (a rate that included a 3% local tax).

Foreign companies and individuals without a permanent establishment in China will be subject to withholding tax at the rate of 10% for income arising within China, unless a double tax treaty states a lower rate (see below).

The tax year for the purpose of enterprise income tax is 1 January to 31 December.

Unifying tax preferences

The EIT Law sets out various new preferences that will be available to both FIEs and domestic companies. These preferences include:

- Small low-profit enterprises (those with annual taxable incomes of less than Rmb30,000) taxed at 20%;
- Key high-tech companies taxed at 15%; an applicant for this special rate will be assessed against a range of criteria, including its industry, whether it owns the intellectual property for its core technology, and the extent of its R&D activities; high-tech status is awarded for three years at a time
- Certain tax reductions or exemptions for agriculture and forestry projects, as well as environmental protection and infrastructure projects which meet specific requirements
- Certain tax offsets for venture capital enterprises which invest in key and encouraged industries (small- and medium-sized high-technology enterprises in particular)
- Continued tax preferences for other encouraged enterprises (such as encouraged enterprises set up in Central and Western China)

Notably absent from the list of tax preferences are income tax reductions for manufacturing and export-oriented FIEs. These preferences were a driver of foreign investment for many years.

Local authorities have some discretion to offer additional tax incentives. Care should be taken, however, if local authorities offer tax incentives that exceed national regulations. Such tax incentives may be revoked at any time by order of the national government.

Dividend withholding tax

Dividends paid by FIEs to their foreign investors were exempt from tax from July 1991 through December 2007. From 1 January 2008, FIE dividends are taxed at a rate of 10%.

However, dividends paid to foreign investors in the following three jurisdictions may be taxed at a rate of 5% (subject to the conditions noted):

- Mauritius – If the beneficial owner of the dividends is resident in Mauritius.
- Hong Kong – If the beneficial owner of the dividends is a resident in Hong Kong and directly owns at least 25% of the capital of the company paying the dividends.
- Singapore – If the beneficial owner of the dividends is a resident in Singapore and directly owns at least 25% of the capital of the company paying the dividends.

However, an investor will not be considered a beneficial owner if it is set up with a primary purpose of taking advantage of these lower rates under the relevant tax treaties.

Chinese-controlled offshore companies

Offshore companies may be regarded as Chinese tax residents and therefore subject to enterprise income tax on worldwide income if:

- senior management responsible for day-to-day operations are mainly located in China;
- strategic financial and HR decisions are made or subject to approval by organizations or personnel in China;
- major assets, accounting records, company stamps, and board/shareholder's meeting minutes are maintained in China; and
- 50% or more of board members with voting powers or senior management habitually reside in China.

These rules are likely to have their biggest effect on Chinese "round-trip" investments. However, these rules may also have negative consequences for foreign investors that have partnered offshore with a Chinese investor (see Section 33 "Taking your Chinese partner offshore").

Capital gains tax on equity transfers

The sale of equity in China is subject to capital gains tax on the difference between the sale price of the equity and the cost of the transferred equity. Historically, many investors set up a special-purpose offshore holding company to invest in an FIE. One benefit of this was that the offshore holding company could be sold without giving rise to a capital gains tax assessment in China. However, in December 2009, the Chinese government introduced regulations that enable sales of certain offshore holding companies to be assessed for capital gains tax in China. The effectiveness of the regulations was backdated to 1 January 2008.

The sale of an offshore holding company that invests in an FIE may now be subject to capital gains tax in China if:

(i) the offshore holding company is subject to an income tax rate of lower than 12.5% in its country or region of establishment; or

(ii) it is not subject to income tax on its overseas income.

In either case, the offshore holding company must submit a range of materials to the Chinese tax bureau in charge of the invested FIE within 30 days of signing the equity transfer agreement.

If the tax bureau considers that the offshore holding company does not have a reasonable business purpose but is rather misusing the corporate form to avoid tax in China, then the tax bureau may (subject to confirmation from the State Administration of Taxation) disregard the existence of the offshore holding company and assess the seller of the equity for capital gains tax in China.

Tax deferrals for M&A activity

Tax may be differed for corporate restructuring deals (including M&A deals) that meet certain criteria. In particular, companies may elect to enjoy special tax treatment (mainly tax deferrals) if:

- the restructuring has a reasonable commercial purpose;
- the assets or equity transferred reach certain prescribed ratios (75% of the target for equity or asset acquisitions; there are no prescribed ratios for mergers and spin-offs);
- the original business activities of the target company do not change within 12 months after restructuring;
- at least 85% of the total deal consideration is paid in equity of the buyer (tax deferrals are only available for the portion of the consideration paid in equity); and
- the sellers do not transfer the equity which they receive as consideration within 12 months after the restructuring.

A company involved in a cross-border corporate restructuring may also elect to enjoy special tax treatment if:

- the restructuring meets the five criteria listed above; and
- the restructuring is one of several specified types of restructuring in which the company transfers assets or equity to its 100% owned subsidiary.

In particular, if a PRC resident company transfers assets or equity interests to its 100% owned overseas subsidiary, income tax associated with the transfer may be paid over 10 years in equal instalments. This is intended to encourage Chinese outbound investment.

Transfer pricing

Chinese tax bureaux may adjust the taxable income of an enterprise that conducts transactions with its affiliates at prices other than those determined on an arm's length basis.

Other taxes

Other taxes include:

- Withholding tax – A withholding tax of 10% is imposed on China-sourced income derived by foreign corporations without permanent establishments in China. The rate of 10% may be reduced if one of China's double tax treaties provides for a reduction (see above).
- Value-added tax – Sales of goods (and certain services) within China are generally subject to VAT at rates of either 13% or 17%. Goods may also be subject to VAT upon importation.
- Business tax – Business tax is levied at rates of between 3% and 5% for certain services, including insurance, construction and the assignment of various IP rights. Entertainment services are taxed at a rate of between 5% and 20%.
- Consumption tax – Certain goods, including luxury and certain "unhealthy" goods, are subject to consumption tax at rates ranging from 1% to 45%.
- Urban maintenance and construction tax – From December 2010, FIEs have been required to pay the urban maintenance and construction tax as a surcharge on their value-added tax, consumption tax and business tax.
- Education surcharge – From December 2010, FIEs have been required to pay the education surcharge on their value-added tax, consumption tax and business tax.
- Customs duties – Customs duties are levied on imported goods and materials. The applicable rates vary significantly. "Encouraged" FIEs (see Section 4 "Open & prohibited sectors") may apply for certain exemptions when importing equipment for their own use.
- Motor vehicle acquisition tax – Purchases of various types of motor vehicles (including cars, motorcycles and certain trucks) are taxed at 10%.
- Deed tax – Transfers, gifts and exchanges of land use rights and buildings are taxed at rates of between 3% and 5%.
- Land use tax – Local governments may impose a land use tax at a rate determined by the local government (within guidelines set by the State Council).
- Land appreciation tax – Upon disposal of real estate, the seller will generally be subject to land appreciation tax at progressive rates of between 30% and 60%.

41. Individual income tax

Chinese nationals and foreign nationals are subject to individual income tax on income sourced from within China. Chinese nationals and certain foreign nationals are also subject to individual income tax on their worldwide income. Individual income rates in China are progressive.

Implementation of the individual income tax rules can vary between different localities. Expert tax advice is recommended.

The tax year for the purpose of individual income tax is 1 January to 31 December.

Liability to tax

Chinese nationals domiciled in China are subject to individual income tax on their worldwide income.

Foreign nationals may also be subject to tax in China on their worldwide income if, by reason of their family or economic interests, they habitually reside in China. Liability to tax for foreign nationals that are not "domiciled" in China is determined by reference to the duration of their "residence" in China.

A foreign national will be "resident" in China during a tax year if they are in China for 365 days of that tax year. A foreign national will not be resident in any year in which they spent 30 or more consecutive days outside China or 90 or more cumulative days outside China. Trips out of China for shorter lengths of time are still counted as time in China.

The duration of a foreign national's residence in China will determine their liability to tax as follows:

- Less than 90/183 days – Foreign nationals in China for less than 90 days in one tax year are not subject to tax on income paid by an employer outside China, provided that the costs of the foreign national are not charged back to an entity or office in China. The 90-day period is increased to 183 days under many of China's double tax treaties.

  Chief representatives of representative offices may not take advantage of the 90/183 days tax exempt period as the expense of their salary is deemed to be borne by the representative office. Accordingly, they are subject to individual income tax for each day they spend in China, commencing from the first day.

- More than 90/183 days and less than one year – Foreign nationals resident in China for 90 days or more in any tax year are subject to individual income tax on income derived from sources within China. The 90-day period is increased to 183 days under many of China's double tax treaties.

  Income from personal services provided in China is deemed as China-sourced income irrespective of where the income is paid and irrespective of where the expense is borne.

- More than one year and less than five years – Foreign nationals resident in China for more than one year and less than five years are subject to tax on their worldwide income. However, a foreign national who is not "domiciled" in China will, subject to the approval of the tax authority, only need to pay tax on China-sourced income.

  It is common practice for foreign nationals in their fifth year of residence to be outside China for 30 or more consecutive days (or 90 or more days cumulatively) to ensure that they do not become taxable on their worldwide income.

- More than five years – Foreign nationals resident in China for more than five years are, from the sixth year, subject to tax on their worldwide income. Credits may be claimed for any taxes paid overseas. Foreign nationals are not subject to tax on their worldwide income for any year in which they are not resident.

Tax rates & monthly taxable income

Individual income tax rates are progressive, ranging from 3% to 45% as set out below.

Monthly taxable income	Tax rate
Up to Rmb1,500	3%
More than Rmb1,500 and up to Rmb4,500	10%
More than Rmb4,500 and up to Rmb9,000	20%
More than Rmb9,000 and up to Rmb35,000	25%
More than Rmb35,000 and up to Rmb55,000	30%
More than Rmb55,000 and up to Rmb80,000	35%
More than Rmb80,000	45%

An amount of Rmb3,500 is deducted from the salary or wages of a Chinese national to arrive at the monthly taxable income. The deduction for foreign nationals is Rmb4,800.

In addition to the monthly deduction of Rmb4,800, the following benefits are not taxable when received by a foreign national:

- Allowances for housing (subject to some restrictions), meals, laundry and relocation expenses, provided that the allowances are in a non-cash form or on a reimbursement basis
- Reasonable allowances for business trips in China and abroad
- Allowances for visiting family, language training or children's education in China, provided that costs are considered reasonable by the relevant tax bureau

Withholding obligations

Employers are subject to withholding tax obligations in respect of salary and wages paid to their employees. The tax withheld must be paid to the relevant local tax bureau within fifteen days of the end of each month.

If a foreign national is paid offshore, then the entity or office in China at which the foreign national is based is the relevant withholding agent.

Annual tax returns

An annual tax return must be submitted to the relevant local tax bureau if the taxpayer:

- has an annual income of Rmb120,000 or more;
- derives and is taxable on income from non-China sources;
- derives salary and wages income from two or more sources in China; or
- does not have a withholding agent.

Taxpayers earning more than Rmb120,000 must submit their annual return within three months of the end of each tax year. Taxpayers deriving taxable income from non-China sources must file a tax return within 30 days of the end of each tax year.

42. Foreign exchange & cash traps

China's currency, the renminbi (Rmb), is not fully convertible. While current account items may be converted with relative ease, China maintains stringent controls on payments of capital.

Foreign currency may only be converted by a designated foreign exchange bank.

Current account items

Designated foreign exchange banks are authorised to convert Rmb into foreign exchange for the payment of current account items. SAFE approval, however, may still be needed for payments exceeding US$100,000. Current account receipts and payments must have a genuine and lawful basis.

Current account items include:

- Interest payments on foreign exchange loans
- Insurance premiums payable in foreign exchange
- Construction expenses payable in foreign exchange
- Other income and expenditure items

Capital account items

The conversion of foreign exchange for capital account items is subject to SAFE approval.

FIEs converting foreign currency into Rmb may only use the Rmb for purposes within the FIE's business scope. Except for real estate FIEs, this means that real estate may only be purchased for an FIE's own use. Moreover, Rmb converted from registered capital contributed in foreign currency cannot, without specific approval, be used for making equity investments.

Capital account items include:

- Foreign exchange loans and repayments of principal of foreign exchange loans
- Registered capital paid in foreign exchange
- Pre-establishment expenses of an FIE remitted into China by the foreign investor

Foreign currency accounts

An FIE may, subject to SAFE approval, open a foreign exchange account with a designated foreign exchange bank. Usually, the account must be opened within the same area in which the FIE is registered. Approval is required to open an account in another area.

Prior to August 2007, foreign exchange account balances were subject to a quota system that required any balance beyond the quota to be converted into Rmb. Foreign exchange account quotas were abolished in August 2007.

An FIE may purchase foreign exchange if it has insufficient funds in its foreign exchange account to meet a foreign exchange obligation.

Foreign currency accounts of FIEs are subject to annual inspections by SAFE.

Foreign investors without an FIE in China may open a multicurrency account with a bank to fund the pre-establishment expenses of an FIE. The quota for such an account is US$100,000 or 5% of the proposed total investment. The account is valid for six months. A foreign investor may also open a multicurrency account for certain other purposes.

Maintaining foreign exchange

In addition to purchases of foreign exchange, foreign exchange may be maintained by:

- The promotion of export sales and procurement of supplies within China
- Rmb loans secured by foreign exchange

For both current account and capital account, Chinese organizations or individuals may also maintain foreign exchange income offshore.

Pricing in foreign currency?

Goods and services for sale between individuals or enterprises in China may not be priced in foreign currency. Moreover, foreign currency may not circulate as legal tender in China.

Foreign companies selling into China may price goods in foreign currency, as may Chinese enterprises selling goods for exportation.

China's exchange rate

The Rmb exchange rate was partially floated on 21 July 2005, and it rose significantly in value. On 16 April 2012, the daily floating range against the US dollar was expanded from 0.5% to 1%.

Trapped cash

Foreign investors often find that cash is trapped in China when it could be used more profitably elsewhere. Careful planning can minimise the amount of cash that is trapped.

Trapped cash is the result of a number of factors:

- Registered capital requirements – FIEs are subject to a fixed ratio between registered capital and total investment. The result is that FIEs are typically set up with more registered capital (equity)—that must be paid in within two years—than they would be in many other jurisdictions. Care must be taken in setting registered capital at the optimal amount. See Section 18 "Equity funding" for additional information.
- Reserve funds – FIEs must pay money into a reserve fund that may only be used for certain purposes. Payments to the reserve fund may only stop once the amount of the fund has reached 50% of the amount of the FIE's registered capital. See Section 20 "Remitting profits" for additional information.
- Limited ability to reduce capital – Registered capital reductions are subject to approvals and are only permitted in certain circumstances. See Section 18 "Equity funding" for additional information.
- Limited Rmb convertibility – As set above, the conversion of Rmb into foreign exchange for capital account items is subject to SAFE approval.

The use of shareholder loans helps to minimise cash traps.

43. Security

Taking security in China can be challenging. Only certain types of security are recognised and multiple registration and approval requirements can exist for the same transaction.

Available security

The Security Law recognises five basic types of security:

- Guarantees – A guarantee under Chinese law is an act whereby a guarantor and a creditor agree that the guarantor will perform the obligation of a debtor should the debtor fail to do so. A guarantee contract must be in writing, and may take various forms, including letters of guarantee, standby letters of credit and bills of exchange.

  Guarantees under Chinese law may either impose a primary or secondary obligation on the guarantor. If the guarantee is unclear or silent as to the secondary nature of the guarantee, the guarantor and the debtor will be deemed to have joint and several liability and a creditor may bring an action against the guarantor before exhausting options against the debtor.

- Mortgages – A mortgage under Chinese law is a type of security whereby a debtor or a third party uses property as security for an obligation without the transfer of possession or title of such property. Mortgages over certain property, including land use rights and buildings, are effective only upon the date of registration with the relevant governmental authority. Mortgages over certain other types of property, including manufacturing equipment, aircraft, vessels and motor vehicles, are effective between the parties when the mortgage contract comes into effect. However, these mortgages must be registered with the competent registration authority before the mortgagee can take priority over a bona fide third party. Floating charges over raw materials, product inventory and future equipment are also possible.

  Mortgaged property must be sold or auctioned in the event of default; the parties may not agree for a mortgagee to keep the property.

- Pledges – A pledge, under Chinese law, is categorised as either a pledge over movable property (which involves the transfer of possession of movable property as security) or a pledge over rights. Either way, the main distinction with a mortgage is that possession of the pledged property changes hands.

  A pledge over rights may be created over: bills of exchange, cheques, promissory notes, bonds, certificates of deposits, warehouse receipts, and bills of lading; unit trusts and FIE equity interests; trademarks, patents, and copyrights that are transferable according to law; and receivables.

  As with mortgages, pledged property must be sold or auctioned in the event of default; the parties may not agree for a pledgee to keep the property.

- Liens – A lien may be created over movable property of a debtor lawfully held by a creditor under a contract of custody, transportation or processing. Property subject to a lien may be sold or auctioned if the debtor does not perform its obligation within a certain time. Liens may not be given as security in favour of foreign parties.
- Deposits – A deposit of up to 20% of the value of an obligation may be given as security for the performance of an obligation. A debtor will forfeit the deposit if they do not perform the obligation as agreed. The party holding the deposit, on the other hand, must refund twice the amount of the deposit if they do not perform their obligation as agreed. Deposit agreements must be in writing. Deposits may not be given as security in favour of foreign parties.

Permitted foreign security

The giving of security to a foreign party introduces an additional layer of registrations, and may also require governmental approvals.

Foreign security refers to security given by an institution in China in favour of an entity outside of China. Foreign security may be created to secure an FIE's (or a domestic enterprise's) own debts, but the possibility of providing foreign security for a third party (such as the investor in an FIE) is severely limited.

The amount of indebtedness that may be secured by security providers which are non-financial institutions is limited to the lowest of:

- the appraised value of the security;
- 50% of the net assets value of the security provider (to be shown by audited financial statements); and
- the security provider's foreign exchange earnings for the previous year (an amount that needs to be certified by SAFE).

Approvals & registrations for foreign security

In addition to any required registrations for domestic security, foreign security must also be registered with SAFE to be valid. If the security provider of mortgages or pledges to a foreign party is different to the secured party, approval by SAFE is also required.

Mortgages may only be registered with the relevant domestic authority after being approved and/or registered with SAFE. SAFE approvals for other types of security must also generally take place prior to any asset-specific registrations in China.

Various other registrations and/or approvals may also be required depending on the type of security being offered to the foreign party.

A contract creating security in favour of a foreign entity is void if it is not duly registered or approved. Accordingly, any party taking security in China must be diligent in ensuring that the security is duly registered and, if required, approved.

In cases where SAFE approval is required, foreign security should be granted promptly following issuance of any SAFE approval. Although this will usually be the case, it should be noted that SAFE approvals automatically become void if the security provider does not issue the security to the foreign secured party within six months of the corresponding SAFE approval.

44. Insolvency

China's current insolvency regime commenced on 1 June 2007. The previous regime comprised many different laws and regulations applicable to different types of enterprises. The new regime, the drafting of which began in the early to mid-1990s, simplifies insolvency law in many respects. Insolvency, however, remains a sensitive issue in a country that has many technically insolvent SOEs and financial institutions.

Insolvency test & commencement

A company will be legally insolvent if it is unable to pay debts as they fall due ("cash flow test") and:

- it has insufficient assets to pay off all its debts ("balance sheet test"); or
- it obviously lacks the capability to pay off all its debts.

Either a debtor or a creditor may apply to the court for reorganization or liquidation of the debtor. A debtor may also apply to the court for conciliation.

The court will appoint an administrator upon acceptance of an insolvency application. An administrator may be an individual or a professional service organization.

The court will also notify known creditors and issue a public announcement upon acceptance of an insolvency petition.

Creditors

Creditors must file their claims with the insolvency administrator within the time set by the court. The time for filing creditors' claims may not be shorter than 30 days or longer than three months. Employees and certain other creditors need not file claims.

Creditors who have filed claims have the right to attend and vote at creditors' meetings. Creditors' meetings have a broad range of powers, including verifying claims, supervising the administrator, deciding to terminate or continue the debtor's business operations, adopting reorganisation or conciliation plans, and adopting the property distribution plan.

Labour union representatives may attend creditors' meetings and express their opinions.

Resolutions of a creditors' meeting are binding on all creditors, although resolutions may be challenged in court.

A creditors' meeting may establish a creditors' committee to assist with, among other things, the liquidation and distribution of property. The membership of a creditors' committee must be endorsed in writing by the court.

Voidable transactions

Certain acts of a debtor are voidable if they take place within the one-year period prior to the courts acceptance of an insolvency petition. These acts are:

- Gratuitous transfers of property
- Sale of property at an obviously unreasonable price
- Provision of security for previously unsecured debt
- Repayment of debts before maturity
- Surrender of claims as a creditor

Payments to creditors are void if made at any time following the acceptance of a bankruptcy application by the court.

Distribution priorities

Property will be distributed in the following priority:

- Secured debts–which in some instances may be subject to employee claims (see below)
- Bankruptcy expenses
- Debts incurred for the creditor's benefit after the court's acceptance of the insolvency application
- Outstanding employee wages and compensation
- Social security premiums and outstanding tax liabilities
- Unsecured claims

Distributions must be in monetary form, unless agreed otherwise by a creditors' meeting.

Secured creditors & employee claims

Secured creditors have priority to proceeds from the security property. However, if the property distributed to unsecured creditors is insufficient to pay outstanding employee wages and compensation that accrued before 27 August 2006, then such employee claims will take priority over the secured creditors. Local courts have been directed to support employee claims in such instances.

Reorganisation

A creditor or debtor may apply to the court for reorganisation. Alternatively, upon acceptance of an insolvency petition, the debtor or more than 10% of the shareholders may apply for reorganisation. If the relevant criteria are satisfied, the court must accept an application for reorganisation.

Reorganisation is similar to the process informally known as "Chapter 11" in the USA, "administration" in England, "provisional liquidation" in Hong Kong and "rehabilitation" in certain other jurisdictions. That is, reorganisation gives companies a limited period of protection from creditors in order to allow an enterprise to reorganise (under the supervision of an administrator) and continue operations, rather than being wound up.

A reorganisation plan must be submitted to the court and the creditors' meeting within six months if the court orders a reorganisation, though the court may extend the period by an additional three months.

The reorganisation plan is subject to the approval of various classes of creditors, though the court may still approve a reorganisation plan that is not approved by all creditor classes. Once approved by the court, the reorganisation plan is binding on the debtor and all creditors.

Conciliation

A debtor may directly apply to the court for conciliation in the absence of an insolvency petition. Alternatively, a debtor may apply to the court for conciliation after the court accepts an insolvency petition but before a declaration of bankruptcy.

Conciliation plans are prepared by the debtor and subject to approval at a creditors' meeting. A creditors' resolution to adopt a conciliation plan must be agreed to by a simple majority representing more than two-thirds the value of the unsecured claims.

A conciliation plan that has been approved by the court is binding on the debtor and all creditors.

45. Real estate

China's real estate laws and regulations are complex. This is, in part, because the modern legal system governing land is less than 20 years old and because significant variation exists at the local level. The basics, however, are relatively straightforward.

Allocated & granted land use rights

Land in China is either State-owned or owned by collectives. Neither domestic companies nor FIEs can own land, although they may hold land use rights. Two types of State-owned land use rights exist:

- Allocated land use rights – Allocated land use rights are allocated to SOEs, the army, public schools and similar enterprises and units. Generally, allocated land use rights cannot be transferred or leased without first being converted into granted land use rights (for which a grant fee must generally be paid to the government). The government may reclaim allocated land use rights at any time without compensation.
- Granted land use rights – Granted land use rights are the right to use land for a specific purpose for a fixed term. A grant fee must be paid to the government for granted land use rights. Granted land use rights are transferable and may be leased.

Collectively-owned land can only be used for industrial purposes in very limited circumstances.

Term of granted land use rights

Granted land use rights are granted for different terms based on the usage of the land. The terms are:

Land usage	Term
Residential	70 years
Industrial	50 years
Educational, scientific and technological, cultural, public health and sports	
Combined or other purposes	
Commercial, tourism and entertainment	40 years

Land use rights & buildings

The general rule is that buildings on land should be owned by the same person that holds the corresponding land use rights. Nevertheless, land use rights and buildings on the corresponding land are sometimes owned by different persons. Due diligence will assist in the discovery of any such situation (see Section 31 "Due diligence").

Land use rights transfers

Only granted land use rights may be transferred. You will not obtain title to allocated land, even if someone purports to sell it to you, unless it is first converted to granted land use rights (for which a grant fee must first be paid to the government).

Vacant land is required to be at least 25% developed before the corresponding land use rights can be transferred. The government may reclaim vacant land if development is not started within two years of transfer.

Renewal of land use rights

From 1 October 2007, the term of residential land use rights will be automatically renewed upon expiry. This is a welcome relief to those owning residential properties in China. It will also ensure that financing remains available for residential property approaching expiration of its land use right term.

Non-residential land use right terms are not granted automatic renewal under the Property Law. Rather, renewal will be subject to other laws and regulations.

Easements

The creation of easements has been recognised under Chinese law since 1 October 2007. The ability to create easements recognised by law is likely to be of particular importance for infrastructure projects that involve the construction of pipelines or other networks requiring access to land over which the project owner does not hold the land use rights.

Leasing

Land must generally have been developed before it can be leased. A lessee is required to comply with the terms and conditions of the land use rights grant contract.

Leases are required to be registered.

Expropriations

Land may be expropriated by the government only in special circumstances and in the public interest. Compensation is required to be paid if land is expropriated. The compensation is required to include compensation equal to the value of the expropriated buildings, the costs of relocation and temporary residence, and the loss arising from cessation of production or business.

46. Environmental issues

China's central government has increasingly focused on environmental issues in recent years. China's 12th five-year (2011 to 2015) plan also emphasises environmental protection.

Foreign investment in energy-saving and environmentally friendly industries is expected to continue receiving greater priority.

Environmental impact assessments

Construction projects (including expansions and existing facility refurbishments) cannot commence without first filing or getting approval for an environmental impact assessment. China's environmental authority has indicated that it is willing to approve (or reject) projects on specific environmental grounds.

Projects without a duly filed or approved environmental impact assessment may be shut down. Penalties and administrative sanctions may also be imposed.

Permits

Permits are generally required to discharge pollutants.

Cleaning up

China's laws generally attribute liability for cleaning up environmental contamination to the person who caused the contamination. The Tort Law, effective 1 July 2010, puts the burden of proof on a polluter to demonstrate that it is not liable for any harm done or that there is no causal link between its conduct and the harm caused to the victim.

Environmental laws are continuing to develop and it is possible that future regulations will require current land use rights holders or occupiers of contaminated land to clean up the contamination. Accordingly, the results of environmental due diligence should be carefully assessed before land use rights are acquired.

Looking forward

The greenhouse gas work-plan set up under China's 12th five year plan requires local departments, among other things, to save energy, reduce consumption and implement a 17% reduction in carbon dioxide emissions by 2015. Reportedly, an environmental protection tax is under discussion, with some provinces implementing trial emissions trading schemes.

47. Corruption

Corruption in China, like in many developing countries, can create problems for foreign investors. The government and the CCP often announce crackdowns and frequently discipline officials. Various laws and regulations set out heavy penalties for corruption–both public and commercial. Moreover, China is also a signatory to the UN Convention against Corruption, which came into force in December 2005. Anecdotal evidence and regular news reports, however, suggest that corruption persists.

Your ethics

The good news is that foreign investors can maintain their home-jurisdiction ethics and still be successful in China. Refusal to engage in questionable practices may result in some lost business. However, the upside is that your business is placed on a surer regulatory footing and your business reputation can be enhanced.

The activities of foreign investors in China can also be regulated in their home jurisdiction. The US Foreign Corrupt Practices Act, for example, imposes significant civil and criminal penalties on US companies and individuals who bribe (or offer to bribe) officials of foreign governments to obtain business. Of particular note in China, is that “foreign officials” includes officers and directors of SOEs.

Bringing home-jurisdiction ethics to China requires special attention to staff training and discipline. Employee codes of conduct are an important tool, especially when employees are contractually bound to comply. Corporate codes of conduct can also be incorporated into many commercial agreements.

Public

Government staff and CCP staff are not permitted to receive cash gifts or valuable securities (eg, vouchers which may be exchanged for cash or sold) for any reason or in any form during their public activities, including ceremonial activities, press conferences and economic activities. In particular, they may not take any gift which might impair fairness in their performance of public duties.

Cash gifts offered during any foreign-related activity must be refused; gifts that are difficult to refuse must be given to the government. Gifts (other than gifts of low value) received during official business must be registered with the government.

District and regional entities (a term that includes FIEs) may not give to any government staff or CCP staff cash gifts or valuable securities in respect of conferences or commercial activities.

The terms “government staff” and “CCP staff” are defined to include government administrative and political consultation personnel and responsible persons working in SOEs or conducting civil activities in social entities to which the state allocates operative funds.

The Supreme People’s Court has expanded criminal liability for state functionaries (a term that includes certain staff of SOEs) engaging in the following forms of corruption:

- Acceptance of bribes in the form of transactions (including buying houses, cars or any other item at lower than market price, or selling houses, cars or any other item at higher than market price)
- Acceptance of stocks and shares as gifts
- Obtaining bribes through jointly running a company or other business venture or accepting business profits
- Obtaining proceeds of gambling for the purpose of benefiting another person
- Acceptance of wages or salary payments when no actual work is performed

Affiliates (including close relatives and lovers) who receive such benefits on behalf of a state functionary may also be subject to criminal sanctions.

Heads of SOEs who are also CCP members may be punished if they take advantage of their position:

- to engage in corruption during reorganisation or the introduction of strategic investors;
- for personal interests (including the interests of a specific third party) during connected transactions or any other business operations;
- to provide favourable conditions for the business activities of another head of an SOE, or that other head's spouse or children, or another interested party; or
- to provide insider information during the process of a company's listing, merger and acquisition, restructuring or issuance of shares.

Criminal sanctions for public corruption include the death penalty. Administrative penalties include the loss of employment and the revocation of CCP membership. Illegally received property may also be confiscated.

Criminal sanctions have also been introduced for the giving of money or property to a foreign official for the purpose of seeking an unjustified benefit. Persons guilty of such an offence may be imprisoned for up to three years. If the amount involved is "huge", then the term of imprisonment is for between three and ten years and a fine will also be imposed.

Commercial

Commercial bribery is subject to both civil liability and criminal sanctions.

Under China's Anti-Unfair Competition Law, a business operator may not:

- use money, things of value or other methods to bribe others into selling or purchasing commodities; nor
- give a secret commission or discount without maintaining a proper accounting record.

A "business operator" is a legal person, economic organization or individual who deals in goods or services for profit. "Things of value" include cash and tangible goods (including promotion fees, publicity fees, sponsorships, R&D fees, labour fees, consultation fees, commissions or reimbursements). Also included are tourism, entertainment and "bogus" inspection trips.

Fines of between Rmb10,000 and Rmb200,000 may be imposed for corrupt activities that violate the Anti-Unfair Competition Law. Illegally gotten gains may also be confiscated. Criminal sanctions are required if the corrupt activities constitute a crime.

Criminal sanctions for commercial corruption include:

- Up to five years imprisonment for an employee (which may include a director) of an enterprise (including an FIE) who takes advantage of his or her position, or accepts money, kickbacks, commissions or other benefits, and the amount involved is "considerably large"; five or more years imprisonment if the amount is "huge"
- Up to three years imprisonment for anyone who gives a considerably large amount of money or property to an employee of any company or enterprise for the purpose of seeking illegal benefits; up to ten years (and not less than three years) if the amount involved is "huge"

For the purpose of determining criminal responsibility:

- "Property" is defined to include money, physical property, as well as property interests which can be valued in a currency amount (eg, provision of house decoration, membership cards containing value, vouchers, and travelling expenses). The property is to be valued according to the amount actually paid.
- A person paying a bribe will be considered to be seeking illegal benefits if that person: (i) seeks a benefit in breach of laws, regulations, rules or government policies; (ii) requests the other party to provide help or convenience for the purpose of violating laws, regulations, rules, government policies or industrial norms; or (ii) breaches the principle of fairness by giving property to people involved in commercial activities, such as bidding or government procurement, for the purpose of obtaining a competitive advantage.

48. Competition law: behavioural provisions

In addition to introducing a comprehensive merger-control regime (see Section 38 “Competition law: merger control”), China’s Anti-Monopoly Law (AML) prohibits:

- monopolistic agreements;
- abuses of dominant position;
- anti-competitive administrative action; and
- abuses of intellectual property rights.

The AML aims to foster an environment of free competition, and seeks to regulate monopolistic conduct both inside and outside of China.

Monopolistic agreements

The AML prohibits certain types of horizontal agreement (price fixing, supply restriction, market division, collusive boycotts) and one type of vertical agreement (resale price maintenance). The categories of agreements covered may also be expanded.

Exemptions from the prohibition on monopolistic agreements may be granted on a number of grounds (including technological progress, improved efficiency/quality, cost reduction, energy conservation, environmental protection and the addressing of over-supply in times of severe recession); however, to qualify for any of these exemptions the undertaking must also show that the agreement will not substantially restrict competition in the relevant market and that consumers will share the benefits of the agreement. The State Council has power to provide (by law) exemptions in other cases as well.

It remains to be seen whether it will be necessary to make an advance application for an exemption or whether an approach similar to the US/EU ‘rule of reason’ concept will be adopted.

The NDRC has jurisdiction over price-related monopolistic cases, while the SAIC has jurisdiction over other types of monopolistic agreements. Both authorities have issued regulations regarding monopolistic agreements.

Under the NDRC provisions:

- The coincidence of price-related behaviour and communications between the undertakings will be examined to determine whether concerted action has taken place. Market structure and market change will also be taken into consideration. Under the AML, concerted action between the undertakings is one of the means through which a monopolistic agreement can be reached.
- Various types of price monopolistic agreement are prohibited, including fixing or changing the prices of products/services, fixing or changing price variance, and agreeing a price calculation formula. The NDRC also has discretion to determine other types of price monopolistic agreement.
- Trade associations are specifically prohibited from formulating rules, decisions or issuing notices that exclude or restrict price-related competition. They are also prohibited from organizing undertakings to enter into price-monopolistic agreements or from taking related actions.
- The first whistle-blower who reports a price-related monopolistic agreement and provides important evidence can be exempted from punishment. The second undertaking reporting the violation and providing important evidence can be subject to mitigated punishment of no more than 50% of the statutory sanction. Undertakings subsequently reporting the violation and providing important evidence can be subject to mitigated punishment of no less than 50% of the statutory sanction.

- The NDRC may delegate its investigative power to provincial-level authorities, which may in turn further delegate to municipal-level authorities. Interestingly, these delegations can reach one level lower than the corresponding delegation of the SAIC.

The NDRC has reportedly taken action against several companies for price-related monopolistic behaviour.

Under the SAIC provisions (which apply to non-price monopolistic conduct):

- Monopolistic agreements can be either written or verbal.
- In order to identify concerted action, the SAIC will examine factors in addition to those prescribed by the NDRC; in particular, the SAIC will also consider: whether the undertakings have exchanged information; whether they can provide a reasonable explanation; the competitive status of the market; and the situation of the industry.
- Specific examples of each category of monopolistic agreement and abuse of dominance under the AML are provided. Similar to the NDRC rules, more specific guidelines are given regarding trade associations and prohibited conduct.
- A whistle-blower among undertakings that are parties to a monopolistic agreement, in addition to the requirements set out in the NDRC Provisions, must also fully cooperate with an investigation in order to be exempted from punishment. Mitigation for subsequent undertakings is discretionary.

Abuse of dominant position

The AML prohibits dominant undertakings from abusing their position in a number of specified ways (imposing unfair prices or other terms, selling below cost, refusing to supply, discriminating between equivalent counterparties, tying). Again, there is scope for flexibility:

- The prohibited activities all have qualifying words ("unfairly" or "without good reason").
- Conversely, the enforcement authority is empowered to identify other abuses.

The AML attempts to clarify the meaning of "dominance", and SAIC provisions set out detailed factors for determining whether an undertaking is "dominant". NDRC provisions set out a similar set of considerations. But, as in other jurisdictions, there is likely to be significant scope for argument (with much turning on the identification of the relevant market).

The definition of "relevant market" in China focuses on the need to carry out an analysis based on demand- and supply-side substitutability. In complex cases, the "hypothetical monopolist" test may also be applied. Under this test a market may be defined according to the smallest group of goods and geographic area over which a hypothetical monopolist may maintain a price level that is higher than the competitive price.

The SAIC (for non-price-related matters) will consider two general factors in determining whether an enterprise has a "good reason" for engaging in what would otherwise be an abuse of a dominant market position. These factors are: (i) whether the conduct in question is part of the normal business of an enterprise; and (ii) the effects of the conduct in question on the efficiency of the economy, social public interest and economic development.

Factors considered by the NDRC (for price-related matters) to determine whether an enterprise has a "good reason" for engaging in what would otherwise be an abuse of dominant market position differ depending on the particular abuse.

One defence that is not available is that an enterprise was directed to act as it did by an administrative authority. Specifically, authorisation granted, restrictions imposed or rules published by an administrative authority do not provide an excuse for undertakings to reach or execute monopolistic agreements or to abuse a dominant market position.

Anti-competitive administrative action

Public authorities are prohibited under the AML from abusing their powers in a number of ways which have become notorious problems in China, such as:

- requiring people to deal with particular undertakings;
- blocking free circulation of goods between regions of China (for example, by imposing discriminatory technical standards);
- setting discriminatory tendering or bidding qualifications for non-local suppliers;
- blocking establishment of local operations by businesses from other regions; and
- making regulations or taking other action to eliminate or restrict competition.

These provisions were amongst the most controversial aspects of the AML in that they directly threaten powerful local interests.

Implementing rules put the enforcement responsibility on the "superior authority" of the public authority that is abusing its powers. The SAIC is entitled to make recommendations to such superior authorities. There appears to have been very little action (if any) taken to enforce the AML provisions against anti-competitive administrative behaviour.

Intellectual property

The AML does not prohibit "legitimate" conduct to protect intellectual property rights, but rather prohibits conduct which restricts or eliminates competition by the "abuse" of intellectual property rights. However, the meaning of "abuse" in this context is not defined.

SOEs

Major SOEs of national (as opposed to merely local) significance are not formally exempt from the AML. However, the AML "protects" their "lawful" business operations and indicates that the State will supervise them so as to protect consumer interests and facilitate technological advancement. The extent to which they are regulated by the AML will likely depend upon political and economic considerations.

Enforcement

Fines for violations may be up to 10% of total sales revenue for the previous year, with provision for lower fines in less significant cases and for mitigation where wrongdoers report their own violations. A "whistleblower defence" to the prohibitions on monopolistic agreements is also available.

Remedies may include orders prohibiting certain activities, disgorgement of unlawful gains and forced unwinding of unauthorised concentrations.

Dissatisfied parties will have the right to invoke an administrative review process or alternatively to go to court.

The AML also provides for civil liability. Although a number of private law suits have been commenced under the AML, most of them have settled out of court, and there have not been any court findings of AML violations. The Supreme People's Court has circulated for public comment draft rules regarding civil actions under the AML.

Until specific implementing rules or a Supreme People's Court interpretation is issued, litigation is unlikely to be an effective remedy (and even with additional rules the efficacy of litigation would still depend on a number of other factors; see Section 53 "Litigation").

49. Representative offices

Representative offices are often set up by foreign companies that want a presence in China without setting up a subsidiary. A representative office generally cannot, however, engage in direct business activities.

Permitted activities

A representative office can represent its head company in conducting business liaison, product introduction, market surveys and research, and technological exchange within the scope of business of the head office. Foreign companies without a registered representative office are not permitted to engage in these activities in China.

In addition, the following types of activities are generally permissible:

- Leasing of office space and arranging for utilities
- Purchasing office supplies
- Coordinating issuance of work permits and visas for foreign staff
- Opening and maintaining foreign and local currency bank accounts
- Displaying office signs and distributing promotional materials
- Engaging local staff through labour service organisations

Representative offices conducting direct business activities may be subject to fines of up to Rmb500,000 and confiscation of all illegal profits.

Setting up

A foreign company may set up representative offices throughout China, although they will generally not be permitted to set up multiple representative offices in any one city. A foreign company must have been established for at least two years before setting up a representative office in China. There are no registered capital requirements.

A range of materials must be submitted to the relevant local AIC to set up a representative office. Upon acceptance of the application, the AIC will issue a registration certificate (similar to an FIE's business licence). Registration certificates are subject to annual renewal.

A sponsor will generally be required to interact with governmental authorities on behalf of the foreign company prior to the establishment of the representative office.

Representative offices in certain industries, such as those in the financial sector, require governmental approvals from industry-specific authorities. In some instances, the approval of a local branch of MOFCOM may be needed.

Representative offices may only be approved for up to three years. Renewals are required if the representative office plans to continue operating.

Other registrations

A representative office is required to register with various other governmental authorities, including the tax bureau, SAFE and customs. Financial and corporate seals are also required for the representative office.

Any change in the registration details (including name of the office, address and identity of the representatives) should be registered with the same local AIC that issued the registration certificate and the other relevant authorities.

Annual reviews

Each representative office is required to submit an annual report to the local administration of industry and commerce detailing:

- the continuous existence of its foreign head company
- the activities of the representative office
- the audited information concerning the cost and expenses incurred by the representative office

Liabilities

The foreign company that set up a representative office is liable for the acts and debts of that representative office. Accordingly, the foreign company should safeguard the financial and corporate seals of the representative office to ensure that they are not misused.

Representatives & other staff

A representative office may generally have no more than three representatives, who may be either foreign or Chinese nationals. A representative office may also have one chief representative.

A representative office may recruit Chinese national staff (including as representatives) but is required to formally engage them through an approved labour service organisation. The labour service organisation will thereafter assist with the payment of withholding tax and social security obligations (see Section 25 "Chinese national employees").

Annual reviews

Each foreign representative office will need to submit an annual report to its registration authority from March 1 to June 30 each year. The annual report must cover the operational status of its foreign head company, business activities carried out by the representative office, an audited statement of income and expenses, and other relevant information. Some local authorities already require annual reports.

Tax

Representative offices are subject to income tax, most often calculated on a deemed profit basis. Representative offices may also be taxed on commissions generated by business liaison activities.

The corporate income tax applicable to representative offices is 25%. A local tax may also be applicable.

Various other taxes, including business tax and value added tax, are also applicable. You are recommended to seek expert tax advice if you are contemplating setting up a representative office in China.

50. Manufacturing in China

Manufacturing in China remains an option for those not wanting to set up their own operations. A number of alternatives exist: manufacturing contracts; processing and assembly contracts; and compensation trade.

These structures are comparatively flexible and require no capital investment by the foreign party. The key issues are similar for each.

Manufacturing contracts

Under a typical manufacturing arrangement, the foreign party grants a manufacturer in China a non-exclusive right to manufacture and package products according to designs and specifications provided by the foreign party.

Processing & assembly

Processing and assembly typically involves the shipment of raw materials or semi-finished products to a manufacturer in China. This importation may be exempt from customs duties if all finished products will be exported. The manufacturer uses the imported materials or products to manufacture the goods, which are then exported to the foreign party. The Chinese manufacturer is typically paid a fee.

Regulatory changes in 2010 increased the number of prohibited goods for processing trade. The changes also sought to both enhance environmental protection and promote high-technology manufacturing by limiting incentives available to low value-added, high polluting and high-energy-consuming manufacturing.

Processing and assembly contracts are subject to MOFCOM or local COFTEC approval.

Compensation trade

Compensation trade is a barter transaction whereby a Chinese party obtains foreign machinery, equipment or technology from the foreign party, and the foreign party receives the product that the Chinese party produces with that machinery, equipment or technology.

Compensation trade is not common.

Key issues

Various key issues should be considered in each of the above arrangements. These include:

- Intellectual property – Intellectual property being licensed to the Chinese party should be appropriately safeguarded through registrations, contractual arrangements and other precautions (see Section 27 "Technology transfers & licensing" and Section 28 "Protecting your IP").
- Product quality & inventory – The foreign party will typically want to control product quality. Among other things, the foreign party should have contractual rights to inspect the products, return sub-standard products and monitor inventories.
- Corporate authority – FIEs (and Chinese enterprises) should have a sufficient scope of business (see Section 14 "Business scopes"). Chinese enterprises may also need to register to obtain foreign trade rights.
- Choice of law & dispute resolution – Commercial contracts with non-Chinese parties may generally be governed by non-Chinese law. Foreign arbitration may also be chosen. Care should be taken in the preparation of the contracts if the parties do not want Chinese courts to exercise jurisdiction (see Sections 52 to 56).

- Foreign exchange – Various documentation are required to be filed with (and, in some cases, approved by) SAFE before foreign exchange can be remitted. It is typical for the Chinese party to be contractually responsible for duly remitting any foreign exchange.
- Tax – Tax requires careful consideration. For example, if the operations of the foreign and Chinese parties are sufficiently interlinked, the relationship may result in the China manufacturer being a "permanent establishment" of the foreign party. In turn, this may give rise to a corporate income tax liability of the foreign party in China. You are recommended to seek expert tax advice if you contemplating a manufacturing arrangement in China.

51. Management contracts

Management contracts are relatively common in the hotel and hospitality industry.

Under such arrangements the foreign party generally provides day-to-day management and training for an enterprise in China in return for a share of revenues. The enterprise in China is generally responsible for providing business facilities, equipment and staff.

A foreign company providing management services to a hotel in China must be approved by the relevant local branch of MOFCOM and must also be registered with the relevant local AIC.

Joint ventures may also be managed by a foreign party to the joint venture.

52. Resolving disputes

In China, as elsewhere, commercial disputes are a fact of life.

The formal processes available for resolving such disputes in China have, in recent years, become increasingly similar to those elsewhere in the world. However, numerous special features should still be taken into account.

Agree early

Agreeing on how to resolve disputes is best done in writing at the initial investment stage. If disputes do arise, you can then focus on resolving the dispute itself, rather than having to argue (or litigate) about the appropriate process.

Choices

The most basic choice is between litigation and arbitration. However, care should also be taken to differentiate between various types of litigation or arbitration.

Many disputes are resolved in practice by negotiation. Often this is for the same reasons as in other countries (eg, the relationship advantage of reaching commercial compromises and the costs of a formal process). However, lack of familiarity with, and in some cases doubts as to the effectiveness of formal processes in China have also led many foreign investors to resolve disputes by negotiation more readily than in their home markets.

Mediated settlement of disputes has a long history in China, and is gaining prominence as a way of resolving Sino-foreign disputes.

International tribunals may also become more significant in resolving major investment disputes in the foreseeable future. Such international tribunals are set up by virtue of the multilateral and bilateral arrangements under which China has assumed investment liberalisation obligations.

Sections 53 to 56 below give a basic introduction to resolving disputes in China. The reality is nevertheless extremely complex and varies from place to place and from case to case.

For a more in-depth consideration of dispute resolution options, please see the Herbert Smith “Dispute resolution and governing law in China-related commercial contracts” guide, a soft copy of which is available on the Herbert Smith website.

53. Litigation

Chinese courts have a relatively brief history of dealing with complex international commercial disputes in a manner acceptable to foreign investors. They have, nevertheless, made significant progress, particularly in the major cities, toward meeting the expectations of such investors.

The People's Courts

The major outside influences upon Chinese civil procedure have been from the continental European ("civil law") tradition, as opposed to the English-speaking ("common law") tradition. Numerous special features have also resulted from China's history and circumstances. Locally-informed, up-to-date advice on a case-by-case basis is essential if caught up in, or contemplating, Chinese litigation.

Key features include:

- Relatively high speed and low cost – The relative simplicity of process in China often results in higher-speed and lower-cost litigation than is available in many English-speaking countries. Cases have been known, nevertheless, to get "bogged down".
- Limits on ability to compel and test evidence – Orders for production of specifically defined evidence are possible in principle but rare in practice. Examination and cross-examination of witnesses is traditionally not particularly searching. In practice, sanctions against perjury are not significant (except in criminal cases).
- Greater emphasis on formal documentation – Compared to legal systems in common law countries, Chinese courts put a relatively high emphasis on formal legal documentation (compared with informal documents and oral evidence from witnesses). Significant attention is also given to the production of authenticated originals, seals on documents, notarisation and formal authorisations (powers of attorney).
- Limited remedies – Damages awards are often relatively conservative (especially in comparison to, for example, the US) as a result of a combination of (i) strict evidential requirements as to the proof of loss, and (ii) a reluctance of the courts to order the defendant to produce records relevant to determining quantum.

  Orders requiring a defendant to do something, or stop doing something, can be difficult to enforce in practice.

  Interim remedies (such as temporary restraining orders) are often unattractive because of requirements for claimants to put up large bonds in support of such remedies.

  Having said that, effective and significant remedies are sometimes possible. However, it is essential to investigate remedial issues at the outset so that you have realistic expectations as to what is, and is not, achievable.

  Other options may also be considered. For example, the civil court system in China has historically often been considered ineffective by foreign investors as a means of preventing or deterring counterfeiting operations (though this is a complex matter and there are signs of change). In such cases, administrative actions should be considered (see Section 28 "Protecting your IP").

- Appeals and reviews – There is usually only a single, relatively rapid level of appeal from a Chinese judgment. Most matters involving foreign companies start at Intermediate (city) court level with an appeal to the Higher (provincial) court, though some very large cases may start at Higher level with an appeal to the Supreme People's Court in Beijing. Matters may be complicated somewhat, however, by a process whereby first instance judgments may, in certain circumstances, be "reviewed" and set aside outside the ordinary appeal process (reform of this system is currently under discussion).
- The judiciary – The first generation Communist leadership was hostile to "bourgeois" notions of law and a legal profession, and it was not until 1979 that a legal profession was re-established in China. The judiciary and legal profession are, however, increasingly sophisticated. There are significant examples of foreign investors prevailing in Chinese courts against SOEs and other well-connected local entities, though the prospects of this and the enforceability of the resulting judgments vary from place to place.

  As in continental Europe, there is no system of binding precedent in China. Moreover, prior decisions lack even the "persuasive" authority of continental European judgements. However, the Supreme People's Court regularly issues detailed "interpretations" to guide the lower courts.
- Regional variation – First instance courts in China operate on a regional basis rather than funnelling major cases to a single centre (ie, more like the US or German systems than the English system). The Supreme People's Court is a centralised final appellate/supervisory court. There are rules for the allocation of jurisdiction between regions: for example, a corporate defendant is usually most appropriately sued in the place of its headquarters.

  Regionalism can give rise to subtle, unspoken bias and the instinctive protection of local interests, though such phenomena are, of course, not unknown elsewhere.
- Ongoing reform – China's national leaders, the Supreme People's Court and others have recognised candidly that China's court system requires ongoing improvement. Observers generally accept that the system's acceptability to foreign investors has improved in recent years, particularly in Beijing, Shanghai and some other major centres. Much still depends, however, on the particular court and the circumstances of the specific case.

Enforcing domestic judgements

Domestic judgments can be difficult to enforce, particularly as one moves from the main commercial centres. Local authorities can, for instance, be unwilling to assist in enforcing a judgment against an enterprise that is important to the local economy. The Supreme People's Court has an ongoing campaign to improve enforcement. Informed local advice is essential.

Enforcing foreign judgments

Enforcement of foreign judgments in China is possible in principle, but challenging in practice.

"Reciprocity" must be demonstrated before foreign judgements can be enforced. That is, you will need to demonstrate that the foreign legal system from which the judgment originates gives equivalent enforcement to Chinese judgments; there remains scope for argument as to what this means in practice. Alternatively, you may meet the requirements laid down by a bilateral enforcement treaty (of which there are a number) between China and the foreign country in question (see Section 56 "International tribunals").

Enforcement of foreign judgments can be more straightforward if, for example, the defendant has significant assets outside of China which can be seized (eg, by way of debt garnishment). A listing on a foreign exchange also increases a defendant's exposure to foreign legal processes.

Judgments from Taiwan, Hong Kong and Macau are subject to special rules:

- Judgments from Taiwan and Macau have been enforceable in the mainland since 1998 and April 2006 respectively, subject to certain conditions. The enforcement of judgments from Taiwan and Macau, nevertheless, remain subject to challenges in practice.
- The 2006 arrangement between the mainland and Hong Kong regarding the enforcement of judgments came into force on 1 August 2008. This arrangement only applies in commercial cases in which the parties have included an exclusive Hong Kong or mainland jurisdiction clause and such clause was agreed in writing after 1 August 2008; even then, enforcement will be subject to major exceptions.

Hague Convention

China took part in the negotiations which led to the agreement in principle in 2005 of a multilateral Hague Convention providing for the mutual enforcement of commercial judgments rendered under an exclusive jurisdiction clause. However, China is yet to ratify this Convention and, in any event, it remains to be seen how widely it will be ratified.

54. Arbitration

Arbitration is only possible if the parties expressly agree to arbitrate. Arbitration is favoured by many foreign investors in China.

Care should be taken in preparing the arbitration clause. A seriously defective arbitration clause will likely mean that a dispute ends up being heard in a Chinese court instead. Please see the Herbert Smith “Dispute resolution and governing law in China-related commercial contracts” guide for more information regarding the preparation of arbitration clauses.

Arbitration in China sometimes required

China does not recognise arbitration outside China for disputes between Chinese entities. This rule can sometimes catch out foreign investors. For example, foreign construction companies operating in China must, for most purposes, set up and contract through an FIE. Foreign arbitration will not be permitted if (as will usually be the case) that FIE contracts with another Chinese entity, since the arbitration will be regarded as purely domestic.

Note also that it is commonly thought (despite legislative ambiguity on the point) that such “domestic” arbitrations must be administered by a Chinese arbitral commission (such as CIETAC), rather than a foreign institution such as the International Chamber of Commerce (ICC). There is also a degree of legal uncertainty as to the validity of an arbitration agreement in a foreign-related dispute which provides for (say) ICC arbitration in mainland China, and it is not suggested that parties include such a mechanism.

Entering into a foreign arbitration clause in circumstances where Chinese law refuses to recognise foreign arbitration is problematic. First, any resulting arbitral award will not be recognised in China. Secondly, the Chinese courts will take jurisdiction over the substance of the dispute (which they would decline to do if the arbitration clause were, in their eyes, valid).

A further complication is that the requirement for certain arbitrations to be conducted in China does not define “China.” However, the majority view amongst practitioners appears to be that it means only mainland China, at least until the Supreme People’s Court or the National People’s Congress clarifies that it may be extended to cover Hong Kong as well.

Arbitration outside China

Foreign parties often prefer to arbitrate outside China, which is permitted in the eyes of Chinese law provided that the dispute is “foreign-related” (which it will be if one of the parties to it is a company incorporated outside of mainland China). Arbitration in Hong Kong is a common compromise, and is often acceptable both to Chinese parties (given that it is part of China) and also to foreign investors (given its long tradition of an independent judiciary, its pro-arbitration legislative framework and its well established arbitration institution, the HKIAC).

Other possibilities include the systems operated by the Singapore International Arbitration Centre (SIAC), the Stockholm Chamber of Commerce, the ICC (commonly with Geneva or Paris as the place of arbitration), and the London Court of International Arbitration (LCIA).

CIETAC

Chinese law requires that any arbitration taking place in mainland China be conducted by an arbitration commission. There are many such commissions in China, but the one most commonly encountered by foreign investors is CIETAC. CIETAC is a government-sponsored organisation, originally established in 1956 but much reformed in recent years. It is headquartered in Beijing but has sub-commissions in Shanghai, Shenzhen, Chongqing and Tianjin.

CIETAC is the busiest arbitral organisation in the world, judged by the number of cases (though CIETAC also deals with many relatively small domestic matters of a sort which in other countries would be dealt with by the court system).

CIETAC reforms

The 2012 revised CIETAC Arbitration Rules, effective 1 May 2012, are intended to bring the CIETAC Rules and CIETAC arbitrations more in line with international practice and to meet the challenges of increasingly complex arbitration cases. Although there are concerns about how some of the reforms will work in practice, on the whole, the reforms represent a positive development for arbitration in China with an increasing scope for the introduction of international rules and standards into the CIETAC process.

CIETAC process & representation

Parties to a dispute between an FIE and a purely Chinese party may select arbitrators from CIETAC's panel of approved arbitrators for foreign-related disputes, which includes many well known international arbitration practitioners. It is also possible to appoint arbitrators from outside the CIETAC panel if this is provided for in the dispute resolution clause. However, remuneration levels are typically less than international market rates so it may not be easy to persuade eminent practitioners to sit.

A typical CIETAC arbitration remains relatively speedy and document-based compared to arbitration in places such as Hong Kong, Europe or the US. If the tribunal is relatively international in nature (which is more likely if the arbitration clause provides for a neutral nationality presiding arbitrator), the tribunal will typically adopt a mixture of inquisitorial and adversarial approaches. There is increasing scope for more extensive cross-examination of witnesses in the CIETAC process. The 2012 reforms noted above increase the scope for parties to agree a particular approach to evidence. Moreover, it is now compulsory (at the request of either party and with the approval of the tribunal) under the 2012 rules for expert witnesses to participate in oral hearings if the tribunal requires, and to give explanations on the reports they have prepared if the tribunal considers necessary.

With certain restrictions, members of foreign law firms may represent parties in CIETAC arbitration. This contrasts with litigation in China, in which only Chinese nationals working for mainland Chinese law firms may appear in court.

Parties are free to agree that a CIETAC arbitration should be conducted in English. Absent such agreement, the 2012 reforms now allow CIETAC to decide the language of arbitration to be a foreign language, having regard to the circumstances of the case. However, given the challenges the use of foreign languages will naturally bring (ie, CIETAC has less experience of conducting arbitrations in foreign languages), it may be a gradual process for CIETAC to use more foreign languages in its administered arbitrations.

Enforcement of foreign arbitral awards

Foreign arbitral awards can, in principle, be enforced in China under the New York Convention. Very narrow exceptions (for example, major procedural irregularities) exist.

As with judgments and domestic arbitration awards, however, enforcement of foreign arbitral awards can be challenging in practice. Enforceability of foreign arbitral awards is nevertheless somewhat improved by a rule (known as the "reporting system") that refusal of enforcement by a lower court requires confirmation by the Supreme People's Court in order to be effective.

A judicial ruling in favour of enforcement, assuming you get one, does not necessarily correspond to execution of the award in practice. Protectionism may still make this difficult. Moreover, Chinese courts are not accustomed to undertaking the tracing and seizure of assets through complicated corporate structures, a tactic commonly undertaken by defendants seeking to avoid enforcement.

Hong Kong and Macau arbitral awards are enforceable in mainland China under arrangements entered into between the relevant governments. These arrangements broadly reflect the New York Convention. In October 2007, the Supreme People's Court confirmed that ad hoc (non-institutional) arbitration awards made in Hong Kong are enforceable in China on the same terms as institutional awards.

Enforcement of CIETAC awards

Foreign-related CIETAC awards are, as a matter of Chinese law, difficult to challenge in the Chinese courts. Any appeal must be based on grounds similar to the ground for legitimately resisting enforcement pursuant to the New York Convention, so there is (for example) no right of appeal on points of fact or law. Similarly, the grounds for refusal of enforcement are similar to the New York Convention exceptions applicable to foreign awards.

Whilst, again, enforcement, is not always straightforward – as with the enforcement of Chinese court judgments, protectionism and other problems can arise – the reporting system mentioned above also applies to foreign-related CIETAC awards.

Enforcement of domestic Chinese awards

In purely "domestic" arbitrations, there are relatively broad grounds of appeal, including potential for review of the merits.

Domestic Chinese arbitration awards are enforceable like domestic judgments subject to certain exceptions broadly equivalent to the grounds of appeal.

55. Negotiated resolutions

The inadequacies of the formal processes described above have given incentives for foreign investors to explore compromises even more readily than elsewhere in the world.

Compromising

As in more developed systems, there are often good commercial reasons to compromise disputes. Given the various issues with formal processes in China, foreign investors in China have frequently accepted terms much less favourable than they would accept if a similar problem arose in their home country. This phenomenon appears likely to decrease as the legal system improves.

Conciliation & mediation

For most foreign investors, compromises are mostly reached by lengthy negotiation between the relevant parties. However, the concept of conciliation or mediation (ie, a negotiation supported by a neutral facilitator) has a long tradition in China, and there are some government-supported mechanisms for this in international cases, involving the China Chamber of International Commerce (CCOIC) and the China Council for the Promotion of International Trade (CCPIT). Parties are also free to use a private mediator without institutional backing.

Moreover, Chinese courts have authority to conduct a mediation of cases and may press parties to attempt a mediated resolution before adjudicating upon the matter. A signed mediation agreement approved by the court has the significant advantage of being enforceable as if it were a judgment, rather than merely a contract requiring additional litigation to enforce.

56. International tribunals

In certain circumstances, foreign investors may seek protection from international tribunals.

WTO

China's accession to the WTO creates scope for international adjudication of investment disputes between states, usually at a sectoral level, through the WTO dispute resolution machinery.

In brief, the WTO dispute resolution machinery involves appointment of a panel of experts agreed by the relevant states or (if they cannot agree) appointed by the WTO's director-general. The system includes conciliation and appeal processes.

Over time, and perhaps unsurprisingly as its WTO commitments have progressively come into force, China's involvement in such processes has steadily increased: as at 26 March 2012, China has been involved in 35 WTO cases. It acted 9 times as the complainant and 26 times as the respondent.

By way of example, on 13 March 2012, China (as respondent) was requested to have consultations with Japan, the European Union and the United States in three separate cases regarding China's restrictions on the export of various forms of rare earths, tungsten and molybdenum.

Bilateral investment treaties and free trade agreements

Potentially even more significant for foreign investors are the remedies provided for under Bilateral Investment Treaties (BITs), and Free Trade Agreements (FTAs) containing investment chapters.

BITs and relevant FTAs provide certain protections for foreign investors in respect of matters such as discriminatory treatment, expropriation and return of capital.

Since these are bi- or multi-lateral treaties, they only provide protection for investors from the particular state(s) party to the treaty. For example, subject to what is said below, only Dutch investors in China may rely on the Netherlands-China BIT.

The usefulness of BITs to foreign investors in China has historically been limited because Chinese BITs did not, except for certain limited purposes, provide for an effective dispute resolution mechanism. However, this may change as China has in recent years concluded a number of 'new-generation' treaties allowing submission to arbitration of much broader categories of disputes.

Moreover, many of the newer treaties, such as the BITs entered into between China and the Netherlands (2002), Germany (2003) and Finland (2004), and the FTAs with New Zealand (2008) and ASEAN (2010), provide for adjudication by the International Centre for Settlement of Investment Disputes (ICSID), a long-established World Bank arbitration body that has been widely used for resolving BIT disputes involving countries other than China.

These treaties allow foreign investors from the relevant countries to bring complaints directly against the Chinese government before the ICSID. This contrasts with the WTO process, under which only states may bring complaints.

The newer treaties also have relevance to investors from other countries:

- Structuring – The treaties give an incentive to foreign investors to structure investments through a covered jurisdiction. Of course, there are many other considerations in structuring such investments (see Sections 3, 30, 32 and 33).
- Most favoured nation clauses – Older BITs typically contain a "most favoured nation" clause requiring, in brief, states to grant each other investment benefits which they agree subsequently to grant to other states. There has been much speculation (in light of other ICSID tribunal decisions) as to whether ICSID tribunals will interpret such clauses in older BITs (eg, the 1986 UK-China BIT) to reach the conclusion that the ICSID mechanism may now be invoked by investors from these countries.

ICSID adjudication is fast becoming more common. As of 23 March 2012, 233 cases had been concluded (this includes all cases filed and brought to a conclusion, whether by adjudication or settlement) and there are 142 cases pending.

A Malaysian construction company was the first investor to bring an investment treaty claim against China at ICSID. The claim was registered on 24 May 2011, and concerned arts and culture facilities. However, the proceeding was suspended pursuant to the parties' agreement on 22 July 2011.

Other arrangements

Foreign investors may also wish to monitor China's future possible accession to other international arrangements for investment protection (eg, the Energy Charter Treaty, under which China currently has only observer status).

57. Common abbreviations

China's legal environment has given rise to many abbreviations. Some of the more common abbreviations, together with abbreviations of various international institutions, are set out below:

English abbreviation	English name	Chinese abbreviation	Chinese name
CBRC	China Banking Regulatory Commission	银监会	中国银行业监督管理委员会
CCOIC	China Chamber of International Commerce		中国国际商会
CCP	Chinese Communist Party	中共	中国共产党
CCPIT	China Council for the Promotion of International Trade	中国贸促会	中国国际贸易促进委员会
CEPA	Closer Economic Partnership Arrangement	紧贸安排	更紧密经贸关系安排
CIRC	China Insurance Regulatory Commission	保监会	中国保险监督管理委员会
CNNIC	China Internet Network Information Center		中国互联网信息中心
CSRC	China Securities Regulatory Commission	证监会	中国证券监督管理委员会
CIETAC	China International Economic and Trade Arbitration Commission	贸仲委	中国国际经济贸易仲裁委员会
CJV	Co-operative joint venture	合作企业	中外合作经营企业
COFTEC	Commission of Foreign Trade & Economic Co-operation	外经贸委	对外经济贸易合作委员会
EJV	Equity joint venture	合资企业	中外合资经营企业
ETDZ	Economic & Technological Development Zone		经济技术开发区
FESCO	Foreign Enterprise Service Company Ltd (a labour service organisation)	外服	对外服务有限公司
FICLS	Foreign investment company limited by shares		外商投资股份有限公司
FIE	Foreign investment enterprise	外资公司	外商投资企业
FTZ	Free Trade Zone		自由贸易区
HTDZ	High Technology Development Zone		高科技开发区
ICC	International Chamber of Commerce		国际商会
IPO	Initial public offering		首次公开募股
IPR	Intellectual property right		知识产权
ITIC	International Trust and Investment Corporation	信投公司	国际信托投资公司

English abbreviation	English name	Chinese abbreviation	Chinese name
JV	Joint venture		合资企业
LAC	Local Arbitration Commission	本地仲裁委	本地仲裁委员会
LCIA	London Court of International Arbitration		伦敦国际仲裁院
LURs	Land use rights		土地使用权
M&A	Merger and acquisition		收购与并购
MOFCOM	Ministry of Commerce		商务部
MOF	Ministry of Finance		财政部
MOFTEC (Pre-2003)	Ministry of Foreign Trade & Economic Co-operation	经贸部	对外经济贸易合作部
NDRC	National Development and Reform Commission	发改委	国家发展与改革委员会
NPC	National People's Congress	全国人大	全国人民代表大会
NPCSC	Standing Committee of the NPC	全国人大常委会	全国人民代表大会常务委员会
PBOC	People's Bank of China	人行	中国人民银行
PSB	Public Security Bureau		公安局
QFII	Qualified Foreign Institutional Investors		合格境外机构投资者
Rmb	Renminbi		人民币
SAFE	State Administration of Foreign Exchange	外管局	国家外汇管理局
SAIC	State Administration for Industry and Commerce	工商局	国家工商行政管理总局
SASAC	State-owned Assets Supervision and Administration Commission of the State Council	国资委	国务院国有资产管理委员会
SAT	State Administration of Taxation	税务总局	国家税务总局
SDPC (Pre-2003)	State Development Planning Commission		国家发展计划委员会
SEPA	State Environmental Protection Administration	环保总局	国家环境保护总局
SETC (Pre-2003)	State Economic and Trade Commission	经贸委	国家经济贸易委员会
SEZ	Special Economic Zone	特区	经济特区
SIAC	Singapore International Arbitration Centre	新仲	新加坡国际仲裁中心
SOE	State-owned enterprise		国有企业
State Council	State Council		国务院
VAT	Value-added tax		增值税
WFOE	Wholly foreign-owned enterprise	独资企业	外商独资企业

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