# Doing Business in China

This document describes some of the key commercial and taxation factors that are relevant on setting up a business in China.

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# Background

## Country overview

The People's Republic of China is situated in eastern Asia on the western shore of the Pacific Ocean, with an area of 9.6 million square kilometres. As the world's most populous country, China has a population exceeding 1.2 billion, which makes up 22% of the world total. The official language is Mandarin.

## Economic overview

With the entry into WTO in 2001, China's economy is developing increasingly fast. Many overseas companies find China a good country to invest in. The strongest labour force is in East China. The currency for China is RMB. A floating exchange rate is used for exchange controls.

## Transport infrastructure

China's transport infrastructure is comparatively convenient in the east area. For business travel, China International Airlines or China Oriental Airlines are good choices. Goods can be transported by road, rail, inland waterway, pipeline, etc. The transport infrastructure in west China is in infant stage, but with China's 'Go West' policy taking centre stage, investment in the interior provinces is increasing. As a result, the transport infrastructure is developing fast.

# Choice of Legal Form

Possible legal forms for foreign investors to invest in China include: equity joint venture, contractual/cooperative joint venture, wholly foreign owned enterprises (WFOE), branch of foreign enterprise, Chinese holding company (CHC), regional headquarter (RHQ), and representative office (RO). Foreign investors may participate in business in China through merger & acquisition (M&A). A particular legal form is sometimes mandated by regulations. For instance, foreign life insurers are allowed to do life insurance business only by setting up equity joint ventures with their equity up to 50% of an equity joint venture. In addition, there are specific regulations on individual forms.

In recent years, more and more foreign investors have adopted WFOE, mainly because they can fully control management of such enterprises. The CHC normally functions as a parent company, offering certain shared services to its Chinese subsidiaries, but its scope is restricted with respect to financial services. The RHQ usually functions as a management company providing services to its affiliates. In recent years, one popular channel through which foreign investors directly invest into China is acquisition of the equity of an existing local Chinese company, upon approval of competent Chinese authorities. Some foreign investors particularly use this type of transaction to target those state-owned enterprises with outstanding assets (e.g. trademark) or sales network.

The legal form of a foreign investment is thus often based on management considerations. However, tax planning is still relevant as tax treatments differ between these forms. Many examples can be given, for instance, import of certain assets into foreign invested enterprises (FIEs) is exempt from import VAT and import duty, while ROs would not enjoy this privilege.

### Limited liability company

A limited liability company shall be established by not more than 50 shareholders that have made capital contributions. The registered capital of a limited liability company shall be the total amount of the capital contributions subscribed to by all the shareholders that have registered in the company registration authority. If any law or administrative regulation prescribes a relatively higher minimum amount of registered capital of a limited liability company, the provisions of that law or administrative regulation shall be followed.

### General partnership

A general partnership enterprise may be formed by private corporations. The partners shall be responsible for the properties of the partnership enterprise and bear unlimited, joint, and several liabilities for the debts of the partnership enterprise.

### Limited liability partnership

A limited liability partnership enterprise shall be formed by general partners and limited partners. The limited partners bear the liabilities for its debts to the extent of their capital contributions. The name of a limited partnership enterprise shall be indicated by the words “limited partnership”.

### Limited partnership

A limited partner may make capital contributions in money, in kind, or intellectual property right, land use right or other properties. However, a limited partner can’t make capital contributions in labour services. They shall make full payment of the capital contributions within the time limit as stipulated in the partnership agreement. If they fails to do so, they shall be obliged to make up the payment and shall bear the liabilities for breach of contract to the other partners. A limited partner may not execute the partnership affairs, nor may they represent the limited partnership enterprise before outsiders.

### Branch / Representative office

A branch of a foreign enterprise is not an independent entity with a legal enterprise status. An RO which has no legal enterprise status is limited to engaging in non-profit seeking activities, such as market research, providing potential customers of its home company with product information, etc. Foreign companies often sell products by managing distribution through a network of ROs in China. An RO would be subject to Chinese taxation if its activities exceed the legal limits for this form.

### Subsidiary

An independent company, operates as a Limited Liability Company.

### Public limited company

A limited liability company that may sell shares to the public in China, and has limited liability.

### Joint venture

A Joint Venture can be classified into equity joint venture and contractual /cooperative joint venture. Both require cooperation with a Chinese partner. Subject to the approval of the appropriate foreign investment authorities, a contractual joint venture can be structured with unlimited liability of its partners, and thus it can enjoy partnership status for tax efficiency.

### Corporation

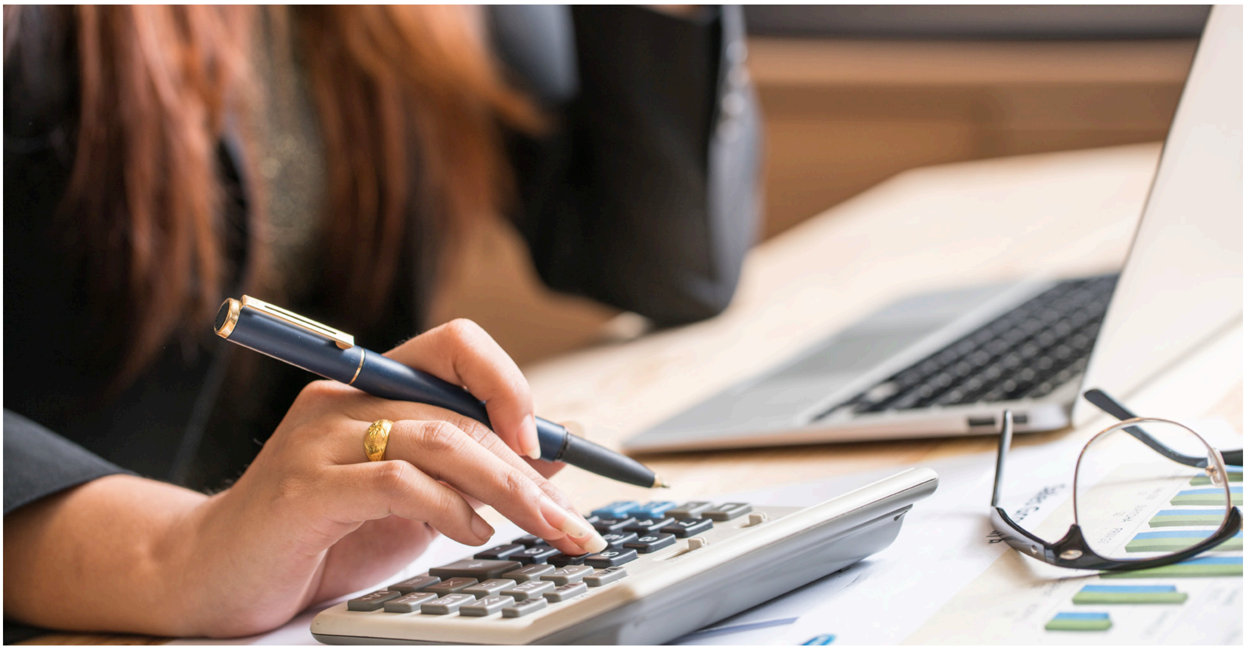
A corporation is the most formal form of a legal entity. According to the company law of the People's Republic of China, corporation here refers to a limited liability company or a limited joint stock company. A corporation is an enterprise juridical person, which has independent juridical personal property and enjoys the property rights of a juridical person. The most important aspect of a corporation is limited liability. That is, shareholders have the right to participate in the profits, through dividends and/or the appreciation of stock, but are not held personally liable for the company's debts.

## Audit Requirements

### Requirement and thresholds

In China, the main organizations that are required to be audited are as follows: limited liability companies, stock companies, public companies and foreign-invested enterprises. These types of organizations are required by law to be audited, whatever the size of their sales or assets.

# Taxation



## Income tax on enterprises with foreign investment and foreign enterprises

### Corporation tax

China uses tax preferences to bring in its much needed companies. Manufacturing enterprises with foreign investment, export-oriented enterprises with foreign investment or advanced technology enterprises, enjoy income tax holidays, VAT refunds for exports, and free duties for importing equipment and machinery needed in production of FIEs. Foreign investors need to ensure that they qualify for these preferences.

Chinese tax preferences are designed to foster growth in certain regions. Foreign enterprises located in Special Economic Zones, Economic and Technological Development Zones, Coastal Economic Open Zones, State New and High-tech Industry Development Zones and/or Bonded Zones, and in the middle and west of China shall enjoy certain tax reductions and exemptions. Therefore, carefully selecting a site is imperative.

### Small companies rate

A small industrial enterprise is one with an annual taxable income which does not exceed RMB 300,000.00; the number of employees does not exceed 100; and the total assets do not exceed RMB 30 million. Enterprise income tax for a small-scale enterprise that meet these prescribed conditions shall be levied at a reduced rate of 20%.

If the above small industrial enterprise's annual taxable income is from RMB 200,000.00 to RMB 300,000.00, income tax shall be levied at a reduced rate of 10% from 1 Oct 2015 to 31 Dec 2017.

Other small enterprises (i.e. not industrial) are those with an annual taxable income which does not exceed RMB 300,000.00; the number of employees does not exceed 80; and the total assets do not exceed RMB 10 million. Enterprise income tax for a small-scale enterprise that meets the prescribed conditions shall be levied at a reduced rate of 20%.

If the above small non-industrial enterprise's annual taxable income is from RMB 200,000.00 to RMB 300,000.00, income tax shall be levied at a reduced rate of 10% from 1 Oct 2015 to 31 Dec 2017.

## Dividend payments

If a foreign shareholder reinvests dividends in China, it can receive a tax refund from the Chinese tax authorities equal to 40% of the enterprise income tax paid by the dividends distributing company. Because of the dividend-reinvestment incentive, it will be tax beneficial to reinvest dividends in China.

## Branch profits tax

Same as Corporation Tax.

## Personal income tax (pay as you earn)

a) Income from wages and salaries shall be taxed at progressive rates ranging from 3% to 45%. A monthly deduction of 3500 Yuan shall be allowed for expenses and anything in excess of 3500 Yuan shall be taxable income. 3500 Yuan is the fixed deductible amount for Chinese while 4800 Yuan is the fixed deductible amount for foreigners working in China.

b) Income from the production and business of individual industrialists and merchants (the amount remaining from its gross income in a tax year after the costs, expenses and losses have been deducted) and income from contracted or leased operation of enterprises or institutions (the amount remaining from its gross income in a tax year after deducting necessary expenses – the allowable expenses are 2000 Yuan per month at the present) shall be taxed at progressive rates ranging from 5% to 35%.

c) Income from an author's remuneration shall be taxed at a flat rate of 20%. The amount of tax payable however shall be reduced by 30%. (14%).

d) Income from remuneration for personal service shall be taxed at a flat rate of 20%. Where a specific payment of income from remuneration for personal service is excessively high, additional tax can be levied at a rate to be specifically determined by the State Council.

e) Income from royalties, interest, dividends, bonuses, lease of property and transfer of property, as well as contingent income and other income shall be taxed at a flat rate of 20%.

For income from remuneration for personal service, author's remuneration, royalties and lease of property, a deduction of 800 Yuan shall be allowed for expenses, if the amount received in a single payment is less than 4000 Yuan. For single payments of 4000 Yuan or more, a deduction of 20% shall be allowed for expenses. The remaining amount after the deduction shall be the taxable income.

For income from transfer of property, the taxable income shall be the amount remaining from the gross transfer income after deducting the original value of the property and reasonable expenses.

For interest, dividends, bonuses, contingent income and other income, the taxable income may be the full amount received in each payment. The part of individual income donated to educational and other public welfare undertakings shall be deducted from the taxable income in accordance with the relevant regulations formulated by the State Council.

For the tax payer who has no domicile in China but derives wages and salaries from sources within China, or has domicile in China but derive wages and salaries from sources outside China, the additional deduction for expenses shall be allowed on the basis of the average income level, living standard and the changes of exchange rates. The scope of application and amount of the additional deduction for expenses shall be regulated by the State Council.

For individual income tax, the income earner shall be the taxpayer and the paying unit or individual shall be the withholding agent. Taxpayers that receive wages or salaries from two or more payers, or taxpayers without withholding agent, shall file tax returns and pay tax themselves.

## Business tax

From 1 May 2016, business tax was cancelled in PRC.

## Consumption tax

### Taxpayers

All enterprises, units and individuals engaged in production or importation of the taxable consumer goods within the territory of PRC are consumption taxpayers.

### Tax items and rates

Eleven taxable items are subject to Consumption Tax either at flat rate, fixed-amount of tax per unit, or compound rate.

a) Compound rate for tobacco;

b) Compound rate for alcoholic drinks and alcohol;

c) 30% on cosmetics;

d) 8% on skin-care and hair-care products;

e) 5% on gold and silver jewellery and diamond and diamond decoration, 10% on other precious jade and stones;

f) 15% on firecrackers and fireworks;

g) 0.2 Yuan per litre on non-lead gasoline, 0.28 Yuan per litre on lead gasoline;

h) 0.1 Yuan per litre on diesel oil;

i) 10% on motor vehicle tyres;

j) 10% on motorcycles;

k) 3%, 5%, and 8% for motor cars with different sizes and cylinder capacities.

## Value added tax

### Taxpayers

All kinds of enterprises, institutions, individual business operators and other individuals who are engaged in the sales of goods, importation of goods, provision of processing, repairs and replacement services within China are VAT payers.

### Taxable items and tax rates

| Taxable Items | Rates |
|---|---|
| Exported goods (except for the goods either in aid of foreign countries or prohibited by the Central Government for exportation) | 0% |
| 1) Since 1st January 2012, the original 5% Business Tax (Sales Tax) has been replaced by 6% Value Added Tax (VAT) in Transportation and some Modern Service Industry in Shanghai.<br>2) R&D service provided<br>3) Transfer of intangible assets, including transfer of land-use rights, patent rights, non-patent technologies, trademarks, copyrights and goodwill | 6% |
| Domestic Transportation service with own vehicles is subjected to input VAT deduction | 11% |
| 1) Agricultural products, forestry products, animal husbandry products, and aquatic products;<br>2) Edible vegetable oil and food grains;<br>3) Tap water, heating, air conditioning, hot water, coal gas, liquefied petroleum gas, natural gas, methane gas, coal/charcoal products for household use;<br>4) Books, newspapers magazines (excluding newspapers and magazines issued by post and tele-communication departments)<br>5) Feeds, chemical fertilisers, agricultural chemicals, agricultural machinery and covering plastic film for farming<br>6) Dressing metal mineral products, dressing non-metal mineral products, coal. | 13% |

| Taxable Items | Rates |
|---|---|
| Crude oil mine salt and goods other than those mentioned above, services of processing, repairs and replacement services. | 17% |
| From 1 May 2016, previous business tax payers under construction, real estate, financial service, and social services industries will change from paying business tax to paying value added tax. | 3%, 6%, 11%, 17% respectively |

## Land tax

Land tax is a collection of various taxes levied on land according to the land area, land grade, price, returns of land, and land appreciation. In China, the primary land taxes are land appreciation tax and real estate tax.

## Tax treaties

Up to now, a tax agreement has been signed between China and other 89 countries. Besides, China has concluded with Hong Kong and Macau an agreement of prevention of double taxation and avoidance of tax fraud. Please refer to appendix 1.

## Transfer pricing rules

Enterprises involved in related-party transactions and tax authorities evaluating related-party transactions shall adopt reasonable Transfer Pricing methods on an arm's-length basis.

# Allowances

## Depreciation

Depreciation on fixed assets shall generally be accounted for on an average basis under the straight line method.

Depreciation rate of the fixed assets shall be calculated and determined on the basis of the original cost, estimated residual value and the useful life of the fixed assets. Estimated residual value is 10% of the original cost.

Since January 1st, 2008, the useful lives of the fixed assets have changed as follows:

- The useful life of buildings and structures is no less than 20 years.
- The useful life of airplanes, trains, ships, machinery and other equipment for production is no less than 10 years.
- The useful life of instruments and furniture is no less than 5 years.
- The useful life of transport facilities is no less than 4 years exclusive of airplanes, trains and ships.
- The useful life of electronic equipment is no less than 3 years.

## Tax credits

Since January 1st, 2008, the foreign-invested enterprises have had no access to preferential income tax policies. The income tax on the enterprise shall be computed on the taxable income at the rate of 25%.

## Arm's length principle

Tax evasion is rampant in China. An earlier figure suggests that illegal tax avoidance may have resulted in an average loss of 30 billion Yuan (US$3.6 billion) a year just by multinationals. 60% of the tax evaded is through abusing transfer pricing to shift Chinese subsidiaries' profits to overseas parent companies. China therefore adopts the Arm's Length principle, which means treating related parties as independent parties. An Advance Pricing Arrangement ("APA") is also used by Chinese tax authorities as an alternative to the traditional dispute resolution process, e.g. transfer pricing audit and defence. Since the first introduction of the APA concept in 1998, under the Transfer Pricing Regulation (widely known as "Circular 59"), around 130 APAs (all unilateral) have been concluded in various regions/cities such as the Pearl River Delta (including Shenzhen), Shanghai, Tianjin, Qingdao, Dalian, and Xiamen.  In 2004, the State Tax Administration (STA) issued Rules on Advance Pricing Arrangements.

# Employment

## Social security

Social Security includes Housing, Unemployment and Pension Insurance. The correct amounts to each as follows.

- Housing Insurance = 7% of the Chinese Employment's payroll
- Unemployment Insurance = 2% of the Chinese Employment's payroll
- Pension Insurance = 22% of the Chinese Employment's payroll

## Employment of foreign personnel

The social security of foreign personnel is paid in his/her mother company. The foreign personnel in China shall pay for his/her IIT based on a progressive IIT form.

## Medical

Medical Insurance is equal to 12% of the Chinese Employment's payroll.

## Payroll taxes

(See Personal Income tax, above)

# Withholding Taxes

## Interest

The tax rates of withholding taxes on interests are 10% for income tax and 6% for value added tax.

## Royalties

The tax rates of withholding taxes on royalties are 10% for income tax and 6% for value added tax.

## Dividends

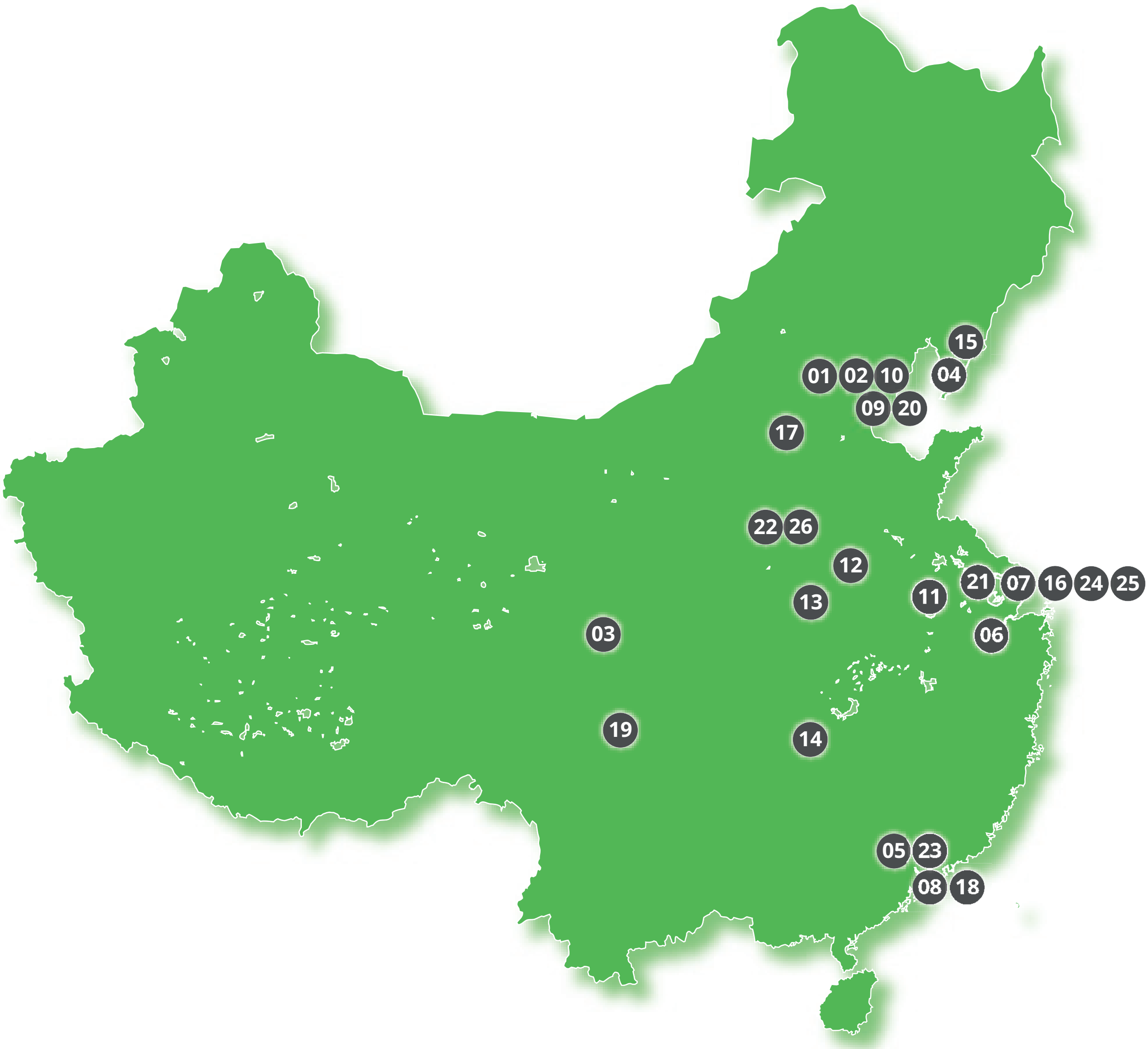
Dividends distributed to foreign investors before 2008 are exempt from withholding tax. The dividends generated after 2008 are usually subject to 10% withholding tax. Tax concession or exemption can apply if there is a Tax Agreement or Treaty between regions. For example, the agreed Tax concession with the US is 10%, with Hong Kong is 5% (if holding 25% or more shares) or 10% (if not).

# Miscellaneous

You can see more details on
www.english.gov.cn

# Appendix I, Taxation Treaties

| | | | |
|---|---|---|---|
| Japan | Switzerland | Armenia | Nepal |
| United States | Cyprus | Jamaica | Kazakhstan |
| France | Spanish | Iceland | Indonesia |
| UK | Romania | Lithuania | Oman |
| Belgium | Austria | Latvia | Nigeria |
| German | Brazil | Uzbekistan | Iran |
| Malaysia | Mongolia | Bengal | Tunisia |
| Norway | Hungary | Serbia and Montenegro | Bahrain |
| Denmark | Malta | Sultan | Greece |
| Singapore | United Arab Emirates | Macedonia | Kyrgyzstan |
| Finland | Luxembourg | Egypt | Morocco |
| Canada | Korea | Portugal | Sri Lanka |
| Sweden | Russia | Estonia | Trinidad and Tobago |
| New Zealand | Papua New Guinea | Laos | Albania |
| Thailand | India | Seychelles | Brunei |
| Italy | Mauritius | Philippines | Azerbaijan |
| Netherlands | Croatia | Ireland | Georgia |
| Czech Republic | Belarus | South Africa | Mexico |
| Poland | Slovenia | Barbados | Saudi Arabia |
| Australia | Israel | Moldova | Algeria |
| Bulgaria | Vietnam | Qatar | Hong Kong |
| Pakistan | Turkey | Cuba | Macau |
| Kuwait | Ukraine | Venezuela | |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