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Chapter 34

Doing Business in China

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DOING BUSINESS IN CHINA

This chapter provides a brief overview of structuring, corporate, commercial, IP, and tax issues that foreign investors should consider before doing business in China.

General Overview

In 2006, according to The World Bank's official measure, China had become the world's fourth-largest economy, behind the United States, Japan, and Germany. China is the fastest growing consumer economy in Asia and, unless conditions change, may soon surpass Japan as the largest Asian economy and the second-largest world economy. China also is close to overtaking Germany as the world's third-largest world economy. China's economic boom is creating unprecedented opportunities, as China has become one of the countries that has absorbed the most foreign investments.

Establishing Operations in China

Representative Office

A foreign representative office was the earliest, and for a time the predominant, form of a foreign related entity that was allowed to do business in China. A representation office can only perform liaison work between the foreign parent entity and the local businesses. A representation office cannot generate revenue in China and cannot sign or enter into any type of revenue-generating contracts with local businesses. It is solely a communications vehicle that helps the foreign parent entity to do business with Chinese clients.

Wholly Foreign-Owned Enterprise

Today, the majority of multinationals are invested in China, entering into joint ventures or setting up wholly owned enterprises for the Chinese market or foreign markets. The wholly foreign-owned enterprise (WFOE) or wholly owned foreign enterprise (WOFE) allows the foreign investor to maintain complete ownership of the business enterprise and to operate the business without the constraints of a local partner that may not share the same goals, expectations, values, or firm culture. For some types of enterprises, such as a research and development facility, the WFOE offers the additional advantage of allowing the foreign investor to maintain closer security and protection over its IP and other proprietary information.

Joint Venture

There are two types of joint ventures in China—an equity joint venture (in which profit and risk sharing are proportionate to the equity of each partner in the equity joint venture) and a cooperative/contractual joint venture (in which profit and risk sharing are divided according to the contractual terms rather than the equity of each partner in the contractual joint venture). While foreign companies are increasingly likely to establish WFOEs in China, equity joint ventures are the second most common way in which foreign companies enter the Chinese market and are the preferred manner for corporations in which the Chinese government and Chinese businesses are concerned. This chapter focuses on equity joint ventures. Normally, operation of an equity joint venture is limited to a fixed period of time from 30 to 50 years. In some cases, however, an unlimited period of operation can be approved, especially when the transfer of advanced technology is involved.

Typical reasons to opt for a joint venture include the following:

- Chinese policy discourages or prohibits WFOE in the sector in question.
- The Chinese partner holds a dominant market position, which the proposed joint venture will inherit.
- The Chinese partner has a distribution network, assets, relationships, or other advantages that will permit the joint venture access to markets, raw materials, or quotas.

Due Diligence

As with investments in other countries, the investor's first line of protection in an investment in China is a thorough business and legal due diligence. A surprising number of experienced international businesspeople appear to ignore this basic tenet when investing in China. Others are aware of the need but consider it a hopeless task. While it is true that conducting a professional due diligence in China does present peculiar challenges and often yields less reliable information than foreign investors are used to, much can and should be done. The special challenges of due diligence in China arise from the often obscure and volatile state of China's legal system, Chinese companies' lack of familiarity (and patience) with corporate formalities and recordkeeping, and the great breadth of authority afforded to China's bureaucracy.

Major due diligence areas should include (i) the nature and powers of the partner, (ii) financial records, (iii) employees, (iv) contractual obligations, (v) tax, and (vi) ownership of assets.

Offshore Holding Structures

Most foreign investors prefer to conduct their Chinese investments through a series of offshore, single-purpose, limited liability companies. The reasons for conducting their investment in such a manner include:

- Permitting the investor to limit its Chinese project liability to one offshore entity.
- Facilitating future transfers of the investor's investment.

- Allowing, in cases in which there are multiple foreign investors in a joint venture, a shareholders agreement among the investors through which (in a useful and discreet manner) the foreign parties may work out the details of their cooperation.
- Achieving, through an offshore company incorporated in a jurisdiction with a modern companies law (i.e., Hong Kong), more complex corporate capital structures, such as preferred stock, redemption rights, or the like, for which Chinese joint venture law does not provide.
- Having an arbitration forum where the offshore entity is located, which is a jurisdiction favorable to the foreign investor.

Feasibility Studies

An important part of the joint venture approval process is submission of a feasibility study. Approval authorities rely heavily on these documents in determining whether to approve a joint venture. The feasibility study is intended to be drafted jointly by the joint venture parties and should set forth in some detail:

- The form and objectives of the joint venture
- Sources and uses of investment
- Products to be produced
- Anticipated scale of production
- Arrangements for obtaining the site, facilities, technology, and equipment to be used (including a discussion of the availability of utilities)
- Sources of raw materials
- Foreign exchange sources and expenditures
- Financial projections and economic benefit analysis
- Labor requirements and training plans
- Market analysis and marketing and distribution plans

Transition Issues for Transfers of Existing Facilities into Joint Ventures

If a joint venture contract requires the Chinese partner to contribute an existing plant or facility into the joint venture, careful thought must be given to the mechanics and details of such a transfer. The joint venture contract should attach an appendix listing all of the Chinese partner's assets and liabilities that are to be transferred to the new entity. Land-use rights, buildings and other fixed assets, inventory, receivables, intangibles, and contractual rights should be clearly identified.

Land-Use Issues

All land in China is owned by the state or by collectives. Local land management bureaus, which administer land-use rights, may either "allocate" or "grant" state-owned land-use rights to a user. Allocated land is transferred to the user for free, although an annual land-use tax is usually payable by the tenant. It is important to note, however, that users of allocated land have no right to transfer it, and the state may recover the land at any time without paying compensation. When land is "granted," the user pays the state a land grant premium for the right to use it for a stated number of years. This granted land-use right is transferable (including by mortgage and lease) by the grantee, and may not be abrogated by the state except for compensation in the exercise of its right of eminent domain.

In the case of an existing facility, the Chinese partner almost always has allocated land-use rights and frequently does not have sufficient funds to pay the land grant premium necessary to convert the allocated use right into a granted right. Therefore, the Chinese partner cannot transfer the land to the joint venture itself, and must persuade local land management authorities to transfer it.

Valuation Issues

In the majority of ventures, the Chinese party's contributions to the company are entirely in kind. Foreign partners are more likely to contribute cash or a combination of cash and kind. In most joint ventures, the relative value of the parties' contributions determines their respective shares of profits, so the value of noncash contributions is usually a hotly negotiated issue. The agreed value of such contributions must be set forth in the capital contribution section of the joint venture contract. Noncash contributions by foreign joint venturers must also be valued by the State Import and Export Commodities Inspection Administration, and the actual contribution of both cash and noncash inputs must be verified by a licensed Chinese accounting firm. In addition, to ensure that state assets are not being dissipated at below fair value, state-owned assets (e.g., assets owned by state enterprises) must be valued by a valuation firm licensed by the State Assets Management Bureau.

Most localities have standards for the value of land-use rights. Because these rights almost always are contributed by the Chinese party, the foreign investor should investigate whether the valuation suggested by the Chinese party falls within the official range. Investors should bear in mind that the official guidelines assume granted land-use rights rather than allocated land-use rights.

Registered Capital

A joint venture contract is required to state the parties' estimate of the total amount of investment (both debt and equity) the venture will need to achieve its then-anticipated scale of production. A percentage of this amount, which percentage decreases in inverse proportion to the size of the total investment, to a minimum of one-third of total investment, must be contributed to the joint venture as "registered capital." With limited exceptions, a joint venture's registered capital may not be reduced without an amendment of its joint venture contract and articles of association and the ap-

proval of the relevant government authorities. The full amount of registered capital must be retained in the joint venture and cannot be distributed to its owners during the joint venture term.

Even if a joint venture has a quickly depreciating asset, which accounts for a large portion of the company's cash flow, cash in excess of profits of the joint venture cannot be distributed to the joint venture parties, but must be retained within the joint venture so as not to impair registered capital. While laws restricting capital impairment are in effect in many jurisdictions, the combined effect of China's registered capital to total investment ratio rules, and its capital impairment rules, mandate that an unusually large amount of registered capital be maintained in joint ventures.

Noncompetition Clauses

If the Chinese partner is to continue to have its own factories or separate operational capabilities, it may be desirable to include a noncompetition clause in the joint venture contract. The scope of this clause, both geographically and by product line, can be an emotionally charged issue for both parties. If the foreign investor feels confident that it can compete effectively with its partner's other facilities, or if the key ingredients to effective competition (e.g., a trademark or unique technology) are being transferred to the joint venture, a noncompetition clause may not be necessary.

Export Percentages and Foreign Exchange

When China first permitted foreign investment, it was hoping that foreign companies would manufacture in China, using domestic content, and export their products to the rest of the world, enabling China to earn foreign exchange. Export earnings were originally intended to be the exclusive source of foreign exchange for joint ventures. Over the years, practice has eaten away at this policy. Many joint ventures now meet only a small percentage of their foreign currency needs with export revenues and rely on the foreign currency markets for the rest. Still, exports are strongly encouraged, especially in lower technology manufacturing enterprises, and a commitment to export a high percentage of production can bring tax benefits.

Capitalization Requirements and Approvals

The permissible debt-to-equity ratio of a joint venture is regulated depending on the size of the joint venture. In situations in which the sum of debt and equity is less than USD $3 million, equity must constitute 70% of the total investment. In joint ventures in which the sum of the debt and equity is more than USD $3 million but less than USD $10 million, equity must constitute at least half of the total investment. In cases in which the sum of the debt and equity is more than USD $10 million but less than USD $30 million, 40% of the total investment must be in the form of equity. When the total investment exceeds USD $30 million, at least one-third of the sum of the debt and equity must be equity.

Feasibility studies must be submitted for examination and approval to the competent department of the State and the department of Beijing Municipality, respectively, in addition to the district and county governments of Beijing, according to the sum of total investment. Capitalization of a joint venture with an investment less than USD $30 million can be handled locally. A joint venture

with an investment of more than USD $30 million, however, must be examined and ratified by the Beijing Municipal Commission of Urban Planning and submitted by the Commission to the State Planning Commission for examination and approval. Contracts and articles of association shall be examined and approved by the Ministry of Commerce (MOFCOM; formerly the Ministry of Foreign Economic Relations and Trade [MOFERT]).

Chinese Law Opinion Letters

Foreign investors must obtain an opinion letter from a reputable Chinese law firm for the joint venture contract and related contracts regarding the formation of the joint venture company. Chinese counsel should be asked to opine on:

- The existence of the Chinese party
- Its power to enter into the joint venture
- Its due authorization and execution of the relevant contracts
- The enforceability of the contracts against the Chinese party

Conditions to Effectiveness of Joint Venture Contracts

While joint venture approval authorities generally disfavor any conditions to the effectiveness of joint venture contracts, as a practical matter, a few reasonable conditions generally do not meet with objection. These are usually stated as preconditions to the foreign partner's obligation to fund its contribution to registered capital, rather than as conditions to the effectiveness of the contract itself. Typical conditions include those mentioned previously relating to finalization of land transfer arrangements and fulfillment of all conditions to the Chinese party's legal and unfettered contribution of its assets, including receipt of all necessary approvals.

If obtaining a special tax ruling or if a particular contract is essential to the contemplated venture (e.g., a fuel supply agreement for a power plant), a precondition to such effect may be accepted. The approval authorities have broad discretion in this area, and what will and will not be acceptable in a particular instance may depend on such factors as the Chinese partner's relationship with the relevant regulators and the perceived value and importance of the project.

Defaults on Registered Capital Contributions by the Chinese Party

With the ongoing credit crunch in China, it is common for the Chinese party to default on cash contributions when a joint venture contract calls for registered capital to be contributed in installments. If the joint venture's total registered capital is not paid by deadlines set by law, the State Administration of Industry and Commerce is authorized to cancel the joint venture's business license. If the Chinese party can raise the necessary cash, the safest way to avoid this problem is to require that all parties' cash contributions be made simultaneously at the outset of the joint venture.

Postregistration

After a joint venture is registered, the entity is considered a Chinese legal entity and must abide by all Chinese laws. As a Chinese legal entity, a joint venture is free to hire Chinese nationals without the interference from government employment industries as long as they abide by Chinese labor law. Joint ventures are also able to purchase land and build their own buildings, privileges denied foreign representative offices.

Exit Routes

Most investors in China are strategic investors, such as manufacturing firms that wish to establish a long-term production facility to service the Chinese and regional market. They typically are not greatly concerned about the mechanics or financial consequences of disposing of the investment.

There is, however, a growing group of financial investors in China, including investment funds, merchant banks, and other financial institutions. These investors are keenly interested in strategies for tax-efficient exit from their investments within a set time frame. In such cases, investors should also consult a licensed Chinese accounting firm before establishing their presence in China.

Post-WTO

China's formal World Trade Organization (WTO) accession process was completed on December 11, 2001, when it became the 143rd member of the WTO. Now that China is a participating member of the WTO, foreign companies have an unprecedented opportunity to enter or expand in a huge, growing market of approximately 1.3 billion people (more than 25% of the world's total population). In many ways, China can be considered an exporter's fantasy. China is a major producer that is becoming a major consumer, and it is hungry for a wide range of Western goods, from dairy to high-tech products. China is already the fourth-largest economy, surpassing Great Britain, and many people are predicting that it could pass Japan as the second-largest trading nation within the next decade. The total value of goods and services has been growing at a double-digit rate for more than 20 years. China's foreign reserves, already the world's largest, rose to USD $1.33 trillion at the end of June 2007 (a 41.6% increase over the figure in June 2006). Driven by domestic demand and supported by WTO accession, the Chinese economy should continue to grow robustly over the next several years.

Cultural Issues

Nonetheless, foreign investors must understand that China is a complex and challenging market. Before considering China, investors should first understand the legal and political processes that are only slowly catching up to the rapid-pace economic change and hype surrounding this vast economy. Foreign investors must find lawyers and consultants who know about doing business in China—someone who speaks the language, both linguistically and culturally. Investors should make every attempt to learn the culture rather than focusing solely on the financial aspects or the legal terms and conditions of the deal. After all, investors are doing business in a foreign country with a different political system, a different culture, and a different view on world affairs and their place

in the world. A lot is said about Chinese "guanxi" (relationship). The key thing to remember is that good "guanxi" is a network of relationships with people at various levels across a broad range of organizations and that "guanxi" is created and cultivated. While someone may say that both American and Chinese businesspeople are motivated by the same thing—profits—the way they go about achieving that goal is very different. Knowing the law, understanding the culture, and having good "guanxi" will help ensure the long-term success of a foreign investor's business in China.

IP Protection and Enforcement in China

How to Obtain IP Rights in China

Chinese law protects IP rights (IPRs) including patents, copyrights, trademarks, and trade secrets. A foreign company must register or apply for its IPRs with the appropriate Chinese agencies and authorities for those rights to be enforceable in China. China's IP laws are described in the following sections.

Patent Law

Eligibility. China grants patent protection to foreign nationals based on a government agreement or an international treaty. U.S. nationals or their assignees or successors are eligible for registration of invention, utility model, and design patents in China based on the Paris Convention and the Patent Cooperation Treaty (PCT). Under the Chinese Patent Law, invention patents cover inventions that (i) show novelty and are not obvious, and (ii) have been developed to the point that they can be utilized in industry. Utility model patents cover creations or improvements relating to the form, construction, or fitting of an object. Design patents cover original designs relating to the shape, pattern, color, or a combination thereof of an object.

Procedure. A patent application must be filed with the State Intellectual Property Office of China (SIPO). Normally, SIPO publishes its preliminary approval of the application within 18 months from the filing date. An invention patent application is subject to substantive review upon the request of the applicant within three years from the date of publication. There is no substantive review for utility model and design patents. An approved patent application will be published, and if no opposition is filed within six months after publication (the six-month opposition period), the application will mature into registration.

Term. Patent rights commence from the date of publication in the *Patent Gazette*. The term varies depending on the type of patent. For invention patents, the term is 20 years from the application filing date. For utility model and design patents, the term is 10 years from the application filing date.

Conditions Barring Patentability. An invention, utility model, or design patent registration will be denied if (i) the invention, utility model, or design was published anywhere in the world or put to public use in China; (ii) a patent has already been granted to the same, and that application was filed earlier than the current application; or (iii) it is obvious to people familiar with the relevant field. In addition, an invention or utility model patent application will be denied if such invention or utility model was displayed in an exhibition, provided that the exhibition was not

sponsored or approved by the government, and no patent application was filed for the invention or utility model within six months from the opening date of the government-sponsored or -approved exhibition.

Unpatentable Matters. The following items are unpatentable in China:

- New varieties of plants and animals, not including the breeding processes for new varieties of plants
- Diagnostic, therapeutic, or surgical methods for treating human or animal diseases
- Scientific principles or mathematical methods
- Rules or methods for playing games or sports
- Other methods or schemes that can be carried out only by means of reasoning and human memory
- Substances obtained by means of nuclear transformation
- An article that is detrimental to public order, good morals, or public health
- An article the shape or the design of which is identical or similar to the party, national, or military flag; the national emblem; or the government medal

Opposition and Invalidation. Oppositions may be filed during a patent application's six-month opposition period to prevent registration. Oppositions are usually filed on the grounds that the approved patent is not novel or is similar to another registered patent. Invalidation requests can be filed after a patent has been granted registration, usually on grounds of (i) obviousness, (ii) lack of enablement, and (iii) lack of written description to support the claims.

Appeal. A party may appeal SIPO's unfavorable decision on an application or on an opposition or invalidation action. Appeals are handled by the Patent Reexamination Board. Appeal from the Board may be made to the Beijing First Intermediate Court and may then be appealed through the court system.

Latest Developments. SIPO published a revised *Guidelines for Patent Examination*, which became effective as of July 1, 2006. Some major revisions in the latest guidelines include the following:

- **Inventions related to embryonic stem cells and their preparation methods, as well as human beings at different development stages, are NOT patentable** under the Chinese Patent Law.
- Computer programs are still deemed as "rules and methods for mental activities" and are still not patentable under the Chinese Patent Law. However, **"means plus function" claims are now allowable** for products involving "modules" that implement computer programs. In other words, one may now obtain patent protection for a computer pro-

gram by drafting claims reciting a product comprising various "functional modules" that implement the steps of the computer program.

- In order to establish novelty of an apparatus claim with features such as superior performance, the applicant must show that these features at least imply that the claimed product has certain structure and/or composition that is distinguishable from the prior art. Otherwise, the claimed product reads on the prior art and, therefore, is not patentable.

Trademark Law

China joined the Madrid Protocol in 1989, which requires reciprocal trademark registration for member countries, which now include the United States. The current Chinese trademark law extends registration to collective marks, certification marks, and three-dimensional symbols, as required by the Agreement on Trade Related Aspects of Intellectual Property Rights (TRIPs). China has a "first to register" system that requires no evidence of prior use or ownership, leaving registration of popular foreign marks open to third parties. However, the Chinese Trademark Office has cancelled Chinese trademarks that were unfairly registered by local Chinese agents or customers of foreign companies. Foreign companies seeking to distribute their products in China are advised to register their marks and/or logos with the Chinese Trademark Office. Further, any Chinese language translations and appropriate Internet domains should also be registered.

Copyright Law

Unlike patents and trademarks, copyrighted works do not require registration for protection in China. Protection is granted to individuals from countries belonging to the copyright international conventions or bilateral agreements of which China is a member. However, copyright owners may wish to voluntarily register with China's National Copyright Administration (NCA) to establish evidence of ownership should enforcement actions become necessary.

Unfair Competition Law

China's Unfair Competition Law provides protection for unregistered trademarks, packaging, trade dress, and trade secrets. Protection of company names is also provided. According to TRIPs, China is required to protect undisclosed information submitted to Chinese agencies in obtaining regulatory approval for pharmaceutical and chemical entities from disclosure or unfair commercial use. China's State Drug Administration and Ministry of Agriculture oversee the marketing approval of pharmaceuticals and agricultural chemicals, respectively.

IP Enforcement in China

Enforcement of IPRs in China follows a two-track system. The first is the administrative track, whereby an IPR owner files a complaint either with the local administrative office or with Chinese customs officials. The second is the judicial track, whereby complaints are filed through the court system.

Local Administrative Office Proceeding

An IPR owner can file a complaint of infringement with a local IP administrative office. The local administrative office will investigate and may impose injunctions on the infringing party and order destruction of the infringing product or the equipment used for making the infringing product. The local administrative office can also decide the amount of damages to be paid to the IPR owner. Parties can appeal the local administrative office's decision to the local court.

IP Customs Protection

Record-Filing IPR. An IPR owner can also protect its rights through customs actions. To do that, the IPR owner must first apply to the Customs General Administration for record-filing of its IPR. The Customs General Administration will make a decision as to whether or not to grant record-filing within 30 days of application. Record-filing of customs protection of IPR becomes valid on the day when record-filing is granted and remains valid for a period of up to 10 years.

Complaint and Seizure. An IPR owner that has recorded its IPR with the Customs General Administration may complain to the customs office where the suspected infringing goods are imported/exported. When requesting seizure of the suspected infringing goods, the complainant must provide securities equivalent to the value of the suspected goods to be seized. If the customs office decides to seize the suspected infringing goods, it will notify the IPR holder in writing and deliver the notice of seizure to the consignor or consignee of the goods seized. The customs office may also ex officio seize goods that are suspected to have infringed the recorded IPRs and notify the recipients/deliverers of the goods as well as owners of IPRs within three days.

Response to Notice. The consignor or consignee must respond to the customs office within seven days of receipt of the notification. If no response is received, the goods shall be deemed infringing goods and shall be disposed of accordingly. If response is received, then the response shall be served to the IPR owner. The IPR owner must bring the case to the competent administrative authorities or to the Supreme People's Court within 15 days after receiving the notice.

Release from Seizure. The consignor or consignee of the seized goods may apply to the customs office for release of the goods by providing securities equivalent to twice the value of the goods in question. Seized goods shall otherwise be released by the customs office if (i) they are determined not to be infringing IPRs after investigation by the customs office or the Supreme People's Court, (ii) the IPR owner does not start legal proceedings with the Supreme People's Court, or (iii) the IPR owner does not respond to the customs office's inquiries or does not wish to pursue the matter.

Civil Judicial Proceedings

Complaint. In China, most cases concerning IPR infringements are handled by civil courts. A plaintiff institutes a suit by filing a written complaint with a court. Foreign plaintiffs not residing in China must also provide documents demonstrating their qualification as IPR owners. These documents must be certified by a local certification agency and must also be certified by the Chinese embassy in the foreign country.

Jurisdiction. Local courts of the defendant's residence and local courts of the place of infringement have jurisdiction to hear IPR cases. If a case involves multiple defendants residing in different places, then every place bearing a defendant has jurisdiction to hear the case.

Statute of Limitations. An IPR suit may be barred by the statue of limitations if it was not brought within two years from the time the IPR owner knew or should have known of the act of infringement. However, if an IPR owner sues after the two-year limitation, the suit is still valid if infringement continues. In that case, damage calculation would start from two years before the suit.

Preliminary Injunctions. An IPR owner may move for a preliminary injunction to stop the alleged infringement pending resolution of the suit. Along with the motion, the IPR owner must provide a security bond, the value of which is determined by the court. After issuance of the injunction, the defendant may move for reconsideration within 10 days of issuance. The injunction remains effective when the reconsideration motion is pending.

Criminal Judicial Proceedings

An IPR owner may also seek criminal remedies against the infringers if the infringement causes severe damages to the IPR owner. In a criminal case, a complaint is usually filed directly with the public prosecutor's office. The prosecutor has authorized discretion to conduct a raid or may do so upon the IPR holder's request. Following a raid, the prosecutor will hold a set of proceedings. The proceedings usually last two to three months before the prosecutor files indictment. Criminal penalties with respect to IP infringement range from less than three years' to more than seven years' imprisonment with a fine. Any appropriate evidence discovered in inspections or searches that may be used to prove the guilt or innocence of a defendant shall be seized. Products other than those named in a warrant are seizable.

Tax Considerations for Investors in China

Overview of Tax Concerns

To date, U.S. investors in China have been confronted with a sometimes confusing array of national and local taxes, the complexity of which is exacerbated by a constantly changing landscape of tax incentives and tax holidays meant to encourage foreign investment. U.S. and other foreign investors must now prepare to deal with a significant overhaul of the Chinese tax system, in the form of the new Enterprise Income Tax Law (New EIT Law), which is scheduled to take effect January 1, 2008. The new Chinese tax rules promise to introduce much needed clarity but may also have the effect of materially increasing foreign investors' Chinese tax liability.

An additional layer of confusion is added once reference is made to the relevant U.S. tax laws, including one set of intricate rules that addresses the enjoyment of foreign tax credits and another complicated group of provisions that imposes current U.S. tax upon "passive" foreign income, even when such income is not repatriated to the United States.

Accordingly, when U.S. investors prepare to invest in China, they need to consider both the Chinese and U.S. tax consequences of the following:

- The form of their investment
- The generation by that investment of income or, alternatively, losses
- The business operations that the Chinese entity will conduct with related parties
- The actual distribution of earnings out of China
- The advisability of using a holding entity, whether located in China, the United States, or a third country
- The U.S. investor's ultimate disposition of its Chinese investment

Many foreign investors are surprised to learn that China and the United States treat Hong Kong as a separate nation both for their own domestic tax purposes and under the 1984 United States–China Income Tax Treaty (China Treaty). Hong Kong, in turn, has a relatively favorable tax regime and concluded a very favorable double taxation arrangement with China on August 21, 2006 (Hong Kong Agreement). While these facts may present investors with yet one more layer of complexity, they also provide them with opportunities if careful planning is utilized.

Chinese Tax Considerations

Forms of Doing Business in China and the Administration of Chinese Tax

Chinese tax law provides a special tax regime for foreign persons who invest in China through what are referred to as "foreign investment enterprises" (FIEs). These FIEs can take a number of forms, including equity joint ventures, cooperative joint ventures, and WFOEs. Related FIEs within China can often file a consolidated tax return. In addition, foreign persons can also invest in China through limited or private companies, listed joint stock companies, and nonentity forms of cooperative joint ventures that are more akin to a contractual relationship. Finally, foreign investors may form Chinese holding companies through which they can structure their other Chinese operations. A variety of special rules (and some limitations) apply to investments that are structured as Chinese holding companies. Foreign persons cannot, however, operate in China merely through a branch; foreign corporations may establish a branch-like representative office in China, but such an office will face serious limitations on its activities.

Chinese taxes that are applicable to foreign investors are administered by the State Administration of Taxation (SAT) or, in the case of local taxes, the appropriate local tax bureau (LTB). LTBs are ultimately subject to the authority and supervision of the SAT. The Chinese tax system is generally based on self-assessment by taxpayers, but the SAT's exclusive power to print and distribute the forms necessary to effect a broad array of sales and service transactions provide it with a means of monitoring taxpayers and back-stopping the self-assessment system. Tax returns and estimated tax payments are due quarterly. If a dispute arises between a taxpayer and the SAT (or an LTB), various mechanisms exist that allow the taxpayer to appeal the decisions of the taxing authority, but most of these require the taxpayer to first pay the disputed amount and to pursue its reimbursement thereafter.

Current Taxation of Foreign Investors in China

Income and Income-Like Taxes. FIEs and certain other forms of foreign investment in China are subject to tax under the Foreign Enterprise Income Tax Law (FEITL). Under the FEITL, the nominal tax rate is 33% of taxable income, either (i) from both Chinese and foreign sources, in the case of FIEs with head offices (i.e., the central office of an FIE responsible for the management and control of the FIE's operations) in China, or (ii) exclusively from Chinese sources, in the case of FIEs with foreign head offices. Taxable income under the FEITL is calculated by deducting various expenses from gross income, but the formula for determining those expenses differs depending on whether the FIE is engaged in manufacturing, commerce, or the service industry (as those terms are defined under the FEITL). Traditionally, FIEs have been granted far more generous deductions than those available to resident enterprises. Where an FIE has net losses, rather than income, such losses may be carried forward, currently for a period of up to five years.

The FEITL does not provide any guidance on the proper treatment of transactions of the sort that, under U.S. tax concepts, would be treated as tax-free reorganizations. The SAT has, however, issued provisional tax regulations that address various types of reorganizations. These regulations provide rules relating to the determination of asset basis; the retention of tax incentives; the continuing availability of loss carry-forwards; and the imposition of tax where FIEs engage in mergers, spin-offs, and other transfers of shares and assets between FIEs. In many cases, however, the regulations do not operate to relieve the FIE or the foreign investor of the Chinese taxes otherwise due on the gains realized through the reorganization.

Foreign investments in China that do not satisfy a *de minimis* foreign capital requirement (e.g., investments in listed shares of Chinese companies, investments in joint ventures where the amount of total registered foreign capital is insufficient to allow for the application of the FEITL regime) are subject to enterprise income tax regulations (EIT regulations) rather than the FEITL. These regulations impose a tax of 33% on taxable income from both Chinese and foreign sources, but the expenses that are allowed in calculating taxable income for the purposes of the EIT regulations differ from those available in the case of the FEITL.

Tax Incentives. The 33% tax provided for under the FEITL is in many ways illusory, because this rate is commonly reduced or eliminated when foreign persons either place their investments in various special economic zones (SEZs) and other investment areas or engage in certain, specified activities. For instance, a rate of only 15% is available for FIEs operating in an SEZ (regardless of the nature of the FIE's economic activity) or for FIEs engaged in production-oriented or export-oriented activities in economic and technical development zones. Enjoyment of this 15% rate by FIEs has been widespread, to the extent that it is rare to see an FIE that is actually subjected to the nominal 33% rate. FIEs are generally exempted from customs duties and import value-added taxes.

China offers various tax holidays as an additional incentive to foreign investment. For example, a production-oriented FIE that has a term of at least 10 years may receive a complete tax holiday from the 33% FEITL tax for two years and a 50% holiday for the following three years. Further, if

the FIE is technologically advanced, and remains so throughout the tax holiday period, it may receive an additional three-year extension of the 50% holiday. Other holidays, for different periods and for different rates, are available depending on the nature and location of the FIE's activities. In many cases, the tax holidays are coordinated with and reduced to reflect the already low tax rates available to foreign investors operating in favored industries or economic zones. It is possible for a single FIE that is engaged in a variety of profit-making activities to be able to access different sorts of tax incentives and holidays. Enjoyment of any of these tax incentives or holidays has, traditionally, been the subject of express and careful negotiations with the local tax authorities.

A final important incentive that China offers to foreign investors is a 40% refund of the FEITL tax on profits where such profits are reinvested in China, via an FIE, for an additional five years.

Withholding Taxes. China generally imposes a 20% withholding tax on the gross amount of dividends, interest, rents, royalties, and similar income earned by foreign persons that is not effectively connected with a Chinese establishment (generally, an office, factory, or other fixed site where management, production, service, or resource extraction activities are conducted) of the foreign payee. Notwithstanding this rule, the payment of dividends by FIEs (but not necessarily by other forms of foreign investment that pay dividends) to foreign investors is not subject to a withholding tax at all. In the case of all other income items, the 20% withholding tax has generally been reduced to an effective rate of 10% under various circulars issued by the taxing authorities.

In addition to the withholding regime described previously, China also imposes an effective 10% withholding tax on gains arising from the disposal by a foreign investor of its interest in an FIE (technically, the rate is the normal 20%, but again the rate reduction has been standard as a practical matter). Technically, such a taxable disposal should consist even of a reorganization that, under U.S. concepts, would not be subject to tax, but China has shown an increasing willingness to allow many sorts of reorganizations to proceed without the imposition of the 10% withholding tax. In contrast, no exemption is generally available for foreign investors with respect to gains on the disposition of publicly traded Chinese securities. The sole exception has been in the case of foreign individual investors who are original holders of privately held Chinese companies that go public and who dispose of their stock in such companies in an initial public offering. The Chinese tax authorities have previously issued notices that exempt foreign individual investors' gains arising from such dispositions.

It is important to note that, in many cases, the 20% withholding tax is reduced under the China Treaty, as discussed in more detail in the last section of this chapter titled "Tax Treaties."

Other Taxes. In addition to the various types of income taxes described previously, China also imposes various value-added taxes, consumption taxes, business taxes, stamp taxes (including those applicable to share trading), offshore resource taxes, land appreciation taxes, and other forms of real estate taxes. While some of these taxes are either exclusively local or national, most are shared between the local and national taxing authorities. Some local jurisdictions offer either tax holidays or reduced rates with regard to these miscellaneous taxes, but the exact amount of such tax incentives

differs between the jurisdictions and is constantly in flux, even within a single jurisdiction.

Transfer Pricing. Transfer pricing refers to the practice, common in all advanced economies and many developing ones as well, of imposing tax on commonly controlled parties in accordance with both the substance of their transactions and with normative arm's-length standards. In essence, what governmental tax authorities seek to do through transfer pricing is to ensure that parties deal with each other—whether with respect to the provision of services, the sale of goods, or the transfer of intangibles—in such a way as to not artificially decrease taxable income in one jurisdiction while increasing it in another. The United States has complex transfer pricing rules and significant administrative and judicial experience with the application of those rules. One result of this is that it is common for U.S. taxpayers to pursue and receive so-called advance pricing agreements (APAs) with the U.S. Internal Revenue Service whereby they obtain some certainty that their pricing practices among their affiliates will not be challenged.

China, in contrast, has historically not dedicated significant attention to transfer pricing, particularly as applicable to foreign investors, who generally treat China as a low-tax jurisdiction and, to the extent that they have deviated from the arm's-length standard, have done so with the result of artificially increasing their Chinese taxable income. This lack of developed transfer pricing rules has maintained an environment of continued uncertainty concerning the standards that the Chinese tax authorities would apply if pursuing transfer pricing cases against foreign investors. Further, only recently has China begun to negotiate APAs with foreign investors.

Hong Kong and the Hong Kong Agreement. Hong Kong, which China and many of China's treaty partners, including the United States, treat as a separate taxable jurisdiction, maintains a very favorable domestic tax regime. Under that tax regime, income derived by a Hong Kong resident company from foreign sources, including China, is exempt from Hong Kong income tax. Similarly, Hong Kong exempts most outbound payments from any sort of withholding tax (certain royalties being a notable, if not the sole, exception). For income from Hong Kong sources, the rate of income tax is generally 17.5%. It should be noted that the Hong Kong sourcing rules can be complex and can result in the characterization (and taxation) of certain income as from a Hong Kong source, even where it might appear, under more general international tax principles, to be from a foreign source.

On August 21, 2006, China and Hong Kong concluded the Hong Kong Agreement, a de facto income tax treaty between the two jurisdictions. Chief features of the Hong Kong Agreement are a 5% withholding rate on Chinese-source dividends (10% if the Hong Kong company does not own at least 25% of the Chinese payor's capital), 7% withholding rates with respect to Chinese-source interest and royalties, and an exemption from the Chinese capital gains withholding tax on stock transfers where the Hong Kong stockholder owns less than 25% of the Chinese company. This last feature makes investment into China through Hong Kong quite attractive, particularly when coupled with the fact that China is apparently in the process of negotiating protocols with other treaty partners (e.g., Mauritius) whereby it is effectively ensuring that no other treaty provides for a capital gains rate reduction more favorable than that appearing in the Hong Kong Agreement.

The New EIT Law

The March 16, 2007 enactment of the New EIT Law promises to introduce sweeping tax law changes, effective as of January 1, 2008, which will dramatically alter the way that both resident and nonresident enterprises are taxed in China, and which should bring the Chinese tax system much closer to modern norms. The net effect may be not only to increase the tax cost of investing in China but also to reduce the complexity of navigating its tax system and to introduce a new degree of predictability.

Much of the impetus for the New EIT Law may be found in China's accession to the WTO and the need to conform to that body's fair competition and transparency standards. But the changes have also been motivated by the changing nature of the Chinese economy, which has moved beyond a simple manufacturing and export center to become a huge final-destination market. In such an environment, laws that conform more closely with those of China's trading partners have become necessary. China has also learned through experience that providing tax preferences to foreign-owned companies has led domestic taxpayers to export capital to foreign jurisdictions from which it has been reinvested in China in a more tax-efficient manner. This practice, often referred to as "round tripping," has led to significant revenue loss in recent years.

Perhaps the most notable feature of the New EIT Law is the consolidation of the two currently separate tax regimes, one applicable to residents and the other to nonresidents. Under the New EIT Law, both resident and nonresident companies will be subject to the same standard 25% tax rate. The New EIT Law also introduces new preferential tax regimes. Under one of these, the standard 25% rate will be reduced to 20% in the case of certain qualified small-scale and small-profit enterprises. The exact definition of these terms is not yet clear, and it is believed that the Chinese tax authorities will leave this task until the implementation of the new law actually begins. A second preference will be made available to high-technology enterprises, which will be eligible for a 15% tax rate. These enterprises will also, presumably, be chief beneficiaries of the enhanced "super deduction" for certain research and development expenses. Again, the breadth of the term "high-technology enterprises" is not currently defined. Finally, it is anticipated that certain regional incentives will be retained as a method of encouraging investment in less-developed parts of China.

The new standard rate and the two preferences will replace the various tax holidays and incentives currently in place. The most notable losers under this change in policy will be those foreign investors who currently are benefiting from either production-oriented or export-oriented tax preferences. Some relief, however, will be available in the form of grandfathering rules, which will allow those foreign investors who qualified for a tax incentive prior to the announcement date of the New EIT Law (i.e., March 16, 2007) to take advantage of a five-year transition period. During the first two years of this period, the taxpayer will continue to enjoy the full benefits of the preexisting tax preference, while those benefits will be halved for the remaining three years.

The New EIT Law also standardizes the withholding tax at 20% (although this rate may still be reduced vis-à-vis a particular income item under a bilateral income tax treaty). Notable uncer-

tainties exist concerning how broadly this rate will be applied. The chief concern focuses on the treatment of dividends. While the New EIT Law has introduced a qualifying dividend concept that serves to reduce or exempt from taxation certain dividends paid between related parties (much like the dividend-received deduction does in the United States), including nonresident enterprises, the law does not appear on its face to extend the current complete exemption for dividends paid by FIEs. Additionally, it is unclear whether the concessionary withholding rate applicable to other income items and currently enjoyed by foreign investors pursuant to various Chinese governmental circulars (which has effectively reduced the 20% rate to 10%) will be extended under the New EIT Law.

While the rate changes and consolidations are the most immediately noticeable features of the New EIT Law for foreign investors, China has introduced various additional important concepts with the new rules. For example, a new concept of "residence" will prevail under the New EIT Law. Under this concept, China will treat as residents both enterprises established under Chinese law and enterprises established under foreign law but with "effective management" within China. The distinction is important because resident enterprises will be subject to taxation on their worldwide income, while nonresidents will be taxed only on Chinese-source income or income connected with a Chinese establishment or place of business. The new rule will present particular challenges to multinational enterprises that may have significant assets (e.g., IP) and operations located outside of China but which retain the majority of their physical management staff in China. The new law also introduces provisions that clarify and significantly expand the availability of foreign tax credits to resident enterprises. This will be a welcome change to investors in Chinese entities that have overseas operations and have previously been subject to double taxation as a result of the meager Chinese indirect foreign tax credit regime.

The New EIT Law contains a number of antiabuse provisions. For example, a new general antiavoidance rule allows the Chinese tax authorities to make adjustments to transactions that are deemed to be without commercial viability or that otherwise lack a business purpose. So far, no practical guidance has been provided in connection with this broad rule and, accordingly, significant uncertainty exists for both resident and nonresident taxpayers. It is hoped that additional guidance will be provided in the near future. Similar uncertainty exists in connection with a new thin capitalization rule, which would deny interest deductions in the case of an enterprise whose debt exceeds a specified related-party debt-to-equity ratio. The ratio has not yet been specified, leaving many taxpayers anxious. A third change clearly acknowledges the expansion of Chinese enterprises' activities abroad by introducing a new controlled foreign corporation rule that will impose current taxation on Chinese resident enterprises that establish or control foreign corporations in jurisdictions where the effective tax rate is "apparently" less than 25% (i.e., the New EIT Law prescribed rate) and that fail to make sufficient current profit distributions. A final notable change is the addition of substantial new guidance in the area of transfer pricing: (i) rules have been set forth that describe the arm's-length standard in more detail, (ii) new related-party transaction reporting requirements have been imposed, (iii) guidance has been provided with respect to cost-sharing arrangements; and (iv)

the practice of negotiating advance pricing agreements has now been officially recognized by the new law, and the authority to conclude such agreements has been granted to the LTBs.

U.S. Taxation of Outbound Investment

Choice of Entity

All of the FIEs described previously have limited liability and, except for listed joint stock companies (e.g., Gufen Youxian Gongsi), all are entitled under U.S. tax law to elect to be treated—solely for U.S. federal income tax purposes—either as corporations or branches if they are wholly owned by single persons, or as corporations or partnerships if they are owned by more than one person. A listed joint stock company will always be treated as a corporation for U.S. tax purposes.

A U.S. investor's decision to elect to treat its Chinese investment as a corporation or a partnership/branch will depend on a variety of factors, not the least of which will be whether or not the investor will hold the investment directly or through a separate foreign holding entity (which may, itself, be a corporation, partnership, or branch). Assuming the U.S. investor invests directly, however, the decision to treat the Chinese investment as a corporation will generally allow the investor to defer U.S. taxation of the investment's undistributed foreign earnings but will prevent the U.S. investor's enjoyment of any of the Chinese entity's losses. In contrast, the election to treat the investment as a partnership or a branch will allow the flow-through to the U.S. investor of the Chinese entity's losses, but all of the entity's foreign earnings will be subject to current U.S. taxation, whether or not actually distributed to the U.S. investor. As discussed in more detail in the next section, the U.S. investor's choice of entity will also affect whether any U.S. tax is imposed on the outbound transfer of assets to the entity and the availability of a U.S. tax credit for the entity's payment of Chinese taxes. Finally, the U.S. tax imposed upon a U.S. investor's disposition of a direct investment in a Chinese entity may differ depending upon whether the entity is characterized as a corporation, a partnership, or a branch.

It is also worth noting that, while all FIEs (except for listed joint stock companies) are eligible to be treated for U.S. tax purposes either as corporations or as partnerships or branches, some are intrinsically more amendable to partnership treatment as a matter of Chinese law. For instance, a cooperative joint venture usually will accommodate the sharing of profits and losses and other flexibility associated with a U.S. partnership to a greater extent than an equity joint venture.

Taxation of Outbound Asset Transfers

A U.S. investor's transfer of appreciated assets to a Chinese corporation will often be subject to a U.S. toll tax. There are exceptions to this rule, however, particularly where the Chinese entity subsequently uses the transferred assets in its active conduct of a Chinese or other foreign trade or business. Some of these exceptions will require the U.S. investor to sign an agreement with the U.S. government at the time of the transfer that will, in effect, limit the Chinese entity's ability to dispose of the transferred asset for a set period of years without causing the original U.S. transferor to incur tax.

Special rules apply where the U.S. investor proposes to fund a Chinese corporation with intangible assets, such as patents, copyrights, or technical know-how. Under these rules, the U.S. transferor will be required to include in its income a deemed royalty over the useful life of the intangible. Further, this royalty may be transformed into a so-called "super royalty" if it becomes subject to retroactive, periodic adjustment by the U.S. tax authorities. This treatment can conflict not only with the economic realities but also with the business deal among the parties, a deal that is often governed by a technology transfer agreement that must be approved by the Chinese government and from which deviation is difficult, as a practical matter.

In contrast to the U.S. tax that is imposed on the transfer of assets to a Chinese entity that is treated as a corporation for U.S. purposes, a transfer to either a partnership or a branch will not incur any current U.S. tax costs.

Antideferral Considerations

While a U.S. investor will generally not be required to pay any U.S. tax on the earnings of its Chinese corporation until those earnings are repatriated to the United States, current taxation may nonetheless be required if certain U.S. antideferral regimes are applied. Because the application of these regimes depends on a complex mix of factors, including the percentage of U.S. ownership of the Chinese corporation (and of any intervening holding entity), the nature of the Chinese corporation's operations and assets, and the Chinese corporation's business dealings with parties to which it is related, careful consideration must be given to structuring a U.S. investor's investment in, and form of ownership of, a Chinese corporation. For instance, if three U.S. investors were to invest in stock representing 40%, 10%, and 7% of the total vote and value of a Chinese corporation, with the remaining 43% held by a Chinese investor, the primary U.S. antideferral regime would not apply. If the three U.S. investors were to decide to contribute their interests to a holding entity, however, then that antideferral regime would apply unless they were to choose the proper holding entity.

Where a third-country holding company is used, a decision to treat the Chinese investment as a partnership or branch of the holding company, rather than a separate corporation, may actually enhance the U.S. investor's ability to defer U.S. tax on the Chinese entity's current income. Accordingly, such structures require careful consideration.

A similar level of caution should be used when considering whether or not to use a controlled foreign corporation as a holding company for interests in a Chinese corporation that the U.S. investor anticipates selling. While the interpositioning of the holding company may produce Chinese tax benefits, care must be taken to avoid the conversion of income that would normally be eligible for the lower, preferential U.S. long-term capital gains rates into ordinary income that is taxed at a significantly higher rate.

Credits for Foreign Taxes

Chinese income and withholding taxes (but not other types of taxes, such as the value-added tax) that are directly paid by U.S. investors (or branches of U.S. investors) with respect to Chinese

earnings may be claimed, subject to certain limitations, as an offsetting credit against the U.S. tax imposed on those same earnings. Similarly, any U.S. investor in a Chinese entity that is treated as a partnership will be entitled to claim a U.S. tax credit with regard to its allocable share of the taxes paid by the Chinese partnership.

In contrast, where a Chinese investment that is structured as a corporation for U.S. purposes pays Chinese taxes on its earnings and then repatriates those earnings to its U.S. investors, such investors can credit the Chinese taxes against their U.S. tax liability on the earnings only if they themselves are corporations that own (either directly or through a partnership, a branch, or another corporation) at least 10% of the Chinese corporation's voting stock. The choice of classifying the entity as either a corporation or a partnership may also affect differently the annual limitations imposed on a U.S. investor's enjoyment of foreign tax credits, particularly if the U.S. investor is borrowing domestically to fund a portion of its investment in a Chinese corporation.

Transfer Pricing

As indicated previously, national tax authorities use the practice of transfer pricing to reallocate income (and tax liability) among controlled parties where the authorities believe that abusive pricing has been adopted. For example, if one company owns IP in a low-tax jurisdiction and licenses it to a controlled party that is located in a high-tax jurisdiction for a royalty rate that appears high in comparison to that prevailing between unrelated parties, one might expect the tax authorities of the latter country to employ transfer pricing principles to reduce the royalty and correspondingly expose more income to tax in the high-tax jurisdiction.

The United States has a well-developed and complex transfer pricing regime that generally requires taxpayers to deal with controlled parties according to the terms of an arm's-length standard that must be determined in accordance with various regulatory guidelines. Specific detailed rules (some in temporary form) are set forth regarding loans, services, transfers of both tangible and intangible property (whether by lease, license, or sale), and the sharing of costs in connection with the development of intangibles.

Faced with the significant uncertainties posed by the U.S. transfer pricing rules, some taxpayers pursue APAs. However, where the United States has a treaty partner that does not participate in the APA process, the taxpayer remains exposed to the possibility that the tax authority in this second country may adopt a position contrary to that agreed to in the APA, thereby exposing the taxpayer to double taxation. The new willingness of China to negotiate APAs should, therefore, provide new opportunities for obtaining certainty.

Tax Treaties

In the case of U.S. investors in China, the China Treaty, rather than Chinese or U.S. domestic law, is the starting point for determining which nation will assert primary taxing jurisdiction over a given item of income and the rate of tax that will be applied. Thus, in certain circumstances, income related to a U.S. investor's operations in China that would otherwise be subject to taxation under Chinese domestic law will, through application of the China Treaty, be taxed only by the United States.

The China Treaty also reduces the rate of withholding on dividends (other than those that are entirely exempt from withholding under Chinese law in the first instance), interest, and royalties from 20% to 10%. A protocol to the treaty limits these and other treaty-derived benefits, however, solely to investors that qualify under detailed residency tests.

Where a third-country holding entity is used, the U.S. investor should analyze the treaties, if any, that exist between that country and China on the one hand, and the United States on the other. Many treaties contain provisions—of greater or lesser complexity, depending upon the treaty—that are intended to prevent tax arbitrage and the exploitation of tax havens. Accordingly, care should be taken that the use of a third-country holding entity does not, ultimately, deprive the U.S. investor of the tax benefits that it would have enjoyed under the China Treaty had it invested in China directly.