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# CHINA Legal Bulletin



YOUR LEGAL ADVISORS IN CHINA

## Executive Summary

### **Corporate Governance: Directors and Senior Managers**

*When establishing a new enterprise in the PRC, investors often make the mistake of assuming that whomever they put in place as their senior level management will have the same responsibilities as in their home country. Unfortunately, China has its own unique system of checks and balances that detail who is ultimately responsible in a corporate structure, and it is paramount that foreign investors understand this set of rules. Corporate specialist Mr. Maarten Roos and his colleague Ms. Chen Yun explain the conflicts associated with appointing senior level management and how to avoid common traps that foreign investors encounter when doing business in China.*

*By Maarten Roos and Chen Yun*

### **New Turnover Taxation Changes to Effect Companies Abroad**

*In the beginning of 2009, a major reform was introduced on how indirect tax is to be collected, which could have a significant effect on the way foreign companies providing services and financing to Chinese companies will do business. Associate Cao Xin provides a brief look into what the changes are and how foreign companies doing business in China should prepare for these new circumstances.*

*By Cao Xin*

## NEWS FLASH

### **Wang Jing & Co. Leading Lawyers**

In the 2009 survey is Asialaw Leading Lawyers, seven lawyers and legal consultants of Wang Jing & Co were singled out for their performance over the past year.

Wang Jing	Zhao Shuzhou	Chen Xiangyong	Shen Xiangman
Zou Zongcui	Maarten Roos	Zachary Wortham	

Asialaw sought nominations from over 9,500 corporate executives, legal counsels and lawyers from international businesses and firms. Nominations were based upon demonstrated legal expertise in a particular area of law. Honorees from Wang Jing & Co included legal experts in Shipping Maritime & Aviation, General Corporate Practice, Dispute Resolution, Mergers & Acquisitions and Intellectual Property. On behalf of the named individuals, our appreciation goes out to all the clients who voted!

*The China Legal Bulletin is produced by Wang Jing & Co. Law Firm*

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# Corporate Governance Directors and Senior Managers



Clients frequently ask us about the rights and responsibilities of directors and senior managers in a foreign-invested enterprise. Unfortunately, many of these clients have experienced directors and senior managers who abuse their positions in the pursuit of personal gain. In some cases, a director or general manager with significant influence over the business and factual control of operations will refuse to follow the investor's instructions, or even go so far as to threaten the investor in order to obtain financial benefits.

Foreign investors generally presume that management problems are inherent in Chinese-foreign joint ventures, but not in companies to which they are the sole shareholder. Unfortunately, this perspective is over-simplified and does not take into account the rights and responsibilities of directors and senior managers. In this article, we will highlight the importance of properly structuring the corporate governance of a wholly foreign-owned enterprise (WFOE).

## Directors and Senior Managers

The Board of Directors, mandatory under the Company Law of the People's Republic of China ("Company Law"), consists of at least three persons appointed by the shareholder and registered with the competent registration authority. An exception is made for small-scale companies that benefit from a simple decision-making structure; these companies are instead permitted to have one Executive Director.

Under the Company Law, senior managers in a limited liability company include the general manager, deputy manager(s), chief financial officer, and any other person(s) listed as such in the Articles of Association. In China, registration of the general manager usually is mandatory, while the registration of other senior managers is optional.

A director may concurrently retain the post of general manager and either the chairman of the Board of Directors, the Executive Director, or the company's legal representative, although the latter decision must be confirmed in the company's Articles of Association. Under PRC law, the legal representative is the official representative of the company and is entitled to act on the company's behalf. Therefore, investors should take extra precaution when making this appointment, both from a practical and liability standpoint.

## Rights of Directors and Senior Managers

### 1. The Director's Authority

Directors shall exercise their authority through the Board of Directors, which in turn is accountable

to the shareholder (note that this is different for Chinese-foreign Joint Ventures, where the Board of Directors by law is the highest authority of the company). Article 47 of the Company Law differentiates the functions of the Board of Directors as follows:

(1) Statutory functions: responsible for convening shareholders meetings and presenting reports thereto; implementing resolutions adopted by the shareholders; preparing plans for issues, such as increasing or reducing the registered capital, annual financial budget, profit distribution, the merger, division, transformation, dissolution and liquidation of the company (subject to shareholder's approval or decision); appointing or removing the general manager of the company; appointing or removing, upon the general manager's recommendation, deputy managers of the company and the financial managers; and determining the remuneration for these officers;

(2) Functions stipulated in the Articles of Association. A company's Articles of Association are binding on the company, its shareholders, directors, supervisors and senior managers, and in many cases will list a number of decisions which must be made or approved by the Board of Directors.

Problems often arise where a decision either required by statute, or as per the company's Articles of Association, must be approved by the Board of Directors, but the signatures of the directors cannot easily be obtained. Say for example that the shareholder wishes to increase the registered capital, but one of the directors does not agree or is not very cooperative. Presuming that the director's agreement is indeed necessary (e.g. if the decision must be unanimous), the shareholder must first replace the director, and only after can apply for the capital increase.

### 2. The General Manager and other Senior Managers

Senior managers shall be appointed and dismissed by the Board of Directors. However, presuming that the Articles of Association does not state otherwise, the general manager has the right to propose the appointment or dismissal of the company's deputy general manager(s), chief financial officer, and other senior management.

Under the Company Law, the general manager implements Board of Directors' resolutions and is responsible for the company's business operations. Moreover, he shall also engage in activities and have the right to make decisions on matters as provided in the Articles of Association, or as authorized in a resolution of the Board of Directors.

## WANG JING & Co. UPDATE:

### Wang Jing & Co. Attend U.S. Consulate DVC

At the invitation of the U.S. Consulate General in Guangzhou, representatives from Wang Jing & Co. attended two panel discussions, the first on the global financial crisis and the second on how the rule of law affects journalism. Both panels allowed for remote participation through the use of a digital video conference system (DVC).

The first panel was led by well-known economists Allan Meltzer and Stuart Mackintosh. Other panel participants included journalists, government officials, and other professionals in four Chinese cities, and in Australia and New Zealand. The second discussion included discussion from famous lawyers Mo Shaoping, Pu Zhiqiang, Jim Fallows, and Eve Burton. Other participants included lawyers and journalists in Guangzhou and Shanghai. During the second panel, Ms. Burton addressed a question posed by Wang Jing & Co. Partner Jiang Guoyong about the core value of journalism.

### Wang Jing & Co. Fields New Class of Interns for Summer of 2009

Wang Jing & Co's summer internship program is having another strong year. This year's interns include promising law school students at top universities (including Georgetown and Yale), from the United States, Sweden, Italy, Tonga, the Czech Republic and the Netherlands. Interns generally spend three months in China working alongside Wang Jing & Co's many legal experts.

Nick Valenti, an intern from Georgetown Law School in Washington DC, says he came to China to "gain legal experience in a geographic region that is continuously growing in importance. I see China as the place to be for a future in the legal industry." Fleur Huijskens, a marketing major based in the Firm's Shanghai office: "This internship not only teaches me about doing business in China; I also learn how to initiate contact with potential clients and referral partners".

# Corporate Governance Directors and Senior Managers



In practice, to prevent the general manager from obtaining too much control over the company's operations, and thereby reduce the enticement and ability of the manager to pursue personal objectives, it is best to include in the Articles of Association a clear statement of the general manager's scope, authority, and the limitations thereof. Alternatively or in addition, these may be confirmed in a resolution by the Board of Directors.

## Obligations of Directors and Senior Managers

The job of director or senior manager also comes with obligations. Directors and senior managers shall bear legal obligations of fidelity and diligence to the company. Articles 148, 149 and 151 of the Company Law provide more details on what this entails. Where directors or senior managers fail in their performance or neglect their duties, this may result in civil liabilities:

(1) The income of any director or senior manager from any act in violation of their obligations shall belong to the company.

(2) Meanwhile where any director or senior manager violates any law, administrative regulation, or the Articles of Association during the course of performing his duties, if any loss is caused to the company, he shall be liable / responsible for compensation. Note that if involving third parties, the company can generally be held liable for such losses, but in turn it can demand compensation from the responsible Director or senior manager. Article 152 of the Company Law also specifies the shareholder's right to request the supervisor or the Board of Directors to sue a director or senior manager. In case the supervisor or the Board of Directors fails to do so or in case of an emergency, then the shareholder may, on its own behalf, directly file the lawsuit.

In addition to civil liability, a director or senior manager may also be held criminally liable for his misconducts, where his actions constitute a crime, such as of illegal operations or embezzlement. This depends on whether certain standards for criminal liability have been met.

## Supervising Directors and Senior Managers

The 2006 amendments to the Company Law made the appointment of a supervisor mandatory to all companies in China, including WFOE's. The supervisor functions as an external controller of the company and primarily serves to ensure that the activities of directors and senior managers comply with relevant PRC laws and the company's Articles of Association. The supervisor may demand corrections by any director or senior manager if their act has injured the interests of the company. This is also the reason why by law, a director or senior manager may not concurrently serve as supervisor.

In practice, foreign investors often limit the role of the supervisor, appointing someone who has no knowledge of the business in China. In many cases, investors themselves will actively supervise the activities of directors and senior managers, and indeed they are entitled to terminate a director's tenure at any time, and may even file a lawsuit against a director or senior manager that damages the shareholders' interests by violating any law, administrative regulation, or the Article of Association.

## Conclusions & Suggestions

The first step in improving the corporate governance of a WFOE is to draft the Articles of Association in a manner which properly divides responsibilities and authority between the shareholder, the Board of Directors, and senior management. This thereby facilitates a balanced decision-making process within

and by the Board of Directors, and senior managers.

Second, care must be taken to appoint directors and managers that are actually involved in the business, can bring value to the company, and will communicate well with and, if necessary, follow instructions from the shareholder. The Board of Directors should also establish detailed rules for chop-management, and the authority of senior managers to approve contracts or engage in other activities.

Finally, it is important to monitor the activities of directors and senior managers. Even a perfectly designed system can be subject to abuse where implementation is not monitored. After years of operations, directors and managers may be so used to one way of doing things that they forget about the checks and balances that the system was designed with. The shareholder should ensure compliance, or instruct the supervisor to complete this task.

## We leave you with a list of do's and don'ts:

(1) Include corporate governance in the Articles of Association, and have the Board of Directors determine detailed rules on authority, safekeeping, use of chops, etc.

(2) Be prudent when appointing directors and a general manager.

(3) Do not leave too much power in one manager's hands – especially if he is a lateral hire.

(4) Establish a mechanism to monitor the company's operations, and where relevant involve the supervisor to ensure that the designed corporate governance is effectively implemented.

*By Maarten Roos and Chen Yun*

# New Turnover Taxation Changes to Effect Companies Abroad

After China unified the corporate income tax system by promulgating the Enterprise Income Tax of the People's Republic of China on 1 January 2008, it shifted its focus this year to implementing major reform to the systems of Business Tax ("BT") and Value Added Tax ("VAT") collection. This article discusses how changes to the collection of BT, which is levied on service income, the transfer of intangible assets, and the sale of real estate, will have a significant, and

primarily negative, affect on foreign companies with business interests in China.

## The scope of the BT taxable services

According to Article 4 of the new BT Implementation Rules, where either the service recipient or service provider is located in China, China shall levy BT on any income derived from

such service. Thus, BT computations are based upon the location of the service recipient or provider, rather than where the taxable service is rendered. This not only broadens the scope of the BT taxable services, but can also result in double-taxation: most foreign jurisdictions impose BT on services performed within their territory, and international tax treaties typically omit provisions preventing double-taxation of BT.

# New Turnover Taxation Changes to Effect Companies Abroad cont.



Some examples of who may be affected:

- A logistics company of country A holds the inventory of a Chinese customer in the warehouse in county A; i.e., the logistics company provides warehousing services to the Chinese company outside China. The logistics company shall pay BT in China (withheld by the Chinese customer) and in country A.
- A foreign company lends money to its Chinese subsidiary. BT shall be levied on any interest payments.
- The Chinese subsidiary of a foreign company is charged for marketing and management services performed outside China. BT shall be levied and withheld by the Chinese subsidiary.
- A Chinese company retains an international law firm for representation in a dispute in country A. BT shall be levied on the fees, to be withheld by the Chinese company.

## New provisions on withholding agent

In accordance with Article 18 of the new Business Tax Regulations, where a foreign company or individual with no operating organization in China provides taxable services, transfers intangible assets, or sells real estate in China, either the foreign company's agent, the purchaser of the services, or the transferee of the intangible assets or real estate will be the withholding agent.

The withholding agent should file a tax return and pay the BT payables withheld in a timely manner. If this is not completed, both the withholding agent and the foreign taxpayer will be subject to considerable financial and legal risk. Under the Law of the People's Republic of China Concerning the Administration of Tax Collection, where it concerns a foreign company, the withholding agent in China shall withhold the payable BT, and may be liable for any delay. However, the liability for paying BT remains with the taxpayer, a principle which has been re-confirmed in a recent circular issued by the State

Administration for Taxation, Guoshuifa [2009] No. 3. If the withholding agent does not or is unable to discharge its withholding obligations, the foreign taxpayer should directly declare BT. If the taxpayer fails to settle the amount, the tax authority may even collect overdue tax from the taxpayer's other projects in China. Under Article 68 of the aforesaid law, the tax authority could also impose a fine of 50-500 percent.

It is advisable to include a provision in the service (or loan) contract stating that the contract price includes BT, and that the Chinese party is responsible to pay such taxes. However, the foreign taxpayer nevertheless remains liable, and the only way to minimize risk is to ensure that taxes are paid, for example by asking the Chinese party to provide payment evidence

## Place of tax return filings

One final change regards the location where the tax return should be filed. Under the old regime, BT should be filed where the services are rendered. This has been changed to the domicile of the taxpayer, or in the case of a foreign taxpayer, the domicile of its withholding agent.

## Conclusion

The costs and benefits of the new systems for indirect taxes will vary individually between companies and generally across industries. The reforms of the VAT system provide a more level playing field and removes double-taxation. Conversely, the BT reforms have the opposite effect, creating new burdens for foreign companies providing services to Chinese companies, and increasing expenses by creating an extra level of taxation. It also remains to be seen how easy it will be to levy these taxes efficiently, especially when it concerns relatively small amounts. In any case, foreign companies providing services and financing to Chinese companies should take appropriate measures to mitigate any risks.

By Cao Xin

## PRC LEGAL UPDATE

### Foreign Investment Restrictions Eased

Over the last year, the Chinese government has tried to boost the economy by easing restrictions on foreign investment in the real estate market. One such effort was implemented in June of 2008, and reduced the amount of oversight by allowing foreign firms to have their real estate investment plans verified at the provincial level instead of at the national level, Ministry of Commerce. Also in January of 2009, foreign enterprises who have acquired real estate in China are no longer subject to the special "Urban Real Estate Tax," which formerly only applied to foreign firms. Instead foreign firms only now need pay the "Real Estate Tax," the same tax that domestic firms pay and which consequently is much lower.

### Supplement to CEPA Further Opens Market with Hong Kong

China has further strengthened its ties to Hong Kong through the implementation of Supplement V of the Closer Economic Partnership Arrangement (CEPA), which went into effect this year. The agreement calls for the further liberalization of seventeen areas of trade services between Hong Kong and the mainland. This includes; accounting, construction, medical, employment services, scientific and technical consulting services, printing, convention and exhibition, environment, banking, social services, tourism, logistics, and individually owned stores.

The agreement also calls for the creation of a Trademark Working Coordination Group which will increase cooperation in regards to trademark registration and trademark protection. Other areas in which Supplement V calls for cooperation are in brand regulation and in the recognition of professional qualifications.

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