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YOUR LEGAL ADVISORS IN CHINA

Executive Summary

The 11 Most Import Points to Consider When Investing in China

Investors and entrepreneurs from around the world are talking about the Chinese market and looking to Chinese consumers as a possible new source of revenue. This has led to an increase in an already growing investment market in China as well as to a proliferation of sources of advice on how best to invest. In order to clarify the situation we have set about providing a no-nonsense look at what you need to know when deciding on whether and how to go about investing properly in China. Senior consultants Zach Wortham and Phenix Zheng combine with tax specialist Deng Yong to provide the 11 most essential points to consider when investing in the PRC.

These points include how the Chinese authorities define Operation Mode, Business Scope, and Investment Amount, As well as what you need to know concerning how to provide Documentation and maintain Communication with the authorities. Then we provide simple introductions into how to pick a Location, what to consider regarding Production and Operating Costs, whether Direct Investment or Merger is preferable, Industrial Policies, Tax considerations, and finally Labor Law and Anti-Monopoly issues.

By Zach Wortham, Phenix Zheng, and Deng Yong

NEWS FLASH

New Regulations for Foreign Investment

The State Council released new foreign investment regulations. The new policies will continue to support Chinese A-share listed companies while also standardizing foreign companies' domestic investment including mergers and acquisitions. Companies affected will include hi-tech industries, service sectors, energy conservation, and environmental projects.

According to the new regulations, a mechanism will be introduced to gauge any national security issues for foreign-funded companies attempting to complete a merger or acquisition, and qualified companies will be allowed to issue corporate bonds or medium-term bills and to launch an IPO.

The regulations also encourage the establishment of regional headquarters, research and development centers, procurement hubs, and financial management centers by foreign companies, especially in the central and western regions.

There will also be tax incentives for Importing items and equipments for use in research and development including; being exempt from tariffs, import VAT, and goods and services tax.

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Points to Consider When Investing in China



The 11 Most Important Points to Consider When Investing in China

Investment in China has been a hot topic for many years and with the recent global, economic downturn still fresh on everyone's mind, never has investing in the PRC been so attractive. However, even with so many experts offering their opinions about how best to invest in China there is often confusion about the basic ways in which to approach the topic as a potential investor. So, we provide in this article those points which we think are most useful in organizing priorities and creating a strategy for entering the Chinese market, as well as giving the perspective as to what the Chinese authorities need to hear to approve it.

PRC Company Law specifies very clearly the formalities for establishing foreign-funded enterprises. According to the law, before establishing an enterprise, a foreign investor should decide the mode for business operation, the business scope, and the investment amounts which will be needed to keep the business running. The question then becomes how to meet the needs of the new project and at the same time satisfy the demands of the local authorities.

1. Operation Mode

Operation mode is divided into the following categories:

- production or manufacturing,
- commercial or trade,
- the combination of production and trade
- or other businesses (services and retailing)

Different kinds of enterprises are subject to examination and approval by different levels of authorities; therefore how the operation mode is defined will play a significant role in the amount of procedural work that needs to be completed. For example, the establishment of a foreign-invested manufacturing enterprise is only subject to examination and approval by the Bureau of Foreign Trade and Economic Cooperation (BOFTEC) at the district level where the enterprise is located. However, trading enterprises are subject to examination and approval from the provincial level (DOFTEC). Also local authorities often enforce their own specific requirements regarding different operation modes therefore, during establishment of an enterprise; it is a good idea to communicate with the local authorities before proceeding too far or making assumptions.

2. Business Scope

Business scope is perhaps the most important aspect to consider as it refers to the commodities and/or services that the enterprise is legally allowed to produce and/or provide during normal business operations. Therefore, the business

scope of an enterprise must be carefully drafted to ensure that future operations will not be deemed to be outside of the approved business scope. Further, the authorities will not approve anything that is too broad or unspecific. When determining if a particular business scope is acceptable, the local authorities will rely on the Classification of National Economic Industries, an official publication which lists those businesses allowable in the PRC and at what level they must be approved. If the proposed business scope is not covered by the Classification of National Economic Industries, it is still possible to negotiate with the BOFTEC and the Administration for Industry and Commerce (AIC) to find a solution. The AIC has the final say regarding any amendments or restrictions placed on the business scope of enterprises.

3. Investment Amounts

Investment amount is the aspect of establishment that brings the most concern to potential investors. In general, investment amount refers to the amount of capital an enterprise will need for its business operations. Normally, the authorities treat investment amounts according to what they deem reasonable for other such businesses to run smoothly in their respective jurisdictions. The authorities are also mindful of the local resources and future industrial planning and so may demand further investment to ensure the enterprise will not be a drag on the local economy. According to the relevant regulations, the investment amount of a foreign-funded enterprise corresponds to its production and operation scale and must be explained fully in the Feasibility Study Report which is submitted during the establishment of the enterprise. The final amount mandated by the authorities is submitted to a Chinese bank account as registered capital and, after having been verified by an accounting firm, is free to be used for normal expenses of the enterprise.

Registered Capital may be submitted in different stages; normally the payments consist of a 20% payment within the first 3 months of receiving the business license, followed by the remaining amount to be paid up during the first two years of operation. It is also possible for the foreign, investing enterprise to make a loan to the newly registered PRC enterprise but the registered capital must be paid in full and the limit of the loan is that it can not exceed the difference between the amount of the registered capital and the total investment amount, which is normally no more than 30% of the total investment.

4. Documentation and Communication

One reality of working in China is that negotiations and communicating with local authorities is key to the long term success of any business. Therefore, the initial stages of establishment are the most crucial. Foreign investors are required to firstly

PRC LEGAL UPDATE:

Annual Audits Not Required for Rep. Offices in Zhuhai

The Zhuhai tax bureau has said that they will not require representative offices (ROs) to undergo an annual audit for tax clearance purposes. Therefore, ROs in Zhuhai may conduct annual tax clearance without filing an audit report. Zhuhai may be the only area where this approach is taking place, in most jurisdictions, an audit report is a compulsory requirement for ROs to be able to fulfill their annual tax clearance responsibilities.

Guangzhou's Collective Bargaining Legislation

The Guangzhou Federation of Trade Unions issued a draft regulation for collective negotiations of labor relationships. "Regulations of Guangzhou Municipality for Collective Negotiations for Labor Relationships," addresses the issue of collective negotiations regarding wages and calls for industry associations, employers, and trade unions to come together for collective wage negotiations to determine salary scales. The employer should discuss with the union and meetings should be held at least once a year. Within 20 days of the negotiations, both parties must complete the negotiation or face fines up to a maximum of RMB 2,000 for individuals and RMB 20,000 for enterprises.

The bill also clarifies that in a labor dispute, the trade union should negotiate with the enterprise on the workers behalf. Further, that all participants in the negotiations are guaranteed both job title and salary and if the participants are terminated or face a reduction in salary, it is to be considered a violation of the law.

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collect the necessary data and documentation that will be submitted to the authorities. It is recommended that before submitting the draft application documents, Feasibility Study Report, and investor information for preliminary review, the enterprise or its agent, consult with the authorities regarding whether the business scope and the investment amount meet their requirements or not. This will give an indication as to the timeline for registration and allow for adjustments to be made on the front end which will avoid situations where the requirements of the authorities affect the operational plan of the enterprise. It is normal that in these initial communications with the authorities, discrepancies may arise between the national regulations and the local regulations (any requirements should be based on the "Catalogue for the Guidance of Foreign Investment Industries" that specifies the encouraged category, permitted category, restricted category, and prohibited category).

However, it is important to note that the local authorities have the final say as to whether and how an enterprise is established in their jurisdiction therefore good communication is vital to completing the registration process quickly and efficiently. If no agreement can be reached or the requirements mandated by the authorities are in conflict with the business plan of the enterprise then it may be necessary to either look for a new location or rethink the investment plan. Considering the difficulties involved in this process, it is highly suggested to obtain advice and assistance from a qualified and experienced law firm who regularly engages in FDI activities in the relevant jurisdiction and which preferably has good relations with the local government.

Once the enterprise and authorities are both satisfied with the suggested project, it is then time to begin preparing the documents for submission. Some local authorities provide a Checklist of the documents needed and what the format should be on their websites. During the final examination, it is recommended to follow the below advice:

1. Use only black ink pens for signatures or completing forms (not a ball point pen)
2. Separate the signature pages from the content pages of applications so that should changes be necessary, re-executing them is not.
3. Pay attention to the time required to have documents notarized and legalized in the country of the investor. These processes can take a significant amount of time in some jurisdictions and incur substantial costs.

It is not unheard of for the authorities to ask for further documentation during the examination and approval period, therefore it is important to keep an open communication channel with the authorities and respond quickly and efficiently

to any new requests. While at the same time it is also suggested that with the help of a qualified agent it is possible to defend the interests of the enterprise by citing relevant laws and regulations and in this way prevent the authorities from raising any unreasonable requests which do not conform with the law.

5. Location

China is a geographically diverse country however most investment tends to be concentrated in the eastern coastal cities. This is primarily due to the fact that the East features more developed markets and a relatively mature infrastructure. Another cultural difference in Chinese markets is that cities or regions tend to be concentrated in one industry. For example, Zhongshan, in the Pearl River Delta (PRD), mainly produces lamps and lanterns; whereas Shunde district mainly produces furniture, and in other parts of the PRD region manufacturing of automotive components and assembling automobiles is quite common. The relatively mature industrial supply chains make investment in these areas, and more specifically in these industries, a major factor when deciding on where to invest. Choosing the right location can have a major impact on the purchase of raw materials, transportation, and sales or exportation of finished products. One downside of this concentration however is that as regions become more mature the land rates and manpower costs will also increase. Therefore, what industry you are investing in can have as much of an impact as anything else when deciding where to invest in China.

6. Production and Operation Costs

Over the past three decades, China has attracted many investors because of its low-cost raw materials and labor force. However, with the economic development of China and the consumption of social resources, this method of economic development cannot continue and thus China is witnessing a movement away from these previous economical advantages. The Chinese government has already started to put forward a strategy to help these changes take place in a controlled manner and such policies focus on; energy consumption, environmental pollution, and the protection of employee's rights. One example of how these new regulations are being put into effect was that from 2008, many local governments began to require foreign investors to hire intermediary institutions to carry out an "Environmental Impact Assessment Report" before applying for establishing a foreign enterprise regardless of whether such an enterprise had the capacity to cause pollution or not. Therefore it is reasonable to assume that in the foreseeable future, the costs for enterprises including; land, environmental protection and labor will gradually increase. However, it should be noted that, compared with other regions of the

world, China is still a relatively low cost region and the changes mentioned above will likely be a lengthy process.

7. Direct Investment or Merger

Throughout the most recent past in China foreigners have only been allowed to invest by establishing joint-ventures or cooperative ventures with domestic enterprises, but that has changed considerably over the past few years and now, unless the government has special requirements, direct investment into China for the establishment of a wholly foreign-owned enterprise or merger with a domestic enterprise are all acceptable. As such the main difference between whether or not to invest through direct set up of a company or to acquire shares in an existing company boils down to time and market considerations. Depending on the complexity of the operation it can take a long time to get from site selection to project approval to administrative examination and to final approval, then to getting the operation up and running and finally to making profits. However, in this direct setup the freedom to manage and develop the enterprise rests with the investor which can be very attractive for small start up businesses or limited investments.

Conversely, when acquiring shares in an existing company, investors should choose those enterprises which possess a significant presence in the market of the relevant industry or field, or which include upstream and/or downstream enterprises of their competitors. Choosing a target companies with a specific production scale, market share, and distribution channels has the advantage of getting the company off the ground quickly and potentially turning a profit faster than by setting up your own company.

8. Industrial Policies

The Chinese government has laid down the Catalogue for the Guidance of Foreign Investment Industries, to promote and strengthen the level and strategic economic development of China. This catalogue categorizes all industries into different classes as pertains to the foreign investment. Those classes include; encouraged industries, allowed industries, restricted industries, and forbidden industries. The catalogue is amended and updated every three to four years (the current version is the fourth edition). Encouraged industries can receive certain tax preferences and other benefits from local governments, including support in establishment procedures. Therefore, foreign investors need to pay a lot of attention to the Catalogue for the Guidance of Foreign Investment Industries when deciding on how to invest in China.

9. Taxes

Prior to 2008, domestic and foreign invested

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enterprises had many different income tax stipulations (foreign invested enterprises sometimes enjoyed more favorable tax policies) to consider. However, beginning in 2008 the Enterprise Income Tax Law of the People's Republic of China was published and stipulates that domestic and foreign-invested enterprises are all subject to the same income tax law and tax rate and that tax preference or tax rebates shall only be determined by the central government. Therefore, local governments lost their authority to establish or grant favorable tax policies. However, it is still quite common to see, in practice, local governments granting favorable tax policies to foreign-invested enterprises, sometimes disguised as rewards or subsidies. But this preferential treatment lacks any legal grounding and should not be counted on as a stable or long-term strategy for investment.

In addition, considering that some multinational companies have in the past, shifted profits to offshore low-tax jurisdictions with an aim to avoid tax liability in China, the tax authorities have begun aggressively supervising and investigating any suspicious enterprises. The central government is following suit by formulating laws against tax avoidance and strengthening the tax and Customs authority to crack down on any malfeasance.

10. Labor Law

In the past two decades, labor in China has remained very cheap, but with the economic development of China, the gradual enhancement of employee's rights has been looming and in response to those forces a large amount of laws and regulations were promulgated by the legislature of China over the past two years. Foreign investors should take into account the fact that labor arbitrations are much more accessible to employees than in the past and therefore the incidences of labor arbitration are on the rise. Also when dealing with any labor disputes with employees the burden of proof to disprove any claims resides with the employer, therefore well drafted employee contracts, employee guidelines, and job descriptions should be in place at the time of hiring. The labor environment in China is in a state of flux at the moment therefore employer's should be prepared to treat all employees in the

same way and with the same standards that they use would in a Western company.

11. Anti-Monopoly Law Considerations

In regards to the rising amount of mergers between foreign enterprises and domestic enterprises, the Chinese government formulated the Rules on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors in 2006 and the Anti-Monopoly Law in 2008. The Anti-Monopoly Law stipulates that if a merger or acquisition of a domestic enterprise by a foreign investor reaches any of the pre-determined declaration standards, a declaration must be made to the Ministry of Commerce in advance and no transaction shall be conducted without declaration and approval. This means that foreign investors may face anti-monopoly investigations by the Ministry of Commerce in any potential merger or acquisition of a domestic enterprise (although the law mainly pertains to only the leading enterprises in specific or sensitive industries or fields). As an example of just such a decision being made to stop a potential merger, in 2009, the Coca Cola Company attempted to take over Huiyuan Juice Group Ltd., but the Ministry of Commerce forbid the transaction by saying that it would have caused a disruption in the relevant market and that Huiyuan was a well-known brand.

Conclusion

Establishing a foreign invested enterprise in China can be quite complicated and difficult work, because of the many different authorities involved, their differing priorities, and the many different laws and regulations involved. Further complicating the process are the different restrictions placed on different industries, which means that it is important to not only comply with national policies, but also with local regulations. Thus, it is very important to approach the process with the proper mindset and knowledgeable advisors. If good advice and the proper planning is followed up with good communication channels with the authorities and an ability to adjust to the circumstances, receiving your business license can be accomplished in a quick and sufficient way.

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PRC LEGAL UPDATE:

Foreign Trade No Longer Allowed in Bonded Zones

Customs, recently modified two measures to disallow import-export and foreign trade within bonded logistics zones and bonded ports. The two circulars have modified the allowable business activities in a bonded logistics zones from "import and export trade, including entrepôt trade," to "international entrepôt trade," and modified the allowable business activities in bonded ports from "foreign trade, including the international entrepôt trade" to "international entrepôt trade" only. The changes take effect May 1st, 2010.

Shanghai Raises Minimum Wage and Benefits

Shanghai raised monthly minimum wage levels from RMB 960 to RMB 1,120 beginning from April 1, 2010. Also mentioned in the March 28th circular was that social security fees, housing funds, overtime wages and allowances, subsidies for meals, transportation, and housing for working in special work environments such as night shifts, high temperatures, or working underground should not be regarded as components of the standard minimum wage.

Unemployment insurance in Shanghai was raised to RMB 555, RMB 610 and RMB 660 per month depending on the recipients' age and how long they had been working. For those injured on the job, the city increased the minimum mandatory worker compensation level to RMB 3,210, RMB 3,030, RMB 2,800 and RMB 2,670 respectively, depending on the severity of the injury.