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CHINA Legal Bulletin

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Executive Summary

Representative Offices Face New Hurdles

Many foreign businesses register representative offices (RO) in China in order to conduct business within the PRC. Reform of the law governing ROs may result in discouraging companies from opening this type of legal entity. One change is that ROs are now subject to heightened taxation. Also new changes regarding how to establish and maintain an RO. We provide an outline of the major changes in the regulations surrounding ROs and suggestions for navigating these new regulatory hurdles.

By Pan Lidong, Deng Yong, and Michael Bordonaro

New Tax Requirements for Non-Resident Enterprises

Recent tax regulations significantly impact foreign enterprises assigning equity in Chinese enterprises to other Chinese or foreign enterprises. These rules levy tax on both equity transactions inside and outside China. We provide a brief glimpse at some of the details of these regulations and how they affect foreign enterprises' tax obligations within China.

By Pan Lidong, Deng Yong, and Margalit Faden

Groundbreaking Stop Payment Action Successful

Wang Jing & Co. represented a domestic manufacturing company and prevailed before a Shanghai court on a claim that a bank should stop payments under guarantees of up to RMB 70 million to a purchaser claiming breach of contract. This type of action is very rare in China due to a lack of specific regulations concerning stop payments and a lack of judicial precedents.

By Chen Xin

NEWS FLASH

Overlapping Jurisdiction of Regulatory Agencies Scuttles Hummer-Sichuan Tengzhong Deal

In 2009 GM agreed to sell the Hummer brand to Tengzhong, a Sichuan-based heavy machinery manufacturer. The deal unraveled when the Ministry of Commerce (MOC) denied receiving a complete application. Sources familiar with the transaction point out that the MOC supported the deal but the National Development and Reform Commission (NDRC) opposed it. Not wanting to directly contradict Beijing's support for Chinese outbound investment, the MOC sidetracked the deal on technical grounds.

The collapse of the Hummer sale provides insight into how numerous regulatory agencies have veto power over Chinese outbound investment. Other powerful agencies include: the State Administration of Foreign Exchange (SAFE) and the State-owned Assets Supervision and Administration Commission (SASAC). The relatively opaque nature of new regulations make foreign companies less willing to be involved in a share transfer with a Chinese firm and result in higher fees for non-completion of the transaction that foreign companies can demand when entering into acquisition negotiations with Chinese corporations.

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Representative Offices to Face New Hurdles



Representative Offices Must Comply with Tax and Procedural Changes

Representative offices have long provided international companies the ability to conduct limited business activity within the PRC without the need to pay corporate income taxes. Representative offices could conduct market research, build business liaisons, introduce products, and participate in technical exchange. Chinese law prohibited representative offices from engaging in full-fledged business activities such as executing contracts, holding inventory, issuing invoices, or receiving payments.

Government authorities have grown increasingly concerned about representative offices that operate outside of their legally circumscribed role, and so have launched a two-pronged reform of the legal structure of representative offices. First, tax increases for representative offices discourage foreign firms from using this form of corporate organization. Second, stricter registration procedures and operations guidelines for new and existing representative offices are aimed at keeping representative offices from operating outside of the permitted legal scope. Further, the new laws enhance commercial and tax regulators' enforcement authority over representative offices.

New Tax Regulations

On the 20th of February, 2010, The State Administration of Taxation (SAT) released the Interim Rules on the Implementation Regarding Tax Management of Representative Offices of Foreign Enterprises (Guoshuifa [2010] No. 18). The Rules apply retroactively, taking effect from the 1st of January, 2010. The Rules raise the deemed profit rate which tax assessors apply to representative offices from 10% to 15%. Tax rules also limit the ability of representative offices to claim that they should receive tax-exempt status.

The Rules emphasize three tax assessment methods:

- (1). Determining the taxable income by converting expenses into income;
- (2). Determining the taxable income according to the total revenue and
- (3). Determining the income tax according to actual revenue.

In applying Method (1) of determining the taxable income by converting expenses into income, tax officials, first, collect the date of the expenses of the representative office; and second, convert the expenses into the total income of the representative office using the deemed profit rate. Tax officials usually apply Method (1) of determining the taxable income by converting expenses into income to representative offices;

thus, the increased deemed profit rate will affect most representative offices operating in China. Method (3) differs from Method (1) and (2) in that Determining the income tax according to actual revenue relies on precise calculation of profit, and not an estimate, in determining tax.

Numerous questions remain regarding the practical implementation of the new taxation rules. For example, it is uncertain how quickly local tax bureaus will assess taxes on representative offices that are currently tax exempt. It also remains to be seen how much record keeping will be required when filing under the Rules.

The following formulas express Method (1) of determining the taxable income by converting expenses into income (the formulas of calculating the payment for income tax and business tax) under the new regulations:

- Total income = total expenses for the current period / (1 – deemed profit rate [currently, at least 15%] – business tax)
- Enterprise income tax (EIT) payable = total income x deemed profit rate x EIT
- Business Tax (BT) payable = total income x deemed profit rate x BT rate

The following formula expresses Method (2) used by representative offices that can calculate their income accurately but cannot calculate expenses or costs, i.e. determining the taxable income according to the total revenue.

- EIT payable = Actual total income x deemed profit rate [currently, at least 15%] x EIT rate

Foreign corporations which determine that the Rules are too onerous may consider restructuring their presence in China into that of a WFOE. Restructuring as a WFOE may decrease tax burden by up to 40% in comparison to a representative office operating under deeming method (1) with deemed profits of 15%. The WFOE structure may also provide benefits including: the ability to engage in business activities; greater flexibility for business expansion in China; greater encouragement by local governments; and more flexibility in hiring expatriate employees. However, restructuring as a WFOE does present some downsides, including: registered capital requirements, more thorough accounting practices, dividend repatriation challenges, and inter-company transfer pricing hurdles.

Procedural Guidelines

In addition to the new tax implications, the Rules present challenges for the establishment, registration, and maintenance of representative offices. We list below the four major changes:

- 1) Foreign parent companies must have been in operation for two years prior to establishing a

PRC LEGAL UPDATE:

Microsoft Awarded Damages in Landmark IP Case

Microsoft won a judgment against Dazhong Insurance for intellectual property damages in April of 2010. The USD 318,000 award represents Microsoft's first successful copyright infringement suit in China. The Shanghai court held that Dazhong used at least 450 pirated copies of software violating nine categories of piracy law. Observers believe the ruling may become a landmark in Chinese IP development.

China IP Policies Concerning Procurement Raise Concern

A new Chinese law requiring local governments, public agencies and some state-owned enterprises to favor Chinese-made products when purchasing certain high-tech goods has drawn criticism from foreign officials. American representatives worry that the policy favoring Chinese "indigenous innovation" may unfairly disadvantage U.S. IP holders by severely restricting American firms' access to the Chinese market.

Chongqing's Liangjiang District Becomes a Special Economic Zone

The State Council approved a new special economic zone (SEZ) in Chongqing's Liangjiang district. Previous SEZs, such as Tianjin's Binhai district and Shanghai's Pudong district, have greatly benefited from the preferential investment, tax, land, and trade policies bestowed upon such zones for the purposes of welcoming foreign investment.

Representative Offices to Face New Hurdles cont.



representative office.

2) Foreign corporations must provide copies of their incorporation certificates as well as notarized and legalized copies of bank reference letters when setting up representative offices.

3) Representative offices must renew their licenses annually.

4) Newly-formed representative offices may not have more than four foreign employees, including the chief representative. Representative offices must hire Chinese nationals through an employment agency but there is no limit on the number of seconded employees. Existing representative offices with more than four foreign

employees need not reduce their number, but such offices may not hire new foreign employees. As with the new tax regulations, the implementation of the new legal requirements for representative offices is still ambiguous. Some local governments continue to follow the old procedures and enforcement of the Rules will vary in different jurisdictions.

Conclusion

In sum, new tax regulation and procedural guidelines make setting up representative offices less attractive for foreign corporations.

As companies contemplate opening WFOEs in lieu of representative offices, executives will encounter various regulatory challenges. For instance, registered capital requirements for WFOEs can range from RMB 350,000 to RMB 1,000,000. Further, various regulatory agencies and local administrators retain control over choosing when and how to implement legal reforms. Thus, it is necessary to receive legal advice regarding the nuances of these regulatory issues as they apply to individual companies.

By Pan Lidong / Deng Yong / Michael Bordonaro

New Tax Requirements for Non-Resident Enterprises

Taxation of Foreign Enterprises' Equity Assignments in Chinese Companies

Recently, China started supervising foreign enterprises' (FE) tax payments within the country. The latest reforms give tax authorities significantly more power to collect taxes when a FE transfers an equity stake in a Chinese company to either another Chinese company or to another FE. According to the State Administration of Taxation's (SAT) published data, the tax authorities collected RMB 56 billion from non-resident taxpayers in 2009, which was a 45.9% increase from 2008. From this amount, about RMB 41.6 billion was enterprise income taxes, which was a 55% increase from 2008.

In 1991, China passed a law mandating that FEs pay enterprise income tax in China on income of property assignment derived in China (including income derived from equity assignment in Chinese companies). Nonetheless, prior to 2009, FEs rarely filed tax returns because of the lack of detailed filing rules. Recently, the SAT and other authorities issued several detailed regulations that detail tax procedures FEs must comply with when assigning equity in Chinese companies. Below, we briefly describe the latest tax payment regulations for FEs' equity assignments in Chinese companies. Consider two model scenarios: 1) FE A transfers an equity stake in Chinese Company D to Chinese Company C; 2) FE A transfers an equity stake in Chinese Company D to FE B.

Despite the fact that FE A does not have any offices or establishments in China, the Chinese government will tax equity assignment income

generated by assigning equity in Chinese Company D to either FE B or Chinese Company C. The income is taxed according to PRC tax laws and the applicable tax rates and tax assessment methods will be exactly the same in both cases. FEs will be taxed at the rate of 10% for incomes derived from equity assignments in Chinese companies. The taxable income is the balance of the total amount of income less the net value of assets. The undistributed profits from previous years or retained earnings, however, may not be deducted.

“ According to the State Administration of Taxation's (SAT) published data, the tax authorities collected RMB 56 billion from non-resident taxpayers in 2009...”

Two possible scenarios: FE A assigns equity to a Chinese company or to a different FE.

When contracting an equity assignment, the two parties should stipulate each party's withholding obligations, as

well as the relevant tax authorities where forms must be filed. Outlined below are two scenarios in which the party's tax responsibilities and relevant tax jurisdictions may differ.

1. FE A assigns equity in Chinese Company D to Chinese Company C.

If FE A assigns equity in Chinese Company D to Chinese Company C, Chinese Company C is responsible for withholding taxes. Additionally, it must file an equity assignment contract with the tax authorities. In this situation, however, Chinese Company C (the withholding company) and Chinese Company D may not be within the same tax authority's jurisdiction. For example, Company D might be registered in Guangzhou, but Company C might be registered in Beijing. In this instance, Company C is responsible

for filing a withholding form with the Beijing tax authority. If Company C fails to withhold or is unable to withhold, then FE A must file an income tax return with the tax authority of the place where the income is derived within 7 days of the payment deadline. Thus, if Company C fails to withhold, FE A must file a tax return with the Guangzhou tax authority (Company D's location).

2. FE A assigns equity in Chinese Company D to FE B and the transaction was conducted abroad.

When both parties to an equity assignment transaction are FEs and the transaction is conducted outside China, FE B or its authorized agent must file a tax return with and pay taxes to the tax authority that has jurisdiction over Chinese Company D. In this scenario, Chinese Company D is not responsible for withholding income tax, but it must submit a copy of the equity assignment to the relevant tax authority when it changes its tax registration. It must also assist the tax authority in collecting taxes from FE B. If FE B fails to pay the tax pursuant to the law, the relevant tax authority may recover the amount from any payable tax owed by FE B on income derived from FE B's other projects in China.

As can be seen above, FEs must now pay more attention to taxation of equity assignments in Chinese companies, even if the transaction is conducted abroad. As the regulations are new and implementation may vary from region to region, it is recommended that FEs consult a tax attorney for assistance.

By Pan Lidong / Deng Yong / Margalit Faden

Groundbreaking Stop Payment Action Successful



Wang Jing & Co. Successfully Applies for Stop Payment Under Guarantees

In May of 2010, the Wang Jing & Co. Shanghai Office was entrusted by a large, domestic manufacturer of machinery and equipment to handle a claim made by one of its overseas buyers against the guarantor bank on the basis of alleged breach of contract. As a result, our Shanghai Office managed to apply to the court to stop payment under the guarantees, which duly protects the legal rights and interests of our client.

Our client and their overseas buyer executed a contract for the sale of a series of machinery and equipment. As required by the buyer, our client applied to a domestic bank to issue a performance guarantee and three advance payment guarantees totaling more than RMB 70,000,000 and subject to the Uniform Rules for Demand Guarantee (URDG) 458. Prior to the expiration of the guarantees, a foreign bank issued a claim letter to the guarantor bank as the assignee of the guarantee claiming for payment of the guaranteed amount within 10 days because of our client's breach of contract. The buyer claimed that our client had breached the agreement due to delay of delivery and failure to make necessary adjustments. Since our client had already delivered the equipment but still had not received payment, there was a huge risk that they might lose the equipment and the guaranteed money, as well as a high level of urgency due to the timing of the payments.

Our team in Shanghai was immediately engaged in the case. After reviewing the situation and transaction documents, we discovered that both parties had previously negotiated postponement of delivery. Thus there was no delay of delivery as alleged. Furthermore, the buyer should bear the responsibility for the failure to complete the adjustments. Therefore, any claim against the guarantees should be deemed malicious and fraudulent. In addition, the aforesaid guarantees are non-transferable, so the assignee foreign bank is not the proper party to demand payment of the guarantees. Accordingly, we suggested that our client apply to stop payment under the guarantees. We then spared no effort in communicating and

sending letters to the guarantor bank specifying that the claim made by the foreign bank was invalid and should be rejected. Eventually, the guarantor bank agreed to suspend the payment.

We then urgently collected evidence and prepared documents, in order to submit applications to the Shanghai Second Intermediate People's Court to stop payment under the guarantees on the grounds of fraudulence and nonconformity with the requirements regarding the foreign bank's claim.

The situation was complicated by the fact that there is neither specific regulations concerning stop payments in PRC law nor relevant precedents from judicial practice. In absence of a firm legal basis and in consideration of the reputation of domestic banks, the Chinese courts are generally very prudent when upholding stop payment applications. In order to convince the court to uphold our stop payment applications, we submitted extensive documentation and evidence. Upon reviewing our applications, the court carried out thorough investigations, studied all the relevant legal grounds, and considered the opinions of all parties concerned. Through our repeated and effective communication with the judges, the court eventually rendered civil rulings supporting all of our applications and ordering the guarantor bank to stop any payments under the involved guarantees. Despite the reluctance of the court to grant a stop payment order, Wang Jing & Co. managed to prevail on this difficult claim and protect our client from suffering a huge economic loss.

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PRC LEGAL UPDATE:

China Releases Rules Defining Commercial Secrets

The State-owned Assets Supervision and Administration Commission (SASAC) has defined commercial secrets as anything that has not been disclosed to the public and could hold economic value for a company. The SASAC has requested that companies attach great importance to protecting secrets. This broad definition of secrets comes in the wake of convictions of four Rio Tinto executives found guilty of stealing secrets and bribery. The secrets in the Rio Tinto trial involved the price Chinese steel mills were willing to pay for iron ore.

Private Equity Firm Acquires Equity Stake in Chinese Automatic Teller Machine Company

US private equity firm Carlyle Group has invested USD 140million in four Asian companies including ATMU, China's largest independent provider of automatic teller machines. With this investment, Carlyle takes a minority equity stake in ATMU which controls 15% of the domestic market for ATMs. Carlyle Asia Capital Partners IV is responsible for the investment. In June of 2009 this fund closed to investment with a total capital of USD 1.04billion. Carlyle's previous Asia growth fund launched in 2005 with USD 680million.