

Investing into China

It's amazing to think that China only opened its doors to the world economy in 1979. At the time, it was an experimental approach with four Special Economic Zones being established. Nick Farmer, Tax Partner at Menzies and Leo Guan, Tax Partner at ThinkBridge look at companies investing into China.

Their success encouraged the government to further open up the country, which led to China becoming a full member of the World Trade Organisation in November 2001. Since then China has continued to improve its business environment and in the first four months of this year maintained double-digit growth in Foreign Direct Investment (FDI).

Whilst China actively encourages FDI, many regulatory requirements must be followed. This is highlighted by the fact that, in terms of the ease of starting a business, China ranked 151 out of 183 economies in the 2011 World Bank Doing Business survey.

Inward investment is controlled and monitored by the Chinese government through its Foreign Investment Catalogue. Known as the Catalogue, this is an essential document for foreign companies considering investing into China, which lists the investment projects that are encouraged, permitted, restricted and prohibited. Particular emphasis is currently given to investment in high-technology industries, energy conservation and modern services. Newly encouraged sectors include venture capital enterprises and intellectual property service institutions.

As well as reviewing the Catalogue, it is also important to carefully define the business scope and to ensure that it mirrors reality. This will be stated on the business licence and open to audit at a later date. Attention must be paid to the exact Chinese translation of the business scope, as any amendments or extension

would require further application and approval.

Foreign direct investment

A UK company will only establish a tax presence in China if a permanent establishment is created as defined in the UK-China tax treaty. It is therefore possible to undertake certain activities in China without creating a tax presence. However, due to the need to continually monitor the position, as well as the uncertainty created with potential customers, in practice a legal entity is usually established.

"Corporate Income Tax (CIT) in China is a flat rate of 25%..."



Foreign investors can select from an increasingly wide range of entities, but the most common are the representative office, wholly foreign-owned enterprise (WFOE) or joint venture.

A representative office is a legal entity that can be established quickly and at low cost. It is ideal for testing the market in China, and although restrictions apply, it can undertake activities such as market research, supplier liaison and procurement assistance. The entity is still

taxable in China, generally on cost-plus basis.

The wholly foreign owned enterprise is the most popular choice of entity for FDI and is used for about 80% of China's approved foreign investment projects. As it can be 100% foreign owned, either by corporate or individual shareholders, it gives investors greater autonomy with full business control, profit rights and protection of existing intellectual property.

Approval of the project is an integral part of the incorporation process and numerous documents need to be prepared and approved before the WFOE can be incorporated. These include a feasibility study report with financial forecasts for the business, and proof that a plant or office is being rented in China. Depending on the type of WFOE being set up, and the size, scope and location of the project, approval typically takes two to five months, so forward planning is essential.

Funding the WFOE requires an understanding of two key concepts: registered capital and total investment. Registered capital is the amount of capital that must be maintained by the business to support itself and will be indicated on the business licence. Total investment includes both registered capital and loans to the business. The ratio between these amounts is important as China has thin capitalisation rules.

The set up of joint ventures is almost exactly the same as for a WFOE, with the main difference being the JV contract between the investors. This type of entity will primarily be used for two reasons:

- It will be required when entering industries where foreign investment is restricted.
- It will enable foreign investors to take advantage of existing resources and expertise of the Chinese partner.

The downside of JVs is that they can be inflexible arrangements that are difficult to change. Diverse corporate cultures must be integrated and unanimous board approval is required for major decisions.

Tax matters

Corporate Income Tax (CIT) in China is a flat rate of 25%, with tax-resident enterprises being subject to tax on their worldwide income. The rate is reduced to 20% for qualified small and low-profit enterprises, and drops further to 15% for qualified high- and new-tech enterprises. There are also incentives for foreign investment into western China, and these regional benefits are specific to particular industries.

Indirect taxes are an important source of tax revenue in China. The main taxes are VAT, Business Tax and Consumption Taxes. Business Tax is assessed on all services carried out in China, usually at 5%, and as it is similar to a sales tax, is not creditable for double taxation purposes.

One of the main issues that foreign investors need to plan for is the repatriation of profits out of China. This may be achieved in different ways, such as through the payments of dividends, royalties, interest, intercompany service charges or trading transactions. Dividends are subject to a domestic withholding tax rate of 10%, and passive incomes, such as royalties and interest are subject to a further 5% Business Tax. Service charges

trigger 5% Business Tax and 25% CIT with a deemed profit rate from 15% to 50%.

Before a dividend can be paid to the shareholders, a board resolution and an audit report are required, and the withholding tax must have been remitted to the tax authorities and a tax payment certificate obtained. This will enable the bank to grant foreign exchange approval for the payment to be made out of China. Similar requirements apply to the payments of passive incomes and service charges.

Trading transactions can represent an easier way to extract profits from a Chinese entity, and it can be important to look at the supply chain as a way of minimising the profits that remain in China. It should be appreciated that China has transfer pricing rules and all transactions must be on an arm's length basis.

Investment structures

Much investment into China comes via Hong Kong or other countries and regions with good double tax treaties with China. An intermediate holding company may be used for a variety of reasons, such as:

- To benefit from lower withholding tax rates on dividend, passive income or capital gain paid from China
- Access to a more stable legal system and to better protect intellectual property
- To avoid Chinese approval processes for matters such as change of ownership
- To obtain reduced corporate tax rates (Hong Kong has a low rate of 16.5%)

With this type of structuring it is essential that the intermediate holding company has sufficient substance or the Chinese tax authorities may look through the arrangements.

Conclusion

As more British companies look to expand their businesses in overseas markets, the Chinese market will be one that is hard to ignore. There are of course issues that need to be dealt with, such as the local bureaucracy, ambiguous laws and cultural differences. But for those companies that are prepared to invest the time and effort in getting to know this dynamic market, the business opportunities are likely to be second to none.

Menzies LLP acts for UK companies wishing to develop international operations through:

- Multilingual capabilities and advice on the best vehicle for overseas expansion.
- Strong relationships with reliable overseas partners and a fast response, so that we can complete transactions to tight deadlines.
- Support on VAT and customs issues, tax clearances, transfer pricing, double taxation relief, anti-avoidance legislation.
- Global audit and assurance solutions designed for single company or group accounts.
- Outsourced bookkeeping, management accounts, accounts preparation and outsourced payroll for reliable financial information.
- Additional support covering corporate residence, permanent establishments, treaty interpretation, HR and private client.

If you would like to discuss the topics raised in this article please contact:

Nick Farmer, Partner
T: +44(0) 1784 497100
E: nfarmer@menzies.co.uk