Bridge to China

通往中国的桥梁

R&L China Consult is based in Örnsköldsvik, north part of Sweden. We are dedicated to providing customized Chinese market access strategies and solutions for our customers. We are flexiable, reliable and efficient. Our vision is to be the right partner for you to make success in the great Chinese market.

Chinese Market Entry Handbook 2011/2012

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Content

1 Introduction

China has undeniable become one of the largest economies, attracting exploration of business from all over the world. However, for many foreign companies, the Chinese market is still considered mysterious because of its huge size, rapid development, totally different business culture compared to western countries, uneven national market, and its young developing market with a heavy footprint of a centrally planned economy. Therefore, a good understanding of the culture and the market and a well planned market entry strategy are necessary to succeed in the Chinese market. This report describes some basic but important issues, including the administrative, legal and financial aspects of setting up business in China, for foreign companies which are preparing to enter the Chinese market.

2 Establishing a Legal Entity in China

The key national regulation for guiding the foreign investment in China is the"Regulations on Foreign Investment Direction", which classifies industries into four categories for foreign investment: encouraged industries, permitted industries, restricted industries and prohibited industries. This classification determines the feasibility and establishment method of projects in different industries. Chinese partners are required for the foreign investment in certain industries, such as media, automotive and telecom industries, etc. The encouraged industries can benefit from tax advantages and preferential policies, while the restricted projects must be examined and approved by the relevant authorities.

As complement, the"Guidance Catalogue for Foreign Investment"[1] lists out all the industries under the four categories. And the "Catalogue on Advantageous Industries for Foreign Investment in Central and West Regions" lists the industries that are greatly encouraged for foreign investments in the central and western regions of China.

2.1 Modes of business legal entities

2.1.1 Representative office (RO)[2]

An RO represents the interests of the foreign investor by acting as a liaison office for the parent company. In China, an RO is only permitted to engage in indirect business activities, such as business liaison, product introduction, market studies and technical exchanges. Any other activity including issuing bills or invoices to customers, collecting money from customers, and warehousing and managing inventory in China for trading purposes is prohibited. The parent

[1] Download the PDF version of the "Guidance Catalogue for Foreign Investment" at [http://www.rlcc.se/docu/Guidance Catalogue for Foreign Investment.pdf]
[2] A detailed guidance of setting up a representative office in China written by the British Embassy in Beijing at [http://www.rlcc.se/docu/Setting up a representative office in China.pdf]

company is subject to the jurisdiction of the Chinese law in case of disputes arising from contracts or other property rights; the mother company also bears all the legal responsibilities for business activities of its resident RO in China. And an RO has no right to hire local employees directly, but go through a government-authorized employment agency.

2.1.2 Branch office (BO)

In China, only a few business sectors such as banks and insurance companies are permitted to set up branches. A branch office in China is not recognized as an independent legal entity; it can only carry out liaison and coordination work. As a result of these restrictions and the lack of legal standing, a branch office is not a common choice for foreign investment in China.

2.1.3 Joint venture (JV)

In China, there are two common forms of JVs, the equity joint venture (EJV) and the cooperative joint venture (CJV). The corporate form of EJVs is a limited liability company with its own registered capital and an independent legal identity, while a CJV is a Chinese-foreign contractual enterprise normally with capital and technology investment from foreign company, and land and labors from the Chinese company. The CJV mode was used more in the 1990s when the Chinese economy was not as developed as today.

More and more international companies choose to enter the Chinese market as wholly-owned enterprise (WOE) due to the risks associated with entering partnership with local companies, for example, different culture and management styles, the difficulty of a comprehensive control and the difficulty in obtaining commercial data of private Chinese companies, etc. However, according to laws and regulations, foreign companies are only allowed to enter certain industries in China by establishing JV with local partners.

A new trend also shows that international companies are entering China through merger & acquisitions increasingly.

2.1.4 Wholly-owned enterprise by foreign investor (WOE)

WOE is the most popular mode of foreign investment in China nowadays, it is a limited liability company fully invested by one or more foreign investors. There is a limit of the minimum registered capital depending on the locality and nature of the business. Generally, the minimum amount of registered capital is 30 000 RMB, which is around 3200 Euro.

It is well known that a key factor for the success of business in China is a strong relationship between local authorities and suppliers. The knowledge of administrative processes and cultural customs of China are the main advantages for an experienced investor, because misunderstanding happens due to communication gaps.

2.1.6 Franchise

A franchisor in China should have a mature business model and the capacity to provide a franchisee with operational guidance, technical support and training services. The franchisor should have at least two directly operated units which have been operating for more than one year.

2.1.7 Launching trade business in China from Hong Kong

Many foreign and Chinese domestic companies choose to register their companies in Hong Kong while conducting their trade in mainland China, instead of registering in China directly. The major benefit is that the company is able to trade in a more flexible situation by avoiding foreign exchange restrictions on the mainland by the State Administration of Foreign Exchange. Besides, companies operated in Hong Kong can legally reduce their tax exposure for all trade businesses that are conducted on the mainland.

2.2 Registration of the entity

In China, the registration of a business entity, both RO and other Foreign Invested Enterprises (FIEs) normally contains three steps: Approval, registration and post-establishment registration.

Before registration, related documents, contracts and business proposal for establishing an RO or a FIE have to be approved by relevant authorities under the Chinese laws. The authorities for approval are different depending on the applicants' main business. The approval authorities are required to make decision within 3 months, but most local approval authorities are able to grant approval within 5-15 working days. It is important to prepare all the required documents carefully as the first step is an "approval" instead of a "registration". It is possible that the authorities reject an application without providing any reason.

Within 30 days of receiving the approval certificate, the applicant should register with the local Administration of Industry and Commerce (AIC) for a business license. Documents required for the registration are similar to those required for an approval certificate. AIC is required to issue the business license within 30 days, but most local authorities are able to issue the license within 5-15 working days.

After a successful registration process, the following procedures should be taken:

- Make the official seal for the company. In China, official company seals are required for many business and baking transactions.
- Open RMB & foreign currency bank accounts
- Apply for a corporation registration code certificate
- Register with Tax Bureau
- Apply for working and resident permit
- Observe customs formalities for the import of office equipments
- Employ local employees

✧ Obtain health certificate

Major Chinese authorities involved in the registration process include the Ministry of Commerce, the Administration of Industry and Commerce, State Administration of Foreign Currency, Taxation Bureau, the Customs Office, and the Statistics Bureau.

2.3 Opening a bank account

There are three types of retail banks in China, the state-owned banks, joint-stock banks and city-level banks (Table 1). The bank system in China, especially those state-owned banks, is famous for its bureaucracy and poor service sense, as well as its undeveloped internet bank system. As known, China Merchants Bank has relatively better service and internet bank system. In addition, foreign banks are also developing very fast in China. By now, more than 200 foreign banks from over 50 countries and regions had established their branches and sub-branches in China.

Table 1 Major commercial banks in China

Category	**Name of major banks**
State-owned banks	Industrial and Commercial Bank of China, Bank of China, China Construction Bank, Agricultural Bank of China
Joint-stock banks	Bank of Communications, China Merchants Bank, China Minsheng Bank, Guangdong Development Bank
City-level banks	Bank of Shanghai, Bank of Beijing, Bank of Ningbo
Foreign banks (locally incorporated)	HSBC, Citibank, Standard Chartered, the Bank of East Asia, ABN AMRO

In China, FIEs are required to open two types of bank accounts: RMB accounts and foreign exchange account. Foreign currency is not allowed to circulate freely in China. As FIE, it is required to register of foreign exchange with local State Administration of Foreign Exchange (SAFE) within 30 days after receiving business license. After receiving the foreign exchange registration certificate, the FIE can open bank accounts in any branch of the retail banks in China.

3 Taxation

Within 30 days after the receiving of the business license, the RO or the FIE must register with Tax Bureau. Generally, the application process takes 10 working days. The most important tax categories for an RO or a foreign invested Limited Liability Company (LLC) are enterprise income tax, business tax, consumption tax and value-added tax (VAT).

3.1 Main tax categories for foreign invested LLC

3.1.1 Enterprise income tax

Enterprise income tax is based on incomes derived from production, business operations and other sources within and outside China, which is total annual income minus expenses and losses. The enterprise income tax is paid quarterly and the applicable rate is 25%.

3.1.2 Business tax

Business tax is one kind of turnover taxes. Any units and individuals engaged in the provision of taxable services including transportation and communications, posts and telecommunications, finance and insurance, construction, culture and sports, entertainment and servicing, are required to pay business tax. Any transfer of intangible assets or the sale of immovable properties within the territory of China will require the payment of business tax. There are three tax rates, ranging from the lowest 3% (e.g. transportation and communications) to the highest 20% (e.g. entertainment).

3.1.3 Consumption tax

The taxpayers of consumption tax comprise all units and individuals engaged in the production or import of taxable consumer goods within China. Taxable consumer goods include tobacco, alcohol, alcoholic drinks, cosmetics, shin care and hair care products, precious jewellery, precious jade and stones, firecrackers and motor cars. Taxpayers who export taxable consumer goods are exempted from consumption tax, unless the taxable consumer goods are restricted by the state from exports. There are 11 different tax rates for consumption tax, ranging from 3% to 50%.

3.2 VAT

In China, all companies and individuals required to pay VAT if they are involved in the sales of goods, provision of processing repairs and replacement service, and the import of goods. Taxpayers are distinguished between general and small-scale VAT payers. Small-scale taxpayers are enterprises with annual turnover less than 500 000 RMB for manufacturing and service and 800 000 RMB for wholesaling and retailing. VAT has to be paid monthly and special VAT invoices must be bought from the tax bureau.

For general VAT payers, the amount of VAT payable is the excess amount of output VAT over input VAT. The basic VAT rate is 17%. The tax rate is 13% if taxpayers engage in selling or importing food grains, edible vegetable oils, tap water, books, newspaper, magazines, feeds, chemical fertilizers, agricultural chemicals, agricultural machinery, etc. If the current output VAT is smaller than the current input VAT, the amount which can not be fully offset or deducted may be carried over to subsequent tax periods.

For small-scale VAT payers, VAT payable is calculated by a simple method on the basis of the overall sales value and without deduction of input VAT. This means the input VAT borne by small-scale VAT-payers is not refunded by the tax authorities. Furthermore, small-scale taxpayers do not have to pay VAT on the value of exported goods. The applicable tax rate is 3%. The formula to calculate is: Tax payable = Sales volume x 3% / (1 + 3%).

3.3 Taxation of representative office

As RO (excluding those engaged in business consulting, legal matters and accounting etc.) are not allowed to generate revenue, their tax base for enterprise income tax and business tax is presumed on the basis of their expenses. A minimum presumed profit rate of 15% is used for calculation. The formulas for calculation are as follow:

Presumed income amount = Operations expense / (1 – presumed profit rate 15% - business tax rate)
Business tax payable = Income amount x Business tax rate 5%
Enterprise income tax payable = Income amount x Presumed profit rate 10% x Enterprise income tax rate 25%.

The result of this relatively complicated computation is an estimated 10.9% tax (Business tax + Enterprises income tax) on operation expenses, which can be used as a rule of thumb. Unlike LLCs which pay their taxes on a monthly basis, RO pay both the business tax and the income tax quarterly.

4 Recruitment of Local Staff

Besides usual employment requirement, such as signing contracts, meeting salary standards and issuing salary timely, etc., employers in China are also obliged to the following requirements:

a. File their staff employment and dismissal with relevant government bureaus;
b. Maintain employees' personnel file – a unique Chinese document that records all academic and employment history of en employee, and the responsibility of maintaining the records is transferred from one employer to another when the employee changes jobs;
c. Withhold and pay individual social benefits and income tax on behalf of their employees;
d. make monthly contributions to their employees' social benefits and housing funds.

4.1 Personnel file

Personnel file is a unique method in China to record all the details of a person's education and employment history. Every citizen of China owns a personnel file, and the personnel file is not allowed to be written or maintained personally. It has to been maintained by the employers and the responsibility is transferred to the next when the employee changes jobs. As an RO is not allowed to hire local employees directly, it must engage a local labor agency to maintain these files.

4.2 The employment contract

Under the Labor Law of China, all companies are required to sign employment contracts with their employees. While LLCs are allowed to sign employment contracts directly with local staff, ROs must engage authorized service providers to hire and dispatch their local employees.

There is no standard contract form, but the following contents should be included in the agreement:

a. Term of contract and probation period;
b. Job title and description;
c. Labor protection and working conditions;
d. Compensation;
e. Termination conditions;
f. Breach of contract provisions and disciplinary rules.
g. other provisions such as Training program, non-disclosure agreement and non-compete agreement, etc.

Some experience should be noticed when signing contract. For example, an employee can only be dismissed without paying severance fee if he/she is found to have seriously breached a company policy which has been acknowledged and signed by the employee. Therefore, it is very important to define behaviors that are harmful to the company.

Do sign a binding contract with employee if paid training is provided. An employee can be required to serve a certain period of time with the company is he/she has been provided with training paid by the company. The company is then entitled to demand payment for the training costs if the employee leaves the company prior to the contract expiration date.

Do set probation periods according to the regulations. The labor contract law requires that the probation period should not be longer than one month if the contract term is shorter than a year; no longer than two months if the contract term is shorter than three years; and no longer than six months if the contract is longer than three years.

4.3 Salary structure

4.3.1 Basic salary

Basic salary is paid monthly and varies from 12-14 months. A 13-month pay scheme is common in China, with the additional month's payment during the Chinese New Year month (usually February). The minimum salary in China is around 1000 RMB, which is very low. However, salaries for middle/high positions and experienced professionals are growing very fast, some of which have been close to those in developed countries. Due to the shortage of managerial talent, competitive salaries are necessary to attract and retain good employees.

4.3.2 Bonus

Bonus can be paid monthly, quarterly or annually. The amount is strongly related to individual performance at work. While not required, most employers pay annual bonuses (the 13^{th} month salary mentioned above) at the Chinese New Year. Performance based bonus is becoming increasingly popular in China, especially in China's first tier cities, success and monetary reward through performance differentiation are concepts that employees usually appreciate.

Some other usual incentives include: individual performance plans, team performance plans, organizational profit sharing plans, sales bonus plans, sales commissions and special recognition awards, etc.

4.3.3 Allowances

Personal allowances are a unique and very important form of compensation in China. Although FIEs are not obliged to provide it, allowances are sometimes viewed to be more valuable than the cash equivalent in the Chinese culture. Usual allowances highly valued by employees include transportation, meals, clothing, and child care allowances, etc.

4.3.4 Social benefits

Social benefits for Chinese employees can be classified as mandatory and supplemental. Mandatory benefits are contributed by both employers and employees, which comprise an important portion of the total compensation.

Social benefits in China usually include six parts and their rates vary slightly in different regions (a general rate is given in the following):

a. Pension insurance: 20-22% by employer and 8% by employee;
b. Unemployment insurance: 1% by employer and 0.2-1% by employee;
c. Medical insurance: 10-12% by employer and 2-5% by employee;
d. Workplace insurance: 0.5% by employer;
e. Maternity insurance: 0.5-0.8% by employer;
f. Public housing fund: 7-12% by employer and 7-12% by employee.

Therefore, based on the gross salary of the employee, the employer pays around 44% social benefits for the employee and the employee pays about 20% self. The net salary of a Chinese employee will thus be the gross salary minus the social benefits paid by employee and individual income tax.

4.4 Excellent employee retention plan

4.4.1 Remuneration

Salary often reflects one's social status in China. Therefore, better opportunities are often synonymous with higher salaries. This is an important reason behind the fast job changing of employees in China, especially for those talented managers, who have been poached by competitors with higher salaries. Thus it is very important to keep salaries competitive with market level, especially for senior positions.

4.4.2 Training and career development

While competitive salaries offer a short-term solution to retaining talent, training and career development allow companies to align their long-term strategies to employee's career goals. Nowadays, preferred training and career development plans include professional training in foreign languages and specific skill sets, clearly specified promotion criteria, and regular departmental rotation programs. However, mentorship programs are not considered desirable now in China, as mentors often withhold important skills and knowledge in order to secure their own positions.

4.4.3 Organizational culture and interpersonal relationships

In general, Chinese employees prefer flexible organizational culture which place greater emphasis on interpersonal relationships. This creates a friendly working environment and allows room for creativity. It is beneficial for foreign companies to adapt their cultures and inculcate a greater sense of "family" in their Chinese offices. This will create a sense of belonging to the company and instill greater teamwork among the employees.

Personal relationships are important in managing and retaining employees in China. It is a common mistake for managers to distant themselves from their subordinates. Mangers should build friendships with their subordinates to remain their loyalty to the company, even in times of difficulties or despite receiving better offers from competitors. However, managers should also notice that such relationships also work in the opposite way; they may eventually find it difficult to terminate non-performing employees as personal relationships get involved.