Willkommen in Peking!

Legal and Tax Considerations for Doing Business in China

KING & WOOD MALLESONS
18 March 2015, Beijing
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- International Debt/Equity Restructuring
- Investment in/Establishment of PRC Financial Institutions
- Project Finance
- Real Estate Finance
- Syndicated Loans
- Insurance

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- Outbound Investment
- Real Estate
- Corporate Governance & Compliance
- Environmental Law & New Energy
- Labor & Employment
- Taxation

Capital Markets & Securities
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- Equity Financing for Private Companies
- Establishment of Investment Funds
- Mergers & Acquisitions of Listed Companies
- Advisory Services for Listed Companies
- Securitizations & Derivatives
- Wealth Management for Private Investors

Competition & International Trade
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- Antitrust Administrative Investigations
- Antitrust Private Litigations
- Antitrust and Anti-Unfair Competition Compliance
- WTO Dispute Settlement
- Customs Measures & Other Import/Export Business
- Trade Remedies
- U.S. Section 337 Investigations

Litigation & Dispute Resolution
- Domestic Litigation
- Cross-border Litigation
- Labor related disputes
- Arbitration
- Alternative dispute resolution
- Bankruptcy, Restructuring & Liquidation

Intellectual Property
- Patent
- Trademark
- Copyright
- IP Commercial
- IP Portfolio Management
- IP Litigation and Enforcement

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Our Clients from Germany
Our Clients in Aviation Sector
PRC- Germany Trade Snapshot
FDI in China: 2014. 1-12

- Top 10 nations/regions with investment in China (as per the actual input of foreign capital):
  - Hong Kong: USD85.74b
  - Singapore: USD5.93b
  - Taiwan: USD5.18b
  - Japan: USD4.33b
  - Korea: USD3.97b
  - U.S.A.: USD2.67b
  - Germany: USD2.07b
  - U.K.: USD1.35b
  - France: USD0.71b
  - Netherlands: USD0.64b

- Accounted for 94.2% of total actual use of foreign investment (USD119.56) in China!
Total amount of imports & exports between Germany and China (USD billion)
Major Legal Considerations
China Government: Policy & Trends

Prime Minister Li Keqiang:
• To use foreign investment more efficiently
• To broaden the service and general manufacture industry that is open for foreign investors
• To amend the law related to foreign investment in order to build up a more fair, transparent and predictable business environment

From 3rd to 15th March 2015, National People's Congress and National People's Political Consultative Conference were held in Beijing
General Considerations

- Foreign investment project (forbidden, restricted or encouraged)
- Investment vehicles (WFOE, JV, RO or others)
- Investment structure (direct investment vs. indirect investment)
- Exit path (listing, transfer)
- Regulatory approval
- Foreign exchange control
Foreign Investment Industry Guidance Catalogue

Difficulty, timeline and complexity of approval process

**Encouraged**
- Covering approx. 349 industries featuring:
  - advanced technology
  - energy-saving or renewable energy
  - environmental friendly
  - emerging industries
  - upgrading products
  - promoting development of central and western China

**Permitted**
- Sectors and industries not listed in the Catalogue
- The broadest category

**Restricted**
- Covering approx. 38 industries featuring:
  - overcapacity industries
  - outdated technology
  - harmful to environment
  - exploration of rare natural resources.

**Prohibited**
- Covering approx. 36 industries featuring:
  - endangering national security and military facilities
  - detrimental to public interest
  - harmful to environment
  - using sizeable tracts of agricultural land
Market Entry in Aviation Industry

**Encouraged Catalogue**

- Production of tyres for big aircrafts
- Production of organic polymer materials: aircraft skin paint
- Development and manufacturing of aviation lightweight and environment-friendly new materials
- Manufacturing of aero engine bearing
- Design, manufacture and maintenance of civil planes: main airlines, regional airlines (Chinese partner shall hold the majority of shares), general-purpose planes (limited to JV or CJV)
- Manufacture and maintenance of spare parts for civil planes
- Design and manufacture of civil helicopters: (3 tons and above: Chinese partner shall hold the majority of shares)
- Manufacture of spare parts for civil helicopters
- Manufacture of ground, water effect plane and manufacture and design of unmanned aerial vehicle and aerostat (Chinese partner shall hold the majority of shares)
- Design, manufacture and maintenance of airplane engines, spare parts and aviation auxiliary power system
- Design and manufacture of air-borne equipment for civil airplanes
- Manufacture of aircraft ground equipment
- Manufacture of optical mechanical and electronic products for spacecraft, temperature control product for spacecraft, test equipment for satellite-related product, structural and institutional product for spacecraft
- Air freight companies (Chinese partner shall hold the majority of shares; one foreign partner and its affiliates cannot hold more than 25% equity)
- General aviation companies for agriculture, forestry and fishery (limited to JV and CJV)

**Restricted Catalogue**

- General aviation companies for official flight, aerial touring, photography, prospecting, industry, etc. (Chinese partner shall hold the majority of equity)
## Traditional FDI Vehicles

<table>
<thead>
<tr>
<th></th>
<th>WFOE (Wholly-foreign owned enterprise)</th>
<th>EJV (Sino-foreign equity joint venture)</th>
<th>RO (representative office)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Ease of set-up</strong></td>
<td>High – Feasible in limited sectors subject to FDI market access</td>
<td>Low – Negotiations can take some time</td>
<td>yes</td>
</tr>
<tr>
<td><strong>Management control</strong></td>
<td>Complete managerial and operational control</td>
<td>Generally consistent with shareholding ratio; Mandatory unanimous board approval for certain matters</td>
<td>May be set up as step stone to test and develop China market and coordinate with Chinese business partners</td>
</tr>
<tr>
<td><strong>IP protection</strong></td>
<td>More control</td>
<td>IP and trade secrets concerns</td>
<td>NA</td>
</tr>
<tr>
<td><strong>Local resources</strong></td>
<td>Depending on whether the foreign investor has relevant experience or management personnel</td>
<td>Chinese party may have strengths in market knowledge, government support and risk &amp; cost sharing.</td>
<td>Limited function in China, engaged in market research, coordination and auxiliary activities only, cannot conduct fee generating business</td>
</tr>
</tbody>
</table>
Approval & Incorporation

- Civil Aviation Administration of China
  - Approval / relevant license
- AIC
  - Name Pre-verification / business license
- MOFCOM
  - Approval Certificate / Anti-monopoly review (if apply)
- NDRC
  - Project review and approval
- MEP
  - Approval on Environmental Impact Evaluation Report

Other authorities:
Post-establishment Registration (organization code, tax, foreign exchange, finance, statistics)

* Timeframe will vary from project to project
Overview of Shanghai FTZ (1/2)

- China (Shanghai) Pilot Free Trade Zone ("FTZ") formally established in Shanghai on September 29th, 2013
- The FTZ used to cover around 28.78 KM² geographical area and encompass 4 existing free trade zones
- Now the FTZ covers 120.72 KM² and encompasses more zones, including Jinqiao, Zhangjiang, Lujiazui
- The FTZ aims to create a more investor-friendly regulatory environment for business operations in China, and the pilot experience gained would hopefully be applied in the future nationally
Overview of Shanghai FTZ (2/2)

- Improved service
- Encourage investment
- Reduced government red tape
- Financial services sector reform
- Greater legal certainty
- Improved legal system and international standard rules for investment and trade protection
- Streamlined approval process to encourage foreign investment
- Lower thresholds and greater regulatory freedom in the financial services sector
- Relaxed administrative regulation
- Upgraded trading and shipping services
Foreign Investment Law – a Changing Landscape

- On 19 January 2015, Ministry of Commerce issued the draft of China’s Foreign Investment Law for public comments
- Once passed, it will replace the existing Foreign Invested Company Law, the Sino-Foreign Equity Joint Venture Law, and the Sino-Foreign Cooperative Joint Venture Law
- It will substantially reduce barriers to foreign investment, but at the same time the government will impose further scrutiny on foreigners trying to evade the regulations on investing in restricted industries.

Major changes:
- “Negative list”: Information reporting vs. approval
- Information reporting system
- National security check
- Introduction of the concept “actual controller”
Major Tax Consideration
Overview of China Tax Regime

• Enterprise income tax
  - China resident enterprise (25%)
  - Withholding tax for non-resident enterprise on China sourced income (10% or treaty rate)
• IIT for individuals (progressive rates apply)
• Turnover taxes: VAT, Business Tax, Consumption Tax
• Land-related taxes: Land VAT, Deed Tax, Real Estate Tax, Land Use Tax
• Stamp Duty
• Customs Duties
Tax Incentives

- Tax incentives for certain areas
  - Western areas: reduced 15% EIT rate for encouraged industries
  - Shanghai FTZ:
    - VAT reduction for cross-border aircraft financial leasing
  - Qianhai & Hengqin: reduced 15% EIT rate for certain industries
  - Many local tax incentives are in the form of financial subsidy – to be abolished

- Tax incentives for certain industries, for example:
  - High technology: reduced 15% income tax rate
  - Software and integrated circuit: tax exemption and reduced income tax rate for 5 / 10 years
  - Investing in infrastructure supported by government: 3 year exempt + 3 year 50% reduction
## Tax treatment under Germany-China Tax Treaty

<table>
<thead>
<tr>
<th>Dividends</th>
<th>Interest</th>
<th>Royalties</th>
<th>Capital gains from share transfer</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Old Germany-China tax treaty (signed in 1985)</strong></td>
<td>10%</td>
<td>10% in general; Nil if paid to government or prescribed banks or on loans guaranteed by certain institution</td>
<td>10%</td>
</tr>
<tr>
<td><strong>New Germany-China tax treaty (signed on March 28, 2014, not effective yet)</strong></td>
<td>- 5% (at least 25% capital); - 15% (RE investment vehicle)</td>
<td>- 10% in general; Nil if paid to government or prescribed banks or on loans guaranteed by government or wholly state owned banks</td>
<td>- 6% for ICS equipment; - 10% for other IPs</td>
</tr>
</tbody>
</table>
Importation into China

• Tangible goods importation will be supervised by GAC at:
  - Import price scrutiny, particularly royalty fee which may be dutiable under certain circumstances
  - HTS code verification

• Import of aviation products will be subject to China government control
  - Relevant licenses may be required for such importation
  - Several governments authorities (MOC, GAC, AQSIQ and CAAC) may supervise aviation products importation

• Preferential customs duty program
  - China government encourage the importation of products including high technology, special equipment etc.
  - Origin of import products may trigger different import duty rate

GAC: General Administration of Customs
MOC: Ministry of Commerce
AQSIQ: Administration of Quality Supervision, Inspection and Quarantine
CAAC: Civil Aviation Administration of China
Importation into China

- Issues: German Company provides technical support, installation, assembling, training, supervising and other services when exporting equipment, machine or goods to China
  - Charging a reasonable service fee separately in the contract for the sale of goods; otherwise the service fee may be deemed to be at least 10% of the total contract price, resulting in VAT liability in China
  - Service PE (permanent establishment) issue: furnishing services for a period or periods aggregating more than 183 days within any 12 month period, resulting in income tax for both offshore company and its employees
Equity Investment in China

- Dividends received by German ParentCo shall be subject to China withholding tax (“WHT”) at:
  - 5% if German ParentCo holds at least 25% shares and is beneficial owner; otherwise, 10% in general (new DTA)
  - 10% (current DTA)

- Limitation on dividend distribution
  - Only when China Sub generates after-tax profits can it distribute dividend.
  - Statutory reserve required before dividend distribution
  - Interim dividend normally disallowed

- Capital gains on exit – 10% (shareholding for 25% or more) or nil (shareholding less than 25%)
Debt Financing Arrangement

• Repayment of debt principal is not taxed in China

• Taxes payable by German ParentCo
  - Interest WHT at 10%
  - Business tax and local levies (5.5%-5.6%)
  - VAT reform (6% or 11% ?)

• Tax deduction of interest expense by China Sub

• Limitation on interest:
  - Thin capitalization rule (debt-equity ratio: 2:1 for normal enterprise; 5:1 for financial institution)
  - Cap on total foreign debt
IP Licensing Arrangement

- Taxes payable by German ParentCo (as Licensor):
  - Royalty WHT at 6%/10% (New DTA) or 10% (current DTA)
  - VAT and local levies (6.72%-6.84%) --- exemption may apply for certain circumstances

- Supporting services provided by the lisensor during the licensing arrangement: the service fee charged is deemed to be royalties

- Tax deduction of reasonable royalty expenses by China Sub

- Limitation on royalty payment: transfer pricing --- on the arm’s-length basis
Provision of Service

- Taxes payable by German ParentCo (as service provider)
  - No EIT unless a permanent establishment is created in China (6 months-current DTA/183 days- new DTA within 12 months period)
  - VAT and local levies (6.72%-6.84%)
- Tax deduction of reasonable service expenses by China Sub
- Limitation on service fee payment:
  - Substance of the service arrangement
  - Arm’s length principle
Indirect Investment Structure

Key observations:

- Provision of flexibility in terms of investment exit and foreign exchange control
- Possibility to utilize a more preferential tax treaty to further reduce WHT in terms of dividend, interest and royalties
- Requirement of commercial substance on Holdco (beneficial ownership requirement in China)
- Transfer pricing rules
- Traditional tax heaven is not recommended
- German ParentCo may be required to pay tax in China if the
Anti-tax avoidance Rules in China

Profits should be taxed in the jurisdiction where economic activities occur and value is created.
- G20 in Sydney

- More stringent and sophisticated tax administration in China since 2008
- Tax avoidance schemes now under attack, especially cross-border transactions
- Major anti-avoidance rules for foreign investors
  - Transfer pricing rules – Circular 2
  - SPVs not entitled to treaty benefits – Circular No. 601
  - General Anti-avoidance Rules (GAAR)
  - Indirect transfer of Chinese taxable assets – Bulletin No.7
New Developments of China Tax System

- More transparent
- Aligning to international standards
- Simplifying / reducing approval procedures
- Strengthening tax collection and administration
- More protection of taxpayers’ rights
Danke sehr!

Any questions, please contact:

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