UNLOCK YOUR OPPORTUNITIES IN CHINA

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Since December 2004, foreign investors are allowed to establish wholly foreign-owned wholesaling and retailing enterprises in China with significantly relaxed entrance requirements. Dickson Leung and Carl Poon of LehmanBrown raise a few practical considerations that foreign investors should keep in mind before making any decision of investment.

China, with its largest population, represents one of the largest consumer markets in the world. Whilst foreign investors have been finding opportunities for penetrating into such a huge domestic market, the PRC government had, in the past, imposed onerous restrictions on foreign investors who wished to enter into the wholesaling and retailing markets. Even if the high entrance threshold was met, foreign investors were only permitted to establish joint venture trading enterprises with Chinese partners and could at most hold 49% equity interests in these ventures. In other words, it was impossible for foreign investors to become the controlling stakeholders.

Because of these stringent requirements, it is not uncommon to find aggressive foreign investors carrying out trading activities that are not in compliance with the PRC business regulations. For example, local Chinese citizens might be used as nominees to circumvent the rigid business entrance requirements, or representative offices may negotiate and conclude trading contracts as well as collecting business receipts from customers. Individual Hong Kong investors, particularly those operating in the Guangdong Province, would even infiltrate the trading market by establishing domestic companies in the form of individual households to carry out their wholesaling and retailing businesses in the PRC. These activities, however, contravene PRC business regulations. For example, the operation of representative offices beyond their permitted business scope can result in fines and, in more serious cases, the revocation of business licenses. Violations such as these can cause foreign investors to be blacklisted, leading to adverse impact on future business expansion in the PRC.

Furthermore, there are practical pitfalls. For example, how can the interests of the foreign investors be safeguarded if these wholesaling and retailing businesses are operated through local Chinese citizens? Who is, or are, the legal owner(s) of the business? Can the financial results of these PRC establishments and the nominee arrangement be consolidated into the foreign investors’ financial statements in their home countries? Last but not least, the establishment of individual households in the PRC is not buttressed on solid legal grounds; this would lead to unnecessary legal disputes. These represent only some of the many questions that have to be considered.

Since China’s accession to the WTO in 2001, the government has promised to gradually ease the restrictions on foreign investment in trading businesses within three years. Finally, the Ministry of Commerce officially announced that foreign investors would be allowed to establish wholly foreign-owned wholesaling and retailing enterprises in the PRC (hereafter referred to as the “WFOTEs”) starting from 11th December 2004. The minimum registered capital for establishing a WFOTE has been significantly reduced to RMB500,000. This announcement is definite good news to foreign investors contemplating to expand their trading operations in the PRC.

From a practical standpoint, the relaxation of the entrance requirements benefits foreign investors in many ways: greater discretion, as WFOTEs can now freely purchase and sell domestically; more accurate and reasonable tax assessments, since Enterprise Income Tax will be computed on the actual profit generated, as compared to those of representative offices, which are generally computed on a cost-plus basis; and also greater flexibility of networking by the ability to establish different business points in the PRC. In addition, WFOTEs can hire employees directly instead of having to appoint the Foreign Employment Service Company, an independent government agency, to hire local staff, as in the case of representative offices.

Although WFOTEs can help realizing unprecedented business opportunities in the PRC, potential practical pitfalls should not be overlooked. We outline some common pitfalls below.

1. Examination on the Status of Ordinary Taxpayer Qualification for VAT Purpose

According to the prevailing tax regulations, a foreign investment enterprise can apply to qualify as an ordinary VAT payer provided that their annual turnover exceeds RMB1.8 million. Once the ordinary VAT payer status is granted, the foreign investment enterprise can legally issue VAT invoices in the PRC. However, the PRC State Administration of Taxation has issued several tax notices in 2004 with a view to tightening such requirements for WFOTEs in connection with the issuance of VAT invoices.

To determine whether a WFOTE is qualified as an ordinary VAT taxpayer, the PRC tax authorities are empowered to make visits to and have meetings with the personnel of the WFOTE, and also to carry out field audit on the WFOTE. In general, the applicant would be monitored by the relevant local tax bureau for a period of at least 6 months, after which the ordinary VAT taxpayer status would be confirmed if the applicant has fulfilled all the requirements set by the PRC tax authorities within the period. It is not uncommon for new WFOTEs to encounter difficulties in dealing with the PRC tax authorities at the initial stage. WFOTEs are therefore recommended to hire experienced tax professionals as their representatives in their discussions and negotiations with PRC tax officials.

2. Potential Transfer Pricing Challenges on Related Party Transactions

Goods imported by WFOTEs into the PRC are subject to both customs duty and import VAT if the merchandise is for sale in the PRC. The prevailing PRC Customs Regulations stipulate that PRC Customs can inquire whether the transaction values adopted for import declaration purposes are true and fair. In particular, transactions carried out by related parties can often be subject to detailed review by the PRC Customs.

The PRC tax authorities are also empowered to adjust the selling or purchase prices of merchandise transacted between the WFOTEs and their overseas affiliates if the authorities consider that the transactions are not carried out on an arm's length basis.

Such challenges will not only interrupt normal business operations, but also raise the issue of double taxation as a result of pricing adjustments. Foreign investors should plan ahead and formulate reasonable transfer pricing policies to defend themselves against possible challenges from the PRC authorities.

3. Appropriate Forms for Future Business Expansion

Once the trading business has developed to a certain size, expansion to other cities in the PRC may become desirable. A WFOTE that desires to penetrate its business into other locations should consider an appropriate mode for establishing its business network in the PRC. There are generally three ways to build up the selling network: to establish a liaison branch, a selling branch or a new WFOTE in each contemplated city. Foreign investors should at least take into considerations the following factors when making their decisions: the relevant set-up cost, minimum capital requirement, timeframe for establishment, PRC income and turnover tax implications, and the tax efficient holding and operational structure from the business and tax perspectives.

4. Local Variations Increase Business Uncertainties

China is geographically broad and hence local variations among different areas are not uncommon. Foreign investors should be aware that local authorities in different areas might have different interpretations on the same piece of legislation. For example, the minimum capital requirement of RMB500,000 for establishing a WFOTE may not be followed throughout the country and a higher threshold might be required in some areas. Foreign investors should therefore conduct proper research into the local business environment before making any investments.

5. Business-driven Decisions

Although WFOTEs provide an effective and efficient platform for foreign investors to penetrate the PRC trading market, foreign investors should always keep in mind their business needs and analyze the relevant PRC tax, customs, foreign exchange and business regulatory requirements in order to achieve an optimal position for their Group.

Conclusion

Factors that should be considered for investment in the PRC are numerous and complex. PRC business and taxation regulations are changing rapidly, and local understandings and interpretations of the regulations may vary. Hence, foreign investors are recommended to seek advice from professional advisors ahead of making their investments in the PRC.

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