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Recent Development: Customs Office Prevents Goods from Leaving China

R&P has recently been engaged in several cases where the shipment of goods of a foreign brand that were manufactured in China was blocked at Customs following an infringement of a trademark registered in China. In each case, the foreign brand owner presumed it was allowed to produce in China if exclusively for export, even though the brand name was lawfully registered as trademark in China by a Chinese company (trademark holder). Herewith, the Chinese trademark holder has the exclusive right to use this trademark in China, which includes manufacturing and transporting the goods in China. Therefore, Customs blocked the export of goods at the initiative of the Chinese trademark holder, leaving us to negotiate a settlement for their release.

R&P Seminars: European Chamber (EUCC) Events in Beijing & Nanjing

On 11 & 25 September 2014, R&P's managing director Maarten Roos, and counsels Robin Tabbers & Rogier van Bijnen were invited by the EU Chamber of Commerce to speak (in Beijing and Nanjing respectively) about corporate structuring in China, and about recent legal developments for foreign businesses in China. R&P discussed case studies involving manufacturing, trading, consulting and retail companies, as well as representative offices, Chinese-foreign joint ventures and Variable Interest Entities (VIE's).

Ms Chen Yun is Named Partner of R&P

With great pleasure, we hereby announce that Ms. Chen Yun has been named partner of R&P China Lawyers as of 1 July 2014. Chen Yun is one of the founding associates of R&P, her practice focusing on investments, litigation and arbitration. In the most recent survey by Asialaw's Leading Lawyers, clients recognized her for expertise in Corporate / M&A and dispute resolution.

R&P China Lawyers is a boutique Chinese law firm headquartered in Shanghai, providing high-end legal services to foreign businesses active in China.

R&P Legal Briefing is written to inform clients and friends of the latest developments in Chinese law and practices.

For more on our experience or the services that we have on offer, or to read more articles on Chinese legal topics, please visit our website: www.rplawyers.com

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Reducing Trapped Cash in China with Outbound Intercompany Loans

By Rogier van Bijnen and Maarten Roos

Many foreign companies struggle to get profits earned in China out of the country in an efficient way. During the past year, repatriating funds has become much easier with relaxed requirements for intercompany loans to affiliates outside China.

Dividend

The most straightforward way to bring money home is to have your Chinese subsidiary (Foreign-Invested Entity, FIE) pay out dividend. However, this is not always as easy as it sounds; moreover,it is expensive. FIEs normally pay 25% corporate income tax (CIT) on their gross profit, and when remitting dividend offshore another5-10% withholding tax is levied(depending on whether a double taxation treaty(DTA) applies).

Dividend may only be paid if all losses for previous years have been made up. Furthermore, an FIE must put 10% of its annual profits into a reserve fund until 50% of its registered capital has been reserved. This inevitably results in cash being trapped in China.

The timing of dividend payments is also restricted. Banks only process dividend payments on the basis of an audit reportand tax returns proving the amount of distributable profits and payment of taxes. This makes the payment of interim dividends virtually impossible, and since the audit report and tax returns usually become available only in June or July, most dividend payments must wait until the second half of each calendar year. Sometimes it may take even longer. In a recent case, an FIE waited for six months to obtain all required documents.

Service Fees and Royalties

Due to the costs and limitations of dividend payments, many foreign companies try to minimize their profits in China by charging their Chinese subsidiaries service fees and royalties. This has tax implications (VAT or business tax is levied, and a 10% withholding tax applies, unless the relevant DTA specifies a lower percentage, although service fees are often charged at 10% regardless of any DTA), but the overall tax burden is usually substantially lower than for dividends.

Service fees and royalties are,however, only allowed for genuine arm's length transactions directly related to the FIE's business (otherwise the payment is not recognized as an expense and 25% CIT will be levied). This condition putsa natural limit on the amount which can be repatriated by using service fees and royalties.

Outbound Intercompany Loans

One way to send the remaining cash back home is through outbound intercompany loans.This has the added advantage that cash may be sent back to China in due course when the business needs to expand further. Granting such loans has become much easier during the past year.

There are basically two schemes for an FIE to extend loans to an offshore affiliate: loans in foreign currency regulated bythe SAFE (State Administration for Foreign Exchange) and RMB loans regulated by the PBOC (People's Bank of China). The key features of each scheme are set out in the table below.

Regulator	**SAFE**	**PBOC**
Currency	Foreign currency	RMB
Lender	Onshore corporates (including FIEs)	Onshore corporates(including FIEs, excluding real estate companies)
Borrower	Offshore companies having an "equity relationship" with the lender (prior to 2014:limited to FIE's offshore parent)	Related companies in the same group
Quota	Max. 30% of an FIE's registered capital(the limit of the sum of dividends payable / undistributed profits was abolished in 2014)	No quota – lender to retain sufficient cash for its operations
Registration / approval	SAFE registration, local SAFE approval when exceeding quota	Bank approval only (in most cities)
Tenor	No limit (2 year maximum tenor abolished in 2014)	No limit
Source of funds	Self-owned or borrowed	Self-owned
PRC tax implication	25% CIT and 5-10% business tax on interest earned by lender	25% CIT and 5-10% business tax on interest earned by lender

Coca Cola was reportedly one of the first companies to utilize the PBOC scheme late last year and managed to send out a RMB 250 million loan to an offshore affiliate within 10 working days. Later reports mention that medium-sized companies have also been able to repatriate cash the same way.Compared to dividend distribution, there are two key benefits in providing outbound loans: (a) greater flexibility and (b) deferral of the 10% dividend withholding tax.

As becomes clear from the table above there is no connection with the FIE's distributable profit (for the SAFE scheme this was previously the case, but it has been abolished earlier this year), meaning that cash which may not (yet) be distributed as dividend *can*be transferred out as a loan (although under the SAFE scheme there is a cap of 30% of the registered capital). This opens the possibility for *de facto* interim dividends (since there is no longer any need to provide audited accounts) and to repatriate profits normally stuck in the reserve fund (see above, up to 50% of the FIE's registered capital ultimately needs to be reserved).

Under the SAFE scheme, loans could be granted for a maximum of two years, but this requirement has been removed this year as well. As long as reasonable business terms are in place, both schemes provide flexibility in terms of repayment and applicable interest rate.

As always in China, practices differ per city (and even per district) and also banks are maintaining their own policies on the conditions for approval. We understand that in practice, lenders may need to satisfy certain basic financial criteria (usually net assets, net profits and net cash flow of the lender all need to be positive, and a no-objection letter from the local tax authorities may also be required). If you intend to use intercompany loans to release trapped cash, make sure to check with your lawyers and bank at an early stage what the exact local requirements are.

Outbound loans have tax implications as well: the FIE needs to pay 25% CIT and business tax on the interest income, though the offshore borrower may offset the CIT paid by the lender if the applicable DTA provides for this. The greater flexibility and deferral of the 10% dividend withholding tax in many cases will outweigh these costs of outbound intercompany loans.

Cash Pooling in the Shanghai FTZ and Cross-border Security

Finally, it is worth briefly mentioning two other recent developments, which are outside the scope of this article, but could also be helpful in reducing cash trapped in China.Multinational corporations (MNCs) established in the Shanghai Free Trade Zone may now set up a two-way RMB cash pooling system. Several banks already offer such system, which enables MNCs to integrate their onshore RMB cash flow (generated throughout China) with their global cash pool (although certain restrictions apply).Saint-Gobain, Dover Corporation (both with HSBC), Sonepar (with RBS) and Roche (with Citi) are reportedly among the MNCs who already have put such cash pooling systems in place.Another method for an FIE to utilize trapped cash is to provide it as collateral for loans obtained by its offshore affiliates. This was already possible by providing a guarantee to a PRC bank (which in turn extends the guarantee to the offshore affiliate bank providing the loan), but since June 2014providing outbound security has been made much easier. An FIE may now directly provide outbound credit support for its offshore affiliates to an offshore lender in both RMB and foreign exchange (arguably, this was already allowed for credit support in RMB). SAFE approval and the quota for credit support in foreign currency have also been abolished.

Information on companies registered in China should become completely transparent, easily accessed and checked by both entities and individuals. At present, the level of transparency varies from location to location, and in many districts only lawyers can check a company's registered information.

At present, every company must have a registered address; only certain buildings can serve as registered addresses (with even stricter requirements for foreign-invested companies); and one address can only register one company. This bars the "post office model" whereby one address (such as an accountant, law firm or service provider) serves as registered address of many companies at one time. Presumably, the new rules will change some of this – though to which extent remains uncertain. With the amendments to the PRC Company Law already promulgated, and further rules expected soon to relax other requirements, the Chinese government is giving a strong signal that it wants to boost the economy by giving more flexibility to businesses – including foreign investors. More detail is expected in the weeks and months to come.

Compliance in China for Foreign Businesses

By Robin Tabbers and Maarten Roos

How can a China subsidiary of a foreign company protect itself against non-compliance? Many companies approach R&P to discuss their compliance issues and associated risks in China. We often help out by developing and implementing compliance and risk management systems, as a useful tool to establish clear internal rules, and to curb or control incompliance, corruption and bribery.

Compliance is China's latest Hot Topic

Until recently, many Western managers accepted that some flexibility on legal issues was needed to thrive in the complex Chinese legal environment. Practices to strengthen relationships such as luxurious dinners and karaoke evenings, sponsored travel, red-pocket money and the like, have often been regarded as part of the local culture: the best - and in some cases the only - way to get things done. Just as paying out part of salaries and bonuses against *fapiao* (legal invoices), thereby reducing the burden of individual income tax (IIT), was seen as a good way to stay financially competitive.

But reality has set in. On the one hand, China is sending a clear message that incompliance will not be tolerated, for example with the GSK scandal (CNY 3 billion in bribes), with Chinese officials at every level (tigers and flies) under arrest, with an active Public Security Bureau seeking to expel foreigners who do not have the right papers, with dawn raids by tax officers and the labor department, and with increase customs checks.On the other hand, foreign governments such as those of the UK (UK Bribery Act), the US (FCPA) and Canada (CFPOA) are increasingly pursuing and penalizing corrupt practices of their foreign subsidiaries, including those in China.We are even seeing managers of Chinese subsidiaries being expelled to appear in investigation hearings in their home country.

Are foreign companies being singled out in China? This is certainly the general impression, and in specific industries it is becoming next to impossible for foreign businesses to remain competitive. In practice though, foreign-invested companies (and their foreign managers) have always had a tougher time to stay under the radar. Large companies such as GSK are juicy targets to set the example, and many international businesses are sensitive to bad press.Moreover, there is no doubt that the Chinese government's current anti-corruption campaign is actually targeting Chinese officialdom. Conclusions are already being drawn on the lasting impact of this campaign on the business environment, which in the long run should benefit Chinese and foreign businesses alike.

For international companies the lessons are clear: whether you are a large multinational or a small- to medium-sized business, to operate successfully in China high level of compliance must be pursued. Here some typical issues that companies should watch out for:

Employment Taxes

Many companies traditionally sought to save on the cost of individual income taxes and social insurance contributions, by paying part of salaries (and bonuses!) as reimbursements against valid legal invoices (fapiao). However, an employee complaint to the Labor Department or local tax officer may be sufficient to trigger an inspection, which could result in back-payments as well as late-fees and fines. If the amounts of evaded taxes are large enough, these practices could even lead to criminal liability (though this is not common).

Tax Evasion and Bribery (Commercial and Official)

Some companies manage to receive income off the books, and then use some of these funds to pay illegal commissions (kickbacks) to promote sales, win projects or obtain licenses. Not only does this practice expose the company and its managers to liability for accounting fraud and tax evasion, but it can also result in administrative, civil and criminal liabilities for commercial or official bribery under PRC laws. Even in industries where such practices are common, foreign businesses in particular may be the first to get caught - with life-altering consequences for the business and the involved managers.

Business Scope Restrictions

China continues to restrict foreign investment in certain sectors, or subjects businesses to special licenses that are difficult to obtain. Examples in the service industry are recruitment (joint ventures only, unless the investor is CEPA qualified), labor dispatch (license difficult to obtain), legal services (closed to foreign investment), accounting and auditing (joint ventures only), as well as certain forms of education (subject to restrictions or licensing). Many foreign investors avoid such restrictions by establishing a general consultancy WFOE. But this exposes the business, and could lead to fines and even revocation of the business license. As part of a long-term strategy, foreign investors should also consider alternatives such as making the extra effort to obtain the required licenses, relocating to a pilot area that allows this business (e.g. the Shanghai Free Trade Zone), using a VIE (Variable Interest Entity) structure or entering into a joint venture with a local partner.

Legal Challenges to Online and Offline Retail in China

China has historically been an ideal destination for outsourcing manufacturing operations, but the country's huge consumer market is now attracting more and more foreign companies to take control of their distribution and manage their own retail sales. Rogier van Bijnen and Maarten Roos of R&P China Lawyers discuss the legal challenges of this strategy and how China's rule of law may affect many trying to set up shop.

By Rogier van Bijnen and Maarten Roos

The pull of China's consumer market cannot be understated. Even manufacturing companies who do not conduct retail sales anywhere else in the world are being attracted by the dazzling numbers offered by China's (online) market. Initially many used B2B solutions, leaving Chinese distributors to sell direct to consumers. However, while this solution provides easy market entry, margins are thin and companies have no direct influence over marketing strategies. Now, numerous third-party online platforms, like Tmall (B2C), Taobao (C2C) and Alibaba (B2B), and the possibility of cheaply outsourcing delivery to logistics companies make setting up online retail operations in China seem easy. But is it?

Online selling: go local

China is at the forefront of online sales. In big cities, many middle-class consumers already purchase most of their consumables through the Internet. This presents two main options for foreign companies that do not wish to invest huge sums in brick-and-mortar stores: sell through a Chinese third-party platform, or develop one's own website in China.

Using a website outside of China is generally not recommended for a number of reasons predominantly established in law. Chinese consumers usually do not have foreign-currency credit cards, and so to avoid foreign-exchange restrictions a company would have to deal with expensive intermediaries. Also, delivery may be hampered by customs due to import restrictions and may be subject to import duties, plus the Great Chinese Firewall that protects Chinese Internet users will markedly slow traffic. If you really want to penetrate the Chinese market, you need to go local.

Third-party platform

The easiest way to sell online to Chinese customers is by operating a (web)shop on a third-party platform such as Tmall, JD.com (B2C), Alibaba or Taobao. Chinese customers are very familiar with buying on these websites, so there is already plenty of traffic, and the platforms are perceived as being reliable.

Before you can even think about selling online, you need to have your brand registered in China. None of the third-party platforms will allow anyone to open shop without a secure brand. This is the rule of law at work: since the amendment of the PRC Trademark Law (effective May 2014), parties who facilitate infringement may be held accountable.

Although officially no Chinese legal entity is needed to sell online in China, some of the platforms do require it (e.g. Tmall). We usually recommend this anyway, since importing goods and transactions with Chinese logistics providers are all much easier through a trading WFOE (wholly foreign-owned enterprise). This can be either a new WFOE or one that already exists and is engaged in other activities. Whether, in case of the latter, an expansion of the business scope is necessary depends on the proposed activities and the existing business scope. For example, as online sales is deemed an extension of a company's sale activities on the Internet, a duly licensed and registered foreign-invested manufacturing or commercial company may directly engage in online sales *without* specifically adding 'online sales' to its business scope.

Additionally, if the merchandise is imported, the WFOE needs an import licence and the relevant products should meet the Chinese legal standards that apply to such products (e.g. product licensing, packaging and labelling standards, which also must be in Chinese). These rules are applied with increasing strictness, so companies for which a smooth completion of Customs procedures is important should prepare in advance to ensure they fully understand all procedures and requirements.

Online payment, warehousing and delivery are usually outsourced. Delivery is not only difficult to organise but also subject to specific licences (as a transportation company), and to date no foreign company has obtained a licence to handle online payment in China.

Owning your website

To operate a website in China, you need an Internet Content Provider (ICP) license from the Ministry of Industry and Information Technology (MIIT). An ICP licence for 'commercial' purposes is very difficult to obtain for foreign investors. Unless you are Amazon, forget about getting an ICP licence to set up a third-party platform to compete with Alibaba (and even Amazon did it with a 49 per cent joint venture, since a foreign majority stake is not permitted).

On the other hand, if a company only sells its *own* products through its *own* website, then under China's legal definitions such a website is deemed to be 'non-commercial'. In this case only a filing with the MIIT is required to obtain the ICP licence and no prior approval is needed (yes, a flexible rule of law can sometimes be an advantage). But only legal entities incorporated in China are eligible to obtain an ICP licence, so you would need to set up a trading WFOE to establish a local website within the Great Firewall.

Offline selling: stores

For larger companies, establishing one's own retail network of brick-and-mortar stores is not only the best way to reach consumers, but it is often also part of the branding and marketing strategy. Allowing consumers to come in and touch the products before buying online is a concept that has been proven to work very well in the Chinese market.

The business scope of the Chinese headquarters of a retailer generally includes both wholesale trading and retail (which automatically includes online sales). The main office can be established at a retail outlet, but larger retailers generally prefer to establish the WFOE in an office building, and then establish each retail store as a branch (it is not permitted to operate multiple stores under one WFOE; each new location requires a separate branch). Alternatives are to use a franchise model, sell through store-in-store concepts or use commercial partnerships.

China's geography also plays a role. Large retailers generally wonder whether they should be establishing one WFOE with branches all over the country, or whether it is beneficial to have WFOE's in major geographical areas (e.g. Beijing, Shanghai and

Guangzhou/Shenzhen) under which to structure the individual outlets. From a tax perspective there may be benefits to having more WFOE's, though this must be weighed against the additional administration as well as relative complexity in finance and governance.

General procedures for branch establishment

Each new store opening starts with finding the right location and subsequent negotiations with the landlord. It is currently a seller's market—demand for the best locations is extremely hot—and so these negotiations are never going to be easy. Moreover, landlords generally do not shy away from using loopholes in lease contracts to get a tenant out if they can get a better deal with someone else, so make sure your contract is properly negotiated. We also see that more and more landlords require evidence that the store's brand has been properly registered, mainly for two reasons. The landlord will be assured by a stable intellectual property (IP) situation, and will want to avoid any risk that it is facilitating the trademark infringement of others.

Once a lease contract has been signed (and all documents required from the landlord have been obtained), your lawyers can proceed to establish the branch. The formal set-up is not complicated, but obtaining the various licences can be time-consuming, especially in second- and third-tier cities, and strict coordination with the landlord regarding the required documentation and licences of the premises is an absolute necessity. The good news: since 13th August, 2014, the Public Place Hygienic Licence can be obtained *after* establishing the branch, instead of before (note that not every city requires this licence, and the criteria may vary per city). This means the licence can be obtained simultaneously with several other post-establishment steps (e.g. tax registration), thus reducing delays when setting up a new store.

LEGAL NEWS

New Credit Disclosure Rules to Impact Companies Operating in China

The Provisional Rules on Enterprise Information Disclosure took effect on 1 October 2014, and include provisions that require all Chinese companies (including JV's and wholly foreign-owned subsidiaries of foreign companies) to submit annual credit reports for public disclosure. These credit reports must include details on basic operations, such as operational status, investment information, capital subscription and contributions, and equity transfer information. Moreover, companies are obliged to keep their "file" updated by disclosing, when they incur, significant activity or material changes.

In addition, the Administration for Industry and Commerce (AIC) that runs this system has the obligation to make relevant information accessible to the public on a real-time basis, and can blacklist and penalize companies that fail to properly disclose relevant information. It also has the duty to randomly audit enterprises on compliance, and should investigate third-party complaints.

Finally, other governmental departments are also required to publicly disclose enterprise information, for example relating to the granting of administrative permits, and the issuing of administrative penalties.

The Rules are not the first attempt to make information on Chinese companies more readily accessible, but the timing is promising. With recent changes to the PRC Company Law and the government's current focus on enforcing compliance, the Rules could be the key to establishing more reliable system of public disclosure that could benefit all companies doing business in China or with Chinese counterparts.