Setting up your Business in the PRC
Issues to consider

The People's Republic of China (PRC) is the second largest economy by nominal GDP in the world after the US. In recent years, the PRCs economic growth continued in spite of the world economic crisis. The PRC remains an attractive investment destination for overseas investors, and it has ranked first among developing countries for attracting foreign capital for 21 consecutive years.

However there are a number of issues which you must consider when you are looking to set up your business in China. This document takes you through some of the common questions we come across and gives you practical information about the issues you need to consider.

What type of Business Structure should we use?

There are advantages and disadvantages to all of them, and there is no one correct answer, it's all dependent on your specific business circumstances and needs. A brief overview of the main structures is below:

Establishment (a branch of your overseas business)

- Not a separate legal entity but an extension of the overseas parent company
- No limited liability or ring-fencing of the PRC operations
- If have a permanent establishment in the PRC then profits from this PE are liable to the PRC Corporate Income Tax (CIT)
- **Parent company accounts** shall be filed under certain circumstances where they are required by the PRC laws or regulations

Limited Company:

- Provides limited liability and ring-fencing to the PRC operations
- Gives a perception of a local business, with longevity
- Minimum capital injection required
- CIT to be paid on company profits
- Accounts shall be filed in CIT annual filing
- Accounts require auditing for certain types of companies, such as public listed companies and foreign investment companies

Limited Liability Partnership:

- Limited members (partners) have limited liability
- Taxable income is allocated to members who then pay Income Tax on their taxable income respective
- The tax residence of the member, and where the taxable income in the LLP originated will determine in what jurisdiction and how these profits are taxed

How much Corporation Tax will the business pay?

Current Corporation Tax rates in the PRC are:

Tax rate (%)		Taxable profit (RMB)
Small co rate	20	0 – 300,000
Full rate	25	Over 300,000

Small scale enterprises, where taxable income does not exceed RMB 60,000 are liable for more preferential incentives. Income of such enterprises can be included in taxable income based on 50% of their income and applied tax rate is 20% until 31 December 2015.

For Advanced and New technology enterprises eligible for key support from the state, CIT is levied at a reduced rate of 15%.

CIT payers are classified as resident enterprises and non-resident enterprises. A resident enterprise shall pay CIT on its income from sources within and outside the PRC. A non-resident enterprise with an establishment or place of business (establishment) in the PRC is subject to CIT on its PRC-sourced income derived by such establishment and on its foreign-sourced income which is effectively connected with such establishment. A non-resident enterprise without an establishment in the PRC is subject to CIT only on its PRC-sourced income.

Important industries and projects whose development is supported and encouraged by the state may enjoy various CIT incentives. CIT on income from the following may be exempted or reduced:
(1) Projects in the agriculture, forestry, husbandry and fishery industry
(2) Investment in and business operations of public infrastructure projects supported by the state
(3) Projects of environmental protection, energy or water conservation
(4) Qualified technologies transfer

What if we use China to set up our holding company?

When certain conditions are satisfied, foreign investors may establish holding companies in the PRC, besides holding equity interests, the holding company may also trade goods manufactured by its investees and provide certain shared services such as financing, marketing, staff recruitment and consulting, etc. A holding company can further apply for "Regional Headquarters" status if it meets specified criteria, which allows a broader scope of services and certain tax benefits.

The PRC holding companies and their subsidiaries are separate entities and are taxed respectively. They do not file a consolidated tax return.

Qualified dividends derived by a resident enterprise from another resident enterprise are exempt from CIT. However, dividends derived by a foreign company from its Chinese investee will be subject to 10% withholding tax, and the foreign company may apply for tax treaty relief if it qualified as a beneficial owner.

Capital gains derived by a foreign company from disposal of its Chinese investee will be subject to 10% withholding tax, and the qualified foreign company may apply for tax treaty relief.

As above mentioned, a resident enterprise shall pay CIT on its income from sources within and outside the PRC, while qualified foreign tax payment may be a credit against the CIT payable by the enterprise.

What if we make cross-border transactions between group companies?

The PRC follows internationally recognized **Transfer Pricing** (TP) rules where cross-border trading and financial transactions between affiliated entities have to be conducted on an arm's length basis. The price and terms should be the same as if the transactions had been between completely independent parties.

Typical transactions between affiliated entities that are covered by TP regulations are:

- Sale and purchase of goods
- Provision of management services
- Property rental charges
- Transfer of intangible assets e.g. trademarks, patents
- Sharing of knowledge, expertise, business contacts etc.
- Provision of financial support e.g. inter-group loans and charging a "market" interest on loans

The new PRC CIT Law reinforces the TP documentation requirements. A business will need to prepare certain Transfer Pricing documents proving the arm's length basis of transactions. The documents may be Related Party Transaction Forms submitted to the tax bureau together with the enterprise's annual income tax returns or contemporaneous documentation, which will include a functional and risk analysis, analysis of the adopted pricing model and benchmarking of the arm's length basis.

SME's are generally less covered under the PRC transfer pricing regime. The following enterprises may be exempted from preparation of the contemporaneous documentation (1) Enterprises with aggregate related party transactions below RMB 200 million of related party purchase or sale transactions and other related party transactions below RMB 40 million; (2) The related party transactions fall in the scope of certain advanced pricing arrangements; (3) Foreign shares constitute less than 50% and related party transactions are limited to related parties in China. Otherwise, the enterprise must prepare contemporaneous documentation on an entity level on or before 31 May of the year following the year in which the related party transactions took place and shall provide it within 20 days on tax authorities' request.

However even if an entity is exempt from the PRC's transfer pricing regime it may fall under the scrutiny of the other international tax jurisdictions where it transacts. There may also be other tax regulations which ensure transactions are undertaken at a commercial value.

What Employment Taxes and Social Security will need to be paid?

If individuals work in China then they may be subject to China tax and social securities laws/regulations.

There are two types of taxpayers under the PRC Individual Income Tax (IIT) Law. Resident taxpayers refer to individuals who have residences in China or have no residences in China but have lived China for at least one year. The resident taxpayers are liable to IIT on their worldwide income. Non-resident taxpayers refer to individuals who have neither residence in China nor live in China, or individuals who have no residence in China but have lived in China for less than one year. The income derived by non-resident taxpayers from China shall be subject to IIT.

It's complicated to determine whether an individual is a resident taxpayer or a non-resident tax payer, which incomes are derived from China and are thus liable to IIT. For example, a foreign individual residing in China for less than 90 days (183 days, where tax treaty can be applied) during one year will not be taxed on income received from a foreign employer, provided such salary is not borne by the foreign employer's establishment inside China.

We would advise any new entrant to the PRC or person who spends time working in the PRC to take professional advice to determine whether they are subject to the PRC IIT.

Current Personal Income Tax rates for wages and salaries in the PRC are:

Band of income (RMB)	Tax rate (%)
0– 1,500	**3%**
1,500– 4,500	**10%**
4,500– 9,000	**20%**
9,000– 35,000	**25%**
35,000–55,000	**30%**
55,000–80,000	**35%**
Over 80,000	**45%**

(NB: New individual income tax rules took effect on 1 September 2011)

The above tax rates are for salary income only. For rental, royalty, subscription or other income, normally a 20% tax rate will be applicable.

Employers and employees also have to pay the PRC social securities, the social securities rates vary from location to location, taking **Beijing** as an example:

Current Social Security rates of Beijing are:

	Categories of fund(RMB)	**Rate (%)**
Employer	Retirement	20%
	Medical	10%
	Unemployment	1%
	Maternity	0.8%
	Injury	Vary from industry to industry
Employee	Retirement	8%
	Medical	2%
	Unemployment	0.2%
	Maternity	n/a
	Injury	n/a

NB: (rates are for the tax year to 31/12/2013)

It is the employers' legal responsibility to withhold the employee's IIT and social securities born by the employee to the relevant authorities in the PRC. The base for above social securities will be determined based on the actual salary or the statistic average social salary.

The PRC has a Reciprocal Agreement with German, South Korea and a few other countries whereby when an overseas national of those countries is seconded to the PRC for a defined period of time and continues to pay social security in their home country, then the employer and employee are exempt from paying the PRC social security.

What is Value Added Tax (VAT) and should the business be registered?

VAT is a tax on the sale of goods, provision of specified services in the PRC as well as on the importation of goods into the PRC. General taxpayers and small-scale taxpayers are distinguished. VAT is charged at a standard rate of 17% on gerneral taxpayers, however, certain products are taxed at a reduced rate of 13% or are exempt. Small-scale taxpayers are entitled to a lower levy rate of 3%. The general taxpayers can claim input VAT credit, but small scale taxpayers are not eligible for input VAT credits.

There are three types of supply of the general taxpayers

- Taxable – must charge VAT on supplies, can reclaim input VAT
- Exempt – cannot charge VAT nor reclaim input VAT
- Outside the scope – not in the PRC VAT system

The supply of most types of goods and many services in the PRC would be classed as Taxable supplies. However when these supplies are made to companies which are outside of the RPC, advice needs to be sought as to what rate of VAT, if any, to use.

Business tax (BT) is imposed on specified services, transfer of intangible assets or immovable property taking palce within the PRC. BT is generally levied on gross turnover and no credit are allowed through a supply chain. BT rates are usually 3% or 5%, however, certain entertainment services may be subject to a rate of up to 20%.

One thing to note is that the PRC is introducing the VAT pilot program to reform its indirect tax system. It is expected that BT will eventually be mergered within VAT to a Goods and Service Tax in the futuer. The national wide pilot program was launched on 1 August 2013. Transportation services and certain mordern services (such as R&D and technical services, information technology services, culture and creativity services, logistics auxiliary services, leasing services of tangible movables, authentication and consultation services, radio and television services), are subject to VAT of 6% or 11% instead of BT since then.

Can we provide Share option plans to our staff?

Many companies see Share Option plans as being an important way of attracting, motivating and retaining key staff.

The PRC has a number of “approved” share option plans which give tax benefits to employees and employers alike and it is often possible to adapt an overseas stock option plan to fit into one of these “approved” plans.

However this is a very technically complex area and careful planning needs to be undertaken as soon as share option plans are being considered for implementation in the PRC. One thing particularly to be noted is that registration with the relevant foreign exchange administration authorities shall be made, where shares of overseas listed company are covered in the share option plans.

How else can we compensate our employees?

The PRC has a very comprehensive range of compensation and benefit options available for companies to offer their employees, such as supplementary pensions, medical insurance and so on. Technically, all the non-statutory insurance and other benefits (e.g. allowance or gifts) will all be subject to personal income tax unless exemptions specified in certain regulations.

To discuss your requirements please contact the International Office on +44 (0) 1245 449266 or email us directly.

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