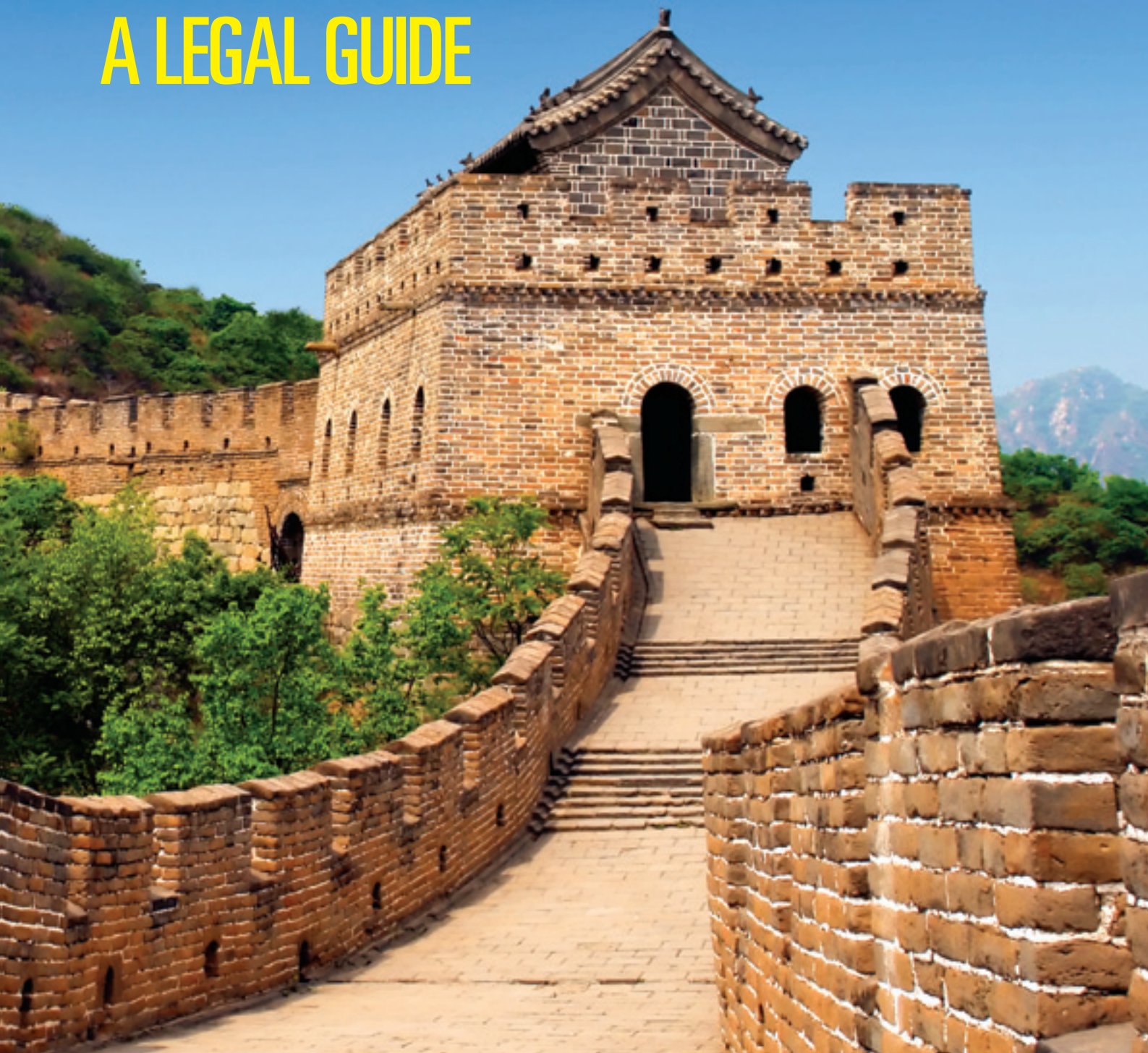


# DOING BUSINESS IN CHINA:

## A LEGAL GUIDE

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# DOING BUSINESS IN CHINA: A LEGAL GUIDE

## CONTENTS

|  |    |
|--|----|
| Executive Summary                                  | 3  |
| General Introduction                               | 4  |
| Foreign Investment Policy                          | 8  |
| Types of Business Entities                         | 9  |
| Alternative Means of Carrying on Business in China | 12 |
| Intellectual Property                              | 13 |
| Taxation   | 14 |
| Employment Issues                                  | 19 |
| Competition Law                                    | 20 |
| Contacts   | 22 |

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## **Executive Summary**

UK Trade & Investment is the Government organisation that helps UK-based companies succeed in an increasingly global economy. Our range of expert services is tailored to the needs of individual businesses to maximise their international success. We provide companies with the tools that they require in order to be competitive on the world stage.

We also help overseas companies bring high-quality investment to the UK, acknowledged as Europe's best place from which to succeed in global business. We provide support and advice to investors at all stages of their business decision-making.

UK Trade & Investment offers expertise and contacts through a network of international specialists throughout the UK, and in British embassies and other diplomatic offices around the world.

This guide outlines the regulatory framework and procedures that apply to a foreign investor establishing a business operation in China and the various commercial and administrative issues which will need to be dealt with once the business is established. It is based on the law in force on 31 January 2009.

This guide has been written specifically for business people, and whilst it will interest professional advisers such as lawyers or accountants, the information is intended to appeal to a wider audience. Deciding what will interest someone conducting business in a foreign country is always difficult but we have covered topics which are relevant for businesses of any size.

We would like to stress that this brochure is only a summary and it should not be relied on as a substitute for legal advice with respect to any particular transaction or specific set of circumstances. If you require more detailed information, please contact your local UK Trade & Investment International Trade Advisers or your nearest branch of the China-Britain Business Council.

## **GENERAL INTRODUCTION**

### **Geography, Government and Population**

China is the third-largest country in the world, after Russia and Canada and has a land area of about 9.3 million sq km. Its vast territory yields impressive natural resources but much of the land is only semi-arable and unsuitable for commercial agriculture.

For administrative purposes, China is separated into 23 provinces, 5 autonomous regions and 4 directly administered municipalities. China also has two special administrative regions (**SARs**). Following an agreement with the United Kingdom, Hong Kong became the Hong Kong SAR of China on 1 July 1997. Following an agreement with Portugal, Macau became the Macau SAR of China on 20 December 1999. China does not impose the Chinese socialist economic system in these two SARs, and both Hong Kong and Macau exercise autonomy, except in defence and foreign affairs.

China's government and the majority of its governmental organizations operate on four administrative tiers: central, provincial, city and township.

China is currently the most populous country in the world with a population density of 135 people per sq km. This population, however, is very unevenly distributed. The eastern coastal areas are densely populated, with more than 400 people per sq km; in the central areas, over 200; and in the sparsely populated plateaus in the west there are less than 10 people per sq km.

China is comprised of 61 diverse ethnic groups. The majority (91.6 percent) of China's population belongs to the Han ethnic group and China's other 55 ethnic groups are customarily referred to as ethnic minorities.

### **Language and time**

The official language in China is Putonghua (also referred to as Mandarin), which is spoken throughout China. However, numerous dialects are also spoken in different parts of China, the most common being Cantonese in southern China and Shanghainese in the greater Shanghai region.

China's entire territory is situated in a single time zone, which is eight hours ahead of Greenwich Mean Time (+8 GMT). China does not implement a system of daylight savings time.

### **Economic system**

In late 1978, China initiated an "open door policy" to modernize China by encouraging foreign investment and trade. The economic reforms that flowed from the open door policy have created an economic system often referred to as a "socialist economy with Chinese characteristics".

Unlike the rigid, centrally planned economies in most traditional socialist nations, China's economy is a hybrid structure in which strategic commodities and industries are controlled by the State, while other industries, including the commercial and private sectors, are governed by a market-orientated system.

Following 20 years of negotiations, China officially re-joined the WTO on 11 December 2001. China's accession to the WTO has had a profound impact on the country's economy and on opportunities for foreign companies to do business. Many industries that were previously restricted to domestic enterprises are now more open to foreign investors. These industries include banking, telecommunications, distribution, construction, engineering, insurance, plus professional services including legal, accounting, and architectural services. Furthermore, restrictions on domestic sales by foreign manufacturing companies are also in the process of being relaxed.

As a consequence of the WTO and its implementing laws, China has unquestionably become a more transparent and less expensive market to do business in. Spurred on by WTO membership and an ambitious modernisation drive, China has become a major economic power, improving overall living standards for most of its citizens and over the past 22 years, lifting more than 200 million out of poverty.

## **Legal system**

China has created what is officially termed a "socialist legal system with Chinese characteristics". Technically, the legal system is based on both statutory law and custom. The National People's Congress (or its Standing Committee) enacts national laws while the State Council (effectively the Chinese government's cabinet) implements and enforces administrative regulations and rules nationwide.

The ministries under the State Council put into effect specific national administrative regulations and rules and can be authorised to issue interpretative implementing rules. Provincial representative bodies known as people's congresses may also enact local rules and regulations where these are not contradictory to laws, regulations and policies enacted at the national level.

In addition, the Supreme People's Court issues judicial interpretations from time to time, which all lower courts are required to follow in adjudicating cases. Apart from this, there is no general system of precedent followed in China's courts. After a period of intensive statutory development over the past 20 years, China now has a relatively complete basic legal system in place.

## **Dispute Resolution**

### **A. The courts**

China has established a four-tier judicial system which includes district people's courts, intermediate people's courts,

higher people's courts and the Supreme People's Court in Beijing. Each province or directly administered municipality of China has its own district, intermediate and higher people's court. The jurisdiction of these courts varies between provinces and municipalities. In Shanghai, for example:

1. a district people's court has jurisdiction to hear civil and commercial cases with a dispute amount of less than RMB 50 million if it only involves domestic interests and of less than RMB 20 million if it involves foreign interests;
2. an intermediate people's court has jurisdiction to hear civil and commercial cases with a dispute amount of between RMB 50 million to RMB 200 million if it only involves domestic interests and of between RMB 20 million to RMB 100 million if it involves foreign interests; and
3. a higher people's court has jurisdiction to hear civil and commercial cases with a dispute amount of more than RMB 200 million if it only involves domestic interests and of more than RMB 100 million if it involves foreign interests.

The Supreme People's Court is the highest court in the land. In addition to its role as the court of final appeal, it is also empowered to conduct first instance hearings in cases of great significance to the country as a whole or in cases which the Supreme People's Court deems should be tried and adjudicated by itself.

A plaintiff in China may commence a civil case by filing a written complaint with the people's court that has jurisdiction over the dispute. A court may order property preservation measures to protect the interests of the plaintiff. A litigant who disagrees with the judgment or ruling of the first instance court may lodge an appeal with a higher court. Under a limited number of circumstances, a litigant may petition the appeal court or the court above for a re-trial or review of the appeal court's

decision if they are dissatisfied with the appeal court's decision. The Supreme Court's judgments or rulings are final and cannot be appealed.

Pursuant to an arrangement between China's central government and the Hong Kong Special Administrative Region, money judgments in commercial cases given by specified courts of the Mainland and Hong Kong may be enforced in each others' courts since 1 August 2008. Legislative changes in both jurisdictions needed to implement these arrangements are still in the process of being developed.

## **B. Arbitration**

Previously, many foreign parties to contracts in China have chosen to resolve their disputes with Chinese parties by arbitration in an overseas location such as London, Stockholm or Singapore. Overseas arbitration awards are enforceable in China under the New York Convention framework. In recent years, owing to the relatively higher costs involved, Stockholm has been a less popular choice and foreign parties have increasingly been willing to refer such disputes for arbitration to China's leading arbitration institution, the China International Economic and Trade Arbitration Commission (**CIETAC**).

CIETAC is one of the busiest international business arbitration institutions in the world. Located in Beijing, CIETAC has established sub-commissions in Shanghai and Shenzhen. Recently, a new CIETAC sub-commission was established in Chongqing to cover the arbitration in western China. It has adopted two sets of arbitration rules, one governing general disputes and the other governing financial disputes. CIETAC is served by panels of PRC and foreign arbitrators, but parties may also appoint arbitrators outside the panels.

Another international arbitration tribunal which is popular for resolving China-related disputes is the Hong Kong International Arbitration Centre

(**HKIAC**). The HKIAC recommends the use of the UNCITRAL Arbitration Rules to govern international arbitrations, but this is not mandatory. Pursuant to the "Arrangement Concerning Mutual Enforcement of Arbitral Awards between the Mainland and the Hong Kong Special Administrative Region" (**Arrangement**), an arbitral award made by the HKIAC may be enforced in a PRC court according to the provisions of the Arrangement.

## **Financial system**

The creation of a modern banking system is a continuing objective of the Chinese leadership as it seeks to improve fiscal and macroeconomic control over the economy. Reforms have focused on modernizing the banking system to fit international norms, enhancing the role of the central bank and separating policy-oriented lending from commercial lending.

The present financial system in China is under the leadership of the People's Bank of China (**PBOC**), with exclusively State-owned commercial banks as the main body, but allowing the co-existence of and co-ordination with State policy-related banks, other commercial banks and various financial institutions.

### **A. People's Bank of China**

The PBOC is China's central bank, responsible for establishing and implementing national financial policies, as well as regulating currency circulation and credit activities. It represents the country to foreign countries and supervises and administers all domestic financial activities.

The PBOC has the following responsibilities:

- Formulating and implementing monetary policies, including regulating interest rates
- Issuing currency and regulating its circulation

- Coordinating and implementing credit plans
- Improving the macro adjustment policy of the financial markets
- Performing inter-bank borrowings.

## **B. Commercial banks**

The Chinese commercial bank system is composed of three parts: exclusively State-owned commercial banks, other shareholding commercial banks and foreign-funded commercial banks. The exclusively State-owned banks constitute the main body of Chinese commercial bank system.

In early 1994, the Chinese government announced significant reforms to the banking system. Under the reforms, the four major specialized banks – the Industrial and Commercial Bank of China, Bank of China, Agricultural Bank of China and Construction Bank of China – were transformed into purely commercial entities. The banks are now responsible for their own profits and losses and can provide a full range of commercial banking services.

## **C. Policy-related banks**

Since 1994, China has constructed three policy-related banks directly under the State Council: the State Development Bank, Agriculture Development Bank of China and the Export-Import Bank of China.

## **D. Foreign-funded banks and branches**

Currently, although foreign funded banks have been permitted to establish branches in China since late 2001, they are limited in regard to whom they may lend, where they may lend, and what currency they may lend. Such banks are not allowed to negotiate with domestic Chinese businesses or lend money to Chinese individuals. However, since 2002, China has designated certain cities

where foreign-funded banks are allowed to handle Renminbi business.

Since late 2007, regional limitations on foreign-funded banks handling renminbi business in China have been lifted, and foreign-funded banks are allowed to apply their own analytical models for credit risk.

## **E. Non-bank financial organizations**

Chinese non-bank financial organizations mainly include Trust & Investment Corporation, Securities Company, Insurance Company, Finance Company, Leasing Company and Credit Union.

## **F. Stock Exchanges**

China currently has two stock exchanges, the Shanghai Stock Exchange (SHSE) and the Shenzhen Stock Exchange (SZSE). The exchanges are regulated by the China Securities Regulatory Commission (CSRC), which establishes regulatory guidelines, formulates and enforces market rules, and authorizes initial public offers.

Over-the-counter trading is carried out in many cities including Beijing, Chongqing, Guangzhou, Shanghai, Shenyang and Wuhan. Although shares of unlisted companies continue to be traded on the over-the-counter markets, listed shares are now traded on only the two exchanges.

## **Currency and foreign exchange control**

The Renminbi (RMB) is China's legal currency, and is issued and controlled solely by the PBOC. The RMB is denominated in units of fen, jiao and yuan (¥). Ten fen equal 1 jiao, and 10 jiao equal 1 yuan. (1 yuan is valued at approximately \$0.12 USD.) In general, references to amounts of RMB indicate units of yuan, unless otherwise indicated. RMB exchange rates are decided by the PBOC and issued by the State Administration of Foreign Exchange, the latter exercising the functions and powers of exchange control.

The Renminbi is not currently a freely convertible currency. Foreign exchange controls are applicable to currency transactions in China. Under the foreign exchange controls currently in place, Foreign Investment Enterprises (**FIEs**) are required to treat their foreign exchange transactions differently depending on whether the transaction relates to a current account item or a capital account item.

A current account item is a transactional item which is of a recurrent nature and includes payments in the context of foreign trade, cross-border supply of services and the overseas remittance of profits and dividends. Foreign exchange revenue from current account items must be sold to or deposited in a foreign exchange account with a designated foreign exchange bank. In order to pay for current account items in foreign exchange, an FIE can use its foreign exchange savings or purchase foreign exchange at a designated foreign exchange bank. The FIE will need to show the bank relevant supporting materials of the underlying transaction for which the payment is made. For instance, if the payment is made for the import of goods, the purchase contract, invoice, etc. must be produced.

A capital account item refers to a transactional item which either increases or reduces the capital or liability from the inflow or outflow of capital in the course of international receipts and payments. Items include direct investment, all kinds of loans, securities investments, etc. As opposed to current account transactions for which verification by a designated bank suffices, capital account transactions often require prior approval or verification by the foreign exchange authorities. In recent years, there has been a moderate relaxation of controls over capital account items.

## **FOREIGN INVESTMENT POLICY**

### **General principles**

The Chinese government has issued a

wide range of rules and regulations to govern foreign investment in the country. Their purpose is to direct foreign investment into certain priority industry sectors while restricting or prohibiting investment in other sectors. The key national regulations for implementing China's foreign investment policy are the Regulations for Guiding the Direction of Foreign Investment (**Guiding Regulations**).

The Guiding Regulations classify all foreign investment projects into one of four categories:

1. Encouraged
2. Permitted
3. Restricted
4. Prohibited

Foreign investment projects belonging to encouraged, restricted and prohibited categories are listed in the Catalogue for the Guidance of Foreign Investment Industries (**Foreign Investment Catalogue**). Projects not categorised under the other three categories are generally regarded as Permitted. Since FDI projects are frequently reclassified among the 4 categories, before making any decision to proceed with an investment, foreign investors should check the most updated Foreign Investment Catalogue to make sure the project is in the right category.

The classification of an investment project under the Guiding Regulations determines the feasibility and establishment method for the project. The principal difference between encouraged and permitted projects is that encouraged projects may be eligible for tax and other preferential treatment under prevailing foreign investment promotion policies. Restricted projects must be examined and approved by the relevant provincial-level departments. A record of the projects must also be filed with the higher level competent authorities and with the authorities in

charge of the industry invested in. If a restricted project exports 70% of its output, it may be treated as a permitted category project with the approval of the relevant state or provincial-level authorities.

The Guiding Regulations provide for the publication of two catalogues, the Foreign Investment Catalogue and the Catalogue of Priority Industries for Foreign Investment in the Central and Western Regions (**Central and Western Region Catalogue**). The Foreign Investment Catalogue lists specific industries in which foreign investment in China is encouraged, restricted or prohibited, whereas the Central and Western Region Catalogue lists the industries in which foreign investment is specifically encouraged in the central and western regions of China. Projects not included in the Foreign Investment Catalogue are considered permitted. The two catalogues constitute the basis for the applicable policies regarding the examination and approval of foreign investment projects and FIEs.

Following its accession to the WTO, China has been gradually removing restrictions on foreign investment in a wide range of industries, although investment limits in certain sectors are expected to continue in existence for the time being.

## **TYPES OF BUSINESS ENTITIES**

### **General**

China recognises a wide range of business vehicles, only a few of which are open to domestic investors. The principal business entities available to foreign investors are:

1. representative offices;
2. equity joint ventures;
3. cooperative joint ventures;
4. wholly foreign-owned enterprises;
5. companies limited by shares with foreign investment;
6. holding companies.

Special regulations have been adopted to govern the establishment and operation of each of these foreign investment vehicles. PRC Company Law mainly regulates two types of business entities: limited liability companies and companies limited by shares.

### **Limited liability Company**

A limited liability company may be set up by between 1 and 50 shareholders. The words "limited liability company" or "limited company" must be included in the name of the company. A limited liability company's constitutional documents are its articles of association. A minimum capital of RMB 30,000 is required for the establishment of a limited liability company but in practice, the minimum capital permitted by foreign investment authorities will be much higher. Capital contributions may be made in the form of cash and non-currency assets that can be appraised and denominated in currency and are legally transferable, such as in-kind contributions, industrial property or land use rights.

A limited liability company is liable for its debts to the extent of its assets, while the liability of its shareholders is limited to the amount of their respective capital contributions.

The highest decision-making authority in a limited liability company is vested in the shareholders' meeting. A limited liability company may choose to establish a board of directors and a supervisory committee.

### **Company Limited by Shares**

A company limited by shares may be established by promotion or share offer. A number of promoters between 2 and 200 is permitted. If the company is established by promotion, the promoters must hold all of the shares. If it is established by a share offer, the promoters must subscribe to at least 35% of the shares and offer the rest to the public. Establishment by share offer is subject to the approval of China's

securities regulator. The minimum capital of a company limited by shares is RMB 5 million.

A company limited by shares is liable for its debts to the extent of its assets, while the liability of its shareholders is limited to the amount of their respective shareholdings.

## **FOREIGN-INVESTED BUSINESS VEHICLES**

### **Representative offices**

Many foreign enterprises have established representative offices in China as the first step of their market entry strategy, as they are fairly easy and inexpensive to establish. A representative office is not an independent legal entity and does not have its own capital.

A foreign enterprise can engage in a limited range of activities through a representative office. In general, a representative office is only permitted to engage in indirect business operations in China. It may represent the foreign enterprise in carrying on activities such as business liaison, product and service introduction, trade name promotion, market surveys and research, and warranty and after-sale service management. A representative office is not permitted to engage in direct business activities.

A representative office cannot employ Chinese employees directly. Local employees must be employed through a designated Chinese labour service agency. A representative office must have a chief representative, who may be foreign or local.

### **Equity joint ventures (EJVs)**

An EJV is a corporate legal entity established by two or more foreign and Chinese parties. An EJV is a limited liability company with its own registered capital and a legal identity distinct from its investors. As an independent legal

person, an EJV is capable of contracting and bearing liability on its own behalf.

The business scope of a joint venture must be clearly set out in the project documentation. An EJV may only conduct business within its approved business scope and the approval of the original approval authority is required to amend an EJV's business scope. Each EJV will have registered capital that represents the equity investment contributed by the parties to the joint venture. The parties' contributions to the registered capital may be made in cash or in kind pursuant to a contribution schedule approved by the Chinese examination and approval authorities.

Foreign investment must normally account for at least 25% of the registered capital of an EJV. However, foreign investment in an EJV may be less than 25% of the registered capital provided that it is established in accordance with the mandatory establishment procedures. An EJV with less than 25% foreign investment will not be eligible to benefit from the preferential policies generally applicable to a foreign investment enterprise (**FIE**).

The highest authority of an EJV is its board of directors. The board of directors must have a chairman and a vice-chairman, one of whom is generally appointed by the Chinese party and the other by the foreign party.

### **Cooperative joint ventures (CJVs)**

A CJV is a business arrangement established by two or more foreign and Chinese parties pursuant to a cooperation agreement. There are two types of CJVs: those that have "legal person status" (ie: involving the formation of a separate business vehicle) and those without legal person status (where no separate business vehicle is formed). CJV's with legal person status are the norm and there are special requirements that apply to CJVs that do not have legal person status. CJVs with legal person status are limited liability

companies. Limited liability does not apply to CJVs without legal person status.

Limited liability CJVs share many characteristics with EJVs and, in particular, they have a registered capital and the liability of the joint venture partners is limited to their respective contributions to the registered capital. A feature that distinguishes CJVs from EJVs, however, is that the parties may agree to a profit and loss sharing arrangement that does not correspond with the ratio of the parties' capital contributions (as is required in the case of EJVs). Greater flexibility is also allowed in the form of permitted capital contributions and the distribution of assets in the event of dissolution.

As in the case of EJVs, foreign investment in a CJV must normally account for at least 25% of its registered capital. If foreign investment accounts for less than 25% of the registered capital, the CJV will not be eligible for the preferential treatments generally applicable to FIEs.

A CJV may be managed by a board of directors or a joint management body. A CJV without legal person status must be managed by a joint management body. A CJV's board of directors or joint management body must be composed of at least three members.

### **Wholly foreign-owned enterprises (WFOEs)**

A wholly foreign-owned enterprise is an investment vehicle established and operated by a foreign investor without the participation of a Chinese partner. WFOEs are prohibited in certain industry sectors. While more industry sectors have been opened to wholly foreign-owned investment following China's accession to the WTO, certain key sectors such as telecommunications and media will remain off limits to this type of investment for the foreseeable future.

A WFOE is usually a limited liability company although, subject to approval, other liability structures are theoretically permitted. A WFOE with limited liability status has its own registered capital and a legal identity distinct from its foreign investor. It is an independent legal person capable of contracting and bearing liability on its own behalf. The foreign investor may make its capital contributions to the WFOE in cash or in kind.

### **Company limited by shares with foreign investment (CLSFI)**

A CLSFI may be formed by way of promotion or share float. If established by promotion, more than half of the promoters must be domiciled in China and at least one of the promoters must be a foreign shareholder. When the share float method is adopted, at least one of the promoters must have been profitable in the three years preceding the share float and the promoters must subscribe for at least 35% of the shares. The required minimum registered capital of a CLSFI is RMB 30 million, which is six times higher than that for a domestic company limited by shares. Foreign investment must represent at least 25% of the registered capital of a CLSFI.

Existing EJVs, CJVs and WFOEs may apply to their original approval authority to convert into a CLSFI provided that they were profitable in the three years prior to the application. The original investors shall act as the promoters of the CLSFI, although they may be joined by new promoters. The application must also be approved by the Ministry of Commerce ("MOFCOM").

A CLSFI may be listed on stock exchanges in China as well on overseas stock exchanges. Such listings are subject to certain requirements in terms of capitalisation, business performance and number of shareholders.

For a variety of reasons, CLSFIs are not a typical business vehicle in China.

## Holding company

Holding companies in China are sometimes also referred to as "investment" or "umbrella" companies. These are FIEs established for the specific purpose of holding equity in various FIEs established by a single foreign investor in China. A holding company may be wholly foreign-owned or a joint venture with a domestic investor. The requirements in terms of capital contribution and existing investments for setting up a holding company are relatively high.

There are two ways in which an overseas investor can qualify to establish a holding company. Under the first method, the investor must have a total capitalisation of at least US\$400 million, and have contributed a minimum of US\$10 million to the registered capital of its subsidiaries in China. Alternatively, the investor must demonstrate that it has established at least 10 FIEs in China with an aggregate paid-up registered capital of US\$30 million or more. These capitalisation requirements put holding companies outside the reach of all but the largest multinational companies.

Nevertheless a holding company is a very useful kind of business vehicle. It is able to provide a wide range of corporate support services to businesses that it has invested in (**invested enterprises**). These services include foreign exchange balancing, procurement of machinery and equipment, loan applications, market information, investment advice, technical support, staff training and human resource management. A holding company may also establish research and development centres and provide financial support to its invested enterprises.

Provided that a holding company satisfies certain requirements, it may provide its invested enterprises with specified additional services such as acting as a distributor for their products on Chinese and overseas markets,

transportation, warehousing, leasing of machinery and office equipment, etc. It may also provide after-sales services, carry out systems integration of products manufactured by its invested enterprises and sell (but not retail) inside China the products it has imported from its overseas parent.

A holding company satisfying other specified criteria may be recognised as the regional headquarters of a multinational company (**Regional Headquarters**). Regional Headquarters may engage in an even wider range of services including inter-company financing, import and wholesale in China of products manufactured by overseas members of its corporate group.

## ALTERNATIVE MEANS OF CARRYING ON BUSINESS IN CHINA

Establishing a formal business presence in China affords a number of advantages, not least of which is the ability to be paid in local (as well as foreign) currency, the ability to repatriate profits back to the UK and generally being able to exert greater control over local business operations. Nevertheless, establishing a permanent presence is an expensive and long-term proposition and generally should not be undertaken unless thorough analysis clearly shows that the intended business model is likely to succeed in China. For those companies that cannot yet justify the commitment of resources to establish a business within China, there are a number of alternatives.

For British companies that simply want to supply the home market and possibly overseas markets, without the expense of establishing manufacturing or trading operations in China, it is possible to source products from contract manufacturers operating in China. Well-established procurement and supply chain specialists are available to help with sourcing a vast range of products. These firms can afford access to potential suppliers on commercially competitive terms, arrange for shipments and payment arrangements,

as well as product design/engineering and quality control.

Consumer markets in China and neighboring countries are burgeoning and may provide attractive opportunities for British goods and services. Nevertheless, developing an effective distribution network in China may require years of patient effort and resources. Starting small and working through an existing distributor or network of agents is often a more viable alternative to going it alone. Engaging local distributors or agents to handle local sales can enable an overseas supplier to penetrate and develop its China market, building experience and confidence along the way. This can be a particularly suitable approach for manufacturers to take in the early stage of testing and developing the market. Once local sales have grown and sufficient experience has been obtained, a local trading operation can be established in select areas, perhaps leaving local agents or distributors to handle specialised regional markets.

## **INTELLECTUAL PROPERTY**

### **Trade marks**

The PRC Trade Mark Law and its Implementing Regulations govern the trade mark application procedure and the protection of registered trade marks. Both trade marks and service marks may be registered in China. Trade mark registrations are the primary means for protecting trade mark rights in China. With the exception of well-known trade marks, China does not recognise trade mark rights acquired through use. The first person to register a trade mark in China is regarded as the owner of that mark. Registration of trade marks is therefore essential to secure protection.

The trade mark registration procedure includes examination as to formality and for prior conflicting marks. The procedure is characterised by short deadlines and the lack of opportunities for formal negotiations with the Trade Mark Office as to the terms on which a

mark may be accepted for registration. There are also strict rules regarding the form in which registered marks may be used. Matters such as the selection, use and registration of Chinese character equivalents to marks in Roman letters must also be considered when registering a trade mark in China.

### **Patents and designs**

Under China's Patent Law, three kinds of patents are available, namely invention patents, utility model patents and design patents. The three requirements for granting a patent are novelty, utility and inventiveness. A granted invention and utility model patent is infringed by anyone who, without the consent of the patent owner, makes, uses, offers for sale or sells products directly obtained through the patented process for production or business purposes. An owner of any kind of patent right also has the right to prevent any other party from importing, without its authorisation, the patented products or product obtained through the patented process for production or business purposes. Similarly, a granted design patent is infringed by anyone who, without the consent of the design owner, makes or sells products incorporating the patented design for production or business purposes.

### **Copyright**

The Copyright Law and its Implementing Regulations govern the protection of copyright works. Works include written literary works, musical, dramatic, folk art and dance works, artistic and photographic works, film, television and video works, engineering design and product design blueprints and maps. Registration is not, in general, necessary in order to acquire copyright. Registration of computer software is separately regulated under the Computer Software Protection Rules. Acts of copyright infringement include copying and publishing a copyright work without the consent of the copyright owner, falsely claiming authorship of a copyright work and adapting, translating,

annotating or editing a copyright work without the consent of the copyright owner.

## Enforcement

The intellectual property (IP) regime in the PRC is subject to unique and specialised considerations, given its reliance on administrative enforcement procedures. Dedicated administrative authorities have power under the relevant IP laws to control the misuse of specific IP rights. Under the PRC Trade Mark Law, the relevant Administrative Authority is the Administrative Authority for Industry and Commerce (**AIC**). The AIC also has power to enforce the PRC Anti-Unfair Competition Law, which bans certain types of intellectual property infringement. The Administrative Authority for Patent Affairs is the relevant authority under the PRC Patent Law and the National Copyright Administration is the appropriate authority under the PRC Copyright Law.

Although the ultimate forum for upholding IP rights in the PRC is the People's Court (IP Division), the most efficient and cost effective way of enforcing IP rights in the PRC is often by way of administrative enforcement action. Administrative enforcement actions can be taken very quickly, sometimes within days of infringing products being found, and can be disposed of completely within 2/3 months. If infringing products are found they can be seized and destroyed. Fines are imposed upon infringers and their abettors and they may be ordered to pay compensation. In serious cases, if the quantity of infringing products is large, criminal proceedings may be instituted against the infringer, thereby increasing the deterrent effect on others.

UK Trade & Investment team at the British Embassy in Beijing has recently produced a report on the current situation of intellectual property protection in China, titled '**China: Intellectual Property: Growing Innovator but still Imitator**'. For more information, please visit

[https://www.uktradeinvest.gov.uk/ukti/fileDownload/China\\_Intellectual\\_Property\\_Growing.pdf?cid=427185](https://www.uktradeinvest.gov.uk/ukti/fileDownload/China_Intellectual_Property_Growing.pdf?cid=427185)

## TAXATION

### China's Tax System

Since the 1980s, China has made efforts to establish a modern, rational and efficient tax system that keeps pace with China's transformation from a command economy into a market-oriented economy. China has developed a two-tier system for levying taxes whereby certain taxes are collected by State Tax Bureaux and others by the Local Tax Bureaux. Every tax levied in the PRC can be classified as a central tax, local tax or a shared tax.

In general, the State Tax Bureau is responsible for the levy and collection of the central taxes which constitute the revenue of the central government and the shared taxes which are revenue shared between the central and local governments. The local tax bureau is responsible for the collection of local taxes which constitute the revenue for the local governments concerned. The State tax bureau will directly pay the portion of taxes shared by the local governments collected by it into the local government treasury.

China's Enterprise Income Tax Law (EIT) came into effect on 1 January 2008, unifying the income tax treatment of domestic and foreign enterprises. The EIT Law is broad in scope and contains a number of key features that represent a significant departure from China's pre-existing tax law.

Since the early 1990s, China has maintained a dual income tax regime, one for domestic enterprises and another for FIEs.

While FIEs historically enjoyed preferential tax treatment under the pre-existing regime, the EIT streamlined rates and allowable deductions for both

domestic and foreign-owned enterprises, thereby creating a more level playing field, promoting competition and transparency for all enterprises in China.

### **New tax rates**

The EIT combines China's tax rate at 25%, which is higher than the 15% to 24% rate that was enjoyed previously by many foreign-owned enterprises located in special foreign investment zones, but is lower than the 33% rate that until 1 January 2008 was applicable to domestically-owned enterprises.

Qualified "meagre-profit enterprises" are subject to a lower tax rate of 20%. To qualify as a "Meagre-profit enterprise", small businesses must satisfy the following conditions:

- an industrial enterprise with an annual taxable income not exceeding RMB 0.3 million yuan, employing no more than 100 employees and holding total assets not exceeding RMB 30 million yuan;
- any other kind of enterprise with an annual taxable income not exceeding RMB 0.3 million yuan, with 80 or less employees and with total assets not exceeding RMB 10 million yuan.

Under the EIT, qualified high-tech and new technology businesses are subject to a more favorable tax rate of 15%. "High-tech" and "new technology" are not well-defined but to qualify for preferential tax treatment as a "high-tech" or "new technology" enterprise, businesses must satisfy the following conditions:

- holds core proprietary intellectual property rights;
- products (or services) meet the relevant criteria for high-tech or new technology;
- proportion of research and development funds meets prescribed ratios set from time to time;
- proportion of income from sales of products (or services) in relation to

high-tech products meets prescribed ratios set from time to time;

- percentage of technical staff in the total employees meets prescribed ratios set from time to time; and
- otherwise in compliance with official policies.

To cushion the impact of the change in corporate tax rates, the pre-existing preferential tax treatment accorded to FIEs that were incorporated before the EIT came into effect (eg: the standard two-year tax exemption and additional three-year, 50% tax rate reduction that all production-oriented business qualified for) have been 'grandfathered' for certain businesses.

### **Effect of tax rate changes**

The principal short-term impact of the EIT has been a relative increase in tax rates for all newly-established FIEs. However, such increases have been effectively nullified for most FIEs that rely on domestically-owned businesses in China since the cost of doing business has fallen for domestically-owned businesses by virtue of reduced corporate tax rates since 1 January 2008.

It is not expected that the increased tax burden for FIEs will have any significant negative impact on foreign investment flows into China – so far, most foreign investors are prepared to accept these and other increased costs of doing business in China in return for access to emerging domestic markets in China and the nearby markets in Southeast Asia.

### **Permanent establishment and transfer pricing**

Under the EIT, tax residency in China is determined by a newly-introduced concept of place of management. A foreign company that is not incorporated in China may be regarded as tax resident in China if its place of effective control and management is in China. Management of FIEs should carefully consider these new residency rules when conducting business and

organising management-level meetings in China or find that their business is inadvertently regarded as being resident in China for tax purposes.

The EIT also emphasizes transfer pricing documentation requirements as well as endorses cost-sharing arrangements and advance pricing agreements.

After the first full year of the EIT being in effect, it is apparent that transfer pricing enforcement and permanent establishment issues have become priorities for the Chinese tax administration. FIEs must carefully consider China tax planning issues to ensure that their business operations are both tax-efficient and comply with the relevant local tax laws.

### Individual income tax

| <b>Monthly Taxable Income<br/>(after deduction of RMB 4,800)</b> | <b>Tax Rate<br/>(%)</b> |
|--|-------------------------|
| Not exceeding RMB 500  | 5                       |
| Part from 501 to RMB 2,000                                       | 10                      |
| Part from 2,001 to RMB 5,000                                     | 15                      |
| Part from 5,001 to RMB 20,000                                    | 20                      |
| Part from 20,001 to RMB 40,000                                   | 25                      |
| Part from 40,001 to RMB 60,000                                   | 30                      |
| Part from 60,001 to RMB 80,000                                   | 35                      |
| Part from 80,001 to RMB 100,000                                  | 40                      |
| Part over RMB 100,000  | 45                      |

Although IIT is payable by the employee, the employer generally has the obligation to withhold the IIT amount and pay it to the tax authorities. Employers that fail to withhold part of their staff's income for IIT purposes are liable for such payments.

An essential element in determining IIT liability is whether an individual is domiciled or resident in the PRC. Persons who habitually reside in China due to family or business relationships or registration of permanent residency are considered to be taxpayers domiciled in the PRC. They are potentially subject

to IIT on their worldwide income. In

Chinese and foreign individuals are subject to the same individual income tax (IIT) regime. IIT is computed at different tax rates depending on the type of taxable income. Income from salaries and wages is taxed at progressive rates, with a highest rate of 45%, whereas the tax rate for income from production and business activities of individual industrialists and business people ranges from 5% to 35%. Other taxable income, such as from author's remuneration, personal services remuneration and royalties, etc. is generally taxed at a flat rate of 20%.

Individual tax payers are allowed a standard deduction of RMB 1,600 per month for the IIT on wages and salaries. Expatriates enjoy a higher deduction of RMB 4,800 per month and are subject to the IIT rates set out on the table below:

most cases, a foreigner working in China is not deemed to be domiciled in China but only resident.

Tax treatment of non-domiciled individuals varies depending on the duration of their residency in China in a calendar year. Individuals who are not residents in China, or were residents in China for less than one year, are generally subject to tax only on income they derived within China. Residents who reside in China for at least one year are taxed on their worldwide income just as domiciled individuals. However, residents who have resided in China for more than one year but less than five years are exempted from IIT on foreign source income paid outside China.

Residents for more than five years are subject to their worldwide income, irrespective of whether derived in or outside China. It should be noted that for the five-year residency rule, any absence from China of 30 days or more on a single trip or for a cumulative period of 90 days or more on a number of trips within the same tax year will generally break the five year period.

Senior executives of FIEs such as directors and senior managers are taxed on the income related to their employment at the FIE, even if the work is performed outside China and regardless of the length of their residence in China.

An expatriate who is physically present in China for more than 90 days (or 183 days in the case of a resident of a country or region with which China has entered into a double taxation avoidance treaty or arrangement) in a particular

calendar year will be subject to IIT on the portion of the wages and salaries which is deemed China-sourced.

A foreign representative of a representative office is taxed as a resident in China irrespective of whether the representative actually resides in China. Therefore, the representative is taxed on the salary attributable to the services rendered in China.

### **Business tax**

Business tax is normally payable on the income derived from the provision of certain types of labour services, the assignment of intangible assets or the sale of immovable property. FIEs and foreign enterprises which engage in these taxable activities in China are also subject to business tax. The tax is levied on gross turnover, with deduction of expenses or costs only permitted in limited instances.

The applicable tax rates are set out in the chart below:

|          |   |
|----------|---|
| 5%-20%   | Applicable to entertainment businesses.   |
| 5% or 8% | Applicable to financial and insurance services.   |
| 5%       | Applicable to services and assignment of intangible assets and sale of immovable property.                  |
| 3%       | Applicable to transportation, construction, post and telecommunications and cultural and sports activities. |

An exemption from business tax is granted to foreign enterprises without an establishment or place of operations in China, which derive interest income or rental income from the lease of tangible and movable properties from sources inside China.

Amongst others, there are also exemptions available for:

1. nursing services provided by nurseries, kindergartens, homes for the aged and welfare institutions for the handicapped;
2. medical services provided by hospitals, clinics and other medical institutions;
3. educational services provided by schools and other educational institutions, as well as services provided by students participating in work-study programmes;
4. agricultural services, such as mechanical cultivation, irrigation and drainage, etc.;
5. admission fees for certain cultural activities, such as those organised by memorial halls, museums, cultural centres, art galleries, etc.; and
6. admission fees for cultural and religious activities conducted at places of religious worship.

Reductions or exemptions from business tax are not dependent on the location of the FIE or its business activities.

The principal applicable tax rates are set out in the chart below:

### Value-added tax

Value-added tax (**VAT**) is levied on the sale of tangible movable property, the provision of processing or repair and replacement services and the import of taxable goods inside China.

|     |   |
|-----|---|
| 17% | The standard rate.  |
| 13% | Applicable to general daily necessities, publications, agricultural materials, machinery and products, though generally not for the purchase of fixed assets.                           |
| 6%  | Applicable to goods sold by small taxpayers and projects involving natural resources taxed on value added at each stage of a production cycle.  |
| 5%  | Applicable to oil and gas produced by Sino-foreign joint exploration projects.  |
| 0%  | Applicable to agricultural products sold directly by producer, imported equipment for processing, assembly or compensation trade, equipment used for scientific research, exports, etc. |

VAT is levied and collected on the basis of the value added to the taxable goods and services at each stage of the production cycle. The seller can generally deduct the VAT that has been paid on the purchase of materials and certain overheads that are used for the taxable sales (input tax) and account for the difference to the authorities.

VAT may be refunded in a number of circumstances. VAT paid on the inputs to manufacture goods which are subsequently exported may be partially refunded. A VAT refund is also available when goods are returned by the buyer.

Capital goods imported by FIEs may be exempt from import stage VAT if the investment project is listed as "Encouraged", involves a technology transfer and is not listed in the Catalogue of Import Commodities for Foreign Investment Projects Not Eligible for Tax Exemption. FIEs may also be entitled to a full VAT rebate on the purchase of domestically-manufactured equipment within their total investment

amount on condition that the project is listed as "Encouraged" or included on a list of encouraged technologies and the equipment is not listed as ineligible for tax exemption.

### Consumption tax

Consumption tax is imposed upon manufacturers and importers of luxury or non-essential goods, as well as businesses which entrust third parties to process such goods. The tax also applies to FIEs and foreign enterprises which engage in these taxable activities in China. The consumption tax is levied on 11 categories of goods, including tobacco, liquor and alcohol, cosmetics, skin and hair-care products, jewellery, fireworks, gasoline, diesel oil, automobile tyres, motorcycles and motor cars. The rate of the tax varies and is sometimes expressed as a percentage of the sales value (with rates ranging from 3% to 45%) or as a fixed amount per volume of the product. For instance, the tax rate applicable to cosmetics is 30%, whereas the tax

amount payable on diesel oil is RMB 0.1 per litre.

Unlike VAT, consumption tax is levied only when goods are sold to the wholesaler, retailer or directly to the end-user and not on any further on-sale of the goods thereafter. Taxable consumer goods used in the continuous production of other taxable consumer goods are exempt from consumption tax. Goods manufactured for exports are generally exempted.

## **EMPLOYMENT ISSUES**

A new comprehensive Labour Contract Law ("LCL") came into effect on January 1, 2008. Under the LCL, employers are required to give employees written employment contracts, the use of temporary labour is restricted in certain ways, and termination of employees requires more diligence. Despite complaints by foreign investors' that the new law makes it more difficult to do business in China, and that it erodes China's low-cost labour advantage, the Chinese government has pursued this new law as the latest step in its campaign to achieve a "balanced and harmonious society".

The LCL can be summarized by the following key points:

### **Non-competition Agreements**

The LCL provides that contractual parties may decide on specific geographic restrictions and compensation for violation of non-competition clauses, but the term of the agreement may not exceed two years. Non-competition clauses, however, may be included only in contracts with senior management and technical personnel and employees with a confidentiality obligation.

### **Probationary Periods**

The LCL provides that the contracting parties may decide on a probationary period for new employees, the maximum duration of which is determined by the length of the contract. Employers may

not terminate employees during the probationary period unless they can prove that the employee did not meet employment conditions. What constitutes adequate proof, however, is not provided in the LCL.

### **Training Costs**

The LCL allows employers that incur training costs for particular employees to require a fixed term of service from those employees who receive such training benefits, and permits employers to collect damages from employees when they are in violation of their term of service.

### **Role of Labour Unions**

Compared to the pre-existing labour law, the LCL grants labour unions a greater role in negotiations and decision-making than the existing labour law. Employers are required to consult with their labour unions or "employee representatives" on an "equal basis" in setting policies regarding labour compensation, work hours, rest and leave, labour safety and health, insurance and benefits, training, and labour discipline and quotas, among other issues.

### **Layoffs**

Enterprises are required to notify labour unions or "employee representatives" 30 days prior to any layoffs under the 1995 Labour Law. Under the LCL, employers must now provide an explanation for layoffs involving 20 or more employees or 10 percent or more of entire staff to the labour union or the entire staff.

### **Severance**

Severance pay is now required under the LCL by employers to employees in various situations such as bankruptcy, closing a business or when a fixed-term contract expires but the employee has not been offered another contract of equal or better terms. In those circumstances, employees are to be paid one month's salary for each year of employment with the employer

with certain maximum compensation amounts.

### **Impact on the Current Employment Contracts**

All employment contracts entered before January 1, 2008 and still effective continued to be effective under their original terms. However, all employment contracts that were not in written form as at January 1, 2008 had to be put in writing within one month after the effectiveness of the LCL (ie: before February 1, 2008) failing which the employer becomes subject to a range of penalties.

The LCL provides the basis for calculating severance payment and other issues in respect of all employment contracts entered into before January 1, 2008 but terminated after that date.

## **COMPETITION LAW**

At the beginning of August 2008, China's first comprehensive competition/anti-trust law, the Anti-Monopoly Law (**AML**) came into force. The AML introduces to China similar competition law principles to those found in the other major jurisdictions.

### **Scope**

The AML applies to all "business operators", including natural and legal persons and any other entities that either produce goods or supply services. It is not clear whether and, if so, to what extent the AML will apply to Chinese state-owned enterprises (**SOEs**). This may potentially have a significant effect on the scope of the AML. Geographically, the AML is extra-territorial.

"Monopolistic agreements" are defined in the AML as any agreements, decisions or actions that "exclude or restrict competition" and are prohibited. The AML specifically prohibits certain types of agreements between competitors, including agreements involving price fixing, restrictions on production and the

division of territories. For non-horizontal agreements, the focus of the prohibition is on price-related provisions. The Chinese authorities also have a broad discretion to prohibit other types of agreements that exclude or restrict competition.

There are, however, a number of 'safe harbour' exceptions for certain types of agreements that offer benefits which outweigh their anti-competitive effects; for example, agreements that result in certain efficiencies.

The AML stipulates that business operators occupying a dominant market position must not abuse this position to exclude or restrict competition. Dominance is presumed, though rebuttable, where a single business operator has a market share above 50%. There are also rebuttable presumptions of collective dominance but it is not clear in what circumstances these will apply.

The AML contains a non-exhaustive list of acts that may constitute an abuse of a dominant position, including: selling/purchasing at unfairly high/low prices; bundling of products/services; imposing unreasonable trading conditions; refusing to trade; and discriminating between counterparties.

All such activities, except the first, may be permitted where there is "valid reason", but no guidance is provided on what this means. The AML stipulates that concentrations which satisfy certain thresholds must be filed in advance with the Anti-Monopoly Enforcement Agency (**AMEA**) and must not be put into effect prior to clearance.

On 3 August, 2008, the State Council promulgated the Implementing Regulations on the Notification of Concentrations of Business, which sets out the following thresholds for the notification of concentrations:

(a) The aggregate global turnover of all business operators to the concentration for the preceding financial year exceeds RMB 10bn, and at least two business

operators each have turnover in China exceeding RMB 400m; or

(b) The aggregate turnover in China of all business operators to the concentration for the preceding financial year exceeds RMB 2bn, and at least two business operators each have turnover in China exceeding RMB 400m; and

(c) In other cases, the AMEA may still investigate where the facts and evidence show that the concentration has or may have the effect of eliminating or restricting competition.

The AMEA will prohibit concentrations that have or are likely to have the effect of excluding or restricting effective competition in the relevant market. Alternatively, the AMEA can impose conditions on concentrations to reduce the otherwise potentially harmful effects on competition.

The AML provides for various penalties that may be imposed on business operators for breach of its provisions, including cease and desist orders, fines or orders to terminate or unwind implementation. No criminal penalties are provided for, although there may be civil liability to third parties who suffer harm as a result of the illegal activity. A leniency programme is provided for under the AML in relation to monopolistic agreements, but no details are given.

The AMEA is responsible for enforcement actions and has wide investigative power, including the power to conduct on-site investigations. It has recently been

confirmed that, at least for an initial period, three existing government agencies will share responsibility for the enforcement of the AML:

- the MOFCOM continues to be responsible for merger control filings;
- the National Development and Reform Commission is responsible for price monopoly-related cases; and
- the State Administration for Industry and Commerce oversees issues relating to abuses of a dominant market position, non-price related monopolistic agreements and abuses of administrative powers to inhibit competition.

There is concern the division of responsibility for enforcement between the three different agencies will result in a lack of consistency.

The AML also provides for the creation of a second authority, the Anti-Monopoly Commission (**AMC**). It has been indicated informally that the AMC will handle any conflicts arising between the above three agencies.

According to a circular issued by the Supreme People's Court in July 2008, the Intellectual Property Civil Division of the Chinese courts will exercise jurisdiction over all anti-monopoly civil litigation, including intellectual property rights (**IPR**) and non-IPR related civil litigation.

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British Diplomatic Posts in china

**[www.uk.cn](http://www.uk.cn)**

China-Britain Business Council

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