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# China Legal Framework

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## 1. Foreign Direct Investment in China

Foreign investments in the People's Republic of China (PRC) may be divided into direct investment and other investment. Direct investments are widely adopted and mainly include Sino-foreign Equity Joint Ventures (EJV), Sino-foreign Cooperative Joint Ventures (CJV), Wholly Foreign-Owned Enterprises (WFOE) and some other vehicles for special purposes. The three are generally referred to as Foreign Invested Enterprises (FIE).

### 1.1 Equity Joint Venture

The key distinguishing feature of an EJV is that profits are distributed, and risks are allocated in proportion to each party's contribution to the registered capital. The risk and profit allocation between the EJV partners may basically not deviate from the proportion set out in the original investment. EJVs are established in the legal form of a limited liability company. In general, the capital contribution from the foreign party must not be lower than 25 %.

### 1.2 Cooperative Joint Venture

CJVs are constituted either a "legal person" (Chinese terminology) of limited liability, or a non-legal person with unlimited liability in accordance with PRC Civil Law.

The key differentiating features of a CJV compared to an EJV are: a) The parties may allocate profits and losses in



accordance with their mutual consent rather than in proportion to their contributions to the registered capital, b) the foreign party may apply to recover its investment capital during the term of the venture. In some cases, recovery of the capital is possible even before payment of income tax. In such cases, the foreign party may apply to recover its investment during the term of the venture with the funds derived from depreciation of fixed assets, amortization of intangible assets, and so on. The flexibility inherent in the CJV makes it particularly suitable for certain types of investment.

### **1.3 Wholly Foreign-Owned Enterprise**

The advantages of the WFOE limited liability company, i.e. a 100% subsidiary are that no Chinese partner is involved and thus potential disputes with such a partner can be avoided. Also, when the WFOE is established by a single foreign investor, a 100% management and financial control over the enterprise is guaranteed. From a practical point of view a WFOE may be established faster.

### **1.4 Comparison between Joint Venture and WFOE**

The major legal reason for opting for a joint venture structure rather than a WFOE is the desire of the foreign party to be active in a restricted industry or business area where a WFOE is not or not yet permitted.

In addition, a joint venture may provide side advantages to foreign investors as they may need to invest less capital

and may be able to diversify risks and/or costs to its Chinese joint venture partner. Moreover, certain assets of the Chinese partner, such as land-use rights, equipment, infrastructure, trained staff, marketing or distribution channels, and so on, may be valuable to the foreign investor. Further, a Chinese partner's network and/or relations with authorities may help securing various licenses, obtaining preferential government treatment or fending off government and administrative interventions.

On January 12<sup>th</sup>, 2017, the State Council published the *Notice of the State Council on Several Measures for Opening Wider to the Outside World and Making Active Use of Foreign Investment* (Notice), to support foreign-invested enterprises to broaden their financing channels. According to the Notice, foreign invested enterprises should encounter a more amicable environment to be listed on the Main Board, the Small and Medium-sized Enterprise Board and the Growth Enterprise Market, the New Third Board, by issuing enterprise bonds, corporate bonds and convertible bonds, and by using debt financing instruments of non-financial enterprises. According to the Notice, there should be less legal obstacles in practice for foreign-invested enterprises to go public. Foreign investors may, depending on their business objectives or operation scale and certain other factors, upgrade their joint venture or WFOE to a foreign invested company limited by shares and be listed in a Chinese stock market.

## 1.5 Representative Office

Opening a representative office is sometimes reckoned to be the easiest way to establish a commercial presence in China. However, such representative offices may generally be engaged in liaison with marketing or other,

non-profit-generating activities. Depending on the circumstances, representative offices may be taxed based on their expenses rather than on their income. This principle is not observed in case of representative offices of foreign service providers such as foreign law firms or accounting and tax firms, whose representative offices in the PRC are allowed to conduct profit-generating activities.

## 1.6 Foreign Investment Company

To create a comprehensive holding vehicle for various types of investment and centralize service functions in China, foreign investors have been given the possibility to establish foreign investment companies. A foreign party seeking to establish a foreign investment company must have good credit standing and either, a minimum asset value of U.S. Dollars (USD) 400 million, calculated for its corporate group as a whole, plus a total registered capital in existing FIE of at least USD 10 million or at least USD 30 millions of registered capital in 10 or more existing FIEs in China. Foreign investment companies may invest up to five or even seven times their registered capital by means of loans, they may also keep a higher leverage ratio than ordinary FIEs and possess a more wide-ranging business license allowing them to act more liberally in many respects compared to ordinary companies. The relevant regulations modified in 2006 (Old Regulations) expanded the scope of services that a foreign invested holding company may provide its affiliates in China, which may help rationalize the organizational structure and improve the efficiency of its investments. The modification has also alleviated the restrictions about investment methods available to the foreign invested holding companies. It allows such companies to make strategic investments in domestic listed companies. In 2015, the Commission of Commerce of China modified the regulations on the *Establishment of*

*Investment Companies by Foreign Investors* (New Regulations), to further expand the flexibility for foreign investments. Compared to the Old Regulations, the New Regulations made significant amendments. They included e.g. joint-stock companies in the legal form of investment companies and deleted the requirements of minimum capital registration of USD 30 million.

### **1.7 Foreign Invested Partnerships**

*The Administrative Measures for Establishment of Partnership Enterprises in China by Foreign Enterprises or Individuals* (the Administrative Measures) generally allow a foreign investor to act as a general partner or limited partner of a limited partnership. Special laws or regulations apply where foreign investors are involved.

The Ministry of Commerce and its local bureaus (MOFCOM) have been the main approval authority for foreign invested enterprises for decades, but the Administrative Measures take a different approach for Foreign Invested Partnerships (FIP). An application for the establishment of an FIP shall be submitted to the local Administration of Industry and Commerce as authorized by the State Administration of Industry and Commerce (AIC). MOFCOM will only be notified of the registration information upon the establishment of a FIP. A FIP is still subject to foreign investment industrial policies, including the *Foreign Investment Industry Catalogue* and the AIC will review an explanation on compliance with foreign investment industrial policies as part of the application process.

## 1.8 Policies for Foreign Investment Industries

Upon China's entry into the WTO and in accordance with its WTO commitments, the country's lawmakers made significant amendments to its laws and regulations promulgated new regulations related to direct foreign investment and stated the will to loosen related restrictions.

On June 29th, 2018, the Commission of Commerce China promulgated the Interim Measures for Record-filing Administration of the Establishment and Change of Foreign-invested Enterprises (Interim Measures). The Interim Measures stipulated the establishment and change of foreign-invested enterprises will just need to go through record-filing procedure instead of approval, as long as the special Market Entry Management Measures prescribed by the Chinese government are not involved. These Interim Measures are aiming to simplify the procedures for foreign investors entering in China.

To figure out whether the foreign investors have to go through examination and approval procedure or just go through record-filing, the *Special Management Measures for the Market Entry of Foreign Investment* (Negative List) needs to be referred to. The Negative List, effective from July 28<sup>th</sup>, 2018, contains restrictions and prohibitions regarding 14 business sectors, which are (1) agriculture, forestry, animal husbandry and fishery, (2) mining, (3) manufacturing, such as printing, nuclear fuel and nuclear radiation processing, processing of prepared traditional Chinese medicine products and production of Chinese patent drugs, (4) electricity, heat, gas and water production and supply (5) wholesale and retail of tobacco leaves, cigarettes, re-dried tobacco leaves and other tobacco products

(6) transportation, warehousing and postal services, (7) information transmission, software and information technology services (8) financial services, (9) legal services, consulting and survey, (10) scientific research and technical services, (11) water conservancy, environment and public facilities management, (12) education, (13) health and social work, (14) culture, sports and entertainment.

In prohibited sectors foreign investors are denied investments at all. The following industries or items are not prohibited for foreign investment, but restricted: (1) the selection and breeding of new varieties of wheat and corn, as well as the production of seeds, (2) exploitation of oil and natural gas, (3) printing, (4) auto manufacturing, (5) nuclear electricity, (6) pipeline and network facilities, (7) air cargo and passenger transport, general aviation service, airports, (8) telecommunications services, (9) capital market services and insurance industry, (10) marketing research, (11) health, (12) cinema, (13) performance brokerage.

To enter a restricted sector listed in the Negative List, foreign investors have to apply for market entry license, i.e. get approval from different Chinese authorities such as the Commission of Commerce, the National Development and Reform Commission. It is the first time the Chinese government sets out investment guidelines clearly in the form of this Negative List. Compared to the previous *Catalogue of Industries for Guiding Foreign Investment published* in 2017, the Negative List relaxes several investment restrictions. With regard to financial industry, foreign shareholding ratio restrictions in the banking industry were canceled. Foreign shareholding ratio has been raised to a limit of 51% in security companies, security investment fund management companies, futures companies, and life insurance companies. According to statements Chinese government, all restrictions in the financial industry,

including the foregoing shareholding ratio limit, are planned to be cancelled by 2021.

The Negative List, as stated by the Chinese government, should be understood as a result of the commitment to an opening-up policy for foreign investments shows China's determination and effort to reform the regulations on foreign investments as well as push more local industries to enter into market competition.

Within the strategy of development of the Middle and the West of China, the government has also enacted the *Advantageous Industries Catalogue for Foreign Investment in Middle and Western Regions* to implement preferential policies for foreign investment in the middle and the western regions.

### **1.9 Liberalization of Company Law**

The latest version of the Company Law, published in 2018, effective as of October 26<sup>th</sup>, 2018, brought significant changes to the existing company administration system including the abolishment of an all-industry minimum registered capital requirement, the time limit for capital contribution, the mandatory ratio of cash contribution and the capital verification requirement. It also carried out the transformation from the annual inspection system to the annual self-report system. In general, the company establishment procedure has been simplified and the control over companies has been loosened. The reform reflects the trend of turning companies into a more self-responsible and self-disciplined actor in a market economy.

Other changes for the purpose of alleviating burdens caused by outdated administrative measures have taken place ever since the liberalization of the Company Law. Particularly, the three principal corporate certificates: the Business License, the Organizational Code Certificate and the Tax Registration Certificate were consolidated into one integrated Business License with a 9-digits unified social credit code on June 23<sup>rd</sup>, 2015. This means that instead of dealing with various authorities to obtain different certificates after the approval of MOFCOM, foreign invested companies only have to go through formalities with the AIC. Such change has already reduced the time and costs for foreign investors. From an administrative point of view, a consolidated business license with a unified social credit code will also enable the administrators to keep a clear and consistent credit record of each company.

### **1.10 Future Tendencies**

The PRC declared, it will continue to improve the political and legal environment for foreign investment, and to enhance quality and transparency of all administrative levels. China is further expected to continue to improve its legal system, subject to ongoing reforms.

Recently Chinese authorities stated that factors, such as optimization of resource efficiency, environment protection and production safety, will be given more significance. Therefore, a series of laws, regulations and national standards were or will be promulgated.

To further expand liberalization and incite foreign investment, the Standing Committee of the National People's



Congress of PRC is currently deliberating on a Draft Foreign Investment Law (Draft Law). The new Draft Law is supposed to integrate three FIE laws (WFOE Law, EJV Law and CJV Law) and the Negative List to provide a clear and stable legal environment for foreign investment. The new Draft Law shows a tendency towards a more equal treatment of domestic and foreign investment in the non-restricted and non-prohibited industries in comparison with the current legal provisions. At the present time it is still unknown if and when the Draft Law will be adopted and become effective.

The Shanghai Free Trade Zone (FTZ), which was officially launched in 2013, is an attempt of China to further open its economy. The Shanghai Free Trade Zone, built on the four existing Bonded Areas, features the opening of the service industry (a “negative-list” mode has been adopted by which the industries that are not listed will be fully open to foreign investment), the simplification of the company establishment procedure (filing for record, instead of approval by MOFCOM) and reform in financial industry (e.g. free convertibility of Chinese Yuan Renminbi (RMB) under the capital account in 2021), and so on.

The guiding principle for building up free trade zones with international standards is to learn lessons and get a deeper understanding, to later extend the reform and opening nationwide. So far, the liberalizations have progressed slower than expected, particularly in the financial sector.

On June 21<sup>st</sup>, 2018, the Management Committee of the China (Shanghai) Pilot Free Trade Zone published the *Opinions of the China (Shanghai) Pilot Free Trade Zone on Further Liberalizing the Financial Services Industry*

*and Forming New Competitive Edges of Development and Opening-up (Opinions)* to further attract foreign investment in the financial industry in Shanghai FTZ. According to these Opinions, several new policies were announced to attract foreign investment in financial industries, e.g. FTZs support the establishment of foreign-controlled securities, funds, futures and life insurance companies, support foreign banks to set up sub-branches and branches, support foreign banks and foreign-invested insurance companies to expand their business scope. These policies are pilot measures only apply to enterprises established in Shanghai FTZ.

### **1.11 Responsible Authorities**

Generally, the Ministry of Commerce (MOFCOM) is the central government authority that examines and approves the establishment of FIEs with foreign contributions exceeding certain amounts, or engaged in certain restricted business areas, or in businesses subject to quotas and specific licenses. The responsible division within MOFCOM is the Department of Foreign Investment Administration.

After the MOFCOM has issued the relevant approvals necessary, the State Administration of Industry and Commerce (SAIC) or its branch offices at the provincial or municipal level (AIC) will be in charge of recording and registering the essential information of the established FIE. Subsequently, a business license will be issued to the FIE, indicating the completion of the establishment process. Any further changes of the information recorded and registered are subject to application or filing process with the SAIC or the AIC.

In this context, it is also worth noting that certain foreign investments in restricted areas where a controlling Chinese partner is mandatory are subject to a further confirmation procedure with the PRC State Council or provincial and municipal government, depending on the total volume of such foreign investments.

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## 2. Customs and Foreign Trade System

### 2.1 Chinese Foreign Trade System

#### 2.1.1 Foreign Trade Regulatory Regime

The Chinese foreign trade regime rests primarily in *the Foreign Trade Law of the People's Republic of China*, last amended on November 7<sup>th</sup>, 2016. As the main legal basis for foreign trade in China, it provides regulations in mainly the following aspects:

- The scope of foreign trade operators: any legal person, organization or individual can act as foreign trade operators. According to *the Measures for the Record Filing and Registration of Foreign Trade Business Operators* promulgated by the Ministry of Commerce (MOFCOM), which became effective on July 1<sup>st</sup>, 2004, foreign trade operators engaged in the import and export of goods or the import and export of technology must register with the MOFCOM or its authorized institution. In addition, if an entity imports or exports goods as consignee or consignor, it must register with the local customs according to *the Administrative Provisions of the Customs of the People's Republic of China on the Registration of Customs Declaration Entities*, last amended on May 29<sup>th</sup>, 2018.
- Import and export of goods and technologies: items imported to or exported from China need to proceed through customs clearance. Certain items may be restricted; hence import/export of such items demand a

valid license. Import and export of items may require a valid license or can only be upheld with respect to certain quotas. The government publishes a list of goods restricted or prohibited from import/export on an annual basis.

- International service providers are generally granted market access and will be treated like national providers. However, the Chinese government still has considerable room for limitations when it comes to the regulation of international service providers.

### 2.1.2 *Customs Clearance Procedure*

The current customs system and the import and export tariffs are based on *the Customs Law of the People's Republic of China* and the relevant regulations. China applies different import and export tariffs.

Clearance must be applied within a certain period of time. Import customs clearance generally must be applied for within 14 days after the declaration of arrival of the transportation vehicle in China. Exporting goods have to be declared within 24 hours at the customs supervision areas before exporting. While applying for customs clearance, the applicant is supposed to submit a series of documents, such as import license, commercial invoices, bill of lading, packing list or purchase contracts, certificate of origin, commodity inspection certificate and so on. Under certain circumstances, foreign trade operators may request early release of their goods from customs by providing a specific guarantee.

With regard to trade with Switzerland, *the Free Trade Agreement between the People's Republic of China and the Swiss Confederation* (FTA), effective as of July 1<sup>st</sup>, 2014, provides various tariff reductions, some of which will enter into force gradually within the next few years.

Chinese industrial products that meet the rules of origin will be allowed to enter the Swiss market without tariff; most of the industrial products exported from Switzerland to China will enjoy full or partial tariff reductions following the effectiveness of the FTA, however, some tariff reductions will be achieved in 5-10 years from then, also under special circumstances, such reductions have to wait to be achieved in 12-15 years. Concerning agricultural products, Switzerland offers generally preferential tariffs for various products imported from China; while China reduces or exempts tariffs on certain basic agricultural products (e.g. cheese, butter, yoghurt and so on) and processed agricultural products (e.g. chocolate, jam, wine and so on) imported from Switzerland. The FTA also applies to the Principality of Liechtenstein as it forms a customs union with Switzerland.

### 2.1.3 Processing Trade

Goods imported for processing trade (i.e. goods that will be re-exported after being transformed in China) are not subject to customs duties. However, foreign investment enterprise (FIEs) which intend to be engaged in processing trade should handle the procedures of record keeping at the customs and obtain a registration manual for processing trade.

In recent years, Chinese government frequently updated *the Prohibition and Restriction Lists of Commodities for Processing Trade*, latest version amended in 2015. As the goods that are listed on the prohibition list of processing trade, however, still can be imported under the general trade customs category, companies active in processing trade are not allowed to import them, even if they are willing to pay customs duty and import value-added tax (VAT). The prohibition of goods is one measurement amongst many the Chinese government applies to restrain that part of the processing industry that engages in labor intensive, low value-added processing trade and follows its stated goal to shift the industry towards the processing of higher technology goods.

#### 2.1.4 Bonded Zones

In principle, goods shipped into bonded zones are not subject to import customs duty and import VAT, as they are not deemed imported. Import customs duty and VAT will become payable only when the goods are transported into areas that are within China but outside of the bonded zones. Furthermore, products that are manufactured in the bonded zones are exempted from export duty when they are exported. Consequently, bonded zones are mainly used for foreign trade, logistics, warehousing and processing trade. In Shanghai, the above is applicable on the bonded zones in Shanghai Pilot Free Trade Zone that unifies the four former bonded zones.

#### 2.1.5 VAT Refund

Pursuant to applicable regulations promulgated by the Ministry of Finance and the State Administration of Taxation

(SAT), entities or individuals who conduct goods-selling are required to pay the VAT. A taxpayer is allowed to offset the qualified input VAT paid on taxable purchases against the output VAT chargeable on the revenue from services provided.

FIEs that export goods manufactured in China can apply for VAT refund on a monthly basis at the respective customs. However, to qualify as a VAT tax payer and enjoy the VAT refund, local approval authorities in charge of foreign direct investment can set certain requirements for the registered capital of the FIEs. Furthermore, VAT refunds in China can be processed with considerable time-lags if the competent authority found there are doubtful points.

China has implemented *the Agreement on Customs Valuation* under the WTO by enacting the *Measures of the Customs of the People's Republic of China for the Assessment and Determination of Dutiable Value of Import and Export Goods* in 2006, which was further amended in 2013.

## 2.2 IPR Protection

China's system for IPR customs protection was established with the promulgation of the *Regulations on Customs' Protection of Intellectual Property Rights* (1995), which was lastly renewed in 2018. Meanwhile, a new implementing rule as *the Measures for Implementation* concerning the regulation was released in 2018.



At present, IPR subject to customs protection include the following:

- Registered trademarks as verified and approved by the China Trademark Office (except service trademarks);
- Trademarks registered internationally with the World Intellectual Property Organization (WIPO) and extended to China (except service trademarks);
- Patents for invention, for utility model and for design as granted by the National Intellectual Property Administration (CNIPA);
- Copyright and related rights as held by citizens or organizations of the member states under *the Berne Convention for the Protection of Literary and Artistic Works*.

The first consideration that IPR' owners should make is whether to record their IPR with the General Administration of Customs (GAC). The recording of trademarks, patents and copyrights serves as a notification on the conditions of the IPR. The IPR' owner has to provide details on whom to contact with in case of suspected infringement, and a picture or sample of the products and its packaging for the recording. While recording is not a precondition for customs protection, it provides the chance for the customs authorities to actively look for fake items being exported out of China and alert the owners of IPRs about possible infringements. For owners of trademarks and design patents, recording will be inexpensive. It will last for an extendable ten years and will ensure that an owner can use customs protection should the occasion arise. For invention and utility model patent rights, recording is less relevant since customs will unlikely detect infringements during their daily supervision of imported and exported goods.

However, for active protection, such recording can still be useful.

Customs protection falls into two distinct categories: passive protection, which relates to customs taking measures in response to an IPR' owner's request; and active protection, in which customs investigates and disposes of infringing goods on their own initiative. Most cases until now still fall into the first category. However, customs are now becoming more inclined to actively investigate infringements. If more active investigations are taken, IPR' owners will be expected to have fewer challenges to overcome.

### **2.3 Future Tendencies**

Starting from early 2018, with the announcement of U.S. President Donald Trump to impose new import duties on Chinese products and China's likewise reaction, China and the U.S. have entered into a trade war. Since then, both China and the U.S. have imposed additional tariffs. Foreign trade enterprises in China that especially rely on the trade business with the U.S. are to be affected the most during the trade war. Though, temporary negotiations between the two governments have been restarted recently, the outcome of this trade war at present is unforeseeable.

### **2.4 Responsible Authorities**

The General Administration of Quality Supervision, Inspection and Quarantine of the People's Republic of China is responsible for the inspection of imported goods; the Customs General Administration is the competent authority for

the supervision and control over import and export, and the collection of customs duties.

**General Administration of Quality Supervision, Inspection and Quarantine**

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**General Administration of Customs**

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### 3. Taxation

#### 3.1 Major PRC Taxes Affecting Foreign Investors

For the past years, China has several tax reforms including changing business tax to the value-added tax and consolidation of state and local taxes. Generally, foreign investors are subjected to the same taxes as the Chinese investors.

##### 3.1.1 *Value Added Tax (VAT)*

Value added tax (VAT) in China applies to all individuals and enterprises that are engaged in sale of goods or processing, repair and assembly services, sale of services, sale of intangible assets such as know-how or intellectual property rights and so on, real estate and generally import of goods.

There is no difference in the VAT rate for foreign invested enterprises and Chinese invested enterprises. In general, the VAT rate for engaging in sale of goods, services, lease of tangible movables or importation of goods is 16 %. The VAT rate for engaging in sale of services and intangible assets is generally 6 %. The tax rate for taxpayers engaging in sale of transportation, postal, basic telecommunications, construction, lease of real estate, sale of real estate, transfer of land use rights, sale or importation of the following goods is 10 %. Generally, there is no VAT for those engaging in exportation of goods, unless otherwise stipulated by the State Council.

Goods sold or services provided by certain small-scale taxpayers are taxed at a special VAT rate of 3 %, unless otherwise stipulated by the State Council. According to the *Notice on Harmonizing the Criteria for Small-scale VAT Payers* which became effective on May 1<sup>st</sup>, 2018, companies with an annual sale of RMB 5 million or less subject to VAT will be qualified as small-scale taxpayers. Furthermore, for the small-scale VAT payers whose monthly sale volume is less than RMB 100'000, the VAT is exempted.

### 3.1.2 *Foreign Enterprise Income Tax*

The 2008 reform of the *Chinese Enterprise Income Tax Law* has unified the tax rates for FIEs and domestic enterprises. Since then, the general unified tax rate of enterprise income is 25 %. A non-resident enterprise which has no office or premises established in China, or in case it has an office or premises in China, but the income derived or accrued has no de facto relationship with the office or premises established, should pay the corporation income tax as the rate of 20 %.

Small enterprises with small profits enjoy a special tax reduction and exemption policy if they are engaged in industries which are not restricted or prohibited by the state, and if they meet the following three conditions:

- annual taxable income is not exceeding RMB 3 million,
- number of employees is not exceeding 300, and
- total assets are not exceeding RMB 50 million.

Such policy stipulates that, the part of the amount of taxable income which is less than 1 million will be reduced to 25 % of the original amount for tax calculation and will be taxed at a reduced tariff of 20 % - for the annual taxable amount which exceeds 1 million RMB but is less than 3 million RMB, it will be reduced by 50 % of the original amount for tax calculation and will be subject to a reduced income tax tariff of 20 %.

The enterprise income tax on important high- and new-tech enterprises supported by the state shall be levied at the reduced tax rate of 15 %. High- and new-tech enterprises supported by the state mean enterprises which own core independent intellectual property and satisfy the following conditions: (1) the products (and services) must fall under the scope stipulated in the key advanced and new technology industries supported by the state, (2) the ratio of research and development expenses to the sales revenue must not be lower than the stipulated ratio, (3) the ratio of revenue from advanced and new technology products (and services) to total revenue of the enterprise must not be lower than the stipulated ratio, (4) the ratio of technical personnel to all employees of the enterprise must not be lower than the stipulated ratio, and (5) any other conditions stipulated in the identifying and administration measures for advanced and new technology enterprises must be satisfied.

### 3.1.3 *Individual Income Tax*

According to the new *Individual Income Tax Law of the PRC* and the *Implement Regulations of the Individual Income Tax Law*, both effective as of January 1<sup>st</sup>, 2019, application of individual income taxes for foreigners in China has changed significantly. At the time this chapter was written, no reliable practices on the authorities'

application of the new provisions were available. However, most common scenarios a foreigner could find himself confronted with in China can be described as follows:

- *Scenario 1*: Individuals who have a domicile in China, will be deemed a resident individual and income derived by resident individuals from China and overseas will in principle be subject to individual income tax.
- *Scenario 2* referring to individuals who do not have a domicile in China (split up in scenarios 2.1 – 2.4):
  - o *Scenario 2.1*: Individuals who have resided in China for 183 days or more cumulatively in a tax year for six consecutive years or more, in principle, their income derived in China and overseas will be subject to individual income tax. Consecutive years will be interrupted and counting starts again each time a foreigner leaves China for more than 30 days in a row.
  - o *Scenario 2.2*: Individuals who have resided in China for 183 days or more cumulatively in a tax year for less than six consecutive years, their foreign sourced income paid by an overseas organization or individual can be exempted from individual income tax.
  - o *Scenario 2.3*: Individuals who resided in China for not more than 90 days cumulatively in a tax year, his/her income sourced in China which is paid by his/her overseas employer and not borne by the employer in China shall be exempted from individual income tax.
  - o *Scenario 2.4*: Individuals who resided in China for more than 90 days, his/her income derived from China will be subject to income tax.

Income is taxed at different rates depending on the nature of the income. Whereas wage income, business income, and management fees are subject to progressive taxation, some other types of income such as remuneration for professional services and rent, royalties, interest and dividends are taxed at a flat rate.

In the case, a foreign country/region entered an effective double-taxation agreement with China, certain income tax will be exempted according to the agreement.

#### *3.1.4 Urban Maintenance and Construction Tax (UMCT) and Education Surcharges (ES)*

Since December 1<sup>st</sup>, 2010, UMCT and ES are imposed on foreigners who are obliged to pay any one of the so called “Three Taxes” which are: value-added tax, consumption tax and business tax. However, due to the tax reformation, the business tax was combined with value-added tax and is not imposed separately anymore. Thus, every taxpayer who is obliged to pay either the value added tax or the consumption tax, will be imposed to pay the UMCT and ES.

Regarding the rates for UMCT on the total amount of the actual paid value-added tax and consumption tax are as follows: 7 % for taxpayers located in urban areas, 5 % for taxpayers located in counties or townships and 1 % for taxpayers located in areas other than urban area, counties and townships.

The education surcharges shall be collected at the rate of 3 % of the total amount of the actually paid value-added tax and consumption tax.



### 3.1.5 *Main Other Taxes*

Other main taxes levied in China are amongst others: consumption tax, agriculture tax, stamp duty, deed tax, land appreciation tax, urban property tax, vehicle and vessel use tax, taxes on luxury goods, slaughter tax, tax on tonnages of ships, vehicle purchase tax and resource tax.

## 3.2 **Tax Incentives for Foreign Direct Investment (FDI)**

Tax incentives are mainly available for company income tax, import duty and VAT. In particular, imported equipment of qualified Foreign Investment Enterprises (FIE) within the range of their total investments may be exempted from VAT. Since the new *Chinese Enterprise Income Tax Law* became effective in 2008, tax incentives for FDI are no more aimed at the investing subject and the place where the investment takes place, but rather on the industry the investment flows into, regardless of the origin of the capital. In other words, preferential treatments in enterprise income tax are granted to the important industries and projects of which the development is supported and encouraged by the state.

## 3.3 **Tax Authorities**

In the first half year of 2018, China decided to merge its two-tax system into one. Before that, there were two different tax systems: The national Tax Bureau and the Local Tax Bureau. All the tax-related duties and power are

now uniformly executed by the State Administration of Taxation (SAT).

The SAT is a ministry-level department under the direct leadership of the State Council, which is responsible for drafting the tax-related regulations and making policy suggestions regarding tax and tax collection, administration of central tax and shared tax as well as other tax related stipulations.

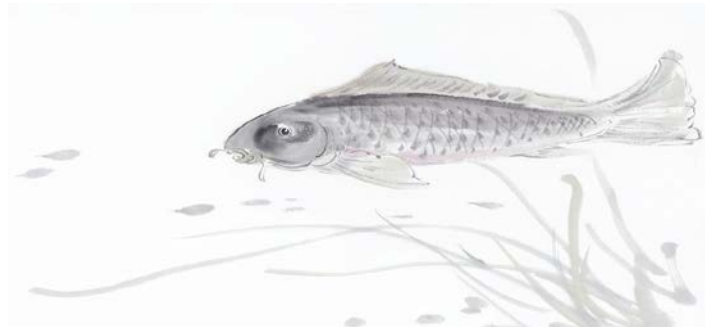
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## 4. Capital Markets

### 4.1 Overview

Since its opening up from around 20 years ago, China's capital market is now best described as emerging. The WTO also opened the door to foreign participation in China's capital market. A number of new regulations issued since 2002 have made it possible for foreign firms to establish joint-venture fund management companies as well as securities companies. In addition, a Qualified Foreign Institutional Investor (QFII) scheme was introduced to permit major foreign financial institutions to invest directly in the domestic bond and equities markets. In 2014, the State Council has issued a roadmap for the ongoing reforms of the capital market, which outlines goals such as further loosening restrictions on shareholding of foreign investors in listed companies, increasing the allowance for foreign investors' participation in the securities and futures industry, and steadily opening the domestic capital markets in order to allow foreign individuals to directly invest in the Chinese capital market while also promoting investment in overseas capital markets by domestic individuals.

In November 2014, the Shanghai-Hong Kong Stock Connect Program was launched. With the program, investors in Hong Kong and Mainland China can trade and settle shares listed on the two separate markets via the exchange and clearing house in their home market. In December 2016, the Shenzhen-Hong Kong Stock Connect Program followed. However, these programs still have a quota system in place to control the initial pace and size of cross-boundary fund flows. Besides the programs mentioned before, China and the UK officially launched the

Shanghai-London Stock Connect Scheme in the end of 2018 that allows the dual-listed companies to issue depository receipts to be traded on the other market. Due to the stated goal of broader opening of the Chinese financial market, more such programs that provide easier access for investments in cross-border financial instruments by multi-places market investors can be expected in the future.

## 4.2 Fund Management Companies

According to Article 10 of *the Measures for the Administration of Securities Investment Fund Management Companies*, the cumulative proportion of capital contribution or cumulative proportion of rights and interests owned (directly and indirectly) by the foreign party in a Sino-foreign joint venture fund management company cannot exceed those proportion in the commitment made by the State on securities industry for opening to the outside world. Under *the Special Administrative Measures (the Negative List) for the Access of Foreign Investment (2018)*, the current stake of foreign participation in fund management companies is a maximum investment of 51 %. According to *the Negative List*, this restriction on foreign stake should be canceled in 2021.

Where the establishment of a fund management company is approved by the China Securities Regulatory Commission (CSRC), the applicant should undergo registration formalities at the administrative department for industry and commerce within 30 days after receiving the approval documents; and receive a Fund Management Qualification Certificate from the CSRC based on the Business License for a Legal Person Enterprise issued by the administrative department for industry and commerce. A fund management company in the form of a

Chinese-foreign equity joint venture has to apply for a Certificate of Approval of a Foreign-funded Enterprise and open a foreign exchange capital account.

### **4.3 Securities Companies**

According to *the Negative List*, the maximum foreign participation in a securities company has been changed to be 51% of the registered capital. With this further opening up in foreign stake in securities companies, the CSRC released *the Measures for the Administration of Foreign-Funded Securities Companies* in April 2018.

Foreign shareholders in a foreign-funded securities company must have been engaged in securities business for at least five consecutive years and must not have received any major punishment from a regulatory authority, administrative agency or judicial authority in the country or region where it is located in the recent three years. Furthermore, it must not be under investigation by the relevant authority on suspicion of any major violation of a law or regulation. Also, all the financial indicators of such foreign shareholder must conform to the provisions of laws and the requirements of the regulatory authorities of the country or region where it is located in recent three years.

### **4.4 Qualified Foreign Institutional Investors (QFII)**

In December 2002, QFII regulations were enacted, allowing foreign institutions who meet certain qualification to

invest in the China's securities market. Once licensed by CSRC, with quota approved by the State Administration on Foreign Exchange (SAFE), foreign institutional investors are permitted to buy RMB denominated A-shares and some other RMB-denominated securities in China's mainland securities market.

*The Measures on the Administration of Domestic Securities Investment by Qualified Foreign Institutional Investors* (Measures) came into force as of September 2006. The Measures provides a better legal environment for QFII investing in the Chinese market and is therefore considered to be propitious for QFII to actively participate in the reform and development process of the Chinese capital market. The Measures are also in favor of dispersing financial risks. In 2012, CSRC promulgated the implementation of the Measures that allows more institutions to gain QFII status and provides facilitation in execution of their investments. In 2016, SAFE issued *the new Provisions on Foreign Exchange Control for Securities Investments in China by Qualified Foreign Institutional Investors*, which broadens the limitation of investment quota of a QFII.

Additionally, the *RMB Qualified Foreign Institutional Investor* (RQFII) scheme was established in 2011 as a policy initiative that allows foreign investors who hold the RQFII quota to invest directly in Mainland China's equity and bond markets using offshore RMB.

#### **4.5 Stock Market**

At present, China's stock market has formed a multi-tier capital market structure that includes the exchanges stock

market and the OTC (over-the-counter) stock market.

The exchanges stock market includes the Main Board, the SME Board, and the ChiNext. The Main Board mainly locates large and mature enterprises, while the SME Board locates the small and medium-sized enterprises in traditional industry. To be listed on the Main Board or the SME Board, the issuer is required to be with positive net profit in the last three consecutive years, the aggregate value of which is no less than RMB 30 million; meanwhile with accumulated revenue in past three years no less than RMB 300 million, or with accumulative net operating cash flow no less than RMB 50 million.

After 10 years of preparation, China launched ChiNext on October 30<sup>th</sup>, 2009, otherwise known as “Growth Enterprise Market” or “Second Board” in Shenzhen. This is a NASDAQ-style board that aims to nurture small and medium-sized growth companies in the country and provide them financing channels. Unlike the standards required by the Main Board and the SME Boards, the issuer will be deemed qualified if it has been profitable for two consecutive years prior to listing with accumulated net profits of at least RMB 10 million, or the issuer has been profitable for the last one year with positive revenue in last one year no less than RMB 50 million. The opening of ChiNext has had clearly positive effect on the development of China’s small and medium-sized enterprises (SMEs), which are often overlooked when it comes to domestic funding routes.

The OTC stock market mainly includes the National Equities Exchange and Quotations (NEEQ), namely the New Third Board, and the regional equity trading center, commonly known as the Fourth Board. The New Third Board

locates innovative, entrepreneurial, growing small and medium-sized enterprises. The regional equity trading center, as a financing center for small and micro enterprises, is committed to the cultivation and regulation of small and medium-sized enterprises and at the same time, extends the intermediary service function of the capital market.

In contrast to the above-mentioned Chinese stock market which is based on an examination and authorization system upon public offering, a new Science and Technology Innovation Board will be established to introduce a registration-based IPO system in mainland China. Recently, on January 30<sup>th</sup>, 2019, the CSRC has published *Management Measures* for a trial implementation of such a system.

#### **4.6 Foreign Strategic Investments in Listed Companies**

According to *the Measures for the Administration of Foreign Strategic Investment to Listed Companies*, lastly revised on October 28<sup>th</sup>, 2015, strategic investment in the listed company by foreign investors is one approach to obtain the A share stock of the listed companies that have completed the share-trading reform and the newly listed companies after the share-trading reform through a scale of medium and long-term strategic merger investment. A foreign investor can, by way of subscribing to a private placement of A-shares or entering in a share transfer agreement with shareholders, carry out a strategic investment in one listed company.

Previously, such strategic investment must be approved by the Ministry of Commerce (MOFCOM). However, the exposure draft of *the Measures for the Administration of Foreign Strategic Investment to Listed Companies* released



on July 30<sup>th</sup>, 2018, seems to relax such approval request and cancel the approval of the MOFCOM when the strategic investment is not engaged in *the Negative List*.

#### 4.7 Acquisition of Domestic Enterprises

*The Provisions on Acquisition of Domestic Enterprises by Foreign Investors* which was latest revised on June 22<sup>nd</sup>, 2009, defined the approaches and procedures to acquire the equity or assets of domestic enterprises. Acquisitions on domestic enterprises must be carried out in accordance with the special measures specified in *the Negative List* for foreign investors. As to the foreign-funded enterprise established after takeover by a foreign investor, if the foreign investor's proportion of investments exceeds 25 % of the registered capital of this enterprise, this enterprise will be entitled to enjoy the treatments to foreign-funded enterprises.

When the acquisition of Chinese domestic enterprise involves any important industry, any transfer of the actual controlling power of a domestic enterprise which holds a famous trademark or China Time-honored Brand, has or may have impact on the national economic security, the parties concerned must file an application with the MOFCOM.

If the acquisition reaches the threshold set forth in *the Anti-Trust Law* and relevant implementation measures for anti-trust notification, the acquisition must be submitted to MOFCOM for notification. MOFCOM has the discretion to conduct an in-depth anti-trust scrutiny if it considers there is a risk of eliminating or reducing competition by the

acquisition. Currently, if the takeover of a domestic enterprise by a foreign investor falls under any of the following circumstances, the investor has the duty to report the relevant information to the MOFCOM and the State Administration for Industry and Commerce (SAIC):

- The current-year business volume of any party to the takeover in the Chinese market exceeds RMB 1.5 billion,
- The foreign investor has accumulatively taken over more than 10 enterprises in the domestic relevant industries,
- The market share of any party to the takeover has reached 20 % in China, or
- The takeover leads to the fact that the market share of the party to the takeover has reached 25 % in China.

Pursuant to *the Provisions of the Ministry of Commerce on Additional Restrictive Conditions for the Concentration of Business Operators (for Trial Implementation)*, became effective on January 5<sup>th</sup>, 2015, for the concentration of business operators that is not prohibited, the MOFCOM has the power to impose additional restrictive conditions to reduce the adverse impacts on competition. Such additional restrictive conditions include:

- Structural conditions including disinvestment of tangible assets, intellectual property rights and other intangible assets or corresponding rights and interests,
- Behavioral conditions including granting access to infrastructures as network or platform, licensing of key technologies (including patents, proprietary techniques or other intellectual property rights), and termination of exclusive agreements, or

- Hybrid conditions that combine structural conditions and behavioral conditions.

#### **4.8 Future Tendencies**

The State authorities constantly follow a policy of opening the capital market, though they maintain many restrictions considered to be crucial for a sound development in this area. A circular of the CSRC calls on domestic listed companies to reveal information actively which could be interesting for direct investment by foreign invested enterprises in these companies. Listed companies are asked to create an account of their business activities that can attract attention of foreign invested enterprises and promote a better mutual understanding. In doing so, listed companies are supposed to regard especially the needs of small and middle-sized investors.

China is currently continuing a share structure reform of state-owned enterprises for the purpose of allowing shares to float on the market. But the government will still hold a controlling position as a shareholder in enterprises that are considered to be of crucial interest for the national economic development.

## 4.9 Governing Authority

The China Securities Regulatory Commission (CSRC) is the dominating regulatory body over China's capital market.

### CSRC

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## 5. Foreign Invested Banks

### 5.1 Overview

In November 2014, China published its updated *Administrative Regulations for Foreign Invested Banks* (Regulations) effective as of January 1<sup>st</sup>, 2015. It further stipulates the establishment, scope of business, supervision and administration and other related matters of the foreign invested banks in China.

### 5.2 Legal Forms of Foreign Invested Banks

The following choices are available for foreign banks or financial institutions in establishing a business presence in China: 1) a representative office; 2) a branch of the foreign bank; 3) a wholly foreign owned bank; and 4) a joint venture bank with Chinese companies and enterprises. The options 2), 3) and 4) are deemed as foreign-funded banking business institutions since they are entitled to do banking business in China after getting approval. While the representative offices are not allowed to do banking business in China.

Wholly foreign owned banks and joint venture banks can provide apart of or full range of banking services including deposit service to Chinese natural persons. However, a foreign bank's branch is not allowed to offer RMB deposit services to Chinese natural person customers - except receiving deposits each with a value of no less than RMB 1 million (roughly USD 145'922). The capital requirement for a wholly foreign owned bank or a joint venture bank is

RMB 1 billion and the registered capital must be fully paid-in.

Another alternative is a joint venture with a local bank, which is usually implemented by acquiring shares in a Chinese bank. One of the advantages of such a strategy is that the existing networks of the Chinese bank can be accessed. Also, according to *the Special Administrative Measures (Negative List) for the Access of Foreign Investment (2018)*, restrictions on the number of shares allowed to be held by a foreign financial institution (including its affiliates) has been canceled.

### **5.3 Approval Procedures**

The establishment of any of the aforesaid business presence has to be first approved by the China Banking Regulatory Commission (CBRC), the supervisory authority over the banking sector in China.

A two-stage process is imposed by CBRC on any application for opening a bank branch and subsidiary bank in China. The establishment application shall be first filed and CBRC will decide whether it approves or not within 6 months. Upon physical establishment, the bank should file its operation application and CBRC will decide whether to give operation license or not within 2 months.

## 5.4 Governing Authority

The China Banking Regulatory Commission (CBRC) is the dominating regulatory body over China's banking sector.

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## 6. Foreign Exchange

### 6.1 Renminbi & Foreign Exchange Risk

The value of the Chinese Yuan Renminbi (RMB) against foreign currencies may fluctuate and is affected by, among other things, changes in political and economic conditions in China and by China's foreign exchange policies. Since investments in China will receive revenues in RMB, significant revaluation of the RMB will have material effect. Further, the currency exchange losses during the operation will be magnified by Chinese exchange control regulations that restrict the ability to convert RMB into a foreign currency.

On July 21<sup>st</sup>, 2005, the Chinese government changed its decade-old policy of pegging the value of the RMB to the U.S. dollar (USD). On November 30<sup>th</sup>, 2015, the Executive Board of the International Monetary Fund (IMF) completed the regular five-year review of the basket of currencies that make up the Special Drawing Right (SDR), and decided that with effect from October 1<sup>st</sup>, 2016, the RMB would be included in the SDR basket as a fifth currency, along with the USD, the Euro, the Japanese yen and the British pound sterling.

### 6.2 Foreign Exchange Administration Overview

The Chinese government imposes controls on the convertibility of the Renminbi into foreign currencies. In certain cases, the remittance of currency out of China is restricted. The principal regulations governing foreign currency exchange in China is *the Foreign Exchange Administration Regulations*, lastly amended on August 5<sup>th</sup>, 2008. Under



the Foreign Exchange Administration Regulations, payments of current account items, such as profit distributions and trade and service-related foreign exchange transactions can be made in foreign currencies without prior approval from State Administration of Foreign Exchange (SAFE), if the payments comply with certain procedural requirements. However, approval from or registration with responsible government authorities is required where RMB is converted into foreign currency and remitted out of China to pay capital expenses such as the repayment of foreign currency-denominated loans.

### **6.3 Individual Foreign Exchange**

Individual foreign exchange, foreign exchange revenue and expenditure under current account are divided into two groups. On the one hand business transactions, such as the settlement of foreign exchange under the item of tourism and shopping or purchases, payments, collections and settlements of foreign exchange handled by an individual foreign trade operator and on the other hand non-business transactions, such as donations, income from legacy inheritance, income from insurances, income from royalties or license fees for exclusive rights.

According to *the Detailed Rules for Implementation of the Measures for the Administration on Individual Foreign Exchange*, the total annual amount must not exceed the value equivalent to USD 50'000 each year for each person. Foreign exchange purchased by an individual may be remitted abroad, deposited into his or her foreign exchange savings accounts or carried out of the territory of China in line with the related provisions.

In addition, for the stated purpose of combating money laundering, financing of terrorism and tax evasion, the government's *Notice of the State Administration of Foreign Exchange on Regulating Bank Card Transactions Involving Overseas Cash Withdrawals in Large Amounts* became effective from January 1<sup>st</sup>, 2018. An individual may withdraw cash overseas not exceeding the equivalent of 100'000 RMB in total each calendar year with his or her domestic bank cards (including additional cards). If the annual quota is exceeded, the individual will be suspended from overseas cash withdrawals with his or her domestic bank cards in the current year and in the following year. Individuals are prohibited to evade or assist in evading the administration of overseas cash withdrawals by borrowing others' bank cards or lending his or her bank cards to others.

Where an individual withdraws cash overseas with a domestic bank card, the cash withdrawal limit per foreign currency card per day has been increased from 1'000 RMB to an equivalent of 10'000 RMB. The cash withdrawal limit for RMB cards remains unchanged at an equivalent of 10'000 RMB per card per day.

#### **6.4 Enterprise Foreign Exchange**

Generally speaking, a foreign invested enterprise must open at least two accounts at bank for doing business in China. A capital account as the foreign exchange account used to collect overseas investment funds and to handle the settlement of funds and a basic deposit account as the RMB account used for the daily income and expenditure and deal with the revenue and expenses related to the capital account. The government monitors the cross-border capital flows under foreign direct investment mainly through the capital settlement in the foreign exchange account.

## 6.5 Anti-money Laundering

With the promulgation of *the Anti-money Laundering Law of the People's Republic of China*, the Chinese government showed efforts to enforce its combat on money laundering and safeguard foreign exchange order. In 2004 the *China Anti-Money Laundering Monitoring & Analysis Center* in 2004 was established. The work of this government office indicates a tougher stance on money laundering. The center is in charge of accepting and analyzing the reports on large sum transactions and doubtful transactions, of reporting the result of such analysis to the administrative department of anti-money laundering of the State Council and of performing any other function and duty as prescribed by the administrative department of anti-money laundering of the state council.

“*Anti-money laundering*” refers to an act of adopting the relevant measures according to the provisions of the present law to prevent any activity for the purpose of concealing or disguising the sources and nature of criminal proceeds generated from any drug related crime, organizational crime of any gangland, terrorist activities, smuggling, corruption or bribery, disruption of financial management order, financial fraud and so on.

According to this law, all financial and non-financial institutions incorporated within the territory of China shall be responsible for establishing procedures and systems to combat money laundering. The law also stipulates that information, such as commercial secrets gained from combating money-laundering, must be used only for legal investigation and litigation.

Where new financial institutions or new branches of existing financial institutions are established, an internal system of anti-money-laundering procedures and systems must be established. Actual and effective identity information about clients has to be recorded.

In addition, according to *the Notice of the State Administration of Foreign Exchange on the Submission of the Information on Overseas Transactions of Bank Cards by Financial Institutions*, domestic bankcard issuing financial institutions must collect the overseas transaction information concerning cash withdrawal and every single consumption transaction of domestic bank cards equivalent to at least 1'000 RMB.

## 6.6 Responsible Authority

The State Administration of Foreign Exchanges (SAFE) is responsible for the supervision and regulation over foreign exchange issues.

### SAFE

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## 7. Intellectual Property Rights

### 7.1 Overview

Foreign investors are often concerned about the protection of their intellectual property rights (IPR) in China. The IPR's protection regime of China consists of the *Trademark Law*, the *Patent Law*, the *Copyright Law* and the *Unfair Competition Law*. In addition, a set of implementation rules and legal interpretations have been promulgated to strengthen the protection in this area.

### 7.2 Trademarks

By virtue of a series of international conventions, of which China is a signing party, trademarks from the other signing parties of these conventions can be registered in China and after getting approval by the Chinese authority, such registration will enjoy the same protection as a trademark registered in China. In addition, a foreign trademark applicant from a signing country of the Paris Convention has the priority right to file for trademark protection in the China within six months after its filing proper application in its home jurisdiction. A foreign trademark from a signing country of the Madrid Agreement or Protocol can extend the protection of its IP rights to China by means of an international registration in Geneva and a separate request of extension.

Except for the applications through the Madrid channel, applications for trademark registration in China by foreign

entities or individuals must be made to the Trademark Office of National Intellectual Property Administration (CNIPA) through one of the officially designated trademark agents authorized to deal with trademark applications in China. A registration is valid for 10 years, commencing from the date of registration and can be renewed. Same as the registration, the renewal application by foreigners or foreign enterprises should entrust an authorized agency as well.

Trademark applications can be lodged for both goods and services. Trademark assignment must be approved by, and license agreements must be registered at, the Trademark Office of the CNIPA.

Once the trademark has been registered, exclusive rights to use a registered trademark are limited to the approved registered trademark and the commodities for which the trademark is approved for use. There are certain circumstances regulated by the law deemed as infringement of exclusive rights; some even constitute unfair competition. For licensed use of a registered trademark, the licensor should file record of the licensing of the said trademark with the Trademark Office, and the licensing should be published by the Trademark Office. A trademark license contract which has not been filed is legally valid, but it cannot be used to oppose third parties acting in good faith (e.g. in the case of an exclusive license).

### **7.3 Patents**

Patents in China include invention patents, utility models and design patents. The Patent Law allows foreign

applicants wanting to file a Chinese patent application to do so through any legally established patent agent firm.

Patent applications are governed by the first-to-file principle. According to the Paris Convention, if an application for an invention or utility model patent filed in another country that is also a member of the Convention, and such application was made within 12 months prior to the filing of an application in China, the original date of filing in the other country will be deemed as the filing date for China as well. For design patents the prior application must be made within 6 months prior to the application in China to enjoy the priority.

For the inventions completed in China, a secrecy examination procedure must be gone through before any patent filing is submitted to a foreign country (the requirement that the patent must be filed in China first was abolished in the 3<sup>rd</sup> revision). Failure to go through the secrecy examination will cause the patent not to be granted in China.

The substantive standards for granting a patent in China are not significantly different from those in most western countries, being “novelty”, “inventive step”, and “practical applicability”. One of the most important changes made in the 3<sup>rd</sup> revision of the Patent Law is the raise of the standard for novelty from “relative novelty” to “absolute novelty”, including the prior publications in a foreign country into the scope of “prior art”, against which the novelty of the technology or design is judged.

The procedures for examining the applications for invention patents and those for utility model patents and design patents are different. For the applications for invention patents, a substantive examination as to the qualification of

the invention will be carried out. For the applications for utility model patents and design patents, only a formal procedure as to the completeness of the application documents is to be gone through.

The term of protection of patents for invention is twenty years, subject to an annual fee, whereas the terms of protection for utility models and designs is ten years. As patent law systems of other countries, the patents granted in China are also subject to certain limitations, including mainly fair use and compulsory license.

The parties concerned should enter into a contract in writing for transfer of the rights to apply for patent or transfer of patent rights and process registration formalities with the patent administrative authorities of the State Council. The patent administrative authorities of the State Council will make a public announcement of the patent data. The transfer of the rights to apply for patent or transfer of patent rights will be effective from the date of registration. Patent license agreements should be registered at the respective Patent Offices within three months after its entering into force.

## **7.4 Copyrights and Software**

Works produced by foreign individuals and which is published in China first are protected by the Chinese Copyright Law. However, if the aforesaid works are first published in outside of China, the protection offered by Chinese Copyright Law is only granted under bilateral or multilateral agreements entered into between the home country or the country of habitual residence of the author and China or under international treaties to which the home country



or the country of habitual residence of the author and China are participants. Furthermore, unlike in Switzerland, copyrights can be registered in China and a corresponding certificate of copyrights can be obtained. The same applies to computer software. The advantage of such registration is that once a dispute arises or escalates into litigation, the registered copyrights and computer software are strong evidences for IPR that could be effectively applied during the litigations. The revision of the Copyright Law in 2010, as the only substantive change made, established that the pledge of copyright must be registered with the copyright administration department of the State Council.

For something to qualify as a “work”, (capable of being protected by copyright) it must be an intellectual creation that can be reproduced in tangible form in domains of literature, art and science and it must have originality. The term of protection for copyrights is usually the author’s life plus 50 years.

If the author is a legal person, e.g. a company, or the original copyright is otherwise granted to a legal person, the term of protection is fifty years after the work is first published. Besides, if the work has not been published within fifty years after the completion of such work, the related copyright cannot be longer protected by law.

Since May 2005, a liability of the net service providers for violation of copyrights by users has been stipulated by law. Owners of copyrights can claim providers to remove such content violating lawful rights of the owner. Providers who refuse to do so or know about unlawful content will be charged with fines. In January 2013, the Supreme People’s Court further published interpretations to offer more detailed guidance to the courts how to assess

net service provider's liability. The responsible authority for copyrights related issues is the State Copyright Administration.

## 7.5 Competent Authorities

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## 8. Land Use Rights

### 8.1 Overview of Land Use Rights

In China, the ownership of land belongs to either the state or the collectives of peasants. No unit or individual is allowed to occupy or illegally transfer land by other means. The law prohibits the transfer of the ownership of land between individuals or entities, with the exception that the state may, in accordance with certain rules and procedures, expropriate collective owned land in return of adequate compensation.

However, the principle of the ownership of land has to be distinguished from so called the land use right (LUR) which are, in general, transferable. Any company, enterprise, other organization and individual within or outside the People's Republic of China can, unless otherwise provided by law, obtain the LUR and engage in land development, utilization and management in accordance with the PRC laws.

### 8.2 Land Use Right on Different Type of Lands

Users of state-owned land in urban areas, who obtain a valid LUR can, within a certain period of time, transfer, lease, or mortgage the LUR or use it for other economic activities. Underground resources, objects buried underground, and the public works such as facilities for water supply are excluded from the scope of the LUR transfer.

LURs for land owned by peasant collectives cannot be leased, transferred or rented for non-agricultural

construction.

In addition, LURs can be restricted or terminated by the state. Out of the purpose of public interests, the state can make expropriation or requisition on land according to the law, such recover on land must be made with compensations accordingly.

### **8.3 Original Acquisition of Land Use Right**

Originally LURs are allocated for use by the state according to law (Allocation of LURs) or assigned by the state upon compensation (Assignment of LURs).

In the assignment of the LUR the state, as the owner of the land, assigns the LUR to land users within the term of a certain number of years and the users have to in turn pay fees for the assignment thereof to the state. The assignment of the LUR can be carried out by reaching an agreement through consultations, by invitation to bid, or by auction. An assignment contract must be signed for assigning the LUR.

Compared to the assigned LUR, an allocated LUR can only be acquired in accordance with the law and is granted free of charge or fees, and without compensation. The allocation of the LUR in some exceptional cases, applies to public welfare or national core projects, such as the land for use by government organs, for military, for building urban infrastructure and others. Generally, there is no contract on an allocated LUR and such allocated LUR cannot

be transferred, leased, or mortgaged without the approval from the government and upfront payment of fees to the government.

#### **8.4 Transfer of Land Use Right**

Investors may also purchase LUR from non-governmental entities (LUR Transfer). During the transfer of the LUR, the ownership of its above-ground buildings and other attached objects (includes basement, garage, attic and so on) must be transferred accordingly. Similarly, during the transfer of the ownership of the buildings and its attached objects, the LUR relative to the said buildings and objects must be transferred accordingly.

With respect to the transfer of the LUR and of the ownership of the above-ground buildings and other attached objects, registrations for the transfer must be undertaken by the parties.

#### **8.5 Term of Land Use Right**

Generally, there is no definite period for the allocated LUR, whereas the assigned LUR can be acquired by payment only for a definite period. The maximum term with respect to the assigned LUR has to be determined respectively in light of the purposes listed below:

- 70 years for residential purposes;
- 50 years for industrial purposes;

- 50 years for the purposes of education, science, culture, public health and physical education;
- 40 years for commercial, tourist and recreational purposes; and
- 50 years for comprehensive utilization or other purposes.

## 8.6 Land Use Tax

*The Interim Regulations of the People's Republic of China on Urban and Town Land Use Tax (Interim Regulations)* was revised on December 2013. According to *the Interim Regulations*, units, such as enterprises, institutions, state organs, individuals and so on, using land within the scope of cities, counties, administrative towns, industrial and mining areas are subject to urban and town land use tax (land use tax).

Land use tax is calculated on the basis of the areas of land actually occupied by taxpayers. The annual amount of land use tax per square meter is as follows (in RMB):

- 1.5 to 30 yuan in large cities;
- 1.2 to 24 yuan in medium cities;
- 0.9 to 18 yuan in small cities; and
- 0.6 to 12 yuan in county seats, administrative towns, and industrial and mining areas.

Within the range of tax amounts specified as above and in light of urban construction, economic development and other conditions, the people's governments of the provinces, autonomous regions, and municipalities directly under

the central government have the discretion to determine the range of tax amounts applicable to the areas under their respective jurisdiction.

### **8.7 Tips for Foreign Investors**

In China, a capital contributor may contribute capital to a company by transferring LUR. The contributed LUR must be of state-owned land and must have been legally assigned with payment. Also, the LUR should be unencumbered to avoid legal disputes regarding priority rights.

Furthermore, Chinese-foreign equity joint ventures established within Chinese territory are Chinese legal persons and must take all the liability within the scope of its own assets. Thus, during the establishment of your Chinese-foreign equity joint venture, please pay attention that the contributed LURs should be transferred to the joint venture company rather than remain registered with the contributing party. Failure in such ownership transfer will bring series of problems. Likewise, this same issue should be taken good care of when in case of establishment of a cooperative joint venture.

### **8.8 Governing Authorities**

You can find more useful information related to the different types of LURs and the registration for Real Estate from the following authorities:

**Ministry of Natural Resources of the People's Republic of China**

No. 64, Funchengmen Inner Street (Funei Dajie), Xicheng District, Beijing, 100812

Tel: +86 10 6388 2118

Email: [mhwz@mail.mlr.gov.cn](mailto:mhwz@mail.mlr.gov.cn)

Website: <http://www.mnr.gov.cn/>

**Real Estate Registration Center, MLR, PRC**

Tel: +86 10 6655 8800

Email: [info@gtzyzcf.com.cn](mailto:info@gtzyzcf.com.cn)

Website: <http://www.erc.com.cn/>





## 9. Labor & Social Security

### 9.1 Labor Contract

The *Chinese Labor Contract Law* became effective on January 1<sup>st</sup>, 2008 and was revised in 2012. According to the law three types of labor contracts exist: labor contracts with a fixed period, labor contracts with an open period, and labor contracts for completing an agreed assignment. Any employer must conclude a written labor contract with the employee within one month after the commencement of employment. An employer who does not comply with this regulations risks sanctions. If a labor contract is concluded with a period of more than three months but less than one year the probationary period may not exceed one month. Where a labor contract was concluded for more than one year but less than three years the probationary period may not exceed two months. A labor contract with a fixed period of more than three years or with an open period may not include a probationary term exceeding six months.

To conclude a labor contract in China the following clauses have to be included: name and address of the employer and the legal representative or key person in charge of the employer, name, address and identity card number or other valid identity documents number of the employee, term of labor contract, job duties and work premises, working hours, rest periods and off days, labor remuneration, social security, labor protection, working conditions and occupational hazard prevention and protection.

If an employee dissolves the labor contract in violation of the law, or if he or she breaches relevant stipulations

concerning the confidentiality obligation or non-competition restrictive covenant, he or she may bear liability if the employer suffers losses through these actions.

Employers in China can only terminate a labor contract without paying an additional payment under particular circumstances, for example if the employee has seriously violated labor discipline or rules and regulations of the employer or if the employee does not satisfy the criteria during the probationary period and so on.

Under particular circumstances, the employer may terminate the labor contract by giving a written notice 30 days in advance and by making an additional wage payment to the employee.

Such circumstances include, for example, the situation that an employee turns out to be incompetent for his or her position, even after he or she has undergone an additional education or has been transferred to a new position. Or an employee suffers from an illness or a non-work-related injury and is unable to undertake the original job duties. Or other job duties arranged by the employer following completion of the stipulated medical treatment period or the objective circumstances for which the conclusion of the labor contract is based upon have undergone significant changes and as a result thereof, the labor contract can no longer be performed and upon negotiation between the employer and the worker, both parties are unable to reach an agreement on variation of the contents of the labor contract.

Generally, the employer must pay to the employee a compensation calculated on the basis of his or her years of

employment and average salary of the last twelve months. The compensation amounts basically to one month's salary for each year of employment, but maximum twelve salaries for terminating a labor contract. In case of high income, the compensation is limited to a multiple of the local official average salary. Except that the employee offers to terminate the labor contract by him or her own accord and in the meantime the employer hasn't violence any stipulation of the labor law or regulations,

If it turns out that the termination is not justified by the reasons stipulated in the law, the employer can be obligated to pay a double compensation. Thus, the termination of an employee must be approached with great caution in China. The sending of a warning letter in case of violation of duties is a must.

Non-competition obligations are limited to employees in a position of a senior manager, senior technician and a position which is otherwise reasonable to be subject to confidentiality obligation. The non-competition clause should stipulate the geographical range, business fields involved, scope and time limit of the non-competition obligation. However, the maximum time a non-competition obligation can be agreed on is two years.

According to article 2 of the *Labor Law of the PRC*, a contractual labor relationship taking place in China must be governed by Chinese law. Thus, the choice of a foreign law is not tolerated.

## **9.2 Representative Offices**

The employment of Chinese nationals by a representative office of a foreign company must be arranged through a government-designated labor service company such as the Foreign Enterprises Service Corporation (FESCO). The representative office will enter into a service contract with the service company and the service company will provide Chinese employees to work for the office. Thus, the representative office only has a contractual relationship with the service company and not with the Chinese staff. A supplementary contract may, however, be entered into by and between the foreign company and the Chinese employee in order to regulate certain specific items such as salary amount, vacation, confidentiality, non-competition clauses and so on.

## **9.3 FIE Recruitment**

In principle, the Foreign Invested Enterprises (FIE) may recruit any Chinese individual directly without going through a service company. FIE must conclude an individual labor contract with each employee.

## **9.4 Employment of Expatriate Staff**

Every foreigner who plans to work in China is required to first obtain a Foreigner Work Permit Certificate, Work Visa, Work Certificate, and Residence Permit.

## 9.5 Welfare and Social Insurances

The mandatory social security to be subscribed for employees are (1) pension, (2) unemployment insurance, (3) medical insurance, (4) work injury insurance, (5) family planning insurance and (6) housing fund. These securities are borne by both, the employer and employee respectively at a certain percentage. The contributions for these types of social security must be deducted and paid directly by the employer. However, for the foreign employees the housing fund is not mandatory. Whether to subscribe the housing fund for the foreign employees depends on the willingness of both the employers and employees.

## 9.6 Labor Dispute Resolution

Labor disputes may be settled by mediation or labor dispute arbitration and may only be brought to the court after having gone through the labor dispute arbitration. According to the *Law on Labor Dispute Mediation and Arbitration*, the statutory period to file an arbitration application in labor disputes is one year starting from the date the applying party actually became aware of or should have become aware of the fact that his or her rights have been infringed. Except for that, the one-year period starts from the dissolution of the employment relationship, if the dispute is concerning the default in payment of labor remuneration.

An arbitration award must be made within 45 days. Due to the complexity of the case such time limit can be extended to 60 days from the date of receipt of the application. Parties unsatisfied with the award may bring a

lawsuit to a People's Court within 15 days from the date of receipt of the written award.

## 9.7 Governing Authority

The related governing authority is the Ministry of Human Resources and Social Security.

### **Ministry of Human Resources and Social Security**

No. 12 Hepinglizhongjie, Dongcheng District, Beijing, 100716

Tel: +86 10 8420 1116

Email: [wzzb@mohrss.gov.cn](mailto:wzzb@mohrss.gov.cn)

Web: <http://www.mohrss.gov.cn>



## 10. Rights in rem and Ownership

According to Chinese law, rights in rem refer to the exclusive rights of direct control enjoyed by the holder according to law over a specific property, including ownership, usufructuary rights, rights in rem for security and possession. The varieties and contents of real rights can only be stipulated by law.

In general, the creation, change, transfer or elimination of rights in rem of a real estate (immovable property) will only become effective after registration with the relevant authorities. The creation or transfer of such rights of a movable property will become effective upon delivery. However, as to certain special movable properties, such as vessel, aircraft and motor vehicle, legal acts concerning rights in rem are effective but cannot challenge any bona fide third party if not registered. This means, for the better protection concerning real rights on special movable properties, you are supposed to complete the registration formalities upon the creation, change, transfer or elimination on such special properties.

### 10.1 Ownership

There are three different types of ownership in Chinese law system, namely: state ownership, collective ownership and private ownership. For specific properties prescribed by law, mineral deposits, waters, sea areas, urban lands, natural resources, wildlife resources, radio frequency spectrum resources, cultural relics, assets of national defense, and so on, are owned by the state and belong to all the people as a whole in China.

Generally, ownership towards a specific property is exclusive ownership. However, some specific properties can be owned by multiple co-owners severally or jointly. Each of several co-owner of a commonly owned real estate or movable property enjoys the ownership of the property according to his shares. A joint owner of a commonly owned real estate or movable property enjoys the ownership of the property on a common basis.

Neighbors should correctly handle the relationship of adjacency and avoid prevention of ownership rights with the principles of facilitating production, making things convenient in life, showing unity and providing mutual assistance, and fairness and equity.

As one of the owners inside a building, the owner enjoys the partitioned ownership as to the building areas. Doubtlessly, the owner is entitled to the ownership over the exclusive parts within the building, such as the residential houses or the houses used for business purposes. Furthermore, each of the owners has common ownership over the common parts within the building and enjoys the right of common management over such common parts.

## 10.2 Usufructuary Rights

Contrary to the ownership, usufructuary rights refer to the right to possess, use and seek proceeds from the real estate or movable property owned by someone else according to legal provisions. The major types of usufructuary rights prescribed by *the PRC Property Law* includes the right to the contracted management of land, the right to use land for construction, the right to use house sites, the easement right, and the right to use natural resources, which



includes the right to use sea areas, the mineral prospecting right, the mining right, the water intake right and the right to use water areas or tidal flats for engaging in breeding or fishery.

The usable term of the right to use land for construction for dwelling houses is 70 years in China, and such term can be automatically renewed upon expiration. However, so far there is no provision explicitly tells whether such renewal is for free.

### **10.3 Mortgage and other Real Securities**

Rights in rem for security under *the PRC Property Law* involve mainly the rights to mortgage, pledge, and lien.

#### *10.3.1 The Right to Mortgage*

The right to mortgage on movable properties will become effective upon the effectiveness of the contract. However, for specific movable properties, which include manufacturing facilities, raw materials, semi-manufactured goods and products, vessel and aircraft that are under construction, and means of communications and transportation, the right to mortgage cannot challenge any bona fide third party without registration. As for the mortgage of a real estate, such as the buildings under construction, the right to contracted management of barren land, and so on, the right to mortgage will be established as of the date of registration.

Furthermore, *the PRC Property Law* stipulates the rules for floating mortgage. The right to floating mortgage will

come into effect as of the effectiveness of the mortgage contract. Upon the written contract between the parties, an enterprise, individual industrial and commercial household or agricultural production operator can mortgage the manufacturing facilities, raw materials, semi-manufactured goods and products it has already owned, or it is going to own. When the debtor fails to pay due debts, or any circumstances for realizing the right to mortgage in the way stipulated by the parties, occur, the creditor will be entitled to seek preferred payments from the movable properties that exist when the parties concerned stipulate to realize the right to mortgage. Such contract for floating mortgage must be registered, and the right to mortgage cannot challenge any bona fide third party without registration.

Furthermore, whenever you are considering an offer for a mortgage, you should be aware that the following properties cannot be mortgaged in China:

- Land ownership;
- The right to use cultivated land, house sites, land set aside for farmers to cultivate for their private use, hilly land allotted for private use and other collectively-owned land, unless it is otherwise prescribed by any law;
- Educational, medical, healthy and other public welfare facilities of schools, kindergartens, hospitals and other institutions and social groups with the aim of benefiting the public;
- Properties whose ownership or use rights are unclear or controversial;
- Properties that are legally confiscated, seized or controlled; or
- Other properties that cannot be mortgaged according to any law or administrative regulation.

### 10.3.2 *The Right of Pledge*

The property to pledge can be either a movable property or certain types of rights, such as checks, securities, transferable intellectual property rights and account receivables. The right of pledge cannot be created on a real estate and the contract for the right of pledge must be in written. The effectiveness of the right of pledge on a movable property rests with the delivery of such object. Without actual delivery, the contract for pledge is valid while the right of pledge could not be created. As to the pledge on rights, the right of pledge will be established after the transfer of the relevant title certificate. For the rights without title certificate, the right of pledge will be established upon registration.

Furthermore, please kindly note that before the time limit for paying debts expires, any clause stipulating that the ownership of the pledge would be transferred to the creditor when the debtor fails to pay due debts will be considered invalid in China.

### 10.3.3 *Lien*

Different from the right to mortgage and the right of pledge, a lien can be created without mutual consent. In case a debtor fails to pay its due debts, the creditor can take the lien of the debtor's movable properties he has lawfully possessed and is entitled to seek preferred payments from these movable properties. The lien can be only created on movable properties. Also, except for the lien between enterprises, movable properties taken as lien by the creditor must fall into a same legal relationship with the creditor's rights.

In case a property under lien is a divisible object, the value of the property under lien must be equal to the amount of debts.

#### **10.4 Possession**

In accordance with *the PRC Property Law*, there are generally two categories of possessions – the lawful possession and the unlawful possession. The possessor is entitled to remedies such as the right to claim the restitution of the property or the elimination of obstacle or danger to the property when his possession is prevented in some way, and the right to claim for damages incurred by such prevention.

Normally, where a person untitled to dispose a real estate or movable property, transfers the property to an assignee, the owner is entitled to the right to recover the property transferred. However, if the assignee accepted the property in good faith, which means e.g. at a reasonable price, and such property has been registered in case registration is required by law, or has been delivered to the assignee in case registration is not required, the assignee then obtains the ownership of such property, and the owner is no longer entitled to recover the property. However, the original owner is entitled to ask the person who was untitled to dispose to make compensation for his losses.

#### **10.5 Protection**

Where ownership or rights in rem are in process or have been obstructed, the right holder has the right to petition for

removing the impediment or eliminating the danger; where a real estate or movable property is damaged, the right holder has the right to petition for repairing, remaking, changing or restoring the original state; where a right in rem is injured and the right holder suffers losses from it, the right holder has the right to petition for the compensation for the losses or the undertaking of any other civil liability. The above ways for the protection can be applied either independently or by combining with each other in light of the specific circumstance of an injury.

## 10.6 Purchase of Real Estate by Foreigners

As to the investments in non-self-use real estate, oversea institutions or oversea individuals are allowed to engage in and operate such relevant business in accordance with the business scope approved after establishing a foreign investment enterprise.

Except for the enterprises that have been approved to engage in real estate business, in accordance with *the Opinions on Regulating the Access to and Administration of Foreign Investment in the Real Estate Market* issued in 2006 and the relevant regulations, branches and representative offices established by overseas institutions and overseas individuals who have worked or studied for more than one year in China are, in principle, qualified to purchase for-self-use or for-self-occupied commercial housing that meet their actual needs.

Purchase of real estate for non-self-use or for non-self-occupied purposes is not allowed. During the real estate purchase, valid certificates, for example, the certificate of approval for the establishment of an institution in China

for overseas institutions, the certificate of work or study in China for overseas individuals are to be provided to prove the purpose in purchase.

Since registration formalities state utmost, the validity status of real rights on real estate and the registration with the relevant housing management authority will be a must during the real estate purchase, we strongly suggest not investing in real estate in China under the name of another Chinese individual, as there is a serious risk of a suffering from great loss.

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