About the author

The JLJ Group – Solutions for China Entry & Growth

The JLJ Group is a one-stop service provider assisting international companies entering or growing in the China market. JLJ has already served more than 400 clients – including Fortune 500, SME’s and government organizations - in more than 10 years of activity in China. JLJ provides services in five areas – Market Research & Consulting, Corporate Formation, Human Resources, Tax & Accounting and Business Process Outsourcing – to support the business needs of foreign companies at different stages of their China projects.

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Establishing a Legal Entity in China

China is notorious for its bureaucracy and the business registration process is no exception to the country’s penchant for regulation. Unlike many other countries, registering a business in China may require the assistance of an agency authorized by the government. Prior to October 2004 companies were even not allowed to register themselves but were required by law to use an authorized agent. Although most districts will allow a company to register themselves, registering a business in China is a complicated multi-step process and using a professional agent can substantially smoothen and speed up the process.

Even when using an agent for registration, understanding the fundamentals of the process and how the investment and business categories affect the operations of a company, is essential for any foreign company with an interest in conducting business in China. Just as China’s economy continues to change rapidly, so do the regulations on establishing legal entities. The following information reflects the process at the time of this writing.

1.1 Nature of the Investment

When a foreign investor decides to launch a business venture in China they will need to decide whether to launch their business in the form of an actual capital investment or whether it is better to start out more carefully by scanning the market and building networks.

Foreign investors without a comprehensive understanding of the China market may wish to test the market strength first to see whether it is worthy to establish a full operation in China and invest a large sum of capital.

Foreign investors with more experience and understanding of the China market who intend to conduct a full range of business activities need to establish a legal entity. In the case that a legal entity is preferred, the form of the entity chosen is quite crucial. Aspects that have to be considered are the sector of business and amount of money invested, if a Chinese partner is desirable or even mandatory for the business, along with other general commercial and strategic considerations. Along with the level of financial risk and control a company prefers for its China operations, government restrictions on specific industries affect the investment type made. Media, automotive and telecom industries are examples of industries that require foreign invested enterprises to have local partners.

A Representative Office (Rep. Office) represents the interests of the foreign investor by acting as a liaison office for the parent company. Rep. Offices may conduct market research, develop partnerships and business channels; however, all business transactions, including issuance of invoices, are managed by the parent company. Furthermore, Rep. Offices may not directly hire local employees but must rely on a government-authorized employment agency. Since Rep. Offices do not have a minimum investment requirement, they are not considered a Foreign Invested Enterprise. Rep. Offices are the least complicated way for a foreign firm to have a legal presence in China and is often the choice for foreign companies with little or no previous experience in the country. However, given the restrictions on direct employment of local employees, transactions and taxation on expenses, Wholly Foreign Owned Enterprises may be a better option.

Wholly Foreign Owned Enterprise (WFOE), the most popular Foreign Invested Enterprise (FIE), is a limited liability company fully invested by one or more foreign entities. Along with the rights afforded to a Rep. Office, a WFOE may also legally conduct business transactions within China and hire local employees on its own accord. However they do have a minimum investment requirement that is dependent upon the locality and nature of the business. WFOEs are becoming more and more common and have begun to outpace Joint Ventures as the most popular vehicle for a China Presence.
**Equity Joint Venture (EJV)** companies have capital investments from both local and foreign firms. The percentage of the capital investment determines the amount of profit and risk that both the foreign and local company assumes. Foreign firms entering industries where WFOE’s cannot operate, often use JV’s although this is becoming less prevalent as more and more industries begin to gradually open up to WFOE’s.

The risk associated with entering into partnerships with other companies applies in China and is often exacerbated by disparities in culture and business practices between the foreign and local partners. Foreign Companies should enter into JV’s only when both parties have reached a clear understanding of the business objectives and appropriate exit strategies have been developed.

**Cooperative Joint Ventures (CJV)** are also partnerships with a local company; however, the amount of risk and profit shared by each party is not determined by capital investment but rather agreed upon at the beginning of the partnership. CJVs were used more in the 1990’s when the Chinese economy was not as developed. International companies often injected funds while the local Chinese companies provided equipment and other necessities. Laws and regulations can vary substantially between industries and procedures vary accordingly.

Recent years have shown a trend towards investing in China through mergers & acquisitions (M&As). There are many options for M&As in China including equity and asset acquisitions as well as mergers. As a form of foreign direct investment, the general rules on establishment of FIEs also apply to M&As.

### 1.2 Registration Steps

Below is the typical process for setting up both foreign invested enterprises and Rep. Offices. The government offices involved in this process include the Ministry of Commerce, the Administrative Bureau for Industry and Commerce, State Administration of Foreign Currency, Taxation Bureau, the Customs Office, and the Statistics Bureau.
1.3 Registered Capital

FIEs- WFOE’s and JV’s- require the foreign investor to establish a minimum amount of funds abroad within China; called Registered Capital. The amount of registered capital must be declared during the licensing phase of the registration process. The total investment figure is represented by a ratio between foreign contributed capital and debt. The registered capital should cover all the initial investment expenses that a foreign entity will have and may be used immediately for the newly formed company’s expenses. This may include paying rents, salaries and purchasing products etc. It is considered a felony to state a specific amount of funds and then not contribute. It is also a felony to inject the funds as stated and then withdraw the injection. One purpose of the registered capital is to provide confirmation to creditors of the company’s financial adequacy.

In theory most small to medium sized companies entering the market are required to invest a minimum of US$ 3,700 (30,000 RMB) for a multiple investor WFOE. In practice, however, this kind of a capital injection would rarely cover the start up expenses of any company, in order to be approved the required amount is usually substantially more. Overall it can be stated that the investment required is dependent upon the scope of business, volume of sales, company size and judged on a case by case basis. Chinese authorities will consider what would be a reasonable capital injection for each specific project in question.

1.4 Nature of the Business

For Foreign Invested Enterprises- WFOE’s, EJV’s and CJV’s- must declare the nature of their business during the licensing phase of the registration process. The intended scope of operations in China and the capital investment the company is willing to make, determines the category of business that a foreign company declares. The following categories are by far not exhaustive but represent the most common forms of foreign invested enterprises operating in China today. Other categories of business include Purchasing Centers, Research and Development Centers, Investment (Holding) Companies and Regional Headquarters.
Service Company
As the name implies, the foreign firm provides services to companies within China. The Company may not manufacture or trade goods. Examples of service companies include consulting, training, restaurants and management service companies.

Manufacturing Company
The nature of this business allows the foreign company to produce goods for sale on premises as well as sell finished goods domestically and internationally. Manufacturing Companies do not require an intermediary to sell goods locally or internationally and may import raw materials for production. The registration process, however, might be more complicated than other business categories as manufacturing plants may require additional certifications.

International Trading WFOE
To set up a trading WFOE, the company has to register in a Free Trade Zone (FTZ). As a trading WFOE, the company is allowed to import and export products with no customs tax as long as trading is conducted within the FTZ. Products sold in China but outside of the FTZ require an Import/Export agency and are subject to applicable tariffs. However, as of July of 2005, FTZ companies have been able to apply for trading rights that will allow them to trade within China without the use of an agent.

Foreign Invested Commercial Enterprise – (FICE)
Commercial Enterprises are a FIE setup that allows foreign companies greater flexibility in terms of business activities. These activities include retail, wholesale and franchising operations. Once established a FICE is granted both import and export rights. FICE’s may also buy and sell products freely in China without an intermediary. It is also possible for manufacturing FIE’s to apply to extend their business scope to include FICE capabilities.

As foreign companies entering the market begin to navigate the bureaucratic landscape, having a clear understanding of the investment and business options available will be crucial to successfully establish a business and operating in China. With China’s gradual compliance with its WTO membership obligations, the business registration process should also continue to improve while more industries open to foreign investment.

When choosing a business registration agency, foreign companies should consider the agency’s knowledge of recent policy changes, transparency on the registration process and its track record of successful registrations. Selecting an appropriate service provider, that can effectively guide foreign investors through the complicated process will go a long way in insuring a smooth entry into the market.

A detailed summary of entity types and their respective allowed business scope, tax treatment and registration process can be found on the next page:
## Legal Entity Comparison Chart

<table>
<thead>
<tr>
<th>Business Activities *</th>
<th>Registration Process</th>
<th>Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Tax Treatment</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Min. Registered Capital**</td>
<td>Duration of Entity***</td>
</tr>
<tr>
<td>Import</td>
<td>Export</td>
<td>Domestic Commercial Activities</td>
</tr>
<tr>
<td>Service</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Manufacturing</td>
<td></td>
<td></td>
</tr>
<tr>
<td>In’t Trading</td>
<td></td>
<td></td>
</tr>
<tr>
<td>FICE</td>
<td></td>
<td></td>
</tr>
<tr>
<td>FICE+Manufacturing</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### Specialized Corporate Formations

| Investment Holding RHQ |   |   |   |   | 30,000,000USD | 50 years |   | 6 Months |
| Management RHQ |   |   |   |   | 2,000,000USD | 50 years |   | 3 Months |
| R&D Center |   |   |   |   | 2,000,000USD | 30 years |   | 3 Months |

*Denotes activities that may generate revenue streams for the entity.

**This reflects the minimum as stated in China’s Company Laws and does not guarantee approval. Investors should invest enough to sustain operations until their projected break-even point.

***This reflects the maximum duration the entity may be approved by the government. All entities’ licenses may be renewed before expiration.

† Capability of the entity to expand to include additional capabilities (i.e., Manufacturing entity expands to include FICE capabilities; Distribution FICE expands to include franchising and retail)

‡ This timing assumes all preapprovals have been obtained and all documents are ready to be submitted to the approval authorities.
2 Taxation of Foreign Enterprises in China

Foreign companies that engage in business operations in China are required to pay taxes according to the Chinese tax laws. The most commonly used forms of business for foreign companies are the Representative Office (Rep. Office) and the Limited Liability Company (LLC). The most important tax categories for these forms of businesses are corporate income tax and business tax. For industrial, commercial and trading companies the value-added tax (VAT) is a major tax liability as well. The main taxes for foreign businesses in China and their methods of calculation will be discussed in this guide.

2.1 Tax Registration and Tax Entry

After the business license is received a Representative Office or a Limited Liability Company (LLC) must register at the relevant tax authorities within 30 days time. This includes both the national taxation bureau and its municipal branch; however, only one application has to be handed in. Generally, the application process takes 10 working days. Companies are not required to hire an authorized agent for this process and can apply themselves. However, if the investor has used a registration service provider for the registration of the Rep. Office or a Limited Liability Company, this tax application service will often be included in the service.

2.2 Main Tax Categories for Foreign Enterprises

Corporate income tax
Corporate income tax is levied on income of LLC’s derived from production, business operations and other sources within and outside China\(^1\). LLC’s have to pay this tax monthly, and the applicable tax rate is at 25%. The method of computation is as follows:

\[
\text{Tax payable} = [\text{Total Annual Income} - \text{Expenses} - \text{Losses}] \times \text{Applicable Tax Rate}
\]

Business tax
The business tax is a turnover tax paid on the revenue of certain services such as communications and transportations (applicable tax rate of 3%), construction (3%), finance and insurance (5%), posts and telecommunications (3%), culture and sports (3%), entertainment (5-20%), sales of buildings within China (5%) and other services\(^2\) (5%). In Shanghai and Beijing, an additional tax of 1% of the tax payable is added (which raises the effective taxe rate from for example 5% to 5.05%). LLC’s are required to pay this tax monthly. Note that the business tax and the value-added tax (VAT) are exclusive; i.e. a company is either considered a service provider and pays business tax, or alternatively a manufacturing or a commercial company and pays VAT. The tax payable is computed as follows:

\[
\text{Tax payable} = \text{Business Turnover} \times \text{Applicable Tax Rate}
\]

Withholding Tax
Non-resident enterprises are subjected to a 10% withholding tax at source. Some scenarios where withholding tax applies include:

- Dividend payment to non-resident parent company
- Interest, rent, royalties, management fees paid to non-resident foreign enterprises
- Net capital gains from transfer of shares or equity interest in FIE-held enterprises

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1. However, if a company is not registered in China, it only has limited tax liabilities for all revenues generated from within China. The applicable corporate income tax rate for this kind of company is 10%.
2. This last category includes hotels and travel agencies, restaurants, rent agencies, advertisement companies, consulting businesses, etc.
3. This method of calculating tax liability for Representative Offices is applicable in Shanghai and Beijing. Currently there is no uniform procedure for calculation throughout China; this is, however, expected to change soon.

### Operations Expense
- **Presumed Profit Rate**
- **Business Tax Rate**
- **Corp. Tax Rate**
- **Income Amount** = \( \frac{\text{Operations Expense}}{1 - \text{Pres. Profit Rate} - \text{Business Tax Rate}} \)
- **Business Tax Payable** = Income Amount \( \times \) Business Tax Rate 5%
- **Corp. Tax Payable** = Income Amount \( \times \) Presumed Profit Rate 10% \( \times \) Corp. Tax Rate 25%

The result of this relatively complicated computation is an estimated 8.8% tax on operation expenses, which can be used as a rule of thumb. Unlike LLC’s which pay their taxes on a monthly basis, Rep. Offices pay both the business tax and the corporate income tax quarterly.

<p>| | | | | | | | |</p>
<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>B</td>
<td>C</td>
<td>D</td>
<td>E</td>
<td>F</td>
<td>G</td>
<td>H</td>
</tr>
<tr>
<td>---</td>
<td>---</td>
<td>---</td>
<td>---</td>
<td>---</td>
<td>---</td>
<td>---</td>
<td>---</td>
</tr>
<tr>
<td>Operations Expense</td>
<td>Presumed Profit Rate</td>
<td>Business Tax Rate</td>
<td>Corp. Tax Rate</td>
<td>Income Amount A / ([1 - B - C])</td>
<td>Business Tax Payable E x C</td>
<td>Corp. Tax Payable E x B x D</td>
<td>Total Tax Payable F + G</td>
</tr>
<tr>
<td>8,500</td>
<td>10%</td>
<td>5%</td>
<td>25%</td>
<td>10,000</td>
<td>500</td>
<td>250</td>
<td>750</td>
</tr>
</tbody>
</table>

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**Example:**

3. *This method of calculating tax liability for Representative Offices is applicable in Shanghai and Beijing. Currently there is no uniform procedure for calculation throughout China; this is, however, expected to change soon.*
2.4 Tax Incentives

Many foreign companies, registered before March 16\textsuperscript{th} 2007, enjoyed preferential tax treatment if they were located in special economic zones or if they were involved in production-oriented businesses. However, with the implementation of the new income tax law from January 1\textsuperscript{st} 2008, such preferential tax treatment is no longer available, and companies currently enjoying reduced tax rates will see their income tax rate gradually raised to the standard 25\% by 2012.

However, some tax incentives remain for certain industries and projects that are encouraged by the state. Below are some examples:

<table>
<thead>
<tr>
<th>Industries / Projects</th>
<th>Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Certain Advanced and New Technology Enterprises</td>
<td>15%</td>
</tr>
<tr>
<td>Certain small-scale enterprises with low profitability</td>
<td>20%</td>
</tr>
<tr>
<td>Income derived from</td>
<td>Tax exemption or reduction</td>
</tr>
<tr>
<td>- certain agriculture, forestry, animal husbandry or fishery projects</td>
<td></td>
</tr>
<tr>
<td>- investment in or operation of certain public infrastructure projects</td>
<td></td>
</tr>
<tr>
<td>- qualified environmental protection and conservation projects</td>
<td></td>
</tr>
<tr>
<td>- certain technology transfer projects</td>
<td></td>
</tr>
<tr>
<td>- a non-resident enterprise</td>
<td></td>
</tr>
<tr>
<td>Enterprises located within certain ethnic autonomous regions (subject to approval from the People’s government of the relevant regions)</td>
<td>Tax exemption or reduction</td>
</tr>
</tbody>
</table>

2.5 Value-Added Tax (VAT)

a. General and small-scale tax payers

The Chinese tax system distinguishes between general and small-scale payers of VAT (see following chart). Small-scale taxpayers are taxpayers whose annual taxable value of sales is below the prescribed limits, namely RMB 1 million for manufacturing and service companies, and less than RMB 1.8 million for those engaged in wholesaling and retailing. VAT has to be paid on a monthly basis and special VAT invoices must be bought from the tax bureau.

b. General tax payers

The actual amount of VAT payable by general taxpayers is the excess amount of output VAT over input VAT. There are two applicable tax rates, a basic rate of 17\% and a lower rate of 13\%\textsuperscript{4}. The formula is as follows:

\[
\text{Tax Payable} = \text{Current Output VAT} - \text{Current Input VAT}
\]

\[
\text{Output VAT} = \text{Sales Volume} \times \text{Applicable Tax Rate}
\]

If the current output VAT is smaller than the current input VAT, the amount that cannot be fully offset or deducted may be carried over to subsequent tax period(s).

\textsuperscript{4}The sale and import of the following commodities are subject to the lower VAT rate: grains, edible vegetable oil, drinking water, heating, air-conditioning, hot water, coal gas, liquefied petroleum gas, natural gas, methane, coal products for domestic use: books, newspapers and magazines; feedstuffs, chemical fertilizers, pesticides, agricultural machinery
c. Small-scale tax payers

VAT payable by small-scale taxpayers is calculated by a simple method on the basis of the overall sales value and the tax rate without deduction of input VAT. This means the input VAT borne by small-scale VAT-payers (through purchasing goods from general taxpayers) is not refunded by the tax authorities. Furthermore small-scale taxpayers do not have to pay VAT on the value of exported goods. The applicable tax rate is 4% for commercial enterprises and 6% for other (i.e. production companies). The formula is as follows:

\[
\text{Tax payable} = \frac{\text{Sales Volume}}{1+4\% \text{ or } 6\%} \times \text{Tax Rate (4\% or 6\%)}
\]

d. General tax payers

Consumption tax is payable on the sales value of certain consumer goods. This includes 11 general items: cigarettes, alcohol, cosmetics, fine jewelry, precious stones, firecrackers, gasoline, diesel oil, motor vehicle tires, motorcycles, and small motor cars. The applicable tax rates range from 3% to 50% and the tax is paid on top of VAT. The producers include the tax in the price of the products meaning that the tax is ultimately borne by consumers. Retailers and wholesalers are not required to pay consumption tax when they trade goods of this category. Also consumption tax is fully rebated for exported goods.

e. VAT on Exports

Generally the value of exported goods is exempt from VAT and consumption tax. Companies can apply for the tax rebate at the relevant tax authorities after the goods have left Chinese territory and if all payments are completed within three months after the end of the year. The official customs declaration must be attached to the application. Small-scale VAT paying companies cannot apply for the tax rebate and are only exempt from VAT when they export goods. The formulas for calculation of the rebate amount are as follows:

\[
\text{Tax Payable} = \text{Domestic Output VAT} - [\text{Input VAT for Total Purchases} - \text{Non Refund VAT}]
\]

\[
\text{Non refund VAT} = \text{Export Sales} \times [\text{VAT Rate} - \text{Refund Rate}]
\]

Note that the rebate rate for certain goods can be smaller than the VAT rate, which means that the full amount paid as VAT on exported goods will not be refunded. To understand the process of the VAT rebate calculation, see the...
following example. The VAT and the rebate rate are 17%. The tax payable is negative meaning that it will be refunded.

**Example:**

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
<th>C</th>
<th>D</th>
<th>E</th>
<th>F</th>
<th>G</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Total purchases</td>
<td>Input VAT A x 17%</td>
<td>Domestic Sales</td>
<td>Export Sales</td>
<td>Domestic Output VAT C x 17%</td>
<td>Non refund VAT D x (17%-17%)</td>
<td>Tax Payable E - [B - F]</td>
</tr>
<tr>
<td></td>
<td>3,800,000</td>
<td>646,000</td>
<td>2,000,000</td>
<td>3,000,000</td>
<td>340,000</td>
<td>0</td>
<td>-306,000</td>
</tr>
</tbody>
</table>

f. VAT on Imports

However, there is a tax on imported goods, which is calculated as follows:

\[
\text{Tax Payable} = \text{VAT Rate} \times [\text{Dutiable Value} + \text{Customs Duty} + \text{Consumption Tax}]
\]

The dutiable value of imported goods includes the purchase price and the transport and insurance cost. See the example with the VAT rate of 17%, a consumption tax rate of 3% and the customs duty of 12%:

**Example**

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
<th>C</th>
<th>D</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Dutiable Value</td>
<td>Customs Duty A x 12%</td>
<td>Consumption Tax [A + B] x 3%</td>
<td>Tax Payable (A + B + C ) x 17%</td>
</tr>
<tr>
<td></td>
<td>120,000</td>
<td>14,400</td>
<td>4,032</td>
<td>23,533</td>
</tr>
</tbody>
</table>

2.6 Annual Audit

Both Rep. Offices and LLC’s are required to be audited on an annual basis (excluding Rep. Offices with a tax exempt status). The annual audit has to be filed before the end of March of the following year. Foreign companies in China can only distribute and repatriate their profits back to their home country after the annual audit and the settlement of their relevant income tax liabilities have been completed. Annual audit of Rep. Offices and LLC’s must be conducted by a firm of Certified Public Accountants (Chinese or foreign JVs) registered in the PRC under PRC regulations.

The chart below summarizes the obligations of both the Rep. Office and the LLC with respect to payment dates and deadlines.

**Tax Timeline**

<table>
<thead>
<tr>
<th>Entity Type</th>
<th>Rep. Office</th>
<th>LLC</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax Registration</td>
<td>within 30 Days After License Approval</td>
<td></td>
</tr>
<tr>
<td>Income &amp; Business Tax</td>
<td>Quarterly</td>
<td>Monthly</td>
</tr>
<tr>
<td>VAT &amp; Consumption Tax</td>
<td>N/A</td>
<td>Monthly</td>
</tr>
<tr>
<td>Housing &amp; Vehicle Tax (deduct Stamp Tax)</td>
<td>May &amp; November</td>
<td></td>
</tr>
<tr>
<td>Annual Audit Filing Deadline</td>
<td>End of April</td>
<td></td>
</tr>
</tbody>
</table>
3 Employing Local Personnel in China

The employment of staff is a fundamental issue that all companies entering China need to be familiar with. What rules and regulations apply for the setting up of a labor contract? How do employees and employers pay social benefits and taxes? What are the differences between employing locals and foreigners? As Representative Offices aren’t allowed to hire local staff directly; how can they employ staff? How can HR outsourcing contribute to solve these issues? These are examples of questions puzzling companies as they begin the hiring process.

Generally, apart from the usual employment requirement, such as signing contracts with workers, meeting wage standards and issuing salary in a timely manner, employers in China are also obliged to:

a. File their staff employment and dismissal with relevant government bureaus
b. Maintain employees’ personnel file – a unique Chinese document that records all academic and employment history of an employee, and the responsibility of maintaining the records is transferred from one employer to another when the employee changes jobs
c. Withhold and pay individual income tax on behalf of their employees
d. Make monthly contributions to their employees’ social benefits and housing funds

Most of the above processes are complicated by the involvement of several government bureaus and tedious paperwork. For the unfamiliar, staffing their China operations may pose a challenge and many choose to rely on service providers and HR specialists to guide them though these HR administrations.

3.1 The Employment Contract

Under the People’s Republic of China’s (PRC) Labor Law, all companies are required to sign employment contracts with their employees. While limited liability companies are allowed to sign employment contracts directly with local PRC staff, a representative office must engage authorized service providers to hire and dispatch the representative office’s local employees.

While there is no standard contract form, the agreement should include:

• Term of contract & Probation period
• Job title and description
• Labor protection and working conditions
• Compensation
• Termination conditions
• Breach of contract provisions & disciplinary rules
• Other provisions such as Training Bond, Non-disclosure agreement and Non-compete agreement
3.2 The Employee Personnel File & Staff Handbook

Every employee in China owns a personnel file and a proof of employment history. The personnel file details the employee’s education and employment history, and the responsibility of maintaining this file is transferred from one employer to the next when the employee changes jobs. Unlike the personnel file, regulations on the proof of employment history vary across regions. For Shanghai and Beijing, employers must withhold the employees’ staff handbooks during the employment period. Rep. Offices, which are not allowed to hire local employees directly, must engage a local labor agency to maintain these files.

3.3 Basics of Compensation

Compensation is typically divided into four elements: base pay, incentives/bonuses, allowances and benefits.

Base Pay
Base pay is paid monthly and varies from 12-14 months. A 13-months pay scheme is common in China, with the additional month’s pay issued during the Spring Festival month (usually February). The minimum wage in Shanghai and Beijing is 960 RMB/month and 800 RMB/month respectively. However, salaries for mid-level positions and experienced professionals are growing fast and may come close to rates in developed countries such as Germany or the US for a few positions. Due to the serious shortage of managerial talent, such competitive salaries are required to attract and retain good employees.

Incentive Pay
Incentives can be paid monthly, quarterly or annually and are increasingly tied to individual performance. While not required, most employers pay annual bonuses (“13th month pay”) at the Spring Festival. The concept of performance-based variable pay is now welcomed by many organizations and Chinese employees. Especially within China’s first tier cities, success and monetary reward through performance differentiation are concepts that employees usually appreciate.

Some of the incentives in use include: individual performance plans, team performance plans, cash profit sharing plans (payouts based on organizational profitability), comprehensive performance plans (awards based on the performance of the company, team and individuals), sales bonus plans, sales commissions as well as special recognition awards.

Allowances
Personal allowances are a somewhat unique and very important form of compensation in China. Although FIEs are not obliged to provide it, allowances are sometimes viewed to be more valuable than the cash equivalent in the Chinese culture. Cash allowances highly valued by employees include transportation, meals, clothing and child care allowances.
Benefits

Benefits for Chinese employees can be classified as mandatory or supplemental. Mandatory benefits contributions by both employers and employees are stipulated by the China Labor Law and comprise a significant portion of the total compensation. An example of the social benefit schemes widely adopted for Shanghai and Beijing residents is detailed below.

<table>
<thead>
<tr>
<th>Social Benefits</th>
<th>Beijing</th>
<th>Shanghai</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>By employer</td>
<td>By employee</td>
</tr>
<tr>
<td>Pension insurance</td>
<td>20%</td>
<td>8%</td>
</tr>
<tr>
<td>Unemployment insurance</td>
<td>1.5%</td>
<td>0.5%</td>
</tr>
<tr>
<td>Medical insurance</td>
<td>10%</td>
<td>2%+3</td>
</tr>
<tr>
<td>Workplace insurance</td>
<td>0.5%</td>
<td>-</td>
</tr>
<tr>
<td>Maternity insurance</td>
<td>0.8%</td>
<td>-</td>
</tr>
<tr>
<td>Public housing fund</td>
<td>12%</td>
<td>12%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>44.8%</td>
<td>22.5%+3</td>
</tr>
<tr>
<td>Maximum cap</td>
<td>RMB 9,966</td>
<td></td>
</tr>
<tr>
<td>Minimum base</td>
<td>RMB 1,329</td>
<td></td>
</tr>
</tbody>
</table>

For non-Shanghai residency employees, another scheme applies whereby the standard contribution by employers is at RMB 216.90. Increasingly common, supplemental benefits are voluntarily provided by the employer, especially for employees over certain pay levels.

The net salary of a Chinese employee will thus be computed as such.

\[
\text{Net Salary} = \text{Gross Salary} - \text{Social Benefits (By Employee)} - IIT
\]

\(IIT: \text{Individual Income Tax (refer to Page 16 for more information on computation method)}\)

A detailed sample calculation of employee’s social benefits, income tax and net salary can be found on page 15.

3.4 Terminating the Employment Relationship

China’s Labor Law requires companies to pay severance unless the employer dismisses its staff with a specifically defined cause, such as the employee failed to satisfy the conditions of the recruitment under the probationary period, seriously violated company regulations or committed a civil crime. In other situations, the employer will be required to give 30 days’ notice to the employee and/or pay compensations stipulated by the provincial governments. Severance pay is generally equivalent to one month’s salary per year of service. The labor law also requires companies to consult with the appropriate labor union if they wish to reduce their workforce.
3.5 Turning to HR Outsourcing Services

HR business processes are often resource-intensive and time-consuming. As a result, more and more companies are now choosing outsourcing as a cost-effective solution. Generally HR outsourcing services can be separated into two categories: **HR Agency Services** and **Talent Dispatching Services**.

**HR Agency Services** encompasses basic HR administration, such as: Employment & Dismissal, Payroll & Individual Income Tax Administration, Social Security & Housing Fund Setup & Administration as well as Personnel File Management.

**Talent Dispatching Services** are used by companies and representative offices to engage an authorized third-party HR representative to employ, sign labor contract and dispatch staff to their offices. The HR representative will also provide all HR Agency Services mentioned above. Particularly for Representative Offices in China, Talent Dispatching is the only avenue to legally recruit local employees.

The details of typical services provided by HR Service Providers include:

- **Labor contract** *(only applicable to Talent Dispatching Services)*
  Sign labor contracts with its client’s employees, taking legal liability as the official employer.

- **Employment & Dismissal**
  Chinese law requires all labor contracts to be registered with the relevant authorities. The authorities would also have to be informed of any dismissal of employees.

- **Payroll and Individual Income Tax Administration**
  Issuance of salary to employees, as well as withholding and submitting taxes to the relevant government authorities on behalf of its client.

- **Social benefits and insurance**
  Administration of all social benefit and insurance payments on behalf for the client’s employees. Some providers may also be able to offer wide variety of insurance schemes, including group insurance provisions for additional coverage.

- **Personnel file management**
  Collects and maintains the personnel file and all related certifications during the employee’s employment period. Each employee in China owns a personnel file, which contains his or her resume, birth certificate, university degree, etc.

- **Recruitment & Staffing**
  Analysis of the job description, search planning and identification of best fit candidate for the clients needs. Staffing solutions are also highly sought after services by companies in China.

A good HR service provider should also provide consultation on labor and HR related policy for the client, as well as assist in negotiating and managing labor disputes and emergencies during the employment term.
Sample Calculation of Social Benefits, Income Tax and Net Salary in Shanghai

The following illustrates the sample calculation of social benefits, income tax and net salary for an employee earning a gross salary of RMB 3,000. In this example, one clearly notices that the total amount payable by the employer can be significantly higher than the gross salary (44% above the agreed upon salary).

### Company Expenses

<table>
<thead>
<tr>
<th>Gross Salary</th>
<th>Social Benefits</th>
<th>Housing Fund</th>
<th>Total Expense</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Pension 22.0%</td>
<td>Medical Insurance 12.0%</td>
<td>Unemployment Insurance 2.0%</td>
</tr>
<tr>
<td>22.0%</td>
<td>660</td>
<td>360</td>
<td>60</td>
</tr>
<tr>
<td></td>
<td>12.0%</td>
<td>12.0%</td>
<td>120</td>
</tr>
<tr>
<td></td>
<td>2.0%</td>
<td>60</td>
<td>120</td>
</tr>
<tr>
<td></td>
<td>0.5%</td>
<td>30</td>
<td>150</td>
</tr>
<tr>
<td></td>
<td>0.5%</td>
<td>30</td>
<td>150</td>
</tr>
<tr>
<td></td>
<td>37.0%</td>
<td>1,110</td>
<td>210</td>
</tr>
</tbody>
</table>

### Employee Expenses

<table>
<thead>
<tr>
<th>Social Benefits</th>
<th>Housing Fund</th>
<th>Income Before Tax</th>
<th>Individual Income Tax</th>
<th>Net Salary</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pension 8.0%</td>
<td>240</td>
<td>2,460</td>
<td>23</td>
<td>2,437</td>
</tr>
<tr>
<td>Medical Insurance 2.0%</td>
<td>60</td>
<td>210</td>
<td>210</td>
<td>2,437</td>
</tr>
<tr>
<td>Unemployment Insurance 1.0%</td>
<td>30</td>
<td>330</td>
<td>330</td>
<td>2,437</td>
</tr>
<tr>
<td>Sub-Total 11.0%</td>
<td>330</td>
<td>330</td>
<td>330</td>
<td>2,437</td>
</tr>
<tr>
<td></td>
<td>7.0%</td>
<td>210</td>
<td>210</td>
<td>2,437</td>
</tr>
</tbody>
</table>

### Employer’s and Employee’s Share of Social Benefits and ITT

<table>
<thead>
<tr>
<th>Components</th>
<th>Example</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employer’s Share of Social Benefits</td>
<td>Add 1,310=44%</td>
</tr>
<tr>
<td>Employee’s Soc. Benefits</td>
<td>Gross Salary 3,000</td>
</tr>
<tr>
<td>Employee’s Taxes</td>
<td>Subtract 540=18%</td>
</tr>
<tr>
<td>Net Salary</td>
<td>Subtract 23</td>
</tr>
<tr>
<td>Client’s Total Expense</td>
<td>Net Salary 2,437</td>
</tr>
<tr>
<td></td>
<td>0</td>
</tr>
</tbody>
</table>

5. In Shanghai: Maximum Housing Fund payment borne by company is 8676*7%=¥ 607.32 and Minimum is 1735*7%=¥ 121.45
6. In Shanghai: Maximum Social Benefit payment borne by company is 8676*37%=¥ 3210.12 and Minimum is 1735*37%=¥ 641.95
7. In Shanghai: Maximum Housing Fund payment borne by individual is 8676*7%=¥ 607.32 and Minimum is 1735*7%=¥ 121.45
8. Includes Standard 2,000RMB deduction and Quick Deduction
9. In Shanghai: Maximum Social Benefits payment borne by individual is 8676*11%=¥ 954.36 and Minimum is 1735*11%=¥ 190.85
4 Individual Income Tax in China

The taxation of individual income has become a major concern for many foreign companies in China as the number of expatriates working in the country rapidly increases. Factors such as what the type of legal entity the employee is working for along with the position the employee holds influences tax liability. This guide gives a short overview on the Chinese individual income tax regime with a focus on the taxation of the income of foreign employees and how it is applied in Shanghai and Beijing at the time of writing. Note that there is no uniformity throughout the country on how individual income tax is applied; there are significant differences even between cities such as Beijing, Shanghai, and Guangzhou. In general, China adopts a tax withholding system, whereby the employer deducts relevant payment from the employees’ monthly salary and pays the local tax bureaus on behalf of the employees.

4.1 Local employees

Local employees are taxed on the basis of the balance of their monthly income after deducting their social benefits contribution, a standard deduction of RMB 2,000 and then applying the nine-grade progressive rate as shown in the table on the right. The employer is obliged to withhold the full tax amount and submit the taxes to the appropriate Chinese authorities on behalf of its employees.

\[
\text{Taxable Income} = \text{Gross Salary} - \text{Social Benefits} - ¥2,000
\]
\[
\text{IIT} = \text{Taxable Income} \times \text{Tax Rate} - \text{Quick Deduction}
\]
\[
\text{Net Salary} = \text{Gross Salary} - \text{Social Benefits} - \text{IIT}
\]

A detailed sample calculation of employee’s social benefits, income tax and net salary can be found on page 15.

<table>
<thead>
<tr>
<th>Taxable Income</th>
<th>Tax rate</th>
<th>Quick deduction</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than 500</td>
<td>5%</td>
<td>0</td>
</tr>
<tr>
<td>501 – 2,000</td>
<td>10%</td>
<td>25</td>
</tr>
<tr>
<td>2,001 – 5,000</td>
<td>15%</td>
<td>125</td>
</tr>
<tr>
<td>5,001 – 20,000</td>
<td>20%</td>
<td>375</td>
</tr>
<tr>
<td>20,001 – 40,000</td>
<td>25%</td>
<td>1,375</td>
</tr>
<tr>
<td>40,001 – 60,000</td>
<td>30%</td>
<td>3,375</td>
</tr>
<tr>
<td>60,001 – 80,000</td>
<td>35%</td>
<td>6,375</td>
</tr>
<tr>
<td>80,001 – 100,000</td>
<td>40%</td>
<td>10,375</td>
</tr>
<tr>
<td>Over 100,000</td>
<td>45%</td>
<td>15,375</td>
</tr>
</tbody>
</table>

4.2 Foreign employees

The incomes of foreign employees in China are taxed by the same rates as incomes of Chinese employees. However the important question is, when foreign nationals’ incomes are subject to Chinese individual income tax liabilities.
**Tax Liability**

The criterion used to determine a foreign employee’s taxes liability in China is the duration of stay. Another distinction has to be made between junior staff and senior executives. Foreigners and Chinese from Hong Kong, Macao and Taiwan have to pay IIT on incomes derived from Chinese sources for work in China if they have lived in the country for less than 90 days (183 days for citizens of countries that have signed a treaty on the avoidance of double taxation with China\(^{10}\)). If a foreign employee has been living in China for more than 90 days (183 days) but less than a year, income for work in China from all sources is taxable. Foreign senior executives (e.g. CEO’s, General Managers, Chief Representatives, etc.) however, are liable for their full income derived from Chinese sources from the first day in the country. For better understanding taxable income for longer periods of stay and for senior officials compared to ordinary employees please see the chart below.

<table>
<thead>
<tr>
<th>Foreign Employees</th>
<th>Foreign Senior Executives</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Work in China</td>
</tr>
<tr>
<td></td>
<td>Income from sources within China</td>
</tr>
<tr>
<td></td>
<td>Income from Chinese sources for work abroad</td>
</tr>
<tr>
<td></td>
<td>Income from global sources for work abroad</td>
</tr>
<tr>
<td></td>
<td>Income from global sources for work abroad</td>
</tr>
</tbody>
</table>

Squares indicate income is taxable in China.

However, one special situation needs to be mentioned: The salary of a Chief Representative (of a representative office), which is issued by the parent company abroad is taxed on a prorated basis even for durations of stay of less than 90/183 days per year. The Chief Representative must apply for part-time status, which allows him to pay taxes on his income from abroad only for the time spent in China. This rule does not apply for senior officials of WOFE’s, because these are registered as Chinese companies and pay their employees from within China.

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\(^{10}\) These include among others: the EU-25 (except Greece), Australia, Brazil, Canada, Hong Kong, India, Indonesia, Japan, Macao, Malaysia, New Zealand, Norway, Russia, Singapore, South Africa, South Korea, Switzerland, Thailand, USA, Vietnam
Registration Procedures
If the employee is liable for China tax filing, the following procedures for registration apply and the following documents are required:

- Original salary certificate from overseas employer
- Copy of employment contract
- Copy of all pages of passport
- If the employer is a “permanent establishment” in China then: employee’s work permit, employer’s tax registration certificate and employer’s business license.

Tax Calculation
After knowing which incomes are subject to Chinese IIT the calculation process is only slightly different from the one described for Chinese nationals. The same tax rates and tax brackets also apply for the incomes for expatriates working in Shanghai or for Chinese companies. Foreign employees may deduct an amount of 4,800 RMB before calculating the tax payable according to the scheme above. Moreover, foreigners don’t have to pay social insurance in China. Therefore some allowances and benefits paid by the employer are not taxable11.

Example:

<table>
<thead>
<tr>
<th>Gross Salary (RMB)</th>
<th>Taxable Income (-4,800)</th>
<th>Tax Level</th>
<th>Tax Rate</th>
<th>Quick Deduction</th>
<th>Tax Payable</th>
<th>Net Salary (RMB)</th>
</tr>
</thead>
<tbody>
<tr>
<td>8,500</td>
<td>3,700</td>
<td>3</td>
<td>15%</td>
<td>125</td>
<td>430</td>
<td>8,070</td>
</tr>
</tbody>
</table>

Foreigners don’t pay social insurance and can deduct an amount of 4,800 RMB from their salary. That is why – for the same salary as the Chinese employee – the taxable income differs and a different tax rate is applied.

4.3 Self Declaration of Individual Income Tax (IIT)

IIT self-declaration in China serves to cultivate the taxpayers’ consciousness of their tax responsibilities, as well as strengthen and develop a scientific and sophisticated tax administration system. China’s tax regulations require taxpayers who fall under any of the following five categories to self-declare their earnings.

1. With annual income of over RMB120,000;
2. Receiving salary and remuneration from two or more employers in China;
3. Generating income abroad;
4. Generating taxable income without withholding agent;
5. Other cases as specified by the State Council.

For Scenario (1), taxpayers are to declare taxes to relevant authorities within three months after the end of a tax year (i.e. between Jan 1st to March 31st each year).
For Scenario (2) to (4), they shall perform tax declaration upon receipt of the income.

11. This includes allowances for home leave, language training, children’s education, housing, moving, food, washing of clothes and business trip expenses.
4.4 Tax Declaration Procedures

Several possible modes of tax declaration include data telegraph (e.g. online declaration), mail declaration or declaration directly in the tax handling hall of local tax authorities. Tax payers may also entrust intermediary agencies or other persons qualified for tax agency service with their tax declarations.

So what exactly are the elements that constitute the taxable income? When computing the annual income, the individual must take into consideration the following 11 categories of income:

1. salary and compensation
2. income from production and operation by individually-owned business
3. income from contract operation and operation under lease of enterprises or social service providers partly or wholly funded by state assets
4. compensation for labor services
5. author’s remuneration
6. royalty
7. interest, dividend and bonus
8. income from lease of property
9. income from transfer of property
10. incidental income
11. other income specified by finance department under the State Council.

As shown in the examples in the earlier sections, tax payers are allowed some deductions from their taxable income, such as social insurance contributions and a general deduction amount of RMB 2,000 for locals and RMB 4,800 for foreigners. On top of that, the regulation also allows certain tax exemptions, such as particular rewards in respect of science, education, technology, culture, etc, interest of treasury and financial bonds issued by China, specific academician subsidy or allowance, welfare and relief for disabled, etc

4.5 Liabilities for non-payment of tax

If the individual fails to declare his/her income tax within the specified three-month period, the local authorities will provide an extended deadline but may impose a penalty of less than RMB 2,000 (or up to RMB 10,000 for serious circumstances). If the taxpayer fails to make tax declaration again, or fails to pay or underpays the tax payable, he/she shall be held liable for the amount of tax he/she fails to pay or underpays and the surcharge thereon. Furthermore, he/she may be fined between 50 to 500 percent of his/her remaining liable taxes.
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