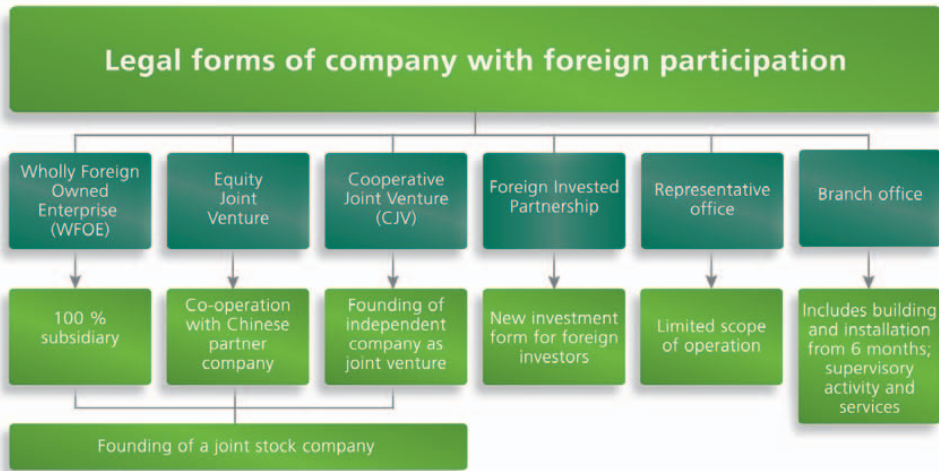


CHINA

## CHINA

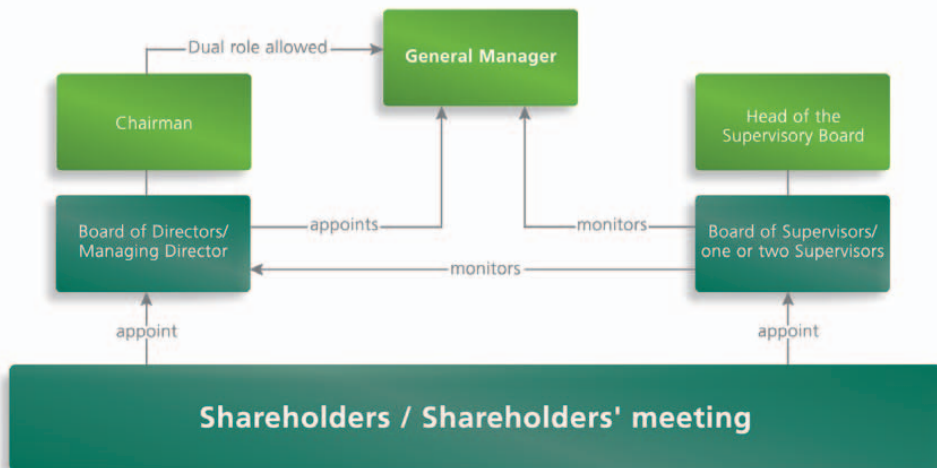
The legal conditions in China are partly fundamentally different to those of Germany. The most frequent company form for foreign investors is the 100 % subsidiary. In addition, joint ventures, partner companies or representative offices can be founded as shown in the graphic:



When founding a company it is essential to observe the guideline catalogue for foreign investment which lists the promoted, restricted, allowed and prohibited foreign investments in China. For the founding of a company a person must be named as legal representative and the purpose of the business must also be given. This is noted on the business licence. The company may not exceed the specified business activity. The operative company management of the company is undertaken by the general manager. In addition, depending on the articles of association there is a board of directors or a managing director.



The following figure provides an overview:



In contrast to the euro, the Chinese currency RMB is not freely convertible. Cross-border payments in foreign currencies and in RMB are subject to foreign exchange restrictions. Financing possibilities in China are considerably more restricted than in Germany. For example, factoring is not practiced in China. Foreign currency loans, including shareholder loans from the German parent company, may only be taken up in a certain relationship to the registered share capital. There is a maximum investment sum.

Furthermore, in the legal system one can observe the labour law is partly stricter and more employee-friendly which can lead to problems when cancelling an employment contract. The appendix to the employment contracts of general managers or CFOs should also include a stamp policy because in China a stamp can be used to completely replace a signature. The stamp should therefore be stored separately and in a safe place where third parties have no access.

China is well-known for violations of intellectual property rights and copyright. However, now that China has joined the World Trade Organisation, the situation has improved. In order to legally safeguard against the theft of intellectual property, invention patents, design patterns and industrial designs and brands should be immediately registered in China.

A double taxation agreement exists between Germany and China. However, in practice processing by the Chinese tax authorities can vary so that as well as studying the agreement it is also necessary to draw on the practical experience of professional advisors. A branch office is more quickly founded than expected in China and with individual projects the employees sent out could possibly be subject to personal income tax from the first day they arrive. When sending out employees the existing social security agreement between Germany and China should also be checked.

In Germany invoices are only printed on company paper. In China this is not sufficient for invoices in the domestic Chinese market. So-called "Fapiaos" must be issued. They are invoices containing sales tax. Corresponding blanks are available from the tax authorities. Fapiaos are required to carry out input tax deduction.

The audit of the annual financial statements for FIEs (foreign invested enterprises) is generally obligatory. The Chinese reporting standards are becoming ever closer to the IFRS. However, Chinese accounting practices cannot yet be compared with Germany and creative financial accounting is frequently seen in China. This is exactly why it is worthwhile having a highly qualified auditor who delivers more than just a 3 page report with the address of the company and the words "Everything's okay".

If you already have a representation located in China and your commitment is developing favourably enough that you are now planning to found a subsidiary, then please plan in good time. The founding of a new company usually takes two to three months (depending on the industrial sector) and with the liquidation of a company or representative office a longer period of time should be taken into account.

We at Rödl & Partner will advise you on your special situation. We will help you to recognise risks early and to establish efficient structures. We offer Mittelstand companies with international operations customised solutions for the Chinese market with four offices in Beijing, Guangzhou, Hong Kong and Shanghai.

# Practical examples

## Auditing

### Background facts:

A number of years ago a German company started a joint venture with a Chinese partner to be able to distribute technical equipment to the Chinese market. From the start a local auditor was commissioned to prepare the audit of the annual financial statement. Every year this auditor delivered an unqualified audit opinion without any reservations. Naturally for an unbeatably low-priced fee. In addition, the 3 page report was quick to read which especially pleased the Chinese partner as then he could attend to more important matters.

However, as time passed the German company became more sceptical because the communicated figures could not be reconciled to the business operations. Reluctantly, this year the Chinese partner agreed to engage Rödl & Partner to prepare the audit of the annual financial statement.

Suddenly the qualified auditor's report included wrongly declared customs duties going back more than three years, social security contributions which were not completely paid, bookings without documents and bank accounts which had not been adjusted for years. This does not correspond to proper financial accounting as we know it in Germany.

### What can be done now?

The execution of an internal audit is advisable. Errors made over a number of years have to be examined in detail. In addition, employees should be trained or retrained to avoid such mistakes

in future. Rödl & Partner offers services for auditing including internal audits and training and provides clients with tax and legal support in order to best avoid possible tax or legal risks.

### What should one have done differently from the beginning?

Even cost-conscious Mittelstand companies cannot afford to dispense with high quality financial accounting. The training of the Chinese employees or the sending of German financial accounting personnel from the start will ensure that the financial accounting is properly managed. Clients should receive advice beforehand on complex issues such as the payment of social security contributions to avoid later surprises. Regular monitoring of and support for the Chinese company is necessary together with critical analysis of the facts of the situation. In addition, an auditor such as Rödl & Partner which is also able to carry out HGB audits is an important control institution, especially as you yourself are a long way away. The higher fee also has a high value because legal or tax risks can have serious consequences and even lead to loss of the business licence.

## Taxes

### Background facts:

"Great!", thinks Mr. Nürnberg, shareholder of Fürth GmbH, "this year we have sent out a German employee to China and our Chinese subsidiary is already making a profit. Now we can increase the wage burden in China. And how practical it is that invoices abroad are even tax free!" Mr. Nürnberg shortly writes an invoice for "Wage expenses: 50,000 euros" to the Chinese subsidiary. In the evening he meets a good friend who also does business in China. His friend talks about the tax authorities in China and slowly Mr. Nürnberg starts to have doubts about his invoice. The next morning he calls Rödl & Partner and asks for advice.

### What can be done now?

The subsequent on-billing of costs for wages presents several risks. A simple charging-on of the costs would only be possible if China was the business employer and this is clearly defined by a contract. To make matters worse, the employee sent out usually continues to be insured for social security in Germany. The condition for this, however, is that no costs are recharged. In the present case the costs should be covered in the form of a service fee. For this purpose a service agreement must be concluded. In addition, there is the risk that the German parent company will be forced to establish a branch office in China. The consequence of this would be that Fürth GmbH would have to pay business tax and corporate income tax in China.

## What should one have done differently from the beginning?

Before the employee is sent out there should be clarity about whether the wage costs will be passed on or not. The International Expatriate Team department at the Rödl & Partner headquarters is available to answer special questions on the sending out of employees. Our four offices in China are your partners in the country. Tax matters and legal steps regarding social security should be clarified before the employee is sent out. This allows clarification of whether the charging on of the costs will be tax-free by means of a so-called cost and reimbursement agreement or not. And it's always true to say that employment contracts and other legal arrangements should be fixed at an early stage and be "water-tight", i.e. without loopholes. Our Chinese legal advisors will help you to achieve this – naturally in German.

## Law

### Background facts:

In the past the German Hangover GmbH took out protection worldwide for the brand name "Schwips". In their venture in China the brand name was then, due to legal regulations and for better recognition, translated into Chinese characters by the local business partner without the permission of the Hangover GmbH company and then also put on the products. After some time the Hangover GmbH decided to separate from its Chinese partner and to found an own subsidiary. Suddenly, however, this subsidiary was confronted with a restrictive injunction and claim for damages from the former Chinese partner who alleged that the trademark of the German company violated trademark law. To the surprise of Hangover GmbH, the business partner had registered the Chinese translation of the brand name "Schwips" in China as his own brand and now demanded impoundment of the products and compensation in China.

### What can be done now?

Now quick action was called for to prevent the impoundment of the products and to contest the claim of a trademark violation. The experts from Rödl & Partner called into action prepared a nullity suit against the Chinese business partner. The enforcement of such an action in China depends on many factors and is only achievable with difficulty. Rödl & Partner was, however, successful in proving the malice of the business partner as the partner had exploited his position of commercial agent to damage Hangover GmbH. As a result the Chinese subsidiary was able to register the brand name in Chinese characters in the usual way and continue to concentrate on its successful business operations in China.

## What should one have done differently from the beginning?

A distribution partner contract should have been concluded before the start of the venture in China which in particular also protects the intellectual property. Furthermore, the brand name in Chinese characters should be registered by Hangover GmbH at the trademark office in Beijing to protect the intellectual property and comply with the legal regulations. Rödl & Partner as your Chinese legal experts in the country support you with a comprehensive, high quality legal advice in the German language with the preparation of contracts, registration and enforcement of your intellectual property rights and copyrights in order to avoid similar unpleasant surprises in the best way possible. In this way we help protect you against additional obligations so that you can completely concentrate on your business operations.

## Law / Administration

### Background facts:

Mr. Yen has organised his collection of stamps neatly and tidily in the drawer of his desk, including the stamp for the legal representative, the contract stamp, the invoice stamp, the finance stamp, the customs stamp and naturally, not least, the company stamp.

Mr. Yen works as supervisor of the financial accounting in the Chinese subsidiary of the German Haushaltswaren GmbH. As he also wishes to share his good position with his friends and relations, he hires his brother as a warehouse worker, concludes a catering contract with the wife and finalises a consulting contract with his brother-in-law. The best thing for the family here is that apart from Mr. Yen no one really has to work. The wife cooks every day for her husband, the brother provides her with the newest household articles he has taken from the warehouse, and the uncle passes on the news from the local community in the course of the occasional enjoyable "business meal" so surely no-one will have anything to say about such contracts. When the auditor informs the managing director in Germany about these points he asks himself how this was possible without his signature.

### What can be done now?

It might seem strange for a German entrepreneur, but in China the mark of a stamp is usually sufficient to conclude a contract. A signature as is required in Germany is not necessary. The most important stamps are the company stamp and the stamp of the legal representative. Using these two stamps one can conclude almost any type of contract and the contract is legally effective. In order to maintain control in the company, these stamps should therefore



not be in the possession of a single person. In the present case Mr. Yen has abused his position. In cases with such a breach of trust the only course of action is the instant dismissal and enforcement of claims for damages.

### What should one have done differently from the beginning?

Rules governing the use of stamps should already be laid down when the branch office is founded. These rules define who uses and stores which stamp. The rules governing the use of stamps can then be included in the appendix of the employment contract of the respective employee. In the case of a violation there is at least internally a legal basis to make the corresponding employee accountable in a civil or criminal court. The liability regarding external parties remains unaffected by this. Many contracts and daily transactions only require the company and finance stamp. Important contracts, e.g. bank registrations or purchase of company shares, also require the stamp of the legal representative. If it is the case that the legal representative is located in Germany, it may be practical to store his stamp externally. Rödl & Partner also offers clients a service to store stamps. Stamps can be stored at our premises and are only released with the approval of the responsible person.

## Fraud

### Background facts:

Mr. Windig is owner of Sturm GmbH, manufacturer of storage battery systems for the field of wind energy. Five years ago Mr. Windig heard about enormous wind farms in North China and saw an opportunity to expand and opened a representative office in the country. He hired the trustworthy chief representative Mr. Chen who made a business-like impression and also spoke good German. Mr. Chen received a low wage of 10,000 RMB (approx. 1,300 euros) and a commission on each sale. Business really boomed and Mr. Chen was happy to receive monthly provisions of 80,000 RMB (approx. 10,100 euros). As business was so good, after three years a decision was taken to close the representative office and the trading company Sturm-China was founded. Mr. Chen had proven himself and Mr. Windig trusted him to handle the founding of the company in a professional manner. After all Mr. Chen is Chinese and knows the conditions and authorities in the country. Why involve an expensive consultant? At the same time Mr. Chen was appointed general manager.

Shortly afterwards the boom in China ended. Wind farms were no longer popular and the energy sector which is very much controlled by the state now promoted nuclear power stations to supply the conurbations on the east coast with electricity. "Luckily things are continuing to

run well in Germany. And Mr. Chen only receives a salary of 10,000 RMB so that our personnel costs are low”, thought Mr. Windig. A short time later Sturm-China needs more money. Due to foreign exchange controls, this is not possible through formal channels, but a transfer of 50,000 euros would not be noticeable on the private account of Mr. Chen. When last month Mr. Chen once again requested money Mr. Windig asked himself where the first 50.000 euros could be. “Which 50,000 euros? This much money has never arrived on our business account”, answered Mr. Chen.

### What can be done now?

Mr. Windig outlined the case to Rödl & Partner and a fraud audit was immediately carried out. After the removal of the commissions Mr. Chen could not maintain his standard of living. Using cash advances he had purchased expensive jewellery and paid for private trips. Expense claims of 15,000 euros pro month were usual. Mr. Chen's oldest friend and also in charge of the financial accounting at Sturm-China had always nodded these measures through. In return for his co-operation Mr. Chen had then made him a gift of a new Mercedes – naturally paid for by the company. Rödl & Partner immediately prepared the instant dismissal of Mr. Chen. The fraud audit was able to establish the extent of the financial loss and accordingly charges were made.

### What should one have done differently from the beginning?

Trust is good – control is better. Every German entrepreneur should keep an eye on the market and the employees. Commission a consultant to support you with the founding of a company. Critically question the demands of your Chinese subsidiary. They may be a sign of bad management. Check the business in the country and have a professional audit of the financial statement made and also internal audits in the course of the year might be an option. Rödl & Partner is familiar with all the relevant themes through the multidisciplinary co operation of legal advisors, tax consultants and auditors.

## White-collar crime

### Background facts:

After a number of years of business operations Mr. Wang takes over as new managing director of the management of the Chinese "Starlight Ltd.", a 100 % subsidiary of the German "Sonnenschein KG". Mr. Wang notices irregularities with transfers, expense claims and similar points and he also has a suspicion who may have been responsible – the long serving manager of the financial accounting department, Mrs. Diabolo.

He advises the parent company in Germany which immediately contacts Rödl & Partner. As a result the experts at Rödl & Partner carry out a fraud audit in order to establish the extent of the breach of trust. Accordingly, the suspicions of Mr. Wang are confirmed and Mrs. Diabolo is accused of extreme breach of trust. Mr. Wang immediately acts on the findings and authorises the instant dismissal of Mrs. Diabolo. However, a few weeks later the company is taken to court for unfair dismissal. Mrs. Diabolo, who has stolen from the company over many years, now demands an enormous settlement due to her dismissal. Mr. Wang again asks Rödl & Partner for legal advice.

### What can be done now?

At Rödl & Partner the team for corporate crime, the so-called white-collar crime team, is put on the case. The experts advise Starlight Ltd. to first of all stop the proceedings at the employment tribunal, where only one word against another would stand, by bringing criminal charges against Mrs. Diabolo. In order to bring criminal charges in China, however, the civil servants must first be convinced that indeed a serious case of corporate crime is present.

This is where the client benefited from the experience Rödl & Partner has in dealing with the authorities. After this persuasion process is completed, Rödl & Partner supports the police to collect evidence in order to meet the high standards for evidence of corporate crime and to prepare the court proceedings. Mrs. Diabolo, who in the meantime has been taken into custody, is sentenced by the court to six years of imprisonment. In the same proceedings a large amount of the losses can be reclaimed.

### What should one have done differently from the beginning?

The introduction of an appropriate internal control system would have made it much more difficult for the employee to inflict damage on the company. Rödl & Partner is happy to support you in the preparation, implementation and on-going adjustment of an internal control system.

Many small and medium-sized companies fear the costly and resource intensive internal control system. But good results can also already be achieved with a relatively low level of resources which better protect your company against misappropriation. In order to prevent employees from inflicting damage on the company, moral values, for example, must be lived and dual control or triple control introduced.