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China and the W.T.O.

Now China has entered the WTO will it offer better opportunities to do business in China, and more importantly, will a better legal and regulatory environment follow ?

We act for clients in Hong Kong and China and are involved in legal work in both jurisdictions, and are therefore in a position to offer some comments based on first hand experience of some of our clients in China,

We do not think that China joining the WTO is the bonanza that many would have us believe. China has no floating exchange rate with fully convertible currency and that factor alone creates immense difficulties in doing business there. As well, we would mention:

1. Beaucroatic supervision and consents from the Central Government Authorities are still the norm;
2. China is chronically short of tax revenue and any new venture in China will soon discover that there is an arbitrary tax system that does not always follow the stated rules; indeed, it is lottery, and we have known of clients meeting with the IRD in China to negotiate in an arbitrary way, the level of tax required for the following year;
3. Corruption is on a scale that few would imagine. As an example, we act for a listed company in Hong Kong that through the machinations of the PRC based director has lost a huge sum of money from a bond issue. The bank deposit slip in China may have been forged, and the whereabouts of the funds are unknown.
4. Police assistance in cases such as fraud may well depend how much you are prepared to pay the police to take some action. We have known of a case where it required payments of a substantial nature to get the police to investigate the possible fraud, and it may well be that the offender escaped justice by being in a position, in turn, to bribe the police. While we do not say that this kind of activity occurs in every case, the point we make is that it offers little comfort to a foreign investor who is expected to risk substantial sums which may not even be safe in a local bank.
5. We believe that what has happened recently in the Immigration area (see below) in China will be a blueprint for what happens to foreign investment in China. Immigration firms in China will be forced to join Joint Ventures with PRC owned and based enterprises, and will have to pay a share of profits to the JV partner. In short, as said, China needs more revenue and we have little doubt that ways will be found by the PRC to take a share of any income generated by foreign investment, and we believe the general celebration of China/WTO is premature.
6. For New Zealand firms we suggest that any new venture have its holding company based outside China in Hong Kong and that arbitration in the event of a dispute take place in Hong Kong. Arbitration decisions in Hong Kong can be enforced in China.

Tax issues for those trading/investing in China

There are a host of tax issues involved when a New Zealand or foreign investor trades with China, licenses software there, or carries out consultancy services in China.

We cannot cover all possible categories of trading in this Newsletter, but will mention just two where in our experience NZ companies have the most involvement in China.

(A) Cross Border Licensing:

Take a simple example. Kiwi Technology (Kiwi) has developed and licensed internet software to its China subsidiary, Kiwi China (KC). It has also delivered and licensed master copies of its software to a local China software company, China. Com. China. Com has the right to sell and install the software in China.

What are the tax implications for Kiwi relative to its royalties, and other income it might derive from China ?

- (1) Kiwi will have to enter into a technology licensing agreement with KC and have it registered with MOFTEC in China.
- (2) As China fears that overseas parent companies may siphon off the profits of its China subsidiaries, the royalty rate will be scrutinized and royalty rates will be limited to a maximum of 5 percent of net sales or 20% of net profits.
- (3) Royalty rates will be adjusted if they are not in sympathy with the rates payable between non affiliated companies.
- (4) Under Article 19 of the Income Tax Law, KC , if it has no permanent establishment or site in China, will pay withholding tax of 20% on royalties, which may be reduced by the provisions of the appropriate double tax treaty.
- (5) KC may also have a liability to pay an additional 5% on the transfer of technology- software licensing is classified as a transfer of intangible assets.
- (6) Complex issues will also arise in relation to customs duties and VAT on the software manuals imported into China. While no duty is imposed on printed books (and therefore the manuals are exempt) China assesses customs duty on the value of media and software. Calculating a value of a master copy is very difficult, and reference to past sales and the current licensing agreement is usually adopted.
- (7) VAT is imposed on goods imported into China and based on the price used for customs duties + the duty x 17%
- (8) There is no clear policy on electronic imports, which currently do not appear liable to customs duties or VAT.

(B) Construction, Consultancy, Development Work

NZ Agricultural Systems (NZAS) is to provide pumps and associated computer equipment to Shanghai Greenhouses (SG), a local company wishing to establish greenhouses in China. NZAS will sell, install and maintain the equipment for a period of 5 years.

What regulatory and tax issues will NZAS face ?

1. NZAS must obtain a Foreign Qualification Permit relative to the construction project, obtain a business license and register for tax. A copy of the contract between NZAS and SG will need to be produced.
2. Generally speaking, absent application of double tax treaty provisions, NZAS will be deemed to have a permanent establishment in China if its business will continue in China over 6 months. Note that the China/Mauritius double tax treaty gave some favourable benefits to activities undertaken for up to 12 months (no permanent establishment) although this is under review.
3. NZAS will be liable to pay PRC income tax on its income derived from China, but there are different rules for calculating the income.
4. One rule is based on the net income of the permanent establishment, and the other on the deemed profit. The deemed profit method is usually adopted.
5. Deductions from the contract price or gross income are allowed, but are defined in a series of circulars issued by MOF- they include payments for sub-contracting to a Chinese enterprise, and amounts paid by NZAS outside China for manufacture of machinery required for the project.
6. Enterprise tax at 33 percent is payable on profits, as well as business tax of 3 percent.
7. The NZ./China double tax treaty may not be of assistance to NZAS where projects are long term over 6 months.
8. If Hong Kong is used as a holding company there will some double tax benefits under the treaty between Hong Kong and China, but the benefits are not generous compared with say Mauritius, and even (surprisingly) Belarus, which allows 20 months activity before there is a deemed permanent establishment in China.
9. If Hong Kong is to be used (and there are some compelling non- tax reasons to do so) then consideration may be given to establishment of a branch in Hong Kong as opposed to a subsidiary thus allowing continued use of home or other treaty provisions.
10. In major construction projects, other issues that will arise are how consultancy fees, fees for feasibility studies etc, can be paid ex China when in many instances the consent of the Bank of China to remission of funds may not be available. Some careful planning is advisable before commitments are entered into in China.

Letters of Credit(L/C) –Use and Common Pitfalls

Most NZ companies exporting goods are aware of and use the Documentary Letter of Credit system as established by the Uniform Customs and Practice for Documentary Credits (UCP) published by the International Chamber of Commerce. We have however come across examples recently where a somewhat silly insular approach has been adopted by NZ companies who tell a buyer in another country that they want “ all the money up front “ before they will manufacture and/ or ship the goods. This displays a crass ignorance of international trading generally, and moreover is unacceptable as a commercial business risk to a buyer. What happens if the NZ Vendor takes the money, and refuses or is unable to perform, or goes bankrupt ? Obviously no sensible international trader will agree to pay all the money up front, absent perhaps a 10% deposit.

In dealing with China and other countries, NZ companies will have no choice but to deal with potential buyers under the UCP system. However, caution is necessary where the Bank in China is unknown, and not of international standing. Hong Kong is not a problem, as its banks are highly regulated and have strict capital ratios to comply with. The Bank of China is acceptable as the issuing bank for a L/C, as is the HSBC, one of the leading issuers of L/C's in Asia.

We mentioned pitfalls when dealing with L/C's and will mention the following as some of the more common problems that our clients have encountered recently.

1. Mode of nomination of the L/C as the payment option in the Sales Contract/Initial Invoice.

Kiwi Fine Skins Ltd (KFS) agrees to sell NZ\$1.00 Million Dollars of treated skins to Below the Belt Trading HK Limited (BBT). There is no formal sales contract, other than a letter referring to “ Payment by L/C through HSBC- no other bank” ” and the same statement in the initial invoice to BBT. BBT arranges for HSBS to issue an irrevocable L/C to ANZ Bank in NZ as the advising bank to KFS with the time for production of Bill of Lading and other usual documents, or in other words, the expiry date of the credit, being the 28/2/2002. Unfortunately, ANZ staff acting for KFS present the Bill of Lading, shipping and other documents to HSBC on 1/3/2002. one day late. KFS ask BBT to honour the contract of sale, but the lawyers for BBT write a letter saying that as the only method of payment specified was payment by L/C and that has failed, BBT has cancelled the deal, and KFS must make it own arrangements to deal with the shipment currently in containers at the Kwai Chung container port in Hong Kong, and incurring storage and other costs at the rate of US\$200.00 per day.

This type of problem is not uncommon, but what is the legal position, and can KFS sue BBT for

L/C – use and pitfalls (continued)

price of the skins ?

The general law is that the L/C is a method of payment only, and is indeed a separate contract for the sale of documents by the Bank in return for the cash. Usually the Vendor retains a right under the sales contract to pursue the buyer for the price of the goods notwithstanding the failure of the L/C. However, in this instance, the buyer may be able to argue that the statement “ Payment by L/C- HSBC only” may have meant that the method of payment was vital, and payment was only to be by L/C through a nominated bank. It is obvious that some care is needed when nominating the method of payment, lest a party is unwittingly caught by a careless statement in an invoice.

2. Discrepancies in the description of Goods

In an L/C the goods are described as “ 20,000 cans of best quality NZ pickled salmon” and the port of shipment is described as Dhaka, Bangladesh

In the Commercial Invoice the goods are described as “20,000 cans of best quality salmon, and the port is stated to be Dhake, Bangladesh.

In all other documents the descriptions are correct in all respects.

The issuing Bank in Bangladesh refuses to honour the L/C on the basis that the description of goods is incorrect and the name of Dhake is spelt wrongly.

The Bank would be correct insofar as the description of the salmon is concerned. It is a general principal that goods described in the Commercial Invoice must correspond exactly with the description in the L/C. However, spelling errors and minor typographical errors do not normally invalidate a credit (there is a Hong Kong case on this point) and the effect of UCP, Art. 37 (C) is that in all other documents goods may be described in general terms not inconsistent with the description of goods in the credit itself.

3 The Obligations of the Issuing Bank on rejection of the L/C.

It should not be forgotten that the Bank refusing to honour the L/C has certain obligations, one of which is to inform the party from whom it received the documents of their rejection. That notice must be given within 7 days- see UCP Arts. 13(b), 14(d) (i).

It must also state in detail the reasons for rejection, and that it is holding the documents at the disposal of or is returning them to presenter. If these requirements are not observed, it is precluded from claiming non- compliance with the credit.

Foreign Immigration firms operating in China

From the 1/1/2002 China has elected to legislate and control the activities of foreign immigration and consultancy firms, and a selection process now in action will set up licensed PRC Government affiliated firms in Beijing, Shanghai, and Guangzhou to operate from the 1/1/2002. These firms will provide premises for rental to the foreign firms and the foreign firm will need to enter into a Joint Venture with the PRC firm under which a share of profits on a percentage basis is paid to the PRC company. However, we cannot see that a local firm with foreign affiliations is caught by these regulations.

This is a poor deal for existing and new foreign firms operating in China, but there appears no choice but to comply in order to avoid being closed down by the police.

Trade Mark Registration in Hong Kong

We provide trade mark services to obtain and register trade marks in Hong Kong. A feature of Hong Kong tax law is that it is possible for say an offshore company to grant a right to a Hong Kong company to sub- license a trade mark outside Hong Kong with the resulting licensing revenues from the HK company paid to the offshore company being exempt from HK profits tax. Apart from tax in a home jurisdiction, this is a tax effective way for a NZ Co. to use Hong Kong as a base.

Our services in New Zealand and Hong Kong

While the focus of our operations is still Hong Kong and China based clients, we are increasingly being asked by NZ companies to assist with advice on trade, investment and IP issues in Hong Kong and China.

We are happy to offer advice on most commercial law and tax issues, and our Mr. Brears remains a practicing member of a Hong Kong legal firm. For the most part it is possible to offer services in New Zealand at NZ charge out rates, which are some 50% cheaper than charge out rates in Hong Kong.

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