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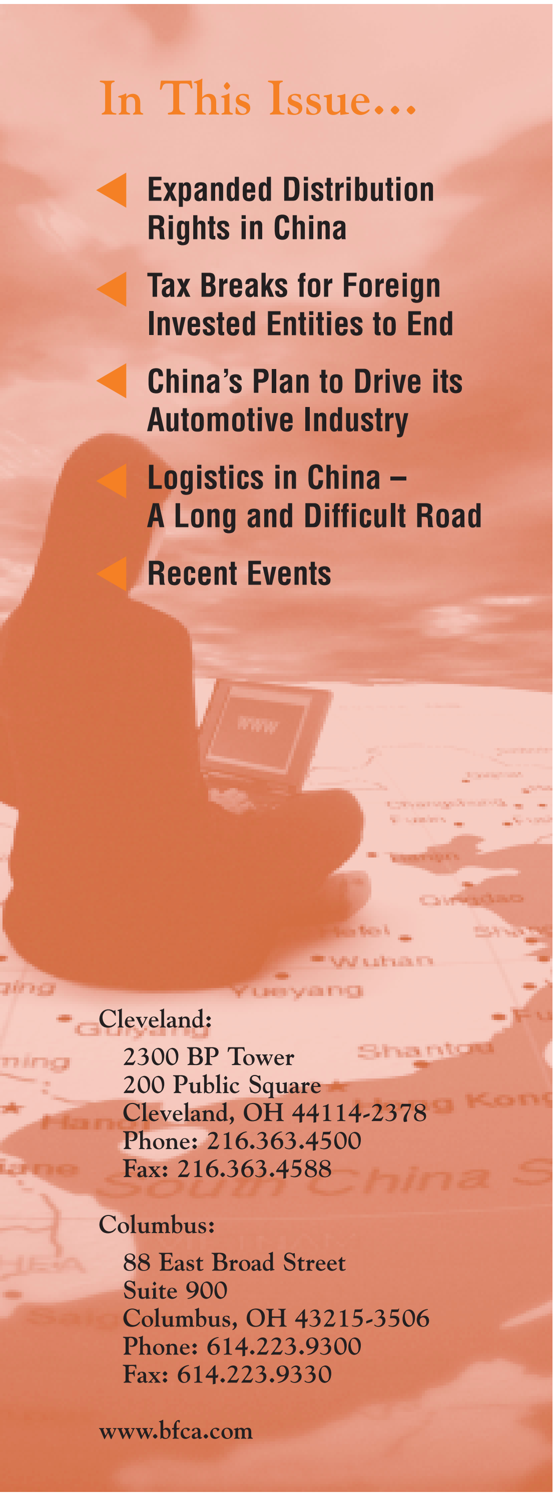

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Expanded Distribution Rights in China

In our 2004 March/April and May/June issues of *China Insights*, we reported that the Measures for the Administration of Foreign Investment in the Commercial Sector were issued by the Ministry of Commerce ("MOFCOM") on April 16, 2004 (the "Distribution Regulation"), by which China took steps to open its commercial sector to foreign investors.

I. BACKGROUND AND SCOPE

The Distribution Regulation allows foreign invested enterprises ("FIEs") to distribute imported and locally-manufactured products through their own wholesale, retail and franchise systems and to provide a host of related services. However, according to the literal meaning of the Distribution Regulation, it is applicable only to foreign invested *commercial*[1] enterprises ("FICEs"), and it does not offer any guidance to non-commercial enterprises that wish to engage in the business of distribution. Such guidance is now available. On April 2, 2005, MOFCOM issued the Notice on Relevant Issues Concerning Expanding Distribution Business Scope of Foreign Invested Non-Commercial Enterprise (the "Notice"). The Notice sets out the necessary procedures for non-commercial enterprises to expand the scope of their distribution business. The Notice makes clear that the Distribution Regulation is applicable to non-commercial as well as commercial enterprises that wish to expand their business scope to include distribution rights.[2]

II. TAX CONSIDERATIONS

In determining the magnitude of its distribution business, an FIE in the manufacturing business should consider certain tax implications. Because certain tax incentives and benefits are available only to manufacturing enterprises, the benefit of expanding into the distribution business must be balanced with the benefit of maintaining status as a manufacturing enterprise by the FIEs in order to continue enjoying certain tax benefits. The Notice provides, among other things, that in order to maintain this status, revenue from distribution activities cannot exceed 30% of total sales.

III. APPROVAL AUTHORITY

Generally speaking, under the Distribution Regulation, if an FIE wants to establish a wholesaling distribution channel, it must receive approval from MOFCOM; retail distribution may be approved by the applicable provincial level commerce bureau. Since the approval process conducted at a provincial level can be significantly shorter than that conducted by MOFCOM, a manufacturing business may wish to engage in retail distribution only. However, determining what constitutes retail distribution requires a careful reading of the Distribution Regulation and proper advice. The Distribution Regulation defines "wholesale" as the "sale of goods to retailers, to industrial, commercial and institutional users, and to other wholesalers, and provision of related subordinated service;" while it defines "retail" as the "sale of goods for individual or collective consumption from a fixed location or via television, telephone, mail order, internet, or vending machine, and provision of related subordinated services." These definitions are contrary to generally accepted concepts in both the U.S. and

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[1] Although neither the Distribution Regulation nor the Notice specifically define "commercial" or "non-commercial" enterprises, a commercial enterprise is understood to be one engaged primarily in selling goods manufactured by others, while a non-commercial enterprise is one that is engaged primarily in selling goods that it has manufactured.

[2] In November 2004, MOFCOM revised the Administration Regulation For China Holding Companies, effective as of December 23, 2004. According to this regulation, a China Holding Company ("CHC") can apply to engage in "domestic sale (excluding retailing) of its parent entity's products imported by the CHC." Upon obtaining regional headquarters status, a CHC can also distribute products imported from related companies. The Notice allows a CHC to import from third parties or engage in other distribution services, such as commission agency and retailing by complying with the Notice and the Distribution Regulation. The Notice is also applicable to holding companies/regional headquarters.

China and the inconsistencies between them confuses, among other things, whether retailing to an industrial user will be deemed to be wholesaling. According to the Merriam-Webster Dictionary, "wholesale" is "the sale of commodities in quantity usually for resale", while "retail" is defined as "the sale of commodities or goods in small quantities to ultimate consumers." These definitions are nearly identical to those defined by the Modern Chinese Dictionary. Under these generally accepted definitions, retailing would not be deemed to constitute wholesaling if the goods are being sold to an industrial user. In order to clarify this issue, we made inquiries of several provincial level commerce bureaus as well as MOFCOM, and, apparently, consistent positions on this distinction have not yet been developed. We expect further interpretation will ultimately be provided by MOFCOM.

According to the Distribution Regulation, the application may be approved by the provincial level commerce bureau if the application is made by a Chinese-controlled joint venture or if a retail, non-commercial FIE satisfies the following conditions:

(1) a retail FIE does not engage in television, telephone, mail order, Internet, or vending machine sales;
(2) it does not deal in the restricted merchandise listed in the Distribution Regulation, such as pharmaceuticals, tobacco, petro-chemicals and cars;[3] and
(3) it meets the following conditions:
   a. if the area of a single shop does not exceed 3,000 square meters and the total number of shops in the province does not exceed three, and the number of shops in the same class opened by the FIE in China does not exceed 30; and
   b. if the area of a single shop does not exceed 300 square meters and the total number of shops in the province does not exceed 30, and the number of the shops in the same class opened by the FIE in China does not exceed 30.

> "...the approval process conducted at a provincial level can be significantly shorter than that conducted by MOFCOM..."

IV. APPROVAL PROCEDURE

In general, a non-commercial FIE should complete the following procedures to engage in the business of distribution:

(1) appropriately amend its articles of association and the joint venture contract, if applicable;
(2) complete the relevant form attached to the Notice, in which the non-commercial enterprise must specify the distribution type, including wholesale, retail, or commission agency;[4] and
(3) submit a list of products that it intends to distribute.

To apply for approval, a non-commercial enterprise must submit its application to the provincial level commerce bureau where the non-commercial enterprise is located. The provincial level commerce bureau will conduct a preliminary review and then transfer the application materials to MOFCOM (if MOFCOM has jurisdiction over the application). The approval process for both steps should not exceed four months (although this time frame has yet to be tested). However, if the provincial level commerce bureau has jurisdiction over the application, the decision should generally take about 15 business days.

If you have questions about revising your company's strategies to seek broader commercial advantage, or have any other questions about doing business in China, please contact Yanping Wang at 216.363.4664 or ywang@bfca.com, or Allan Goldner at 216.363.4623 or agoldner@bfca.com.

[3] Some of the restrictions on particular classes of goods will be lifted by the end of 2006.

[4] Approval procedures for franchising are provided under the Measures for the Administration of Commercial Franchise Operations, promulgated by MOFCOM on December 30, 2004 and effective as of February 1, 2005. The rules governing non-commercial enterprises wishing to expand their business scope to include franchising have not yet been released.

Tax Breaks for Foreign Invested Entities to End

Following several months of speculation that "corporate" income tax unification is at hand, Chinese and western news sources are now reporting that China will, in fact, end its system of taxing domestic and foreign enterprises at different income tax rates.

Under China's 1993 enterprise income tax regulations, the nominal income tax rate for domestic enterprises is 33 percent. China's 1991 income tax law provides that foreign invested enterprises ("FIEs") are generally taxed at a 30 percent rate; however, FIEs operating in special economic development zones ("EDZs") typically pay income tax at a 15 percent rate. Moreover, FIEs in EDZs are generally afforded an income tax holiday reducing the tax rate to zero for the first two years of *profitable* operations and reducing the otherwise applicable rate by one-half for the next three years.

Tax rate unification has been expected in large part because of China's accession to the World Trade Organization ("WTO") in December, 2001. While the WTO does not require the change, member countries are strongly encouraged to provide a level playing field for domestic and foreign businesses, so that domestic businesses are not disadvantaged by favoritism shown to FIEs.

Although the relevant regulations have not yet been published, the May 30 issue of China Daily reported that the income tax break for FIEs will end in 2007. New FIEs, as well as domestic businesses, are then expected to be taxed at 24 percent, and FIEs that entered China prior to 2007 will likely benefit from a five-year transition period, during which they will be taxed at current discounted rates.

It is too early to know what impact tax unification will have on foreign investment in China, but it seems unlikely that these changes will have a significant long-term impact on the flow of tens of billions of dollars of annual investment from around the world. Indeed, the rate of foreign investment may accelerate between now and the as yet undetermined 2007 effective date of the new regulation, as foreign businesses attempt to lock in current tax rates for the five-year transition period. In the coming months, we will monitor updates in China's tax laws in order to determine the ultimate treatment of FIEs, as the new tax rates, as well as specific exemptions and other tax breaks that may still be afforded in certain industries and EDZs, are formalized.

For more information regarding this article, contact Peter Shelton at 216.363.4169 or pshelton@bfca.com.

China's Plan to Drive its Automotive Industry

Much can be read about the current precarious state of the automotive industry in the United States. For a change of pace and perspective, this commentary reports on the Chinese view of the state of China's automotive industry.

While in China last month, my colleague, Peter Shelton, and I attended The Second International Forum for the Development of Automobile and Auto Parts Industries in Qingdao, China. We attended several presentations regarding China's fast developing automotive industry, including a discussion by Ms. Wang Qinhua, Director General of the Industrial Damage Investigation Bureau of the Ministry of Commerce. This Bureau is charged with protecting domestic Chinese industry. A significant focus has been placed upon the automotive industry's prospects in China after China's accession to the WTO. From 1953 to 1991, total automotive production volume in China was about 1 million vehicles annually. From 1992 to 2000, that number increased to 2 million. In the three years since accession to the WTO, production volume has increased by 1 million each year and in 2004 was 5 million, presently ranking China fourth in the world in automotive production.

> "The Chinese government is encouraging the Chinese automotive industry to enter international competition actively…"

Automobile parts exports have also become an increasingly key business sector. In 2004, the automotive industry in China was responsible for U.S. $8.2 billion in exports, a 73% increase over the prior year. Ninety percent of those exports are automotive parts (rather than complete vehicles).

The Industrial Damage Investigation Bureau ("the Bureau") is concerned with the competitiveness of China's automotive industry, especially as import duties in China are reduced or eliminated under WTO agreements. The Chinese fully recognize the large gap between foreign production technology, scale, brand, marketing and service, both domestically (within China) and internationally. The Bureau has been investigating the global automotive industry and publishes those learnings so that domestic Chinese companies might improve and compete more effectively in the global market.

Ms. Qinhua presented a plan to quickly develop the industry. The four points of the plan stem from the acronym "AUTO."

"A" stands for Active. The Bureau encourages businesses to actively face the challenge of the post WTO entry transition period. Chinese companies must improve their competitiveness and establish independent intellectual property and brand in order to achieve sustainable development. She also encouraged avoiding "trade strife" by actively adopting common international practices.

"U" stands for Users. Rather than focus solely on production of automotive parts for export, Ms. Qinhua encourages synchronistic development of complete automobiles. This requires more rationalization of the development of the domestic Chinese automotive market.

"T" stands for Technology. China clearly recognizes that it lags behind in research and development. Ms. Qinhua said, "Nowadays some companies are wild about assembling for short time profit and neglect R&D and the absorption of imported technology." Most anyone who has done business in China, whether through a joint venture or otherwise, can testify to the incredible importance technology transfer plays in negotiations. This is the very reason that protecting intellectual property is a paramount consideration when determining how to do business in China.

"O" stands for Overseas Market. Ms. Qinhua encouraged the Chinese automotive industry to enter international competition actively and place greater emphasis on development of overseas markets – both for export and investment – to take advantage of both markets and resources (domestic and international).

Significant resources are being dedicated to the rational development of the automotive industry in China. Given China's rapid development in recent years, it is not unrealistic to expect that Chinese designed and manufactured cars will be sold in the United States in the next several years. In fact, Visionary Vehicles, a privately held New York company, announced earlier this year that, by 2007, the first Chinese-made automobiles would be brought to the United States and Visionary has reportedly been selling dealership franchises for one Chinese auto maker, Chery.

For more information on this topic, contact Megan Mehalko at 216.363.4487 or mmehalko@bfca.com.

Logistics in China – A Long and Difficult Road

U.S. businesses with operations in China need to be concerned with establishing and maintaining efficient and dependable arrangements for the movement of their goods. A comparison of the logistics system in China to the logistics system in the U.S. demonstrates the challenge. Logistics costs in China are 25-30% of overall product costs, compared to 5-7% of overall product costs in the U.S. In China, transportation and logistics costs account for up to 19% of GDP compared to 7% of GDP in the U.S. Businesses moving goods in China have to deal with an underdeveloped transportation infrastructure and with a lack of the experienced management needed to facilitate the movement of goods.

In part, the inefficient logistics system is a function of geographic barriers in China that can make the movement of goods difficult. However, the system is also a victim of political barriers created by multiple government bureaucracies. The result is a highly fragmented, underdeveloped logistics industry where inefficiency is the norm rather than the exception.

In light of the importance of a dependable logistics system to China's economic development, it is not surprising that government officials are trying to address the weaknesses in the country's infrastructure. Based on information that we view as being reliable, we make the following observations:

HIGHWAYS

Over the next five years, China intends to add 23% more roads, thus giving China total highway length of 50,000 km. Ninety

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percent (90%) of population centers of 200,000 or more will be connected by highways. Over the next 15 years, China expects to have 3 million km of paved roads, of which 70,000 km will be highways. All population centers of 200,000 or more will be connected by highways. Anyone who has seen the amount of highway construction going on in China today can have little doubt that massive road building is, in fact, under way.

RAIL

China has similar plans to develop its inadequate rail system. The current five year plan includes construction of 100,000 km of new rail, of which 30,000 will be high speed passenger rail. In addition to the rail construction, the plan includes establishing competition among the rail systems and an improved information technology infrastructure.

However, development of freight transportation by rail continues to lag behind the other modes. Only a small percentage of freight is containerized and only a small percentage of that freight has access to intermodal loading and unloading facilities. In addition, scheduling can be difficult because a freight train may be delayed in deference to passenger traffic. Only time will tell whether, by the end of the next five year period, rail will begin to rival highway freight transportation.

> **"Logistics costs in China are 25-30% of overall product costs, compared to 5-7% of overall product costs in the U.S."**

WATER

Most of the traffic between China and the U.S. goes by container ship. Congestion in Long Beach and other west coast ports has created major delays that have had a negative impact on U.S.-China trade. According to the April 14, 2005 "online" edition of the *Journal of Commerce*, container volumes in China increased 20 to 30 percent in 2004. However, because of expansion projects, ports experienced minimal congestion compared to the problems in the U.S. To keep up with anticipated volume increases, Cosco Pacific, China's largest container line, has announced that it is expanding its terminal operations from approximately 25 million TEU's (twenty-foot equivalent units) to approximately 36 million TEU's. Facilities will be expanded in Tianjin, Nansha, Ningbo and Nanjing.

AIR

A relatively small portion of China-U.S. freight moves by air – obviously because of the greater cost. However, shippers of certain high price-low volume goods, such as proprietary electronic components and bio-medical devices, make use of air freight, as do shippers subject to urgent time constraints. The number of U.S. – China air freight carriers and routes has been increasing significantly in recent times, and this trend can be expected to continue. Competition for landing slots at crowded Chinese airports is fierce.

CONCLUSION

Infrastructure improvements will improve logistics performance in China. However, logistics managers need to be able to deal with a variety of problems in their day to day operations. For example, transportation regulation in China is complex and, by U.S. standards, irrational. Each province establishes its own rules, and accordingly, a truck that may be perfectly acceptable in one province might be prevented from traveling in the next province. In addition, provincial rules may conflict with the rules established by the central government. To make matters worse, the application and enforcement of those rules can vary from day to day, as is true in many other aspects of China's complex and evolving regulatory environment. The result can be delays and frustration for logistics managers who are not prepared.

Given the growth in the U.S.-China trade, the infrastructure improvements will be welcome. However, logistics in China will remain a challenge for the foreseeable future.

For more information on this topic, contact Robert Spira at 216.363.4413 or rspira@bfca.com.

How We Work With Clients

We help U.S. companies: (1) establish China-related strategic alliances and joint ventures for manufacturing and distribution; (2) establish wholly owned manufacturing or other business operations in China; (3) acquire the shares or assets of China-based companies; (4) deal with governmental and operationally-related legal issues in China; (5) source components or products from China, and deal with related logistics issues; and (6) develop U.S.-based solutions to competition from China.

We help clients structure, negotiate and document China-related transactions, and provide counsel with respect to capital structure, operating control, governance, due diligence and other issues.

In the area of intellectual property, we are experienced in working with our China-based colleagues and governmental officials to maximize the protection of our clients' valuable patents, trademarks, know-how, trade secrets and other intellectual property rights.

Our established network of highly competent, experienced and reliable U.S. and China-based service providers enable us to help produce complete China business/legal solutions. Together we provide U.S., China and other international legal, tax, governmental relations, import/export, construction, operational and other solutions for our clients in a cost effective manner.

Recent Events

In April , China Group members Peter Shelton and Megan Mehalko traveled to China with a number of U.S. businessmen exploring opportunities for investment in the PRC. While in China, the group attended a major automotive show in Shanghai and an automotive conference in Qingdao, where they also had the opportunity to tour a number of special economic zones and meet with representatives of Chinese manufacturing businesses as well as government officials. The group was able to tour plants owned by Eaton, Delphi, First Auto Works and Heier, among others. (*See* Megan's article discussing the Qingdao conference on page 3 of this issue.)

On May 6, Benesch intellectual property attorney Scott Harders addressed intellectual property rights in China at the *China Challenge* conference held in Sandusky, Ohio. Allan Goldner and Yanping Wang were among the members of the China Group in attendance at this Benesch-sponsored event.

FOR MORE INFORMATION OR TO DISCUSS ANY ASPECT OF YOUR CHINA STRATEGY, CONTACT ANY MEMBER OF OUR CHINA GROUP:

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