Cross-Border Technology Transfer to China: Traps, Pitfalls and Critical Issues

September 20, 2012
Palo Alto, California
Mitigating the Risks of Doing Business in China

September 20, 2012

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Strategy & Operations Director
Deloitte Consulting, LLP
China offers significant market potential that can be hampered by significant risks

Companies are expecting increased revenues from China over the next 3 years

Revenue Expectations from China in next 3 years

Global weakness has affected China’s economic growth, slowing to 7.6% in Q2 2012, however the China market is growing faster than the global average indicating continued investment opportunity

Potential revenue opportunity in China

Sources: (1) Deloitte Consulting emerging markets survey conducted in 2011; (2) Weekly Economic Update (7/9/12) (3) 22 companies reporting revenue earned in China, Economist Intelligence Unite and Deloitte Analysis
Mitigating risks to profitability and value creation is critical

<table>
<thead>
<tr>
<th>Type of Risk</th>
<th>Likelihood</th>
<th>Potential Impact</th>
</tr>
</thead>
<tbody>
<tr>
<td>IP Protection</td>
<td>High</td>
<td>1</td>
</tr>
<tr>
<td>Negative Impact on USG-Related Business</td>
<td>High</td>
<td>2</td>
</tr>
<tr>
<td>Export / OFAC Compliance</td>
<td>Medium</td>
<td>3</td>
</tr>
<tr>
<td>Compromise of U.S. Ethics Laws</td>
<td>Medium</td>
<td>4</td>
</tr>
<tr>
<td>Ineffective Legal Entity and Business Structure</td>
<td>High</td>
<td>5</td>
</tr>
<tr>
<td>Partner Turning Competitor</td>
<td>Medium</td>
<td>6</td>
</tr>
<tr>
<td>Market Restrictions</td>
<td>Medium</td>
<td>7</td>
</tr>
<tr>
<td>Profitability in China</td>
<td>High</td>
<td>8</td>
</tr>
</tbody>
</table>

Diagram:
- USG-Related Business (1)
- IP Protection (2)
- Ineffective Legal Entity & Business Structure (5)
- Export / OFAC Compliance (3)
- Partner Turning Competitor (6)
- Profitability in China (8)
- Market Restrictions (7)

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Protecting IP is typically cited as the most significant challenge to operating in China

<table>
<thead>
<tr>
<th>% of Companies Citing Challenges in China as Significant¹</th>
<th>IP Risks in China</th>
</tr>
</thead>
<tbody>
<tr>
<td>Adequate IP protection</td>
<td>Local companies are known to introduce rival products within 2-6 months of a new product introduction by an MNC</td>
</tr>
<tr>
<td>Competition from local competitors</td>
<td>Significant number of IP related lawsuits between MNCs and Chinese companies indicate existence of IP infringement practices (~60,000 in 2011, up from ~43,000 in 2010)²</td>
</tr>
<tr>
<td>Understanding customers buying behavior</td>
<td>Government regulations on IP creation and usage makes it mandatory for MNCs to share IP in China in certain instances</td>
</tr>
<tr>
<td>Brand awareness in the market</td>
<td></td>
</tr>
<tr>
<td>Providing affordable products and services</td>
<td></td>
</tr>
<tr>
<td>Adequate supply of skilled labor</td>
<td></td>
</tr>
<tr>
<td>Protectionist policies or government red tape</td>
<td></td>
</tr>
<tr>
<td>Establishing partnerships with local companies</td>
<td></td>
</tr>
<tr>
<td>Supply chain capabilities</td>
<td></td>
</tr>
<tr>
<td>Infrastructure problems</td>
<td></td>
</tr>
</tbody>
</table>

Sources: (1) Deloitte Consulting emerging markets survey conducted in 2011, (2) China Patent Agent LTD., (3) Nera Economic Consulting estimate
An IP protection strategy should be integrated from the product strategy through the operating model and tactics

1. Identify products being sold in China

   - Identify the products and services best suited to China market – determine whether to:
     1. Take the whole stack (but restrict access to core technology), or
     2. Dedicate less valuable technology that is sufficient to meet current market demand

2. Establish a clear integrated strategy

   - Create a China IP Protection Control Structure that integrates politics, partners, people, process, vendors, and technology
   - Define clear operating model (e.g., human resources, vendor management, manufacturing, supply chain, information technology)

3. Manage operations with IP protection in mind

   - Redesign R&D processes to increase compartmentalization and protection; this will result in higher IP management costs
   - Program, implement, and commercialize technology development with value management in mind, building IP protection into processes

4. Apply the right tactics to protect IP

   - Define processes and controls throughout all business functions to safeguard IP
     - Change product development cadence and release cycles

Implementation Steps

1. Identify products being sold in China
2. Establish a clear integrated strategy
3. Manage operations with IP protection in mind
4. Apply the right tactics to protect IP
In addition to IP protection concerns, there is a risk that U.S. government (USG) agencies could have concerns about offshore operations in certain countries.

**Key Risks**
- Certain USG agencies may have concerns surrounding their product and/or service providers operating in certain countries.
- Key concerns appear to revolve around the following:
  - Loss of U.S. IP
  - Products or product code being infiltrated or corrupted by foreign parties
  - Network and IT access into USG data centers or systems
  - USG related information becoming accessible

**Mitigation Approach**
- Companies should wall-off foreign operations from public sector business in a way that is auditable.
- Leading practices include creating two sets of operational, network, and IT firewalls:
  1. Between Offshore and US businesses
  2. Between US and US Government Services divisions
- Companies should proactively develop programs to educate government customers.
- Mitigation approach should be structured to address operations for each business function across eight key security threads.

Negative USG perceptions of the company may impact existing and future contracts / business may lead to loss of revenue and USG audits.
Protecting IP and assuaging U.S. Government concerns requires a reengineered operating model.
Risks should be managed through an integrated, cross-functional program

**Function Responsible For Mitigating Risk**

- **Executive Office**
  - Operations
  - Sales & Marketing
  - Finance

- **HR**

- **IT**

- **Legal & Risk**

**Sample Roadmap**

<table>
<thead>
<tr>
<th>Initiatives</th>
<th>Year 1 (FY10)</th>
<th>Year 2 (FY11)</th>
<th>Year 3 (FY12)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Specialized buy-sell entity</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2 International – Holding Co. &amp; Location</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3 Increase Manufacturing Footprint</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4 No U-Turn</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>5 IP and R&amp;D Strategy</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>6 Enable Direct Sales</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Type of Risk**

1. IP Protection
2. Negative Impact on USG-Related Business
3. Export / OFAC Compliance
4. Compromise of U.S. Ethics Laws
5. Ineffective Legal Entity & Business Structure
6. Partner Turning Competitor
7. Market Restrictions
8. Profitability in China
Andy is a business advisor with more than 15 years of experience leading efforts to help business executives overcome their most pressing challenges. His primary focus is on advising companies on ways to improve financial position by restructuring their operating models to improve the focus on future growth prospects. In addition to this focus area.

Andy is a lead in Deloitte’s cross-border investment practice with a focus on helping companies meet U.S. national security expectations, as well as helping them protect their intellectual property as they expand globally. He has led Deloitte’s efforts on a number of high profile CFIUS cases.

Andy has worked with telecom and high tech clients and has worked in China, Latin America and Europe on their behalf. He is the author of a number of articles, including, most recently an article published in the Wall Street Journal entitled “Improving the Yield on your corporate investment portfolio.”
Legal, Regulatory and Transaction Issues

James C. Chapman, Partner
Foley & Lardner LLP
China’s Regulations on Administration of Technology Import and Export (Technology Regulations), effective January 1, 2002, govern the import and export of technologies into and out of China.
The Technology Regulations classify technologies into three broad categories, including:

1. Prohibited technologies: Cannot be imported into or exported out of China.
2. Restricted technologies: Import and export must be pre-approved by the relevant Chinese governmental authority, and copies of the relevant technology transfer agreement must be submitted to the relevant governmental authority.
3. Permitted technologies: Can be imported into or exported out of China without prior Chinese governmental approval.
Forms of Technology Transfers

- Technology transactions may take a variety of forms. All of the following transactions are subject to the Technology Regulations:
  - Patent assignments
  - Assignments of patent application rights
  - Patent licensing
  - Assignments of know-how or trade secrets
  - Licensing of know-how or trade secrets
  - Technical services and other unspecified forms of technology transfer covered by the Technology Regulations
  - Cooperative research and development contracts
  - Technology consultancy contracts
  - Technical training contracts
  - Technology brokerage contracts
  - Software import and export contracts
  - Trademark licenses or assignments involving patented or non-patented technology
Unified Contract Law, adopted in 1999 provides substantial freedom for the parties to enter into agreements.
Obstacles to Technology Transfer to China

- Lack of control over future developments, modifications and enhancements of transferred technologies.
- Warranty requirements.
- Collecting royalties and other payments.
- Protection of Intellectual Property.
- Lack of Trust.
Mandatory Provisions of Chinese Law

Chinese law requires that the foreign licensor to:

- “Guarantee” that the licensed technology be complete, correct, valid, and capable of accomplishing the specified technological objectives.
- “Guarantee” that it is the legal owner of, or the party with the right to license, the technology.
- If the Chinese licensee infringes on another party’s right by using the licensed technology pursuant to the license agreement, the licensor is required to bear the responsibility for such infringement.
The Technology Regulations prohibit the following provisions:

- Requiring the transferee to accept incidental conditions unnecessary for the imported technology, including the purchase of unnecessary items.
- Requiring the transferee to pay for, or undertake obligations relating to, a technology for which the patent right has expired or has been announced as invalid.
- Restricting the transferee’s improvement of the technology provided by the transferor, or restricting the transferee’s use of the improved technology.
Prohibitions (cont.)

- Restricting the transferee’s acquisition from a third party of any technology similar to, or competitive with, the technology provided by the transferor.
- Unreasonably restricting the transferee’s channels or sources for the purchase of raw material, parts, components, products, or equipment.
- Unreasonably restricting the quantity, variety, or price of products produced by the transferee.
- Unreasonably restricting the transferee’s export channels for products manufactured by the transferee using the transferred technology.
Anti-monopoly Issues

- The Contract Law provides that any “technology contract” that illegally monopolizes the technology, impedes technological progress, or infringes on technological results of others is null and void.

- Pursuant to the Chinese Supreme People’s Court’s interpretation issued on June 19, 2001 (Supreme Court Interpretation), the term “illegal monopoly of technology and impeding of technological progress” includes, in addition to the prohibitions relating to import of technology set forth in the Technology Regulations.
Anti-monopoly Issues (cont.)

- The unequal rights of the parties relating to the exchange of improved technology, such as requiring a party to provide its improvements to the transferred technology to the other party without compensation, to assign its improvements to the transferred technology to the other party without mutual benefits, or to grant the non-improving party the exclusive or joint right to enjoy the improved technology without compensation to the improving party.
Typically, a technology license agreement will cover the following key issues points:

- Field of use
- Geographic scope/territory
- License fees and payment terms
- Ownership of technology
- Ownership of improvements
- Exclusive or non-exclusive/sublicense
- Nondisclosure
- Noncompetition
- Term/termination
- Indemnities/liabilities
- Dispute resolution
- Governing law
- Governing language (i.e., Chinese or English)
Key To Successful Technology Transfer

- Find the “right” licensee.
- Invest in the relationship and work to build trust.
- Thoroughly document the transaction.
- Work to keep interests aligned.
- Maintain constant communication and support.
Contact Information

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Intellectual Property Protection in China

Alex Y. Nie, Ph.D., J.D.
Foley & Lardner LLP
# IP Enforcement Stats

<table>
<thead>
<tr>
<th>Type of IP Case</th>
<th>New Case No. (2011)</th>
<th>% over 2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>Patent</td>
<td>7819</td>
<td>35.16%</td>
</tr>
<tr>
<td>Trademark</td>
<td>12991</td>
<td>53.56%</td>
</tr>
<tr>
<td>Copyright</td>
<td>35185</td>
<td>42.34%</td>
</tr>
<tr>
<td>IP Contract</td>
<td>557</td>
<td>-16.87%</td>
</tr>
<tr>
<td>Competition</td>
<td>1137</td>
<td>0.53%</td>
</tr>
<tr>
<td>Others</td>
<td>2193</td>
<td>11.55%</td>
</tr>
<tr>
<td>Total</td>
<td>59882</td>
<td><strong>40.14%</strong></td>
</tr>
</tbody>
</table>

Source: Supreme People’s Court, “Intellectual Property Protection by Chinese Courts in 2011”
## Patent Filings from Chinese Companies

### International Patent Filings*:

<table>
<thead>
<tr>
<th>Rank</th>
<th>Applicant</th>
<th>Origin</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>Change from 2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>ZTE CORPORATION</td>
<td>China</td>
<td>517</td>
<td>1,868</td>
<td>2,826</td>
<td>958</td>
</tr>
<tr>
<td>2</td>
<td>PANASONIC CORPORATION</td>
<td>Japan</td>
<td>1,891</td>
<td>2,153</td>
<td>2,463</td>
<td>310</td>
</tr>
<tr>
<td>3</td>
<td>HUAWEI TECHNOLOGIES CO., LTD.</td>
<td>China</td>
<td>1,847</td>
<td>1,527</td>
<td>1,831</td>
<td>304</td>
</tr>
<tr>
<td>4</td>
<td>SHARP KABUSHIKI KAISHA</td>
<td>Japan</td>
<td>997</td>
<td>1,286</td>
<td>1,755</td>
<td>469</td>
</tr>
<tr>
<td>5</td>
<td>ROBERT BOSCH CORPORATION</td>
<td>Germany</td>
<td>1,588</td>
<td>1,301</td>
<td>1,518</td>
<td>217</td>
</tr>
<tr>
<td>6</td>
<td>QUALCOMM INCORPORATED</td>
<td>United States of America</td>
<td>1,280</td>
<td>1,675</td>
<td>1,494</td>
<td>-181</td>
</tr>
<tr>
<td>7</td>
<td>TOYOTA JIDOSHA KABUSHIKI KAISHA</td>
<td>Japan</td>
<td>1,068</td>
<td>1,095</td>
<td>1,417</td>
<td>322</td>
</tr>
<tr>
<td>8</td>
<td>LG ELECTRONICS INC.</td>
<td>Republic of Korea</td>
<td>1,090</td>
<td>1,297</td>
<td>1,336</td>
<td>39</td>
</tr>
<tr>
<td>9</td>
<td>KONINKLIJKE PHILIPS ELECTRONICS N.V.</td>
<td>Netherlands</td>
<td>1,295</td>
<td>1,433</td>
<td>1,148</td>
<td>-285</td>
</tr>
<tr>
<td>10</td>
<td>TELEFONAKTIEBOLAGET LM ERICSSON (PUBL)</td>
<td>Sweden</td>
<td>1,241</td>
<td>1,147</td>
<td>1,116</td>
<td>-31</td>
</tr>
</tbody>
</table>

But, IP enforcement is still difficult

- Some basic strategies to protect your IP
  - Registration (early, broadly, variations)
  - Utilize all possible IP strategies
  - Use good contracts
  - Operational means
  - Relational means

- Follow the law, and avoid silly mistakes
For example

- Trademark transaction Procedure
  - Pre-transaction due diligence
  - Agreement
  - Approval and Registration
The iPad case

- Proview, founded in 1991, HK public company
- Subsidiaries in China, Taiwan etc.
- One of the top 5 screen manufactures in late 90’s
- 1998 – Proview started to develop iFamily products, including iPad,
- 2000 – Proview Taiwan registered iPad in Taiwan and other regions
- **2001 – Proview China registered iPad in China**
- 2008 – Suffering financial difficulties
- 2009 – Approached by IPADL for trademark acquisition
- 12/23/2009 – Proview Taiwan sold the mark to IPADL for 35K GBP
- **12/23/2009 – Proview Taiwan signed contract to sell the Chinese mark to IPADL for 1 GBP**

- 1/27/2010 – Apple announced iPad
- 2/2010 – Apple bought the Chinese mark from IPADL for 10 GBP
- 2/2010 – Apple requested Proview to complete government registration
Understand the system

- The “fairness” mindset
  - Dongfang Machine Core Factory v. Jinling Hardware Ltd. Co.
  - Johnson & Johnson

- The societal “efficiency” rational
  - High data requirement in patents (the Viagra case)
  - Doctrine of equivalents
Contact Information

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China Tax Update

Vivien Wang,
International Tax Partner
National Tax Leader, Chinese Service Group
Deloitte Tax LLP

September 20, 2012
# China tax trends

China tax system is evolving

<table>
<thead>
<tr>
<th>From a domestic-oriented system to an international transaction-oriented system</th>
<th>Shifting tax policies and tax incentives to encourage hi-technology and service-oriented sector investments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Increased scrutiny and compliance with respect to non-resident taxation and cross-border transactions</td>
<td>Increased use of anti-avoidance rules and intensified tax audits</td>
</tr>
</tbody>
</table>
## VAT reform pilot program in Shanghai / Beijing

### Starting point

<table>
<thead>
<tr>
<th>Value-added tax</th>
<th>Business Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>(&quot;VAT&quot;)</strong></td>
<td><strong>(&quot;BT&quot;)</strong></td>
</tr>
<tr>
<td>1. Levied on sales of tangible and moveable goods, provision of processing, repair and replacement services, as well as importation of goods into China</td>
<td>1. Levied on transfer of intangible assets or immoveable property and provision of service which are not subject to VAT.</td>
</tr>
<tr>
<td>2. Tax Rate: 17% and 13%</td>
<td>2. Tax Rate: 3% - 20%</td>
</tr>
<tr>
<td>3. Credit mechanism</td>
<td>3. No Credit mechanism</td>
</tr>
</tbody>
</table>
## The Selected Service Sectors

### Transportation Industry

<table>
<thead>
<tr>
<th></th>
<th>Land</th>
<th>Waterway</th>
<th>Airway</th>
<th>Pipeline</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. R&amp;D and technology</td>
<td>R&amp;D • Transfer of technology • Technology consulting</td>
<td>Management of energy saving contracts • Project exploration</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2. IT</td>
<td>Software related • Circuit design and testing</td>
<td>IT system services • Process management</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3. Creative cultural</td>
<td>Design • Transfers of copyrights and trademarks</td>
<td>Services related to intellectual property rights • Advertising • Conference and exhibition services</td>
<td></td>
<td></td>
</tr>
<tr>
<td>4. Leasing of moveable and tangible goods</td>
<td>Operating lease of tangible goods</td>
<td>Financing lease of tangible goods</td>
<td></td>
<td></td>
</tr>
<tr>
<td>5. Attestation and consulting</td>
<td>Certification • Assurance • Consulting</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>6. Logistics and ancillary</td>
<td>Aviation • Harbor • Ancillary services related to the transportation of passengers and cargo</td>
<td>Salvaging • Freight forwarding • Customs declaration • Warehousing • Loading/unloading</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Indirect Share Transfer / Circular 698  
China’s biggest capital gain tax case  
Shanxi case

1. Reported on 6 April 2012, tax collected RMB403M
2. Tax authorities discovered the transaction through monitoring Key Taxpayers.
3. BVI sold 100% of the shares in its wholly owned subsidiary HK Hold Co to the buyer (another HK Co) at price of USD669m.
4. HK Hold Co owns 56% of the shares of Shanxi Co.
5. Gains taxable as HK Hold Co were disregarded based on Substance over Form principle.
6. Local authority obtained SAT approval for invoking GAAR.
7. Discussion points
   - Reporting? Any punitive treatment if not reported? FIN48 concerns?
   - Any impact from the Indian case?
China’s 1st GAAR applied Individual Income Tax (IIT) case
Shenzhen case

1. Reported on 8 June 2011, tax collected RMB13.7M
2. Transferor was a non-resident individual
   1. HK Hold Co was disregarded based on Substance over Form principle
   2. Local authority obtained SAT approval for invoking GAAR
3. Discussion points
   – Is China extending Circular 698 to non-resident individuals? Trend or exception?
   – What is the legal basis under IIT framework?
   – How would substance be defined by SAT in the future?
Treaty Benefit / Circulars 601, 124, 30
Dividend withholding
Ningbo case

1. Reported on 15 September 2011, tax collected RMB100K
2. Taxpayers voluntarily withdrew the treaty benefits application for dividend withholding tax (WHT)
3. Discussion points
   - What conclusions tax authority drew
     • No management, activities, or employees in HK
   - Tax authority requested various documents / information to examine “beneficial owner” status of the offshore entity
     • Shareholders’ information, audit report, tax return and tax receipts, as well as various other information to be disclosed in a number of treaty benefits application forms as outlined in Circular 124
Managing Overall Tax Burden
Importance of reviewing the business model

• Understanding the market to determine customer source, supply flow, and currency

• China’s tax incentives moved from predominately production based and location oriented (e.g. tax holidays) to high technology, R&D and environmental based

• Formulating both effective onshore and offshore structures from both tax and business perspectives
  – Limit functions and risks in China where possible

• Awareness to increased reporting and scrutiny by the Chinese tax authorities in relation to non-resident investments and outbound payments (e.g. Rep offices, secondment arrangements)

U.S. investors should

• Consider the change in tax/financial incentives, and likely increased effective tax rate, for both current and future investments and business models

• Ensure that their business models are set up with sufficient commercial purpose
China tax and treasury considerations

- **VAT & Customs**: Export VAT refund costs; trading restrictions for foreign principals
- **Corporate Tax**: Limited availability of incentives and application of WHT
- **FOREX/ Regulatory issues**: Inflexibility on doing business in China
- **Transfer Pricing**: More aggressive application of arm’s length standard
- **Business Tax**: Multiple layers of BT increase overall costs

**Business Model Optimization**
Business Model Structure - Manufacturing with Market Risk

- China Co income taxed at 25% rate
- Risk bearing model tends to result in higher profits attributable to China Co
- Royalty taxable to Parent Co
- Duties on imported raw materials
- Export VAT refund cost
- Withholding tax, Business tax and Tax-on-tax on royalty and / or services fees
Planning Options – Reduce Tax and Streamline Process

Offshore Principle With Contract Manufacturing Model

- Lower income tax costs if Principal Co. located in a low tax jurisdiction
- Profits attributable to the Principal Co. is not subject to foreign currency exchange controls
- Eliminates any business tax on royalty or services

• Royalty or buy-in & service fees

Offshore Principle With Toll Manufacturing Model

- Lower income tax costs if Principal Co. located in a low tax jurisdiction
- Profits attributable to the Principal Co. is not subject to foreign currency exchange controls
- Eliminates any business tax on royalty or services
- Exemption from VAT on tolling service fee
- Achieves deferral of offshore earnings more effectively
Other examples of operating models to reduce China tax burden

- Using a separate trading company for exported goods manufactured in China to save export VAT;
- Using a separate software company to supply manufacturer to obtain VAT and income tax benefit;
- HNTE – a solution for OEM/ODM where TP is heavily challenged;
- Provision of supply chain management (i.e., procurement services) eligible for TASC status
Observations and Recommendations
Observations and Suggestions

1. VAT reform will expand nationally
2. Evaluate business model to best utilize the VAT credit system
3. GAAR being applied more broadly and frequently, including in IIT law
4. Strong focus on taxation of PRC residence’s overseas income
5. Tax authorities are proactively making efforts to identify offshore transactions
6. Using low-tax jurisdictions to establish intermediate holding companies will attract more attentions from the tax authorities
7. The tax authorities will continue to focus on “substance” of intermediate companies
8. The tax authorities are becoming more sophisticated in applying TP as an anti – tax avoidance tool
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Partner
International Tax
Chinese Services Group
Deloitte Tax LLP

Vivien Wang has over 14 years of public accounting and international tax experiences, providing tax consulting, compliance and tax accounting assurance services to various high-tech and venture capital clients. Her experience includes structuring and globally managing both U.S. inbound and outbound investments. Vivien assisted in the planning and implementation of the worldwide restructurings, mergers, acquisitions, and IP migrations for multinational clients.

Vivien is also the National Tax Leader of Deloitte’s US Chinese Services Group, specializing in China strategy planning for US companies and investment funds and US inbound investment issues for China based investors. Vivien travels frequently to Asia and is fluent in Mandarin and Cantonese. She is also a frequent speaker in CalCPA, the Council for International Tax Education (CITE), HYSTA, etc.
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RMB Cross-border Settlement
One currency, two systems, three curves

One Currency - “RMB”

Literally ‘People’s money’ and sole legal tender in PRC

2 systems

Onshore

Offshore

The two separate jurisdictions create separate supply and demand conditions for the RMB markets (onshore and offshore), which are accessible to two pools of participants

3 Separate Curves

CNY
Onshore Deliverable RMB

- Highly regulated
- Onshore (residents), permitted offshore investors (Foreign Direct Investment, Qualified Foreign Institutional Investor)
- Accessible under cross border trade settlements and personal RMB business in Hong Kong

CNY ND
Offshore Non-Deliverable RMB

- US Dollar settled in non-deliverable market for risk management
- Strictly offshore, but link to the onshore CNY market for fixing

CNH
Offshore Deliverable RMB

- Liberalized market with no restriction on conversion to corporates
- Primarily traded on the Hong Kong interbank market
- Strictly offshore while proceeds can be used for investment, trade settlement or general purposes
Applying RMB in your business

1. Can I pay or receive in RMB? When?

2. Do I need an RMB account? Where?

3. What to do with idle RMB? How?
Can I pay or receive in RMB? When?

PAYMENTS INTO THE MAINLAND

1. Trade payments for GOODS
   Mainland Enterprises with Import and Export qualifications may export goods in RMB*

2. Trade payments for SERVICES
   Allowed (contract and invoice in RMB required)

3. Intercompany loans
   Allowed (subject to SAFE filing)

4. Additional Capital Infusion
   Allowed (subject to MOFCOM approval)

5. Foreign Direct Investment
   Allowed (subject to MOFCOM approval)

6. Expatriates Salaries
   Not Allowed

PAYMENTS FROM THE MAINLAND

1. Trade payments for GOODS
   Allowed (contract/invoice/customer declaration required)

2. Trade payments for SERVICES*
   Allowed (contract and invoice in RMB required)

3. Intercompany loans
   Case-by-case approval by PBOC/SAFE

4. Capital investment overseas (ODI)
   Allowed (subject to MOFCOM approval)

5. Dividend Payments / Repatriation of Profit
   Allowed

6. Expatriates Salaries
   Allowed

Overseas-to-overseas RMB transactions are not regulated by PBOC, but may be subject to the local regulations

* Mainland Designated Enterprise (MDE) requirements will remain in force until publication of blacklist names - Contact local HSBC branches for more information
Do I need an RMB account? Where?

**OPTION 1. NON-RESIDENT RMB A/C (MAINLAND CHINA)**
- PBOC approval is required
- Regulated interest
- Currency exchange not allowed
- Cash withdrawal/deposit not allowed
- Same-name funds transfer between NRA and overseas a/c is allowed

**OPTION 2. OFFSHORE RMB A/C (HONG KONG)**
- Current a/c and saving a/c allowed for both resident and non-resident companies
- Interest not regulated
- No restrictions for currency exchange
- Cash withdrawal / deposit allowed
- No restrictions on the transfer of RMB funds between different customers in Hong Kong

**OPTION 3. OFFSHORE RMB A/C (OTHER COUNTRIES)**
- Subject to local regulations and banking infrastructure
- Payment proceeds will be converted to/from the denominated account currency

**OPTION 4. NO RMB A/C**
- Subject to local regulations and banking infrastructure
- No restriction from PBOC
What to do with idle RMB? How?

Offshore Liquidity Management Solutions

Outside China, RMB is treated as another foreign currency. It depends on local practices and regulations in respective jurisdictions whether Global Liquidity Solutions (GLS) suite is applicable or not.

- Cash Concentration
- Single Currency Notional Pool
- Multi-Currency Notional Pool (Interest Optimisation Facility)
- X-border/ X-currency Yield Enhancing (Interest Enhancement Facility)

Offshore RMB Products (Hong Kong)

Following the establishment of the interbank market in 2010, Hong Kong developed into an offshore RMB Investment Center with a wide range of RMB investment products available:

- Time deposit, certificate of deposit
- Primary and secondary RMB bonds trading
- FX linked structured deposit
- Interest rate linked structured deposit
- Equity linked structured deposit
- Gold linked structured deposit
- RMB investment funds
Investments
Utilizing China cash

Offshore

- CNY deposit in China + CNY LC + CNH Loan + USD/CNH CSW
- Client’s entity in China pledges CNY funds with HSBC China to issue CNY LC to Hong Kong.
- The CNY funds pledged will earn a deposit rate of 3.50% for 1 year (as an example). It is worth noting that the issuance of the LC will also depend on trade documents and quota available for issuing bank.
- HSBC HK grants a 1 year CNH loan price margin secured by the RMB LC issued by HSBC China,
- Client enters into an USD/CNH CSW to swap proceeds into USD.
- On maturity, Client repays CNH loan to HSBC HK; RMB LC closed with HSBC China

Numerical example – 1 year

- RMB deposit: 3.50%p.a.
- CNH Loan : 4.20 %p.a.
- LC opening commission: 0.50 %
- CNH USD : 1.80% p.a.
- USD Implied: L+240 bps
## Utilizing China cash

### Onshore Investment Options

<table>
<thead>
<tr>
<th>Investment Options</th>
<th>3M</th>
<th>6M</th>
<th>12M</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank Deposits</td>
<td>3.10%</td>
<td>3.30%</td>
<td>3.50%</td>
<td>Controlled by PBOC</td>
</tr>
<tr>
<td>Structured Deposits</td>
<td>2.70%</td>
<td>2.80%</td>
<td>2.90%</td>
<td>Varies during different periods in the funding cycle</td>
</tr>
<tr>
<td>Government Bonds</td>
<td>2.50%</td>
<td>2.70%</td>
<td>2.80%</td>
<td>Market levels, tax exempt</td>
</tr>
<tr>
<td>Corporate Paper</td>
<td>4.00%</td>
<td>4.10%</td>
<td>4.20%</td>
<td>Market levels, Domestic AAA rating</td>
</tr>
<tr>
<td>Funds</td>
<td>3.00%</td>
<td>3.20%</td>
<td>3.30%</td>
<td>The higher of average yields of money market funds and liquid risk-free bills (PBoC bills)</td>
</tr>
</tbody>
</table>
Cash management: Asian asset swap opportunities
Relative value of China CNH bonds versus other Asian currencies

- A cross currency asset swap on a foreign currency denominated bond extinguishes all foreign currency flows and provides the Investor a USD return without any FX risk.
- Theoretically, after an asset swap into USD, according to interest rate parity, all foreign currency sovereign bonds should yield the same rate as US Treasuries. However, due to several factors, bonds in different currencies can be cheap or expensive after swapping back to USD.
- **Astute investors can take advantage of this to enhance returns on excess short term cash returns while only holding sovereign bonds.**
- Currency basis is often the driving force behind different valuations. It reflects the demand for using one currency over another for funding assets. In Asia, most countries have a negative basis to USD (ie, there is more demand for USD funding). This imbalance generally means that there are opportunities to swap local currency obligations to USD for a pickup.
- While the opportunity is small in Chinese government CNH bonds, Japan, Korea, Malaysia and Thailand offer the best opportunities.

The above chart shows the 5Y USD/JPY currency basis. This is indicative of most basis curves – they were fairly stable around zero before the crisis, when USD liquidity zoomed to a premium. They continue to reflect the need for USD liquidity, which means that funding foreign currency denominated assets is cheaper.

We show sovereign asset swap levels above, where the underlying is a government bond denominated in the government’s own currency and swapped back to USD. In some countries, notably Korea, Malaysia and Thailand, significant premiums over US Treasuries can be earned using asset swaps while still taking sovereign risk.
HSBC RMB Capabilities
## HSBC’s RMB capabilities

<table>
<thead>
<tr>
<th>Offshore RMB Products¹</th>
<th>Onshore RMB Products (China)²</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Payments and Cash Management</strong></td>
<td><strong>Custody</strong></td>
</tr>
<tr>
<td>• No restriction on account opening</td>
<td>• RMB Custody and Funds Administration Services</td>
</tr>
<tr>
<td><strong>Exchange Services and Risk Management Products</strong></td>
<td><strong>Exchange Services and Risk Management Products</strong></td>
</tr>
<tr>
<td>• Spot FX (for trade / general purposes)</td>
<td>• Spot FX</td>
</tr>
<tr>
<td>• Deliverable FX Forward, FX Option and FX Swap</td>
<td>• Forward FX</td>
</tr>
<tr>
<td>• Deliverable Interest Rate Swap, Cross Currency Swap and Interest Rate Swaptions</td>
<td>• FX swaps</td>
</tr>
<tr>
<td>• Non Deliverable Forward</td>
<td>• Interest Rate Swap and Cross Currency Swap</td>
</tr>
<tr>
<td>• Non Deliverable Option</td>
<td>• Credit Risk Mitigation Agreement / Warrant</td>
</tr>
<tr>
<td><strong>Borrowing / Financing Products</strong></td>
<td><strong>Borrowing / Financing Products</strong></td>
</tr>
<tr>
<td>• Trade financing facilities and commercial loans</td>
<td>• Trade financing facilities and commercial loans</td>
</tr>
<tr>
<td>• Issuance of offshore RMB bonds / certificate of deposits (CDs)</td>
<td>• Money Market</td>
</tr>
<tr>
<td><strong>Investment Products</strong></td>
<td><strong>Investment Products</strong></td>
</tr>
<tr>
<td>• Time deposit, CDs</td>
<td>• Time deposit</td>
</tr>
<tr>
<td>• Primary and secondary RMB bonds trading</td>
<td>• Call deposit</td>
</tr>
<tr>
<td>• FX linked structured deposit</td>
<td>• Structured deposit</td>
</tr>
<tr>
<td>• Interest rate linked structured deposit</td>
<td>• Bonds</td>
</tr>
<tr>
<td>• Equity linked structured deposit</td>
<td>• Non-financial bonds</td>
</tr>
<tr>
<td>• Gold linked structured deposit</td>
<td></td>
</tr>
<tr>
<td>• RMB investment funds</td>
<td></td>
</tr>
<tr>
<td>• RMB equities</td>
<td></td>
</tr>
<tr>
<td>• RMB QOFII funds</td>
<td></td>
</tr>
<tr>
<td>• RMB gold ETF</td>
<td></td>
</tr>
</tbody>
</table>

### HSBC trades CNH³ FX option in Germany

### HSBC trades CNH³ Dual Currency deposit traded in Japan

### HSBC trades CNH³ Dual Currency Forward traded in the market

### Acted as joint listing agent for first offshore RMB IPO

### First CNH³ Multicallable Forward traded in Japan

### HSBC trades GBP CNH³ structured forward with UK corporate client

### First FX index linked to CNH³ traded with European fund manager

### First CNH³ dual currency investment offered to retail investors in Singapore

### HSBC’s RMB ‘Going Out’ – HSBC – your bank of choice in international RMB business

1. Offshore RMB products currently available in HSBC Hong Kong. Products may vary in other regions
2. There are certain restrictions on the types of clients to which the products can be offered
3. CNH is the name used in the market to refer to offshore deliverable RMB
### HSBC’s offshore RMB FX capabilities

**HSBC played a leading role in driving the rapid product development in CNH market**

**HSBC offers a complete panel of solutions to match clients’ investments, financing and risk management needs**

<table>
<thead>
<tr>
<th>Deliverable RMB Products</th>
<th>Non-deliverable RMB Products</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>FX Product Components</strong></td>
<td></td>
</tr>
<tr>
<td>• Spot FX (for trade and for general purposes)</td>
<td>• Non-deliverable Forward</td>
</tr>
<tr>
<td>• Deliverable Forward (for general purpose)</td>
<td>• Non-deliverable Currency Swap</td>
</tr>
<tr>
<td>• Deliverable CCS (for general purpose)</td>
<td>• Non-deliverable Option</td>
</tr>
<tr>
<td>• Deliverable Option (for general purpose)</td>
<td></td>
</tr>
<tr>
<td><strong>Product Capabilities</strong></td>
<td></td>
</tr>
<tr>
<td>• Vanilla, European and discrete barriers, callable variations, target redemption variations and any structured forwards offered by HSBC</td>
<td>• Vanilla, European and discrete barriers, callable variations, target redemption variations and any structured forwards offered by HSBC</td>
</tr>
<tr>
<td>• Baskets</td>
<td>• Baskets</td>
</tr>
<tr>
<td>• Vanilla and Barrier options on other currencies quanto to CNH¹ (e.g. AUD/USD DNT quanto to CNH¹)</td>
<td>• Vanilla and Barrier options on other currencies quanto to CNY (e.g. AUD/USD DNT quanto to CNY)</td>
</tr>
<tr>
<td>• FX Indices</td>
<td>• FX Indices</td>
</tr>
<tr>
<td><strong>Wrappers</strong></td>
<td></td>
</tr>
<tr>
<td>• OTC in HK, London &amp; selected centres*</td>
<td>• OTC</td>
</tr>
<tr>
<td>• Structured Deposit in HK, London &amp; selected centres*</td>
<td>• Structured Deposit</td>
</tr>
<tr>
<td>• Structured Note using HSBC HK or London as issuer</td>
<td>• Structured Note using HSBC HK or London as issuer</td>
</tr>
<tr>
<td><strong>Selected Credentials</strong></td>
<td></td>
</tr>
<tr>
<td>• 1st spot USDCNH¹ deal in market</td>
<td></td>
</tr>
<tr>
<td>• 1st CNH¹ FX option traded in market (Oct 2010)</td>
<td></td>
</tr>
<tr>
<td>• Amongst the 1st globally to trade deliverable RMB structured deposit</td>
<td></td>
</tr>
<tr>
<td>• 1st CNH¹ Multicallable Forward traded in market (Jun 2011). Over CNH¹ 20bn of volume traded of multicallable and target redemption variations</td>
<td></td>
</tr>
<tr>
<td>• 1st FX-linked index with CNH¹ as component traded in market (with European client)</td>
<td></td>
</tr>
</tbody>
</table>

*Availability varies based on transacting HSBC entity

1. CNH is the name used in the market to refer to offshore deliverable RMB
Disclosure appendix

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