Doing Business in China

July 2012

1. GENERAL INFORMATION

1.1 Geography

Next to Canada and Russia, China is the third largest country in the world. With an area of 9.6 million square kilometers, it covers one-fifteenth of the world's land mass. It begins from the confluence of the Heilong and Wusuli rivers in the east to Wuqia County in Xinjiang Uygur Autonomous Region in the west, about 5,200 kilometers apart; and from the midstream of the Heilong River north of Mohe in the north to the South China Sea, about 5,500 kilometers apart. The border stretches over 22,000 kilometers on land and the coastline extends well over 18,000 kilometers, washed by the waters of the Bohai, the Huanghai, the East China and the South China seas.

1.2 History

The history of China dates back 4,000 years. The history of modern China, however, begins in the 1910's with the over throw of the Qing Dynasty. From a backward feudal society, ruled by a succession of dynasties, with many parts of its coastal land being occupied by western imperial powers, China spent the first half of the 20th century undergoing drastic, bloodied, traumatic, and chaotic changes. After ridding China of the dynastic system, Dr. Sun Yet-sun, commonly known as the Father of modern China, formed a government in the name of Republic of China. The establishment of a government, however, could not prevent the country from disintegrating, with different parts of the country falling under the control of various warlords. It was not until the late 1920's that the central government was able to establish authority over the entire country. Peace and quiet, however, was short-lived as the country was soon ablaze in battles. It first plunged into a bitter fight against Japanese occupation, and later into a civil war between the Nationalist Party and the Communist Party. This struggle for the control of China continued until the Nationalist Party was driven off the mainland by the Chinese Communist Party in 1949. China then was united as the People's Republic of China.

The Communist Party began to rebuild China along socialist lines. Civil order was established, and the economy began to develop. From the 1950's to late 1970's, as the country underwent dramatic political upheavals - with the purge of rightists movements, the Great Leap Forward, and later the Cultural Revolution - the economy experienced surge and stall. It was not until mid-1970's that the economy stabilized. In 1978, a new era slowly emerged as economic reforms were instituted. The reforms of the 1970's centered around a limited acceptance of some form of capitalism and an "open door" policy toward Western knowledge, technology, and investments. This is China's current policy.

Limited capitalism is seen as a tactic to develop socialism. It is however recognized that capitalistic market mechanisms may be discarded if China's leaders feel they threaten the socialist status quo. It is believed that China's economic reforms will inevitably lead to social and political reforms, as happened in South Korea. Thus, foreign investors should be prepared for rapid changes in policy.

1.3 Government

The Constitution of the People's Republic of China provides for six organs in the central state:

The National People's Congress,
The President of the People's Republic of China,
The State Council,
The Central Military Commission,
The Supreme People's Court,
The Supreme People's Procuratorate

The National People's Congress (NPC) reigns supreme over the other five organs in that the latter are responsible to the NPC and its Standing Committee.

The National People's Congress (NPC)

The NPC is the highest organ of State power in the People's Republic of China. Its main functions and powers include legislative power; appointing and removing power in electing the country's top leadership, including President and Vice-President, Premier, Vice-Premiers, State Councilors, Chairman and Members of the Central Military Commission, the President of the Supreme People's Court, etc. Decisive power of major State events include approving the plan for national economic and social development, state budget, establishment of special administrative regions, questions of war and peace, etc.; and supervising power in the implementation of the Constitution. As the State council, the Supreme People's Court, and the Supreme People's Procuratorate are created by the NPC, responsible to it and supervised by it, the NPC's exercise of its supervisory right is to supervise the government and other State organs on behalf of the people.

Under the current Constitution and related laws, the NPC holds a session on the first quarter of each year convened by its Standing Committee. The NPC is elected for a term of five years.

The Standing Committee of the NPC is the permanent supreme State organ of power and legislation. It exercises the highest State power and legislative power when the NPC is not in session. The Standing Committee of the NPC exercises several main functions and powers. It interprets the Constitution and supervises its implementation, enacts and amends laws, with the exception of those which should be enacted by the NPC, partially supplements and amends laws enacted by the NPC when it is not in session, and interprets the laws.

The President of the People's Republic of China

The President is the head of the State, as well as the supreme representative of China both internally and externally. The state presidency is an independent State Apparatus, and a component part of China's State organization.

The State Council

The State Council, namely the Central People's Government, is the highest executive organ of state power, as well as the highest organ of state administration.

The Premier is responsible for the entire State Council, while various ministries and commissions under the State Council follow the system of ministerial responsibility. In dealing with foreign affairs, State councilors, entrusted by the premier of the State, can conduct important activities on behalf of the premier. The auditor-general is in charge of the work of auditing bodies, auditing and supervising the State financial situation. The secretary-general, under the premier, is responsible for the daily work of the State Council.

The State Council is responsible for carrying out the principles and policies of the Chinese Communist Party, the regulations and laws adopted by the NPC, as well as handling the affairs such as China's internal politics, diplomacy, national defense, finance, economy, culture, and education.

The Central Military Commission (CMC)

The CMC is the supreme military leading organ, directing and commanding the national armed forces. According to the Constitution, the national armed forces are commanded by the State CMC, which exists concurrently with the CMC of the Chinese Communist Party. Members of the former are also members of the latter. While the Chairman of the CMC is elected by the NPC and responsible to the NPC, he has the right to make final decision on affairs within its functions and powers. The CMC now heads an armed force of three million strong.

The Supreme People's Court

The Supreme People's Court is the highest judicial organ in China. It exercises the highest judicial right independently by law, without any interruption by administrative organs, social organizations or individuals. It includes a judicial committee, the highest-level judicial organization, and court.

The Supreme People's Procuratorate

Article 129 of the Constitution of the People's Republic of China states that the people's procuratorates are state organs for legal supervision. By exercising their procuratorial authority, the people's procuratorates suppress all treason, attempts to split the country or other counterrevolutionary activities, and prosecute counter revolutionaries and other criminals. Their purpose is to safeguard the unity of the country, the people's democratic dictatorship and the socialist legal system; to maintain public order, including order in production and other work, in education and scientific research, and in the daily life of the people; to protect the socialist property owned by the whole people and by collectives and the private property lawfully owned by individuals; to protect the citizens' rights of the person and democratic and other rights; and to ensure the smooth progress of socialist modernization. The people's procuratorates also educate the citizens, encouraging them to be loyal to their socialist motherland, to conscientiously observe the Constitution and the laws and to combat illegal activities.

1.4 Population

China's population today is slightly over 1.37 billion, about 21% of the world's total population. Currently, China's population is increasing approximately 0.57 percent a year and has encountered the challenge of having an aging population.

1.5 Climate

Because of the country's large size, China's climate is varied. Six broad temperature zones run north and south and range from tropical to cold-temperate. January is generally the coldest month, and July, the hottest. Each year from October to March, cold, dry winter winds blow from Siberia through the Chinese mainland. They cause severe cold and dry winters in much of China except in the southernmost region. From April to September, eastern China is dominated by a warm, humid air stream from the Pacific Ocean, bringing high temperatures and rainfall. Wide variations of climate from region to region cause an unbalanced distribution of population and economic activities.

1.6 Language

Putonghua, or Mandarin, is the national language based on the Beijing dialect. Mandarin is a dialect that uses tones to convey meaning. Words may have as many as four meanings, according to the tone used. There are numerous other dialects. The principal of these are Cantonese, which is spoken chiefly in Guangzhou, and especially Hong Kong; Shanghainese, spoken in Shanghai; and Fukienese, spoken in Fujian, the coastal province facing Taiwan in the other side of the Strait of Taiwan. The written language, which is ideographic and not phonetic, is uniform, although many of the characters have been simplified.

2. BUSINESS ENVIRONMENT

2.1 Economic Outlook

The Chinese economy has grown an average of 9 percent a year during the 1980's and much of the 1990's. In the twenty-first century, the country's growth rate was in the double digits year in and year out, until the financial crisis of 2008. The GDP growth was achieved 9.2% in 2011; a slightly drop from 10.3% in 2010. The GDP growth is expected about 8.5% in 2012. The wages of urban workers have increased considerably in ten years.

While China's 1.37 billion population may represent enormous demands for modern goods, it is about 70% of the population living in rural area and still remaining poor. An average family in rural area earns less than US$4,500 a year and can buy relatively few products. Basic products considered necessities in the West may be out of reach to the majority of the population.

2.2. Imports and Exports

Both imports and exports are subject to central planning and state control. Basically, import of nonessential or nonpriority items, especially consumer goods, is restricted; those that are approved are tightly controlled for which import licenses must be obtained from relevant government authorities. These will then be subject to customs duties at varying rates.

Export, on the other hand, is encouraged to enable the country to maximize foreign exchange earnings. Export-oriented enterprises are encouraged and products manufactured and exported by a foreign investment enterprise do not require export licenses.

2.3 Special Economic Zones

At the time when the "open-door" policy was adopted, the Chinese government introduced the concept of Special Economic Zones (SEZs). It was intended that the establishment of these SEZs and later the Free Trade Zones (as discussed below), will enable these regions to achieve prosperity, with the view that the wealth will trickle down to the other regions; they are used as the forefront of the country's reform movement. The zones were also used as the forum for experimentation with economic reform, testing ground for foreign investment legislation and regulations. Currently, there are six SEZs in Shenzhen, Zhuhai, Xiamen, Shantou, Kashgar and the Hainan province.

Privatization and capitalist ventures were first approved and practiced, and now more wide spread at the SEZs. Each of the zones has introduced its own legislation to govern investment, as well as approval procedures relating to foreign investment enterprises; enterprises set up in SEZs may enjoy special tax concessions. Often before national legislation is passed at the Chinese Government level, an SEZ will promulgate its own legislation to test its effectiveness.

With the Chinese economy achieving double digit growth for most of the years since the beginning of the millennium, the use of the SEZs as a forefront of growth has become less ubiquitous. In fact, in 2008, under the new tax law, the Enterprise Income Tax law, most of the tax preferential concessions of the SEZs were taken away. With the central government's policy to promote the economies of the interior and western regions, by 2009, the usefulness of investing in the SEZ has been much reduced.

2.5 Other Zones

In addition to the SEZs, a number of coastal cities have been opened up as Economic and Technological Development Zones, High-tech and New Technology Industry Development Zones, or simply open coastal cities. Similar to the SEZs, the free trade zones were established principally to encourage export processing; foreign enterprises and investments are much welcome. Raw materials and goods that are imported for processing within the zones and directly exported will enjoy exemption from duties. Again, with the new tax law enacted in 2008, the benefits of setting up in coastal cities have been curtailed.

2.6 Government Agencies

To establish a presence in China by foreign enterprises, the most important government agency is the Ministry of Commerce (the "MOC"). It is a department under the State Council in charge of the overall administration of China's foreign trade and economic cooperation. Its main tasks are to develop the policies and strategies for foreign trade and economic development, draft laws and regulations in foreign investment, carry out the administration of respective trades, coordination, supervision and inspection in foreign economic and trade work.

2.7 Foreign Exchange Control

The currency of China, the Renminbi (RMB) is not a freely convertible currency now, and the foreign exchange rate system is a controlled floating one on the basis of market demand by the State Administration of Foreign Exchange (SAFE). On December 1, 1996, China announced to accept Articles 8 of the International Monetary Funds, that is, RMB can be freely converted under current account.

For foreign investment enterprises (FIE), they need to register with the local bureau of SAFE soon after the issuance of the business license. Armed with this register, they can then open a Foreign Exchange Account with an authorized bank for the inflow and outflow of funds in foreign currencies. It is to be noted that all such receipts and utilizations have to be reported, and subject to an annual audit by qualified accountants. The Exchange Control Register can only be renewed upon the presentation of the report on the annual foreign exchange audit.

Enterprises carrying on domestic sales business within China may not present bills in foreign currencies. All payment in foreign currencies must be duly supported by contracts and invoices, receipts, import/export bills, etc.

2.8 Land

Generally speaking, ownership of land belongs to the state. An enterprise wishing to construct a building or other premises needs to obtain the land use right. Often, this right is granted to the Chinese party who in turn uses it as its contribution to the joint venture. Alternatively, the foreign enterprise may apply to the local authority for an allocated land use right. One of the major differences between the two types of rights is that "granted land use rights” require a large premium, which could be waived, and a smaller regular fee; whereas “allocated land use rights” require a smaller premium but larger regular fees.

It was not until 1994, upon the promulgation of Urban Land Regulations, that real estates can be transferred, leased, or mortgaged. Such transfers, however, are still restricted to “granted land use rights” and not to “allocated land use rights.” Further, should the government need to repossess the land, it may pay a compensation for the former rights but no compensation may be paid on the latter.

Beginning in 1980's, the central authority has made an attempt to register all land titles; registered land users should be in possession of land use right certificates.

2.9 Labour Relations and Conditions

Before the reform movement, all of China’s labor force is primarily government-directed. The government dictates where a person may work upon graduation from school. Since all enterprises are government owned, such matters as pay, hours worked, reasons for dismissal, and working conditions are also determined by governmental agencies. Hiring is done through the municipal agency that allots new workers according to need and national policy. However, all school graduates needing work are given positions irrespective of demand.

With the reform movement, enterprises operating in the SEZs or Free Trade Zones are allowed to source workers on their own. Strictly speaking, after procuring them, it is still necessary to report to Foreign Employment Service Corp. (FESCO) the persons who have been engaged. If the foreign enterprise works with a joint venture partner, it is better that the matter of hiring local staff be left to the Chinese partner.

3. FINANCE

3.1 Currency

The currency of China is the Renminbi (RMB), or "people's currency." The basic unit is the yuan (¥), which is divided into 10 jiao; the smallest subdivision is the fen, or cent. One jiao equals 10 fen; one yuan equals 100 fen.

Notes are issued in denominations of ¥100, ¥50, ¥20, ¥10, ¥5, and ¥1 and 5, 1 jiao. Coins are issued in denominations of ¥1 and 5, 1 jiao.

3.2 Financial Institutions

The central bank of China, the People's Bank of China, is in charge of approving, regulating and supervising domestic and foreign financial institutions. Other government authorities also play certain roles in the financial system. Those authorities include the Ministry of Finance (MOF) and the SAFE.

3.3 Stock Market

There are currently two formal stock exchanges, one is Shanghai Stock Exchange, the other is Shenzhen Stock Exchange. All the listing and trading of securities are operated in those two exchanges.

Initial Public Offering in the domestic market may be done in two manners: listing of A shares which are denominated in RMB and may only be acquired by domestic investors; listing of B shares, which are denominated in foreign currencies for foreign investors. For initial public offering in foreign markets, there are H shares in Stock Exchange of Hong Kong, N shares in New York Stock Exchange and S shares in Singapore Exchange.

4. BUSINESS ENTITIES

The followings are the principal forms of business entities for foreign investment enterprises (FIE) through which business is undertaken in China:-

- Chinese - Foreign Equity Joint Venture (EJV)
- Chinese - Foreign Cooperative Joint Venture (CJV)
- Wholly Foreign Owned Enterprise (WFOE)

4.1 Chinese - Foreign Equity Joint Venture

An EJV is a joint venture between a Chinese and a foreign party joining up in the form of a Chinese limited liability company. The joint venture partners share profits, losses and other risks in proportion to their respective contributions to the registered capital of the joint venture.

The foreign party may be a company, an enterprise, or other economic organizations formed and registered as a legal entity under the laws of a foreign country; or it may be an individual.

The Chinese party may be companies, enterprises or other economic organizations, namely, State-owned enterprises, collective enterprises, private enterprises and other economic organizations formed under the law of China, approved by the department in charge and registered as a legal entity, and wholly owned by Chinese nationals.

4.2 Chinese-Foreign Cooperative Joint Venture

A CJV pools the resources of both the Chinese and foreign parties, joining together to form a partnership. The forms of cooperative operation are relatively flexible. Cooperative operations are suitable for industries which do not require much technology. For instance, one of the parties provides assets such as the building and the right of the use of land, while the other party provides capital and equipment to jointly operate a specific project. The cooperative joint venture format is mainly applied to medium-size or small projects in the fields of housing, the construction of travel facilities, car renting, light manufacturing and processing industry, etc.

4.3 Wholly Foreign Owned Enterprise

A WFOE is an independent legal entity entirely owned by the foreign investor. WFOE are usually permitted in industries involving hi-tech transfer, or exporting major part of production. A WFOE is more convenient for investors who are more familiar with operating in China, whereas for new comers, it may be advantageous to have a local partner to facilitate the formation of the joint venture and the operation, smooth the way not only any authorities who may have jurisdiction over the operation, but also to deal with the labour force.

4.4 Formation Procedures

Each entity involving foreigner must first obtain approval from Ministry of Commerce (MOC) or state or local authorities according to the project’s nature, industry and investment volume. All project proposals, feasibility study reports and Articles of Association have to be approved. After MOC, the foreign investor or its agent must then bring along the Articles of Association, its contracts and approval documents to the state or local Administration for Industry and Commerce for business registration purposes and to obtain a business license. The enterprise also needs to apply for tax registration, foreign exchange control registration, bank account, registration with statistic bureau, custom registration, fiscal registration, land use approval and capital verification, etc.

4.5 Representative Offices

Short of a full scale investment, foreign investors may set up a representative office in China. Such representative offices may carry out the activities of customer liaison and support, market research, or any activities that do not give rise to earnings. As such representative offices may not operate manufacturing or production activities, engage in sales or direct marketing.

4.6 Joint Venture Agreement

The JV agreement is the most important agreement in the setting up of the joint venture. There is a standard form of contracts issued by MOC. For many foreign parties, however, this form may not be advantageous in that it is written with the Chinese party's interest in mind. On the other hand, the use of this form often ensures a shorter approval time. The following are some of the important matters to bear in mind when entering into such contracts:

(i) The language - MOC requires that the contract must be in Chinese. The foreign party naturally will insist on an English version. Quite often, especially for legal terms, it is not possible to translate from one to the other. It is important that the draftsman be familiar with both languages to identify and eliminate as much as possible any discrepancies.

(ii) Party to the contract - only enterprises that have "legal person" status may enter into contracts. The person representing the enterprise must also be confirmed as the designated legal representative.

(iii) Governing laws - all JV agreements are governed by Chinese laws. It is important that where the laws appear to be deficient, the necessary terms be inserted to supplement the applicable laws.

(iv) Companies law - companies law is not as well established in China as the western countries.

(v) Arbitration - while each party may prefer to settle dispute in its own country, the best way may be to designate a neutral third country as the place for arbitration.

5. ACCOUNTING

The national regulatory authority for China's CPA profession is the Ministry of Finance. The Chinese Institute of Certified Public Accountants (CICPA), which was established in late 1988, is the organization that actually regulates the profession. In addition to licensing CPA's, CICPA's main functions are to ensure that all CPA's perform their duties in accordance with the relevant laws and regulations, promote the development of the profession, enhance the professionalism of its members and maintain their legitimate professional rights, promote the exchange of working experiences and business information, and improve association between the Chinese CPA's and their foreign counterparts.

An FIE is required to maintain a complete accounting system and prepare financial statements. Three kinds of primary accounting books should be set up: journals, general ledger and subsidiary ledgers and supporting documents. Computerized accounting records are also allowed. All supporting documents, accounting books and financial statements should be prepared in Chinese. However, foreign language can also be adopted along with Chinese. Generally, RMB is adopted as the base bookkeeping currency. If a foreign currency is used, the financial statements must be converted into RMB at the year-end.

In China, the accounting year is the calendar year, i.e., January 1 to December 31. The accounting system is based on accrual basis instead of cash basis.

In the area of accounting standards, November 1997 was a watershed date when the Ministry of Finance adopted a new set of accounting standards that are more in line with the International Accounting Standards. Prior to that date, all Chinese enterprises are required to follow one set of accounting standards. These standards are slightly modified for foreign investment enterprises. Should the Chinese enterprise desire to seek a listing in the Stock Exchange of Hong Kong (commonly known as the "H-share listings") or in one of the exchanges inside China (commonly known as the "B" listing), it is required to restate the accounts in accordance with the Hong Kong/International Financial Reporting Standards for H-shares or the International Financial Reporting Standards for B-shares.

New Accounting Standards

With the reform movement in 1979, Chinese companies began to realize the benefits of tapping into the vast capital market of Western societies as well as Western funds. It was recognized, in the mid-1990's, that the accounting system must be overhauled in order to enable Chinese financial statements to bear the scrutiny of foreign investors. Ministry of Finance issued New Accounting Standards for Enterprises in 2006, which was effective on 1 January 2007. All companies listed on the stock exchanges of China and all foreign investment enterprises are required to adopt the new standards. Other enterprises are encouraged but not essential to adopt the new standards. The Ministry of Finance has worked diligently to update the Accounting Standards to bring it in line with the IFRS.

For domestic enterprises with staff count of 300 or less, turnover of RMB30 million or less, or total assets of RMB40 million or less, they may apply the Small Business Accounting System. The small business accounting system disbands with the requirements to provide for impairment of most of the assets, and is a more simplified version of the current Accounting Standards.

6 AUDITING

Enterprises with foreign investment and foreign enterprises are required to engage a Chinese-registered CPA firm to audit their annual accounting statements and books of accounts for the accounting year and to issue an auditor's report. It is generally the duty of the board of directors of a foreign investment enterprise to appoint the auditor. Although permission has been granted for the establishment of a limited number of joint venture accounting firms, foreign CPA firms still cannot conduct official audits for statutory and income tax purposes. However, the foreign partner to a joint venture accounting firm may become involved in the performance of the audit, or a foreign CPA firm may be engaged to cooperate with a local CPA firm in performing audit or related work, but the local CPA firm must issue the report.

Audits are required under the income tax laws in China and audited financial statements are therefore prepared primarily for tax reporting purposes. Enterprises with foreign investment and foreign enterprises are required to provide the auditors with all the enterprise's documents, books and reports. The accounting statements to be submitted for an annual audit include the balance sheet, profit and loss account, and statement of cash flow.

7. TAXATION - INCOME TAX

Prior to 1 January 2008, there was a different set of tax for domestic enterprises and for foreign investment enterprises. In 2008, upon the effective date of the Enterprise Income Tax Law (EIT), the tax laws for domestic and foreign enterprises have converged and there is no difference in the taxation of a domestic enterprise versus that of a foreign one.

There are basically two types of tax: income tax and turnover tax. For disposal of land or land use right, there is a Land Appreciation Tax.

7.1 Income Tax - FIE

7.1.1 Enterprises subject to tax in China

Rather than delineating whether a company is domestic or foreign, tax is levied on:

(i) the worldwide income of a resident company, being a company that is registered in China or a company with a permanent establishment in China;

(ii) China sourced income derived by a non-resident company, being a company without permanent establishment in China.

Under the EIT, for a company that is not registered in China but whose principal place of business is effectively in China, its worldwide income would deemed to have a China source and would be subject to the EIT.

7.1.2 Tax rates

7.1.2.1 Under the EIT, the tax rate is reduced from 33% to 25%.

7.1.2.2 Other than the high-technology preferential tax rate as discussed under paragraph 7.1.2.3, a foreign investment enterprise would no longer enjoy any tax holiday. This elimination of the tax holiday is being phased out effective 17 March 2007, being the date on which the EIT was enacted. Any tax holidays previously granted prior to that day will expire over the maximum period of five years.

7.1.2.3 The high-technology preferential tax rate of 15% is available to companies that qualify for a high-technology license. This license may be obtained by applying to the technology bureau of each city.

7.1.3 Taxable income

7.1.3.1 Income – resident companies

Income includes income from production and business operations of all sorts of industries, as well as dividend, interest income, rental, royalties, and other non-business income. Generally, income is recognized using the accrual basis.

7.1.3.2 Income - non-resident companies

For foreign enterprises without establishments in China, income tax is charged on income derived from a source in China. These include dividends, interest income, royalties, rent, earnings from assigning assets, and other deemed income. These may also include service and consultancy income. Withholding tax of 10% to 20% is applied to such income. Such withholding taxes may be further reduced by tax treaties between China and the recipient country.

7.1.4 Deductible Expenses

In general, most expenses incurred in relation to business operations are deductible. Notable exceptions are:

bad debts	-	these are only deductible if the debtor has ceased business, died, or outstanding over three years;
depreciation	-	using straight-line method, the depreciation rates are normally 10%;
entertainment	-	for companies engaged in manufacturing and trading, the claim is limited to the lower of 60% of the actual entertainment fee or a ceiling of 0.5% of total annual revenue;
exchange difference	-	the loss on exchange in the pre-operating period is to be amortized in no less than five years;
intangible assets	-	the cost is to be amortized; gain or loss on transfer of intangible assets is to be charged as the profit or loss for the period;
loan interest	-	interest on loans for capital contribution is not deductible if the loan is not registered with SAFE or if the loan exceeds the thin-capitalization rule; interest computed above commercial rates is not deductible;
management fee	-	deductible if there is supporting document to prove the reasonableness of the computation basis;
stock valuation	-	any common stock valuation method, including LIFO is allowed;
tax losses	-	carried forward for five years.

7.1.5 Administration

An enterprise commencing to carry on business must register with the State Administration of Tax or with the local tax bureau within 30 days from the issuance of the business license. A Tax Registration Certificate will then be issued within 30 days. An enterprise with two or more places of operation may file consolidated tax reports.

Proper accounting books and records must be prepared in Chinese, with RMB as the reporting unit. All records must be kept for 15 years. All enterprises, unless otherwise approved, must adopt the January to December period as its fiscal year.

Tax returns, including Business Tax, Value Added Tax and EIT, are to be filed either monthly or quarterly within 15 days of the end of the period involved. They must be in Chinese. The tax payments are also to be made within 15 days from the end of the period. The annual examination of EIT is to be filed within five months of the year end.

7.1.6 Withholding Tax

7.1.6.1 All enterprises without a permanent establishment in China but receiving China sourced income are liable to withholding tax. The party disbursing the amount becomes the withholding agent and is required to withhold 20% (or such lower rates as determined by tax treaties) of such income as dividend, interest, rent, royalties, and such income from the transfer of property or land use rights. Under most tax treaties, the withholding rate is reduced from 20% to 10%. Under the Closed Economic Partnership Arrangement between Hong Kong and China, the withholding tax rates on interest and royalties paid by a Chinese entity to a Hong Kong company is reduced to 7%.

7.1.6.2 Withholding tax on dividends - Prior to 2008, all payments of dividends by a Chinese company to its foreign holding company are exempted from dividend withholding. Upon the enactment of the EIT, beginning 2008, all dividends are subject to the withholding of 10%, except where the dividends are paid to a Hong Kong parent, the withholding tax is reduced to 5% under specific circumstances.

7.1.7 Transfer pricing

The Chinese government released its latest version of the transfer pricing regulations in January 2009.

7.1.7.1 Associated company - Transactions carried out between two companies that are associated would be subject to the transfer pricing regulations. An associated enterprise is defined as a company that has common ownership interest of 25% or more as the Chinese enterprise. In addition, the definition is broadened to cover transactions between two enterprises which have mutually beneficial or reciprocal associations. This definition may therefore be extended to major suppliers or customers or an enterprise.

7.1.7.2 Transfer pricing documentation and requirements - An enterprise that engages in related party transactions must make an annual declaration if it has engaged in RPT's. Transfer pricing documentation contains:

a. An organization chart describing the structure;
b. Summary of business operations;
c. Includes a Functional and Risk Analysis of the enterprise's business;

d. Includes a description of the Group's supply chain arrangement and the place of the enterprise on the chain;
e. Includes analysis of the enterprise's performance, and market and competition analysis;
f. Related party transactional model and operation flows;
g. Comparability analysis;
h. Rationalization of TP methods

The transfer pricing documents must be made available by May 31 of each year and be made available to the tax bureau within 20 days upon request.

7.1.7.3 Transfer pricing methodology.

7.1.7.3.1 Any best method depending on the circumstances:

a. Comparable uncontrolled price method (CUP);
b. Resale price method;
c. Cost plus method;
d. Transactional net margin method;
e. Profit split method

7.1.7.3.2 Comparability analysis - should use public as well as private industry data.

7.1.7.3.3 Transfer pricing method is to be applied on a transactional basis rather than the "whole of an entity" basis.

7.1.7.3.4 Transfer pricing method is to be applied to each entity and not on a consolidated basis

7.1.7.4 Transfer pricing adjustments.

7.1.7.4.1 If an enterprise's profit is lower than the median profitability of comparable companies – the tax bureau may adjust the profit to the median.

7.1.7.4.2 If, as a result of an adjustment, interest, royalty, etc., was reduced, the withholding tax that has been paid would not be refunded.

7.1.7.4.3 If an adjustment is made to one enterprise, the tax authority may not allow the counter-party of that enterprise to claim the contra adjustment.

7.1.7.4.4 Even if there are set-offs among transactions, there may still be transfer pricing adjustments arising from VATs and business tax

7.1.7.5 Penalties.

7.1.7.5.1 Maximum of RMB50,000 for failure to produce contemporaneous documents.

7.1.7.5.2 5% p.a. of tax adjustment from 1/1/2008.

7.1.7.6 Exemptions - The following enterprises are exempted from maintaining transfer pricing documentation:

7.1.7.6.1 Where related party sales and purchases are less than RMB200 mil (about US$30 mil) and related party financing of less than RMB40 mil (US$6 mil).

7.1.7.6.2 Where the transactions are already covered by an advanced pricing agreement.

7.1.7.6.3 Foreign shareholding in the Chinese enterprise is less than 50% and the Chinese enterprise only has related party transactions with domestic parties

7.2 Income Tax - Representative Office

7.2.1 Deemed income

While representative offices may not carry out income earning activities, they are nevertheless deemed to have carried out taxable activities. The tax is charged on the compensation that they receive. There are three methods to determine the compensation:

7.2.1.1 Actual Income

Subject to an audit by a qualified accountant in China, the regular tax rate of 25% may be charged on China-sourced actual gross income generated by the representative office. This method, however, is rarely applied except for professional service firms such as lawyers, engineers, accountants.

7.2.1.2 Deemed Income

This method is used when the actual gross income of the representative office cannot be readily determined but sales contracts are available as a guide for the approximate sales amount.

The deemed profit rate is assessed by the tax bureau in accordance with the nature of business activities carried out by the representative office, the normal rate is not less than 15% of total sales.

7.2.1.3 Cost plus method

This method is commonly used by the tax bureau to ascertain the taxable income of the representative office. The deemed gross income is calculated based on total actual expenses incurred by the representative office multiplied by the deemed profit rate, which is not less than 15%.

7.3 Individual Income Tax

As of 1994, the Individual Income Tax Law applies to both Chinese nationals and foreign individuals. Our discussion in this section will only cover foreign individuals.

7.3.1 Foreign taxpayer

A foreign national who spends less than 90 days in China in a calendar year (or 183 days if a tax treaty is applicable) is not charged with any individual income tax if his salary is paid by an overseas company and not charged to the accounts of that company in China. This tax relief, however, is not available to persons who hold the position of Chief Representatives of representative offices in China, or to foreign directors or senior managers of Chinese domestic enterprises,

A foreign national who lives and works in China for less than one year in a calendar year is liable to individual income tax on the portion of income derived from sources within China (which may be paid in or outside China).

A foreign national who lives and works in China for more than one year but less than five years is, subject to approval of the taxation authority, liable to individual income tax for the income derived from China. Any foreign sourced income will not be taxable unless it is paid by individuals or enterprises in China. For the purpose of counting 365 days in a full year, absences of less than 30 days in one trip or for 90 days in total during the year are regarded as temporary absences and are not deducted from the 365-day count.

An individual who has lived in China for five consecutive years or more, beginning 1 January 1994, is liable for tax on his world-wide income. However, after five years, if the individual spends less than the full 365 days in China in any one year, he will only be liable for the tax on his China-sourced income.

7.3.2 Scope of tax

Individual income tax is levied on the following income if they are China-sourced even if the payments are made outside of China. These are income derived from:

(i) Employment income - salaries and wages;
(ii) Personal services rendered in China pursuant to an office or contract;
(iii) Leasing of property in China;
(iv) Assignment of properties in China;
(v) Interest, dividends, bonus paid by companies, enterprises, or individuals in China

7.3.2.1 Salaries and wages

Individual income tax is charged on the basic salary, hardship allowances, cost of living and automobile allowances, bonuses, tax borne by employer, stock option, cash compensation, allowances, and subsidies.

Not included in this head and not taxable are housing paid for by the employer, home leaves, relocation and moving costs, local transportation, reimbursement of meals and laundry, children's education, medical benefits, and reimbursement of business-related expenses. An employment package that includes fringe benefits that do not result in a direct cash payment to the taxpayer will reduce the individual income tax liability.

Certain compensations such as acquiring an automobile or property for the employee are taxed on the basis that the cost will be spread over a period not exceeding five years.

It should be noted that the tax is paid on the income sourced in China. If the individual is paid a bonus or a stock option after his term terminates in China, he is still liable to tax in China.

7.3.2.2 Personal services

Individual income tax is levied on income derived by an individual as remuneration for providing personal services as an independent contractor, including director's fees. Personal service, as distinguishable from employment, refers to service provided by an individual independently, using her own tools and equipment, and not requiring to attend a place of work at regular hours. The distinction is important due to the different tax rates and method of deductions.

7.3.3 Deductions

(i) Employment income - RMB4,800 per month for foreigners;

(ii) Personal service income - the higher of 20% of income in one month, or RMB800 per month;

(iii) Leasing income - the higher of 20% of a single receipt, or RMB800 per month;

(iv) Royalty income - the higher of 20% of a single receipt, or RMB800 per month;

(v) Salaries in Shanghai - beginning 1998, foreign employees earning salaries from an enterprise in Shanghai may deduct from their salaries the cost of the purchase of properties in Shanghai over a five year period.

7.3.4 Tax rates and computation

(i) Wages and salaries - progressive rates ranging from 3% to 45% are applied to monthly income (see tables A and B in Appendix II for details); as this category of income is computed monthly, it would be necessary to divide any annual income by 12 before using the table. It should also be noted that there are different computation methods for tax liability borne by the employer, bonus paid annually, and stock options;

(ii) Production and business - progressive rates ranging from 5% to 35% are applied (see table C in Appendix II for details);

(iii) Contract and leasing - progressive rates ranging from 5% to 35% are applied (see table C in Appendix II for details);

(iv) Personal service income - progressive rates range from 20% to 40% (see table D in Appendix II for details);

(v) Interest, dividends, royalty, rental, manuscript income - straight rate of 20% is applied.

7.3.5 Administration

7.3.5.1 Individual tax returns

Any individual liable to pay individual income tax is required to register with the tax authorities. Most often individual income taxes are reported and withheld monthly by the withholding agent who is required to then remit the amount to the tax bureau. In the case where there is no withholding agent, or where there is income from more than one source, or where the tax bureau simply stipulates it, an individual taxpayer is required to complete and lodge a monthly tax return. The monthly return is required to be lodged within seven days of the end of each month. An annual return is required for each individual who has resided in China for at least one year to report his income earned from sources outside of China.

7.3.5.2 Withholding Agent

Any individual or unit which pays taxable income to a taxpayer is deemed as a withholding agent. The agent is required to report and withhold tax from income subject to individual income tax. The report and tax are required to be submitted within seven days from the end of each month. The agent is also required to provide the taxpayer with a Certificate of Tax Withheld. The government pays the agent a fee of 2% on the tax withheld for service rendered. This fee, if received by an individual, is not subject to tax.

8. TAXATION - TURNOVER TAX

Effective on 1 January 1994, there are four turnover taxes: Value-added Tax (VAT), Business Tax, Consumption Tax, and Resource Tax. Our discussion will focus on the VAT and Business Tax; the other two taxes are less relevant to foreign investors.

8.1 VAT

8.1.1 VAT in China

Effective on 1 January 1994, VAT is charged on foreign investment enterprises as well as domestic enterprises. The old Industrial and Commercial Consolidated Tax was appealed.

VAT is levied on income from sales of goods or provision of certain labour services. The principle of VAT is that it is a consumption tax levied on the added value of the commodity.

Each time goods are purchased, VAT is paid on the purchase price (the input VAT). When the goods are processed and later sold, the seller collects VAT on the sales value (the output VAT). The difference of the two is then remitted to the tax authorities.

VAT is charged at each level of production, distribution and sales. It is also charged on the import of raw materials.

Services subject to VAT include processing, repair and replacement, installation. If a business carries on mixed VAT exempt activities as well as VAT ones, the VAT output is charged on the entire sales.

8.1.2 Tax rates

The usual VAT rate is 17% for most goods. It is reduced to 13% for certain goods such as food, agricultural fertilizer, books, etc. It is further exempted for agricultural products, contraceptive drugs, equipment and machinery imported for manufacturing purposes. Goods meant for export are exempted from VAT. However, for the export of such raw materials as platinum, copper, sugar, oil, musk, the full rate of 17% is charged.

For certain activities, there is deemed input VAT. These include purchases of exempt agricultural products and freight charges. On the other hand, certain VAT paid, such as VAT on goods used for non-taxable items, no input VAT deduction can be claimed.

8.1.3 Administration

Each taxpayer potentially liable to VAT is required to be registered with the local tax authorities. Taxpayers should issue VAT invoices for their sales. The amount of VAT payable is taken as the total of output VAT invoices less the total of input VAT invoices that the taxpayer has collected. The time to remit the tax varies, from three days to one month, according to the product, the location, and the amount.

8.2 Business Tax

8.2.1 Business Tax in China

Business tax is levied on the provision of services, the assignment of intangible assets, or the sales of landed properties in China. As a general rule, any services not captured by VAT should be liable to business tax.

Business tax is charged on nine categories of services as follows:

(i) Transportation
(ii) Construction
(iii) Finance and insurance
(iv) Communication
(v) Entertainment
(vi) Services - Agency, hotels, tourist, warehousing, rental, adverting and other services
(vii) Sports and cultural activities
(viii) Assignment of intangible assets
(ix) Sale of immovable properties

8.2.2 Tax rates

The tax rates range from 3% to 5%, depending on the type of services. For details of the applicable rates, please refer to Appendix III.

China is planning to merge the Business Tax with VAT to extend the coverage of VAT as a general tax on consumption ("VAT Reform"). The pilot scheme for VAT Reform on the transportation and chosen modern services sectors has been implemented in Shanghai on January 1, 2012. Major cities, such as Beijing and Shenzhen, are planned to follow soon.

8.2.3 Taxable income

Taxable income is calculated as the total amount of consideration plus any other charges and additional fees in respect of the provision of taxable services, the assignment of intangible assets, or the sale of immovable property. Additional fees include service charges, handling fees, fees received on behalf of others and other additional charges.

8.2.4. Administration

Business tax is assessable over a period from five days to one month, depending on the size of the tax.

Appendix I

FOREIGN ENTERPRISE INCOME TAX CALCULATION FORMULAE

Taxable income should be computed according to the following formulae:

Manufacturing

Taxable income = Sales profit + Other operating profit + Non-business incomes - Non-business expenese

Sales profit = Net sales - Cost of goods sold - Turnover tax on sales - (Selling expenses + Administrative expenses + Financial expenses)

Net sales = Gross sales - (Returns inward + Discount allowed)

Cost of goods sold = Cost of goods manufactured in the period + Opening stock for finished goods - Closing stock for finished goods

Cost of goods manufactured in the period = Production cost for the period + Opening WIP - Closing WIP

Production cost for the period = Direct raw material + Direct labour + Manufacturing costs

Trading

Taxable income = Sales profit + Other operating profit + Non-business incomes - Non-business expenses

Sales profit = Net sales - Cost of goods sold - Turnover tax on sales - (Selling expenses + Administrative expenses + Financial expenses)

Net sales = Gross sales - (Returns inward + Discount allowed)

Cost of goods sold = Opening stock of goods + [Purchase in the period - (Returns outward + Discount received) + Purchase expenses] - Closing stock of goods

Service

Taxable income = Net business income + Non-business incomes - Non-business expenses

Business income = Gross business income - (Turnover Tax on business income

+ Operating expenses + Administrative expenses + Financial expenses).

Appendix II

INDIVIDUAL INCOME TAX RATES

Table A

Tax rates applicable to Wages and Salaries (Effective September 1, 2011).

Monthly taxable income	**Tax rate**
Not exceeding Rmb1,500	3%
That part exceeding Rmb1,500 but not exceeding Rmb4,500	10%
That part exceeding Rmb4,500 but not exceeding Rmb9,000	20%
That part exceeding Rmb9,000 but not exceeding Rmb35,000	25%
That part exceeding Rmb35,000 but not exceeding Rmb55,000	30%
That part exceeding Rmb55,000 but not exceeding Rmb80,000	35%
That part exceeding Rmb80,000	45%

Table B

In order to simplify the calculation, a quick calculation method is used.

Monthly taxable income	**Tax rate**	**Quick calculation deduction**
Not exceeding Rmb1,500	3%	Rmb 0
Rmb1,500 - Rmb4,500	10%	Rmb 105
Rmb4,500 - Rmb9,000	20%	Rmb 555
Rmb9,000 - Rmb35,000	25%	Rmb 1,005
Rmb35,000 - Rmb55,000	30%	Rmb 2,755
Rmb55,000 - Rmb80,000	35%	Rmb 5,505
Exceeding Rmb80,000	45%	Rmb 13,505

Table C

Tax rates applicable to Production and Business Income, Contracting or Leasing Income.

Annual taxable income	**Tax rate**
Not exceeding Rmb15,000	5%
That part exceeding Rmb15,000 but not exceeding Rmb30,000	10%
That part exceeding Rmb30,000 but not exceeding Rmb60,000	20%
That part exceeding Rmb60,000 but not exceeding Rmb100,000	30%
That part exceeding Rmb100,000	35%

Table D

Tax rates applicable to Personal Services Income.

Taxable income of each payment	**Tax rate**	**Quick calculation deduction**
Not exceeding Rmb20,000	20%	-
That part exceeding Rmb20,000 but not exceeding Rmb50,000	30%	2,000
That part exceeding Rmb50,000	40%	7,000

Appendix III

BUSINESS TAX RATES

Taxable Items	Scope	Tax Rates
1. Transportation	Land, sea and river, air, pipeline transport, loading and unloading	3%
2. Construction	Construction, installation, repairs, decorations and other engineering projects	3%
3. Finance and Insurance		5%
4. Post and Tele-Communications		3%
5. Cultural activities and sports		3%
6. Entertainment	Ballrooms, night clubs, karaoke bars, lounges, billiard rooms, golf courses, bowling alleys and venues for shows and performances	5% to 20 %
7. Services	Agency services, hotels, restaurant and catering services, tourist services, warehousing, rental and leasing services, advertising and other services	5%
8. Assignment of intangible assets	Assignment of land use rights, patent rights, non-patented techniques and know-how, trademarks, copyright and brand names	5%
9. Sale of immovable property	Sale of buildings, structures and other fixtures built on land	5%