

Doing Business in China

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GENERAL INFORMATION

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.

History. The history of China dates back 4,000 years. The history of modern China, however, begins in the 1910's with the overthrow 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 rightist's movements, the Great Leap Forward, and later the Cultural Revolution - the economy experienced surge and stall. It was not until mid-1970s that the economy stabilized. In 1978, a new era slowly emerged as economic reforms were instituted. The reforms of the 1970's centered on 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.

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 counter-revolutionary activities, and prosecute counter-revolutionaries and other criminals. Their purpose is to safeguard the unity of the country, the people 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.

Population. China's population today is over 1.29 billion. Currently, China's population is increasing approximately 0.6 percent a year - a rate that is low for developing countries.

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.

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.

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BUSINESS ENVIRONMENT

Economic Outlook. The Chinese economy has grown an average of 8 percent a year during the 2000 and 2004. It is estimated that for 2005, the country managed growth of 8.5%. The wages of urban workers have tripled in ten years, though some of this advance has been taken away by inflation.

While China's 1.29 billion population may represent enormous demands for modern goods, the population remains poor. An average family earns less than US\$1,200 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.

Imports and Exports. Both imports and exports are subject to central planning and state control. Basically, import of non-essential or non-prioritized 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.

Special Economic Zones. The concept of Special Economic Zones (SEZs) was introduced at the time of the reform movement of the late 1970's. 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 five SEZs, in Shenzhen, Zhuhai, Xiamen and Shantou and on Hainan Island.

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.

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 (see Appendix 1 for a list of such cities), with more to be expected. The free trade zones are 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.

Government Agencies. To establish a presence in China by foreign enterprises, the most important government agency is the Ministry of Foreign Trade and Economic Cooperation (commonly known as MOFTEC). 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, co-ordinations, supervision and inspection in foreign economic and trade work.

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 for Exchange Control (SAEC). 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 administration on foreign exchange control 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.

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 rights. 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 certificates.

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.

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FINANCE

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 fens; one yuan equals 100 fens.

Notes are issued in denominations of ¥100, ¥50, ¥20, ¥10, ¥5, ¥2, ¥1 and 5, 2, 1 jiao. Coins are issued in denominations of 1 yuan; 5, 1 jiao and 5, 2, 1 fen.

Financial Institutions. The central bank of China is the People’s Bank of China which 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 State Administration for Exchange Control (SAEC), which is a bureau under Bank of China in charge of foreign exchange control.

Security Market. There are currently two formal security exchanges, one is Shanghai Security Exchange, and the other is Shenzhen Security 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 Security Exchange and S shares in Singapore Security Exchange.

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BUSINESS ENTITIES

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

- Chinese - Foreign Equity Joint Ventures (FJV)
- Chinese - Foreign Cooperative Joint Ventures (CJV)
- Wholly Owned Foreign Enterprises (WOFE)

Chinese - Foreign Equity Joint Ventures. An FJV 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. No political party or government body and no Chinese individuals can act as the Chinese joint venture.

Chinese-Foreign Cooperative Joint Ventures. 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.

Wholly Owned Foreign Enterprises. A WOFE is an independent legal entity entirely owned by the foreign investor. WOFE are usually permitted in industries involving hi-tech transfer, or exporting major part of production. A WOFE is more convenient for investors who are more familiar with operating in China, whereas for newcomers, 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.

Formation Procedures. Each venture involving foreigner must first obtain approval from Ministry of Foreign Trade and Economic Cooperation (MOFTEC) 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 MOFTEC, the joint venture 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.

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.

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 MOFTEC. 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:

a. The language - MOFTEC 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.

b. 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.

c. 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.

d. Company law – company law is not as well established in China as in the western countries. It is important that the Chinese party's understanding of such terms as limited liabilities, outstanding capital, paid-up capital, etc. is the same as the foreign party.

e. 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.

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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 CPAs 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 CPAs 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 Statements of Standard Accounting Practice of Hong Kong for H-shares or the International Accounting Standards for B-shares.

Old Accounting Standards. The old accounting standards were designed to reflect the financial performance of enterprises owned by the State in a centrally planned economy. The following discussion highlights the major differences between the old accounting standards and international accounting standards:

Basic accounting concepts. While the accounting conventions of double-entry system, accrual basis of accounting, consistency, prudence, and materiality are generally recognized, in practice, the books as kept are more likely to be fund-based, rule-based, or tax-based. They are fund-based to reflect the funds allocated to the enterprise under the centrally planned economy; rule-based to reflect the various regulations that prescribe the headings of accounts, the type of entries to be made in each type, lives of fixed assets, etc.; and tax-based as the accounts are to be used for tax computation purposes.

Accounting standards

Fixed asset valuation

- No revaluation of fixed assets is provided for or allowed; Depreciation policy
- prescribed by the Ministry of Finance and tax regulations;

Investment

- Equity accounting is not required where the investment exceeds 25% interest in another company; no provision for permanent diminution in value is allowed;

Stock valuation

- LIFO may be used. There is generally provision for write-down of obsolete or slow-moving stocks;

Accounts receivable

- A general provision up to the limit of 3% of the account balance may be made, but subject to the approval of the authorities. Specific provisions may only be made upon the approval;

Sales

- Sales are generally recognized if goods have been shipped or service performed, but often, sales are also recognized where payments have been received prior to the delivery of goods or performance of service;

Staff welfare and bonus

- The item must be shown as an after-tax expenditure in the profit and loss account and a current liability in the balance sheet;

Research and development

- All such expenditures must be expensed and not capitalized;

Foreign currency

- must be translated at the official rate and not the swap rate;

Contingencies

- There are requirements for disclosure of contingent liabilities, commitments, or any other off-balance sheet items;

Disclosure requirements

- There is only nominal note disclosure; there are generally requirements to disclose material and relevant financial information.

New Accounting Standards. With the reform movement, 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, that the accounting system must be overhauled in order to enable Chinese financial statements to bear the scrutiny of foreign investors. The new standards were promulgated and applied in 1998. It should be noted that as most of the Chinese accountants are schooled in the old standards, they may not be as familiar with the requirements of the new standards, especially when it comes to valuation of assets and note disclosure. It may take another few years before the new system becomes an ingrained practice nationwide.

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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 CPAs 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.

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TAXATION

INCOME TAX. The tax regime in China is still in a state of flux, with tax laws being amended and updated regularly, and new interpretation, administrative policies, and enforcement rules being introduced from time to time. There is a different set of tax for domestic enterprises and for foreign investment enterprises. Our discussion will only cover the tax law as they affect FIE and foreign individuals. There are basically two types of tax: income tax and turnover tax. For disposal of land or land right, there is a Land Appreciation Tax.

Income Tax - FIE. Foreign investment enterprises, foreign enterprises with establishments or places of operation of business in China, or foreign enterprises deriving income from China but without establishments or places of operation in China, are subject to Foreign Enterprise Income Tax (FEIT). An FIE with head office in China will be subject to tax on its worldwide income. All other FIE are subject to tax only on income generated from China.

Tax rates. The tax rate is 33%, with 30% levied by the central government and 3% levied by the State. Generally all FIE are entitled to the tax holiday of zero tax rates in the first two years beginning from the year on which it generates profit and half rate in the next three years. Extra tax concessions and incentives may be granted depending on the industry, location, and nature of business.

Taxable income

Income - FIE with establishments. 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. For income from production and business operations, there are different formulae for the computation of taxable income for different industries. Where the FIE is unable to provide proper accounts to support the tax computation, the State tax authorities may estimate by reference to other companies in the similar industry. Generally, income is recognized using the accrual basis.

Income - FIE without establishments. 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, rents; 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.

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

Bad debt

- These are only deductible if the debtor has ceased business, died, or outstanding for two or more years;

Depreciation

- using straight-line method

Entertainment

- For companies engaged in manufacturing and trading, the claim is limited to:
 - 0.5% of net sales for annual sales below RMB 15 million and
 - 0.3% of the portion of annual sales over RMB 15 million;
- For companies engaged in service industry, the claim is limited to:
 - 1% of net sales for annual sales below RMB 5 million and
 - 0.5% of the portion of annual sales over RMB 5 million;

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; interest computed above commercial rates is not deductible;

Management fee

- Not deductible if the payment is to an offshore company, except to the extent that there is sufficient proof of the services provided by the offshore company;

Royalty

- Not deductible if paid to head office;

Stock valuation

- Any common stock valuation method, including LIFO is allowed;

Tax losses

- carried forward for five years.

Administration. An enterprise commencing to carry on business must register with the State Tax Bureau or with the local tax bureau within 30 days from the issuance of the business registration certificate. 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 are filed quarterly, within 15 days of the end of the quarter. They must be in Chinese. Quarterly tax payments are also to be made within 15 days from the end of the quarter. All FEIT for any one year are to be settled within four months of the year end.

Withholding Tax. All enterprises without a permanent establishment in China but receiving 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.

Transfer pricing. The issue of transfer pricing has recently begun to draw the attention of the Chinese tax authorities. Regulations have been drawn up in 1998 to address the issue. The rules first define the term Associated Enterprises and then set out the reporting requirements.

The term associated enterprises, as defined, may have wide implication in that, in addition to the normal considerations such as the degree of control one exercises over another or two enterprises being controlled by common owners, 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.

Once the association between two enterprises is established, it is then necessary that all transactions between the two be reported in the format as stipulated in the rules.

Income Tax - Representative Office

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:

a. Actual Income

Subject to an audit by a qualified accountant in China, the regular FIE tax of 33% 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.

b. 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.

With the sales figure, gross income is deemed to be 3% to 7% of sales (the rate depends on the local tax authority), and net income is 10% of the China-sourced gross income.

c. Cost plus method

This method is most commonly applied. The costs, as certified by a qualified accountant in China, are simply grossed up by 117.65% to arrive at the deemed gross income figure. Net income is taken as 10% of this gross income. The expenses would include fixed assets used at the representative office, which may be taken in total or amortized over the tax depreciation rate, but would exclude that part of the costs attributable to services rendered outside of China.

Exemptions. Where an overseas manufacturing company sets up a representative office in China to handle market surveys, business liaison, commercial information, and preparatory and auxiliary activities, such activities are exempt activities and not subject to tax.

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.

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 to 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.

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:

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

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.

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

Deductions

a. Employment income

- RMB4, 000 per month for foreigners;

b. Personal service income

- the higher of 20% of income in one month, or RMB800 per month;

c. Leasing income

- the higher of 20% of a single receipt, or RMB800 per month;

d. Royalty income

- The higher of 20% of a single receipt, or RMB800 per month;

e. 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.

Tax rates and computation

a. Wages and salaries

- Progressive rates range from 5% to 45%. It should be noted that there are different computation methods for tax liability borne by the employer, bonus paid annually, and stock options.

b. Production and business

- Progressive rates ranging from 5% to 35%

c. Personal service income

- progressive rates range from 20% to 40%

d. Interest, dividends, royalty

- straight 20% Rental, manuscript income

Administration

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.

Withholding Agent. Any individual or unit which pays taxable income to a taxpayer is deemed 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 required to also 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.

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TAXATION - TURNOVER TAX

Effective 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.

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

For each sale of goods or the provision of certain labour services, VAT is levied. 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 importation of raw materials, unless the goods are meant for export.

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.

The tax 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 fixed asset purchases, VAT on goods used for non-taxable items, no input VAT deductions can be claimed.

Small scale taxpayers with turnover of less than RMB1 million in production income or RMB 1.8 million in wholesaling or retailing income, is charged 6% of output VAT but is otherwise not entitled to claim any deduction of input VAT. Enterprises with poor accounting and record system may also be deemed a small scale taxpayer.

Each taxpayer potentially liable to VAT is required to be registered with the local tax authorities. Taxpayers may issue VAT invoices for their sales. The amount of VAT to be remitted is therefore 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 according to the product, the location, and the amount. It may go from three days to one month.

Foreign investment enterprises established prior to 31 December 1993 may claim a refund for five years if they have incurred more VAT than under the old Industrial and Commercial Consolidated Tax.

Business Tax. 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. These are:

- Transportation
- Construction

- Finance and insurance
- Communication
- Entertainment
- Services - Agency, hotels, tourist, warehousing, rental, advertising and other services
- Sports and cultural activities
- Assignment of intangible assets
- Sale of immovable properties

The rates range from 3% to 8%, depending on the type of service.

Turnover 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 collected on someone else's behalf, and other additional charges.

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

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APPENDIX I SPECIAL ZONES AND CITIES**Special Economic Zones**

City	Province
Shenzhen	Guangdong
Zhuhai	Guangdong
Shantou	Guangdong
Xiamen	Fujian
Hainan	Hainan

Economic and Technological Development Zones

City	Province
An'hui	Anhui
Wuhu	Anhui
Beijing	Beijing Municipality
Dongshan	Fujian
Fuzhou	Fujian
Rongqiao	Fujian
Lanzhou	Gansu
Guangzhou	Guangdong
Daya Bay	Guangdong
Nansha	Guangdong
Zhanjiang	Guangdong
Nanning	Guangxi
Guiyang	Guizhou
Yangpu	Hainan
Qinhuangdao	Hebei
Zhengzhou	Henan
Harbin	Heilongjiang
Wuhan	Hubei
Changsha	Hunan
Huhhot	Inner Mongolian
Kunshan	Jiangsu
Lianyungang	Jiangsu
Nanjing	Jiangsu
Nantong	Jiangsu
Suzhou	Jiangsu
Nanchang	Jiangxi
Changchun	Jilin
Dalian	Liaoning
Shenyang	Liaoning
Yingkou	Liaoning
Chongqing	Chongqing Municipality
Yingchuan	Ningxia
Xining	Qinghai

Qingdao	Shandong
Weihai	Shandong
Yantai	Shandong
Caohejing (high-technology park)	Shanghai Municipality
Hongqiao	Shanghai Municipality
Jingqiao	Shanghai Municipality
Minhang	Shanghai Municipality
Taiyuan	Shanxi
Xián	Shanxi
Chengdu	Sichuan
Lhasa	Tibetan
Tianjin	Tianjin Municipality
Haicang	Xiamen
Shihezi	Xinjiang
Urumqi	Xinjiang
Kunming	Yunnan
Daxie	Zhejiang
Hangzhou	Zhejiang
Ningbo	Zhejiang
Wenzhou	Zhejiang
Xiaoshan	Zhejiang

Open coastal cities in which ETDZ's have been set up

- Dalian
- Qinghuang Island
- Tianjin
- Yantai
- Qingdao
- Lianyungang
- Nantong
- Shanghai
- Ningbo
- Fuzhou
- Guangzhou
- Zhanjiang
- Wenzhou
- Weihai

High-tech and New Technology Industry Development Zones

City	Province
Hefei	Anhui
Beijing	Beijing Municipality
Fuzhou	Fujian
Xiamen	Fujian

Lanzhou	Gansu
Foshan	Guangdong
Guangzhou	Guangdong
Huizhou	Guangdong
Shenzhen	Guangdong
Zhongshan	Guangdong
Zhuhai	Guangdong
Guilin	Guangxi
Nanning	Guangxi
Guiyang	Guizhou
Hainan	Hainan
Baoding	Hebei
Shijiazhuang	Hebei
Daqing	Heilongjiang
Harbin	Heilongjiang
Luoyang	Henan
Zhengzhou	Henan
Wuhan	Hubei
Xiangfan	Hubei
Changsha	Hunan
Zhuzhou	Hunan
Baotou	Inner Mongoli
Changzhou	Jiangsu
Nanjing	Jiangsu
Suzhou	Jiangsu
Wuxi	Jiangsu
Nanchang	Jiangxi
Changchun	Jilin
Jilin	Jilin
Anshan	Liaoning
Dalian	Liaoning
Shenyang	Liaoning
Jinan	Shandong
Qingdao	Shandong
Weifang	Shandong
Weihai	Shandong
Zibo	Shandong
Caohejing	Shanghai Municipality
Baoji	Shaanxi
Xi'an	Shaanxi
Taiyuan	Shanxi
Chengdu	Sichuan
Chongqing	Chongqing Municipality
Mianyang	Sichuan
Tianjin	Tianjin
Urumqi	Xinjiang
Kunming	Yunnan
Hangzhou	Zhejiang

Yangling

Shanxi

Border open cities

City	Province
Dongxing	Guangxi
Pingxiang	Guangxi
Heihe	Heilongjiang
Suifenhe	Heilongjiang
Manzhouli	Inner Mongolia
Hunchun	Jilin
Ta Cheng	Xinjiang
Bo Le	Xinjiang
Yining	Xinjiang
Hekou	Yunnan
Ruili	Yunnan
Wanding	Yunnan

Other special areas

- Hainan
- Shanghai Pudong New Area
- Beijing New Technology Industry Development Experimental Zone
- Suzhou Singapore Industrial Park

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