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Preface

This book was prepared by Ernst & Young, China. It was written to give the busy executive a quick overview of the investment climate, taxation, forms of business organization, and business and accounting practices in China. Making decisions about foreign operations is complex and requires an intimate knowledge of a country’s commercial climate, with a realization that the climate can change overnight. Companies doing business in China, or planning to do so, are well advised to obtain current and detailed information from experienced professionals. This book reflects information current at 1 May 2006.

This book covers information regarding mainland China only, and does not specifically address the Hong Kong Special Administrative Region of China or the Macau Special Administrative Region of China.
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Introduction

Geography
The People’s Republic of China (PRC or China) is the third largest country in the world, with a land area of 9.6 million square kilometers (3.7 million square miles). It is situated at the eastern end of Asia. Neighboring countries include Afghanistan, Bhutan, Burma, India, Kazakhstan, Kyrgyzstan, Laos, Mongolia, Nepal, North Korea, Pakistan, the Russian Federation, Tajikistan and Vietnam.

China is primarily a mountainous country. More than 60% of its land mass is composed of mountains and highlands. The land surface slopes downward from west to east, from the Himalayas in the southwest to the Pacific Coast in the east. Beijing, the capital, is situated in north-central China.

Population and Language

Population
China has the largest population of any country with more than 1.3 billion people in 2005, which accounts for nearly one-quarter of the world’s total population. During the 1980s, the annual population growth rate fluctuated between 1.3% and 1.7%. However, the growth rate dropped to 0.7% by 2004. Under the government’s birth control policy, the population is projected to reach 1.37 billion by the year 2010.

Ethnic Chinese (Han) comprise approximately 92% of the total population. The remainder is composed of 55 ethnic groups spread along the country’s western borders. The population is distributed unevenly, with the majority of the population concentrated along the coastal plains and in the southeastern part of the country.

The majority of China’s population, approximately 58%, still resides in small villages and rural areas. However, the process of urbanization (transformation from an agricultural to an industrial economy) is clearly evident. The trend towards urbanization started in 1979 and coincided with China’s adoption of an “open door policy.” According to the Asia-Pacific Economic Cooperation Forum, China’s urban population is expected to grow to 750 million by 2020.
The country’s total workforce represents 58% of its total population. 49% of the workforce is employed in the agricultural sector, 22% in the industrial sector and 29% in the services sector. Approximately 22% of the population is under 15 years of age, 70.5% is from 15 to 64 years of age and 7.5% is 65 years of age or older. The average life expectancy in China is 72 years of age, better than in most developing countries. Like other countries, China is braced for the impact of an ageing population resulting from longer life expectancies. By 2025, nearly 200 million people in China will be 65 or older. This will have a massive impact on Chinese society and will require urgent reform regarding pensions, healthcare and other benefits.

Language

The official language in China is Putonghua, also referred to as Mandarin, which is a dialect spoken around the greater Beijing area. However, numerous other dialects are also spoken in different parts of China, such as Cantonese in southern China including Hong Kong and Shanghainese in Shanghai. Although the written language is ideographic, many areas frequented by foreigners also utilize the Pinyin system of romanization.

Time

China’s entire territory is situated in one single time zone, which is eight hours ahead of Greenwich Mean Time (GMT). Time differences between Beijing and other major world cities are shown in the following table.

<table>
<thead>
<tr>
<th>City</th>
<th>Hours Ahead of or Behind Beijing</th>
</tr>
</thead>
<tbody>
<tr>
<td>Buenos Aires</td>
<td>-11</td>
</tr>
<tr>
<td>Cairo</td>
<td>-6</td>
</tr>
<tr>
<td>Cape Town</td>
<td>-6</td>
</tr>
<tr>
<td>Frankfurt</td>
<td>-7</td>
</tr>
<tr>
<td>London</td>
<td>-8</td>
</tr>
<tr>
<td>Los Angeles</td>
<td>-16</td>
</tr>
<tr>
<td>Moscow</td>
<td>-6</td>
</tr>
<tr>
<td>New Delhi</td>
<td>-2</td>
</tr>
<tr>
<td>New York</td>
<td>-13</td>
</tr>
<tr>
<td>Paris</td>
<td>-7</td>
</tr>
<tr>
<td>Rome</td>
<td>-7</td>
</tr>
<tr>
<td>Sydney</td>
<td>+2</td>
</tr>
<tr>
<td>Tokyo</td>
<td>+1</td>
</tr>
</tbody>
</table>
Public Holidays

National public holidays are listed in the table below. Dates for the Chinese New Year are based on the lunar calendar and vary from year to year.

<table>
<thead>
<tr>
<th>Holiday</th>
<th>2006</th>
</tr>
</thead>
<tbody>
<tr>
<td>New Year’s Day</td>
<td>1 January</td>
</tr>
<tr>
<td>Chinese New Year</td>
<td>3 days</td>
</tr>
<tr>
<td>International Women’s Working Day*</td>
<td>8 March</td>
</tr>
<tr>
<td>International Labor Day</td>
<td>1-3 May</td>
</tr>
<tr>
<td>National Day</td>
<td>1-3 October</td>
</tr>
</tbody>
</table>

* Holiday granted for women only.

Useful Addresses and Telephone Numbers

For a listing of useful addresses and telephone numbers in China, see Appendix 1.
A. Government Structure and Economic Climate

A.1 Government Structure
The PRC was founded on 1 October 1949 under the leadership of the Chinese Communist Party (CCP).

Chinese Communist Party
China is a socialist state. Its political system is principally a one-party system led by the CCP. Within the CCP, the Politburo is the highest authority on party matters and it is responsible for determining and adopting long-term plans and policies. Power within the Politburo is centralized in the Politburo Standing Committee. The Politburo is appointed by the Central Committee of the Communist Party of China. The power of the Politburo resides largely in the fact that, generally, its members simultaneously hold positions within the state and positions with control over government personnel appointments.

The CCP exists at all levels, and until recently, all significant government policies required its endorsement in order to be adopted. Although party membership generally remains an important criterion for holding a senior government position, efforts have been made in recent years to separate the CCP from the government by transferring power from leaders and party politics to institutions.

National People’s Congress
The NPC, which is under the leadership of the CCP, is the highest body of state power in China. It is composed of deputies elected from the provinces, autonomous regions and municipalities. The NPC meets every year to pass legislation.

A standing committee of the NPC is elected at the first session of each congress and performs the work of the NPC when it is not in session.

NPC members are elected for terms of five years.

State Council
The State Council is the executive body of the supreme organ of state power. It is responsible for the country’s administrative affairs, including diplomatic relations with foreign countries.
A number of administrative bodies, bureaus (for example, the State Statistical Bureau, the State Administration for Industry and Commerce, and the General Administration of Customs) report directly to the State Council.

**Administrative Subdivisions**
For administrative purposes, China is separated into 23 provinces, 5 autonomous regions and 4 directly administered municipalities. Government and the majority of governmental organizations exist at four administrative levels: central, provincial, city and township.

In addition, China has two special administrative regions (SARs). Following an agreement with the United Kingdom, Hong Kong became the Hong Kong SAR of China on 1 July 1997. Following an agreement with Portugal, Macau became the Macau SAR of China on 20 December 1999. China does not impose the Chinese socialist political and economic systems in these two SARs, and both Hong Kong and Macau exercise autonomy, except in defense and foreign affairs.

For a listing of administrative subdivisions in China, see Appendix 2.

**Constitution**
China has a written constitution. The current constitution, which is the fourth version since the founding of the PRC, was promulgated in December 1982. It was most recently amended by the National People’s Congress in March 2004.

**A.2 Economy**

**Type of Economy**

*Structure*
In late 1978, Deng Xiao-ping initiated an “open door policy” to modernize China by encouraging foreign investment and trade. The economic reforms that flowed from the open door policy have created an economic system often referred to as a “socialist economy with Chinese characteristics”. Unlike formerly, China’s economy is now a hybrid structure in which strategic commodities and industries are controlled by the state, while other industries, including the commercial and private sectors, are governed by a market-oriented system.
Decentralized Decision-Making
Under China’s hybrid system, most decision-making authority has been delegated to the local level. The government’s role is limited to setting macro-economic policies. In particular, the management of a state-owned enterprise (SOE) is entrusted with the autonomy to set its own policies regarding the operation of the enterprise. State-owned enterprises are responsible for their own financial affairs and the government no longer subsidizes loss-making SOEs, except for those in key sectors such as post and telecommunications, petrochemicals and transportation.

Private Enterprises
Private enterprises, primarily in the industrial and service sector, have dramatically reemerged and now account for a significant portion of established enterprises in China. Foreign investment continues to flow in heavily. Accumulated direct foreign investment has reached $650 billion and more than 500,000 foreign investment enterprises (FIEs) had been established in China by the end of 2005.

As part of its economic reform policy, the Chinese government is now permitting SOEs to convert to joint stock companies. Generally, an SOE must apply to the local government for approval to convert to a joint stock company. The enterprise’s assets must then be revalued and approved. Once approved, the company’s assets are divided into shares of equal value that may be freely transferred and listed. Employees may purchase “individual” shares and other enterprises may purchase “enterprise” shares. The objective of the privatization reform is to separate government administration from management and to make enterprises responsible for their own operating results.

In addition, foreign investors and private Chinese companies may acquire certain SOEs through mergers and acquisitions, except for SOEs that could greatly influence China’s security or economy. The three most common types of mergers and acquisitions between foreign companies and SOEs are the acquisitions of a small SOE, the acquisition of between 25% and 100% of the assets of a domestic enterprise, and the asset restructuring of an SOE with foreign investment.
Floating Wage-and-Price System
The government has dramatically relaxed its wage-and-price control policy and now allows market forces to determine prices of almost all nonessential items. The ultimate goal of this policy is to eliminate completely the system of state subsidies. Similar price reforms are being extended to the labor, property and financial markets.

Labor Mobility
Under the old so-called “iron rice bowl” system, an individual assigned to a work unit would normally remain with that unit for the rest of his or her working life. Today, people are allowed, and even encouraged, to seek their own jobs to relieve an overburdened system of its responsibilities and to help to find employment for all graduates.

General Economic Trends
China’s economy continues to grow at a fast and steady pace. China experienced a gross domestic product (GDP) growth rate of 9.5% in 2004 and 9.9% in 2005. However, due to concerns overheating, China is attempting to rein in growth and discipline the economy by tightening credit and slowing fixed asset investment growth.

For information regarding China’s leading economic indicators, see Appendix 3.

A.3 Leading Industries

Agriculture
China replaced the original commune system in its agricultural sector with a household responsibility system, which links remuneration to output. Under the new system, agricultural output has more than doubled.

Industrial Sector
China is now the world’s manufacturing base. In order to move up the value chain, China encourages the development of new and advanced technologies, including high-value manufacturing, information technology, microelectronics and biotechnology.
**Services**

Coinciding with the increases in per capita income and living standards, the services sector is becoming increasingly important to the economy, particularly in large cities. Since China has become a member of the World Trade Organization (WTO), the country has gradually opened up more service industries to foreign investment, including the banking, insurance, trade and retail industries. With a population of more than 1.3 billion people, China provides a vast market for consumer goods and services. The services sector accounted for an estimated 40.7% of China’s GDP in 2004.

**A.4 Financial System**

**Central Bank and Bank Regulators**

The creation of a modern banking system is a continuing objective of the Chinese leadership, as it seeks to strengthen fiscal and macroeconomic control over the economy. Reforms have focused on modernizing the banking system to fit international standards, strengthening the role of the central bank and separating policy-oriented lending from commercial lending.

*People’s Bank of China and China’s Bank Regulatory Commission*

In March 2003, the People’s Bank of China (PBOC) was divided into two parts: the PBOC, and China’s Bank Regulatory Commission. The PBOC functions as the government’s central bank and it is controlled by the State Council. The PBOC is entrusted with the independence and autonomy to make decisions regarding monetary policies, but it must report its decisions to the State Council.

The Bank Regulatory Commission is responsible for regulating banking financial institutions.

*Ministry of Finance*

The Ministry of Finance (MOF) is an independent body under the supervision of the State Council. It formulates long-term economic strategies, enforces economic, tax and other finance-related policies, and manages state revenue and expenditure.
Financial System

Specialized Commercial Banks
China’s specialized banks have traditionally engaged in both policy-oriented lending (low-interest, long-term loans made to enterprises in strategic industries) and commercial lending. In early 1994, the Chinese government announced significant reforms to the banking system. Under these reforms, the four major specialized banks: the Industrial and Commercial Bank of China, Bank of China, the Agricultural Bank of China and the Construction Bank of China, were transformed into purely commercial entities. These banks are now responsible for their own profits and losses and they have the ability to provide a full range of commercial banking services. The reforms transferred the responsibility for making policy loans to newly-created policy banks, as noted below. The specialized banks also transferred their nonperforming loans to four newly-created asset management companies.

China has recently restructured the share holding of the four wholly state-owned commercial banks to allow for foreign ownership. The Industrial and Commercial Bank of China, Bank of China, and Construction Bank of China have completed share holding restructurings. The Construction Bank of China and Bank of China have successfully completed an initial public offering on the Hong Kong stock exchange.

In addition to the four specialized commercial banks, a number of regional commercial banks, such as Pudong Development Bank and Shanghai Bank, have emerged. Some of these banks have minority foreign shareholders.

Policy Banks
In 1994, three policy banks were established: the State Development Bank, the Import and Export Bank and the Agricultural Development Bank. These policy banks were established to assume the policy-oriented lending formerly handled by specialized banks.

Foreign-owned Banks and Branches
Currently, foreign-owned banks are limited with respect to whom they may lend, where they may lend, and what currency they may lend. Such banks are not allowed to negotiate with domestic Chinese businesses or to lend money to Chinese individuals. However, since 2002, China has designated certain
cities where foreign-owned banks are allowed to handle RMB business. Within five years of China’s accession into the WTO, (that is, by the end of 2006), all these limitations will be lifted and foreign-owned banks will enjoy full market access.

Insurance
Like banks, foreign-owned insurance companies in China are subject to various restrictions. However, these restrictions should be removed by the end of 2006.

Fund Management
The China Securities Regulatory Commission (CSRC) regulates the Fund Management sector. Under the relevant rules, foreign investors are allowed to form joint venture fund management companies with qualified Chinese partners.

According to the Measures for the Pilot Administration of Establishing Fund Management Companies by Commercial Banks, with effect from 2005, domestic commercial banks may form fund management units. The first three approved lenders are the Industrial and Commercial Bank of China, China Construction Bank and Bank of Communications.

Group Finance Companies
Under the Measures for the Administration of Finance Companies of Enterprise Groups that were issued on 27 July, 2004, qualified enterprises, such as foreign-owned investment companies in China (China Holding Companies), may apply to set up group finance companies.

Lease Financing
Prior to 2003, foreign investors were not allowed to establish lease financing companies in China. A regulation issued on 17 March 2003 created a way for foreigners to participate in this type of business. A subsequent regulation issued in March 2005, allowed foreign investors to conduct lease financing business through joint ventures or through wholly foreign-owned enterprises.
Stock Exchange and Security Regulating Authority

China currently has two stock exchanges: the Shanghai Stock Exchange (SHSE) and the Shenzhen Stock Exchange (SZSE). The exchanges are regulated by the China Securities Regulatory Commission (CSRC), which establishes regulatory guidelines, formulates and enforces market rules, and authorizes initial public offerings.

Over-the-counter trading is carried out in many cities including Beijing, Chongqing, Guangzhou, Shanghai, Shenyang and Wuhan. Although shares of unlisted companies continue to be traded on the over-the-counter markets, listed shares are now exclusively traded on the two exchanges.

Two classes of shares exist in China: “A” shares and “B” shares. “A” shares may be purchased by Chinese nationals and certain Qualified Financial Institutional Investors (QFIIs). “B” shares may be purchased by both Chinese nationals and by foreigners. A QFII is defined as an overseas fund management institution, insurance company, securities company or other asset management institution that meets certain requirements and has been approved by the CSRC to invest in China’s securities market. A QFII may invest in RMB financial instruments such as “A” shares, Treasuries, and convertible bonds listed on China’s stock exchanges.

Shares on the stock exchange are divided into: state-owned shares, enterprise shares and individual shares. Only individual shares may be traded freely. Although the trading of state-owned shares was formerly prohibited, the Chinese government recently started a program to make state-held shares in over 1300 listed companies fully tradable. The program is a significant step toward improving corporate governance in listed firms and it offers investors additional investment channels. By the end of 2005, around 330 companies had completed the share restructuring by providing bonus stock, warrants or cash to compensate public investors for the perceived downward pressure on stock price caused by the increase in the volume of tradeable shares as a result of the conversion of hitherto non-tradeable state-held shares into tradeable shares. Concurrently, the government allowed foreign institutions to purchase the stock of companies that have completed their conversion of non-tradeable government ownership to tradable entities.
Subject to the approval of the CSRC, state-owned enterprises may issue “H” shares on the Stock Exchange of Hong Kong. Companies issuing “H” shares must meet Hong Kong’s listing requirements and they must comply with internationally accepted standards. In addition, several foreign investors’ investment vehicles are listed on exchanges in London, New York and Toronto.

In March 2005, the Chinese government allowed China Development Bank and China Construction Bank to become the first lenders to sell asset-backed securities. This was done on a trial basis. The two banks sold the first batch of asset-backed securities and mortgage-backed securities to institutional investors in late 2005.

In October 2005, the Chinese government revised corporate and securities laws as part of its moves to boost transparency at mainland bourses and to protect minority shareholders. As part of the changes, the CSRC allowed stock exchanges to vet companies’ listing applications.

A.5 Currency
China’s official currency is the renminbi (RMB), which is issued by the PBOC. The RMB is denominated in units of fen, jiao and yuan (¥). Ten fens equal 1 jiao, and 10 jiaos equal 1 yuan. In general, references to amounts of RMB indicate units of yuan, unless otherwise indicated.

On 21 July 2005, China abandoned the RMB’s US dollar peg, which had fixed the exchange rate at RMB 8.28 to the US dollar since 1997. The RMB is now linked to a basket of currencies and trades in a narrow band as part of a managed floating exchange rate regime.

Prior to 1996, the approval of the State Administration of Foreign Exchange (SAFE) was required for all foreign exchange transactions. In 1996, the foreign exchange system was reformed. Transactions categorized as current account items are freely convertible. Remittances of after-tax profits, dividends, interest, and payment of royalties no longer require the SAFE’s approval. Although capital account items remain subject to controls, the trend is to move towards full convertibility of the RMB. For details regarding foreign exchange controls, see Section B.2, page 16.

For a list of exchange rates for the RMB against selected major foreign currencies, see Appendix 4.
B. Investment Climate and Foreign Trade
Following 20 years of negotiations, China officially joined the WTO on 11 December 2001. China’s accession to the WTO bears great significance for the country’s economy and the future of global trade. Many industries that were previously restricted to domestic enterprises are now open to foreign investors; these industries range from banking, telecommunications, distribution, construction, engineering, and insurance, to professional services, including legal, accounting, and architectural services. The former restrictions on domestic sales by foreign-owned manufacturing companies have been lifted.

Most of the prior requirements relating to foreign exchange balancing, local content and export performance have also been lifted in accordance with the WTO timetable.

As a WTO member, China must comply with key mechanisms of the agreement including substantial tariff reductions; phasing out quotas, import licenses, and other nontariff barriers to trade; and liberalization of trade barriers as well as the systematic reform of corporate transparency, uniform application of laws and judicial reform.

Since China’s accession, the Ministry of Foreign Trade and Economic Cooperation (MOFTEC, now dissolved and absorbed by the Ministry of Commerce or MOC) has eliminated 830 rules and has announced more than 2,300 amendments to the laws and regulations.

B.1 Investment Incentives
China offers special investment incentives to foreign investors. These incentives mainly include tax breaks and low land prices. Tax breaks are both location and industry driven.

Economic Zones
To promote economic development and foreign direct investment in certain areas, the Chinese government initially granted special status to five special economic zones (SEZs), Pudong New Area, Suzhou Industrial Park, and various open coastal cities, coastal open economic zones, high-technology development zones and free trade zones. SEZs are located in Shenzhen (including Shekou), Zhuhai, Shantou in Guangdong Province, Xiamen in Fujian Prov-
ince and Hainan Province. The open coastal cities are Beihai, Dalian, Fuzhou, Guangzhou, Lianyungang, Nantong, Ningbo, Qingdao, Qinhuangdao, Shanghai, Tianjin, Wenzhou, Yantai and Zhanjiang. The coastal open economic zones are located in Liaodong Peninsula, Shandong Peninsula, Changjiang and Pearl River Deltas, and Southern Fujian, including Zhangzhou and Quanzhou Delta Areas. Later, the scope of economic zones extended to most inland areas.

Special incentives and privileges, including the following, are accorded to foreign investors in these zones:
• Reduced corporate income tax rates;
• Tax holidays;
• Lower land use fees; and
• Simplified entry and exit procedures.

Grants
The Chinese government generally does not provide specific grants or financial assistance to newly established entities.

Tax Incentives
For information regarding tax incentives available to foreign-owned companies, see Section C.4.

B.2 Special Investment Considerations

Land
All the land in China is essentially owned by the state. There is no private land ownership, although the property above the land may be privately owned. Commercially, companies are granted and pay for “land use rights.” The maximum terms for land use rights range from 40 years for commercial use to 70 years for residential use. Land use rights may be transferred, leased or mortgaged
Intellectual Property

China recognizes intellectual property rights (IPRs) and has promulgated the Patent Law, the Trademark Law, the Copyright Law and subsequent measures to protect and enforce such rights. To receive protection under the laws, patents, trademarks and copyrighted works must be registered with the relevant authority. China is a party to the WTO agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPs Agreement), as well as other intellectual property rights agreements.

By way of background, in 1995, China and the United States signed an agreement regarding the protection of U.S. intellectual property. The agreement sets forth specific intellectual property rights protections and enforcement mechanisms to combat the piracy of audio and video products, computer software and compact discs. Under the agreement, all existing factories must register with the relevant authority. Unlicensed operators must be shut down and their products must be treated as illegal publications. Enforcement Task Forces (ETFs) have been established to conduct inspections and investigate suspected infringements. ETFs are authorized to enter and search premises and to order the cessation of infringements pending an investigation. If an infringement is established, an ETF may impose fines and destroy infringing goods and tools without compensation.

Under customs measures promulgated in 1995 to protect intellectual property rights, holders of rights may apply in writing to the customs authorities for the protection of ownership of intellectual property imported into or exported from China. Upon approval, the customs authorities issue a Customs Intellectual Property Rights Protection Recordal Certificate to the rights holder, which is prima facie evidence of ownership of the rights. If any suspected infringement occurs, rights holders may request the customs authorities to detain the suspected infringing goods upon submitting surety as security. If the People’s Court determines that the goods are infringing, the customs authorities may confiscate the goods and return the surety to the rights holder after deducting any costs.

The government promulgated a series of measures in 1996 to control the import, publication and reproduction of recorded audiotapes, recorded videotapes, records, compact discs, laser discs, and other audio and video products. The State Press and Publications Administration must approve the import,
publishing and reproduction of such products and the necessary permits must be obtained. In addition, the relevant authorities must examine the goods. Violation of these measures may result in the confiscation of illegal income, cessation of business and the imposition of fines. In serious cases, criminal proceedings may be initiated against the offenders.

**Patents**
The Patent Bureau administers the registration of patents. Registration is governed on a first-to-file basis. Chinese patent law encompasses not only patents for inventions, but also for unique utility models and designs. Patents may not be granted for scientific discoveries, methods of diagnosing or treating diseases, rules and methods for thought processes, animal and plant varieties, and substances obtained by means of nuclear transformation. Patents protect inventions for a term of 20 years from the date of filing the patent application. Patents protect utility models and designs for a term of 10 years.

Foreign parties may assign or license their patents to a Chinese party without prior approval by the authorities. In these circumstances, the written contract concluded between the parties governs the rights and obligations of each party. For an assignment of patent rights to be effective, a contract must be registered and published by the Patent Bureau. However, any assignment of patent rights by a Chinese entity or individual to a foreign party requires approval.

Foreign entities or individuals with no habitual residence or business office in China that apply for a patent, or have patent-related issues, must appoint a patent agent designated by the State Council. The five patent agencies in China are: the China Council for the Promotion of International Trade (CCPIT), the Shanghai Patent Agency, China Patent Agent (HK) Ltd., China Trademark Service and NTD Patent Agent. The relevant patent administration body or People’s Court settles disputes regarding the ownership of patents.

**Trademarks**
The Trademark Bureau is responsible for the registration and administration of trademarks. The right of priority governs the registration of trademarks. Registered trademarks include trademarks, service marks, collective marks, and certification marks that have been approved and registered with the Trademark Bureau. Trademarks must be “so distinctive as to be distinguishable.” Marks do not qualify for registration if they are generic in nature, lack
distinctive features, or have direct reference to the physical characteristics of
the goods the trademark is representing. A registered trademark is valid for a
term of 10 years from the date the registration is approved. A registration may
be renewed for an additional 10-year period by filing a renewal application
within six months of the trademark’s expiration. If a registration of the same
trademark has been filed in a foreign country, documents concerning its exami-
nation overseas must be submitted when applying for registration in China.
Trademarks may be assigned or licensed in China if certain registration pro-
cedures are followed. The parties must sign written contracts to protect the
parties’ rights in an assignment or license of a trademark. For an assignment,
the parties must jointly file an application with the Trademark Bureau. For a
licensing arrangement, the parties need only submit the trademark licensing
contract to the Trademark Bureau. Foreign entities or individuals in China
that apply for registration of a trademark or that have trademark-related issues
must appoint a trademark agent designated by the state. If the Trademark Re-
view and Adjudication Board cannot resolve a trademark issue, the issue may
be brought before the People’s Court.

Copyrights
The Copyright Bureau is responsible for the nationwide administration of
copyrights. Copyright Administration Departments in each province, autono-
mous region and municipality under the central government administer copy-
rights in their respective administrative regions.

Copyrights protect the rights of publication, authorship, alteration, integrity,
reproduction, distribution, rental, exhibition, performance, showing, broad-
casting, communication of information on networks, making cinematographic
work, adaptation, translation and compilation. The rights of authorship, alter-
ation, and integrity have an unlimited duration. All other rights are protected
for a term of the life of the author plus 50 years (ending on 31 December) after
the author’s death. The copyright law protects works, regardless of whether
published, of Chinese citizens, legal entities and organizations, as well as
those of foreign nationals or stateless persons. Foreign nationals are not re-
quired to appoint an agent to apply for copyright protection.

The copyright law specifically addresses contract terms, remuneration, and
rights of the parties regarding the publication of books, newspapers, and peri-
odicals; performance; sound recordings and video recordings; and broadcast-
ing by radio stations and television stations. Parties who exploit works created by others must conclude a contract with, or otherwise obtain permission from, the copyright owner.

Copyrights may be licensed or assigned without approval by the authorities. The terms of written contracts govern the rights and obligations of each party to the license or assignment. The People’s Court resolves copyright related disputes.

Computer software is also subject to the above rules.

**Government-Owned Industries**
Prior to the “open door” policy and the subsequent economic reforms, competition was largely unknown in China. With the implementation of the hybrid economy and the relaxation of trade barriers, state-owned enterprises (SOEs) must now compete with foreign companies, FIEs and other domestic entities. China’s accession to the WTO ensures that SOEs make purchases and sales based solely on commercial considerations, such as price, quality, availability and marketability. The purchase of goods or services by SOEs does not constitute “government procurement” and is subject to WTO rules.

**Restrictions on Foreign Investment**
Foreign investment must be approved by the Ministry of Commerce. Whether an approval is granted or not mainly depends on whether the foreign investment falls into the right category under the Guidance Catalogue for Industries with Foreign Investment (the latest version was issued on 30 November 2004 by the State Committee of Development and Reform and the Ministry of Commerce and came into effect on 1 January 2005). The Catalogue is the primary basis for guiding the review and approval of foreign investment projects. It also serves the purpose of guiding foreign investment into the constantly changing needs, or the perceived needs, of China.

In the Catalogue, foreign investment projects are divided into four categories, namely: *Encouraged, Permitted, Restricted and Prohibited*.

The “*Encouraged*” category mainly includes projects with new and high technology, advanced technology, and technologies that may increase product quality, conserve energy, and increase efficiency.
The “Restricted” category includes projects that have been sufficiently developed domestically, industries where China is experimenting with foreign investment but would like to retain some protection, and the prospecting for and exploitation of rare and valuable mineral resources.

The “Prohibited” category includes projects that endanger state security or the public interest, cause pollution, or use special Chinese arts or technology.

All other projects are considered Permitted projects.

Encouraged projects not only enjoy the privilege of quicker approval, but they also qualify for certain preferential tax treatments. For example, machinery and equipment imported by an encouraged project may be exempted from customs duty and import VAT.

**Foreign Exchange Controls**

**General Considerations**
As a developing country, China still imposed strict controls over foreign exchange movements. However, to promote economic development, to attract increased foreign investment, and to relieve the pressure on RMB revaluation, the government has relaxed its foreign exchange controls in phases and permitted limited convertibility of RMB.

Under the current rules, FIEs must open a current account and a capital account in foreign currency with a designated foreign exchange bank. The current account deals with daily recurring transactions in the ordinary course of business and involves international receipts and payments, including trading receipts and payments, service receipts, payments and unilateral transfers such as payments of royalties, repatriation of after-tax profits and dividends, remittances of after-tax wages and other income of foreign employees, and payments of interest on foreign debts. The capital account deals with inflows and outflows of capital, direct investments, and loans and securities investments such as repayments of principal on foreign debts, overseas investments, investments in FIEs and remittances of capital by FIEs after liquidation.

Foreign exchange transactions that are categorized as current account items generally no longer require prior approval from the SAFE. This means that
foreign exchange required for the payment of current account items may be purchased from a designated bank, upon presentation of documents to substantiate the transaction.

In addition, an FIE may retain foreign exchange receipts generated from sales of goods and services, subject to a limit. The current limit is the sum of 80% of its previous year’s revenue receipts and 50% of its previous year’s revenue expenditure in foreign currency that go through the current account. Any excess foreign exchange receipts must be converted to RMB at designated foreign exchange banks. Transactions involving capital accounts, however, requires approval from the SAFE.

The process for conversion of capital funds held in foreign currency by FIEs has been simplified since Circular 59 came into effect on 1 July 2002. Under this regulation, the responsibility of the SAFE to monitor foreign exchange has shifted to authorized foreign exchange banks. SAFE approval is no longer required if an FIE converts funds in a capital fund account. An authorized bank approved under Circular 59 is deemed to be authorized by the SAFE to deal with such transactions

**Holding Accounts**
Nonresidents in China may open short-term nonresident bank accounts with authorized banks and financial institutions. Foreign companies may open bank accounts in China if needed for short-term projects or prior to making an investment or acquisition in China.

**Borrowing Abroad**
Foreign-owned companies may receive foreign exchange loans from banks, enterprises or individuals located outside China (including Hong Kong and Macau) but they must register their borrowings with the SAFE.

On the other hand, domestic Chinese entities that borrow from abroad are subject to strict controls. All such loans must be approved by and registered with the SAFE. The number of Chinese entities that may borrow directly from abroad is limited, with the amount of such lending subject to an annual credit and investment plan issued by the relevant authorities. Other Chinese entities may also borrow for authorized purposes, subject to case-by-case approval by the relevant authorities and upon application to the SAFE.
**Lending Abroad**
Lending abroad used to be legally prohibited. However, a Notice issued by the SAFE, on 18 October 2004, provides that qualified regional headquarters companies in China that are established by multinational companies may lend foreign exchange to affiliates outside of China, up to an amount equal to the 20% of the lender’s equity. Such lending may be conducted by a group finance company or by authorizing a designated bank. Loans to an overseas affiliate may also be made directly.

**Investing Abroad**
Companies that wish to invest overseas must obtain approval from the SAFE regarding the foreign exchange aspects of the investment and they must submit an application to the relevant government authorities for examination and approval.

**Remittances of Dividends and Profits**
With effect from 1 July 1996, the Chinese government permits free convertibility of foreign exchange relating to current account items, which include the payment of dividends from after-tax profits. Payments must be effected at designated foreign exchange banks and supported with written resolutions by the board of directors regarding the profit distribution.

In general, dividends may not be paid unless profits are available for distribution. In determining whether profits are available, cumulative losses from earlier years must have been fully set off against the profits from later years. Also, before any dividend distribution, a portion of each year’s after-tax profits must be allocated to two mandatory funds: the reserve fund and the enterprise expansion fund. In the past, the employees’ bonus and welfare fund allocation was also mandatory, but the new Company Law has removed that requirement. FIEs can now choose to provide for employees’ bonus and welfare fund at their discretion. And for wholly foreign-owned enterprises (WFOEs), the expansion fund is not required.

**Remittances of Interest and Principal**
Payments of interest on foreign loans made by FIEs are permitted. Interest on foreign loans is regarded as a current account item, and it may be paid through a special foreign exchange banking account.
However, repayments of principal are considered as a capital account item, and prior approval from the SAFE must be obtained before a remittance is made. The Chinese enterprise must submit its application to the SAFE for approval, together with a Foreign Exchange Loan Registration Certificate, the loan agreement and a notice of repayment of principal issued by the foreign creditor. Upon receiving the SAFE’s approval, the Chinese borrower may repay its principal either from its capital account or it may effect the conversion and payment at a designated foreign exchange bank.

Remittances of Royalties and License Fees
Payment of royalties and license fees may now be made either from a current account or by conversion and payment at a designated foreign exchange bank, with the presentation of supporting documents such as royalty agreements, tax receipts and invoices.

Repatriation of Capital
Repatriation of capital in foreign exchange is considered a capital account item and it is permitted only upon approval. Foreign exchange arising from the liquidation of a company may be remitted, subject to the approval of the SAFE.

Tax Documentation for Remittance of Non-trading Payments
All Chinese registered enterprises are required to obtain tax clearance documentation from the local tax authorities to remit a non-trading type payment (for example, service fees and royalties) overseas for an amount exceeding US$50,000. Payments of direct expenses, including employee travel expenses and product promotion expenses incurred by the company are exempt from requirement for the tax clearance documentation.

Annual Examination
All FIEs must submit an annual Foreign Exchange Examination Report prepared by a Chinese-registered certified public accounting firm. The report must include the FIE’s status of foreign exchange registration, capital contribution, foreign exchange bank accounts maintained and overall foreign exchange balance position. The report must also contain a summary of foreign exchange transactions conducted and foreign exchange debts borrowed and repaid.
FIEs that meet all the requirements are issued an “approved” certificate and they may conduct direct foreign exchange buy and sell transactions at designated foreign exchange banks. FIEs that do not meet the requirements, including FIEs that fail to submit a report, must obtain the specific approval of local foreign exchange control authorities for each foreign exchange transaction.

**Minimum Registered Capital/Debt to Equity Ratio**

For FIEs, the amount of minimum registered capital largely depends on the total investment amount. The total investment amount is generally defined as total funds projected to start and operate the business of an FIE. In accounting term, the total investment amount simply equals total debt plus total equity (i.e., registered capital).

The difference between the total investment and registered capital is also the maximum amount of debt that an FIE may have.

The ratios of registered capital to total investment amount (that is, the debt to equity ratios) are as follows:

- If the total investment of the FIE does not exceed US$3 million, the registered capital should be at least \( \frac{7}{10} \) of the total investment.
- If the total investment of the FIE is between US$3 million and US$10 million, the registered capital should make up 50% of the total investment. However, if the total investment of the FIE is between US$3 million and US$4.2 million, the registered capital should be at least US$2.1 million.
- If the total investment of the FIE is between US$10 million and US$30 million, the registered capital should make up at least \( \frac{2}{5} \) of the total investment. However, if the total investment of the FIE is between US$10 million and US$12.5 million, the registered capital should be at least US$5 million.
- If the total investment of the FIE exceeds US$30 million, the registered capital should make up at least \( \frac{1}{3} \) of the total investment. However, if the total investment of the FIE is more than US$30 million, but less than US$36 million, the registered capital should be at least US$12 million.

**B.3 Regional and International Trade Agreements and Associations**

China has established diplomatic relations with more than 165 countries and has engaged in economic, trade, scientific, technological and cultural exchanges with more than 200 countries and regions to attract foreign investment.
China joined the United Nations (UN) in October 1971 and serves as a permanent member of the UN Security Council. China is also a member of more than 480 international organizations, including the International Monetary Fund, the World Bank, the Asian Development Bank, and since December 2001, the World Trade Organization (WTO).

B.4 Major Trading Partners and Leading Exports and Imports

**Major Trading Partners**
China has trade surpluses with the United States, the European Union, and Hong Kong, but has deficits with Taiwan, Korea, Japan, and Singapore.

**Leading Exports and Imports**
China is a significant exporter of high-tech products, electrical equipment and electronics as well as of textiles, fabrics and related products.

China’s leading imports include electrical products, integrated circuits, microelectronics, and crude oil.

For a list of China’s leading exports and imports, see Appendix 5.

B.5 Importing and Exporting

**Restrictions**
Foreign trade is regulated primarily through import and export licensing and quotas. The MOC is the authority responsible for setting foreign trade policies and issuing import and export licenses. FIEs that import and export products subject to controls must first obtain a relevant license from the MOC. Commodities subject to license and quota controls are determined by the MOC annually, according to domestic and foreign market conditions, government policies and foreign trade laws.

**Import Controls**
The government issues notices of goods that are prohibited from being imported into China and goods that are subject to licensing and quota control. Prohibited goods include weapons, drugs and goods capable of carrying disease. Because the government has a policy of liberalizing trade, the number of categories of goods subject to import controls has diminished.
Export Controls

Goods that are prohibited from being imported into China are also prohibited from being exported from China. In addition, information carrying state secrets and articles of cultural value are prohibited from being exported.

Customs Duties

China became a member of the World Trade Organization (WTO) on 11 December 2001. In joining the WTO, China agreed to eliminate non-tariff barriers, reduce duty rates to levels similar to those in other Most Favoured Nations (MFN), and gradually open the Chinese market to foreign competition.

China has been gradually decreasing customs duty rates to conform to WTO commitments. However, duty rates continue to be relatively high in comparison with a number of developed countries, ranging from 0% to 65% depending on the type of goods imported, with an average about 9.9%.

Customs duties are imposed on imports and exports at various rates. All customs offices in China are under the direction of the General Administration of Customs of China, which reports to the State Council.

Customs Valuation

Customs duty is a product of the customs value of an imported product and its applicable tariff rate or duty rate. China uses six different valuation methods applied on a hierarchical basis to determine the customs value for a given product. The valuation methods must be applied in the following order: Transaction Value, Transaction Value of Identical Goods, Transaction Value of Similar Goods, Deductive Value or Resale Minus, Computed Value or the Reasonable Fallback Method. A later method may only be used if a previous method is impossible to apply. The Deductive Value and the Computed Value Method may be used interchangeably at the importer’s discretion.

At the start of each year, the Customs Tariff Commission of the State Council announces updated rates for customs duties and taxes on imported and exported goods. There are two main categories of applicable customs duties, which apply based on the origin of the imported goods: MFN rates and general rates.
MFN rates apply to goods imported from most foreign countries, which are generally either WTO members or countries that have entered into bilateral trade agreements with China. General rates apply to products imported from all other countries and are much higher than MFN rates.

Customs duties in China are assessed in the following three ways:

- *Ad valorem* rates;
- Specific duty rates; or
- Compound duty rates (that is, a combination of ad valorem and specific duty rates).

*Ad valorem* rates are assessed as a specific percentage of the cost, insurance and freight (CIF) value. Generally, Chinese Customs accepts the actual transaction price paid for imported goods as the basis for the duty calculation. However, according to WTO and Chinese Customs valuation regulations, this value may be subject to adjustment or a different valuation methodology under certain circumstances.

Customs duties for some products are assessed at a specific rate, based on quantity or net weight. On rare occasions, duties are calculated on a compound basis whereby the calculation is based on both the value and the quantity of the imported product.

Customs also publishes a list of products for which the current assessed duty rate may be different from the standard published rates. These “interim duty rates” only apply to goods imported into China during a certain time.

In addition, the Chinese government periodically announces duty concessions on specific products during the year. These special duty concessions are limited to certain highly encouraged industries, which make significant investments into China.

China has adopted the Harmonized System of Classification for determining the applicable duty classification for goods imported into China. Harmonization allows customs authorities worldwide to converse in the same “language” and enables customs authorities and importers to easily identify particular types of products. For a particular type of product, the classification system provides information on duty rates, export VAT refund rates, quotas, licensing and other restrictions.
Because certain differences may exist in the interpretation of tariff regulations from one region to another, business executives contemplating doing business in China should seek specialized advice at an early stage regarding whether customs duties apply to their products.

**Free Trade Agreements**
China has entered into Free Trade Agreements (FTAs) with a number of different trading partners. In each FTA, China has agreed that customs duties will be reduced or eliminated with respect to certain groups of product.

China is increasing its use of FTAs and expanding the coverage of existing ones. The following table lists FTAs that China has agreed to or is in the process of negotiating:

<table>
<thead>
<tr>
<th>Name of Agreement</th>
<th>Signatory Countries</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bangkok Agreement¹</td>
<td>Bangladesh, China, India, Korea, Laos, Sri Lanka</td>
</tr>
<tr>
<td>Closer Economic Partnership Agreement (“CEPA”)</td>
<td>China and Hong Kong, China and Macao</td>
</tr>
<tr>
<td>ASEAN – China FTA</td>
<td>Brunei, Cambodia, China, Indonesia, Laos, Malaysia, Myanmar, Philippines, Thailand, Singapore, Vietnam</td>
</tr>
<tr>
<td>China – Australia FTA²</td>
<td>China and Australia</td>
</tr>
<tr>
<td>China – Chile FTA³</td>
<td>China and Chile</td>
</tr>
</tbody>
</table>

**Advance Rulings**
Importers and exporters may apply for advance rulings on the classification of goods, as well as on a variety of other customs issues. Customs headquarters must make these rulings available to the public. Importers also have the right to require China to provide a written explanation of its customs valuation of a product, to appeal a local port’s valuation decision to Customs Headquarters and, if necessary, to challenge valuation decisions in the People’s Court.

¹ Recent discussions on expanding the coverage and benefits of this FTA have taken place. The Bangkok Agreement is likely to be renamed the “Asia Pacific Free Trade Agreement”.

² Under discussion.

³ Under discussion.
Penalties
The statute of limitations for normal customs cases is three years, but it is unlimited for smuggling cases. Penalties of up to three times the duty value paid may be imposed for customs violations. Serious violations may even result in criminal sentences and the loss of import or export rights.

Antidumping Regulations
In March 1997, the government enacted Regulations on Antidumping and Opposition to Subsidies. The subsidizing of goods imported into China at a price less than the normal value of the goods in the exporting country is prohibited. The objective of the law is to protect the market for domestic products of an identical or similar nature. If dumping is established, the relevant authority may levy antidumping tariffs on the goods.

Consumption Tax and Value-Added Tax
Other import related taxes include a consumption tax and a value-added tax (VAT). Consumption tax is imposed by customs on luxury consumer goods including alcohol, cosmetics, perfume, and tobacco. Based on the type of goods, the consumption tax is calculated either on an ad valorem basis or on a specific basis. Import VAT is charged on the customs duty and consumption tax inclusive value of the imported goods. The standard VAT rate is 17% for most industrial products or 13% for agricultural products.

To encourage the development of a robust export sector, China has implemented a VAT refund scheme for exported goods. The VAT refund rates range from 0% to 17% based on the type of exported product. The most common refund rate is 13%. Exports of high-tech products, or of products of other highly encouraged industries, usually qualify for a full refund of 17%. A 0% export refund rate applies to products whose export China would like to discourage. Such products include paper products, natural resources, and minerals. The applicable refund rate is determined by a product’s duty classification code.

If the refund rate is less than 17%, companies have a “non-recoverable VAT” cost (also called the “VAT haircut”) related to export sales. Companies should carefully monitor the prevailing refund rates to understand the cost of their export activities.
C. Companies

C.1 Forms of Enterprise

State Owned Enterprises
Located mostly in urban areas, state-owned enterprises (SOEs) are primarily large concerns operating in critical areas of the economy, including post and communications, transportation, pharmaceuticals, energy and heavy industry.

To stimulate the economy, the government has implemented policies to reform SOEs by granting these entities autonomy in management, by requiring them to establish independent accounting systems and by holding them fully responsible for their financial affairs. More significantly, the state is reducing its holdings in certain SOEs by allowing them to convert into companies limited by shares under Company Law and to list shares on domestic and foreign stock exchanges. SOEs are also being restructured through mergers and acquisitions. As a result, the number of SOEs has been reduced significantly. Also, SOEs have stepped down from leading positions in many sectors.

Collective Enterprises
Collective enterprises (COEs) are formed by private individuals and domestic business organizations in rural areas. Because approximately 60% of the population resides in rural areas, COEs were originally established to promote employment opportunities and economic development in rural areas. Most of the COEs are in the light industrial sector and produce consumer-oriented products. Although COEs are generally smaller than SOEs and are located primarily in rural areas, they are more entrepreneurial than their state-owned counterparts. The number of COEs has also decreased dramatically due to continuing economic reform in China.

Private Enterprises
Private enterprises refer to individually owned domestic enterprises that are located in both rural and urban areas and that operate primarily in the services sector, and in small-scale industry and commerce.
Limited Liability Companies

A limited liability company is one of the two forms of modern company under Company Law. Company Law does not apply to existing SOEs, COEs and private enterprises, unless they are converted into one of the two companies under Company Law. The introduction of Company Law aims to reform the system of enterprise management, improve the operational efficiency and autonomy of enterprises and open channels of finance.

A limited liability company is a legal entity in which the investors’ liability is limited to their respective investment contributions. The company itself is liable for its obligations only to the extent of its total assets. A limited liability company cannot have more than 50 shareholders. Capital contributions may be made in cash or in tangible and intangible assets. The minimum capital requirement is RMB 30,000. Registered capital must be certified and investment certificates must be issued to all investors. Shareholders may transfer among themselves all or part of their capital contributions. Capital may be transferred to third parties if a majority of the shareholders approve such a transfer. Because capital is not divided into shares, these companies do not have the option to raise capital in the stock market or offer stock options.

Management powers are vested in the investors, not the directors. A board of directors comprises from 3 to 13 members. Small companies may have just one managing director, not a board.

Companies Limited by Shares

A company limited by shares is the other type of company under Company Law and it is similar to a corporation in many countries. It may be formed by promotion or by offering shares to the public. The company must have at least 2 promoters, more than half of which must be domiciled in China. The total registered capital is equivalent to the value of all shares. The minimum amount of registered capital is RMB 5 million. The capital is divided into shares of equal value, which are evidenced in the form of share certificates. Shares may be freely transferred. However, shares held by the promoters may not be transferred within one year of the company’s date of establishment.

A company limited by shares raises capital by issuing share certificates either by promotion or by offer. Shares may be issued at par value or at a premium and shares of the same class carry equal rights. Shareholder liability is limited to the amount of shares purchased and the company is liable for its obligations.
to the extent of its assets. Capital contributions may be made in cash or in tangible and intangible assets. As with limited liability companies, management powers are vested in the shareholders. The board of directors is composed of 5 to 19 members.

Both limited liability companies and companies limited by shares are required to set up supervision boards.

**Foreign Investment Enterprises**

Foreign investment enterprises or FIEs may take one of the following four forms: Equity Joint Ventures, Cooperative Joint Ventures, Wholly Foreign-owned Enterprises, and Foreign Investment Companies Limited by Shares. FIEs are subject to Company Law. However, to the extent that the FIEs laws contain different provisions from the Company Law, the FIEs laws prevail.

Recently, China has opened up non-manufacturing sectors to foreign investors. Special rules apply to certain FIEs that are in the business of investment, group management or retailing and distribution. This section thus also discusses those FIEs, which are: China Holding Companies, Regional Headquarters Companies, and Foreign Investment Commercial Enterprises.

**Equity Joint Ventures**

Equity joint ventures (EJVs) are governed by the Law on Joint Ventures Using Chinese and Foreign Investment and by related regulations concerning registration, taxation, labor, accounting, minimum equity requirements and contributions of registered capital.

An EJV must be formed as a limited liability company and it must have the status of a legal person (that is, it is an independent entity separate from its shareholders). Parties to the joint venture may include Chinese corporations, enterprises or other entities, and one or more foreign companies, enterprises or individuals. Each party shares profits in proportion to its equity contribution.

Capital contributions to an EJV may be made in the form of cash, equipment and machinery, technology and industrial property rights, and other assets. By law, the foreign party or parties must contribute at least 25% of the total registered capital.
Capital contributions may be made in one lump sum or in installments. In the case of one lump sum payment, contributions must be made within six months from the date of the business license. For installments, the first installment must equal at least 15% of each party’s share and it must be made within three months from the date of the business license.

An EJV partner cannot transfer its equity interest unless the other partner(s) approve the transfer.

On 16 March 2000, the NPC passed an amendment to the EJV Law. Under the amendment, EJVs are no longer required to file their production and business plans with their governing departments. EJVs are also no longer required to grant priority to purchasing local raw materials, fuels and auxiliary equipment, but they may purchase materials inside China or from an overseas market, according to standards of what is fair and reasonable.

Cooperative Joint Venture
A CJV is similar in legal structure to an EJV but with more flexibility in some respects. CJVs are typically formed to develop projects that have a limited duration and a specific objective, such as the development of a building, hotel or service project. Theoretically, a CJV may also be used for manufacturing projects.

A CJV must take the form of a limited liability company unless the cooperative contract stipulates otherwise. Legally, a CJV may be formed as an unincorporated business vehicle akin to a partnership. This type of CJV is probably the only type of FIE that may be structured as a partnership for tax planning purposes.

In comparison with EJVs, CJVs offer greater flexibility in structuring capital contributions, profit and loss sharing and investment recovery, even those that take the form of a limited liability company. The ratio of the investors’ equity interests in a CJV does not need to follow their capital contributions and may be determined contractually by the cooperative contract. The parties may also agree to the method and timing of profit distributions, which do not need to follow the equity ratio and may be determined by the contract. For example, one party may obtain a portion of the CJV products as a return, or different profit-distribution ratios may be applied to the parties for different years of operation.
In addition, the flexibility in equity ratios and profit distributions associated with a CJV enables other investment strategies to be considered as long as the relevant authorities approve them. One common structure is to permit the foreign party to receive a higher percentage of the profits in the early stages in order to accelerate recovery of its capital investment. In that case, however, the fixed assets of the CJV must legally belong to the Chinese party at no cost at the end of the CJV term.

The parties to a CJV may use cash, fixed assets, technology and other intellectual property rights, land use rights, and other assets as investment contributions. Unlike an EJV, a CJV may also accept “cooperative conditions” such as arranging financing as contributions.

Without the approval from the other partner(s) and the relevant authorities, a party to a CJV cannot transfer its equity interest in the CJV.

Under amendments to the CJV Law made in 2000, similar to EJVs, CJVs are no longer required to balance foreign exchange or give preference to the use of domestic materials and fuels.

*Wholly Foreign-Owned Enterprises*

A WFOE is a limited liability company in which one or more foreign investors hold the entire equity interest of the enterprise and no Chinese investors are involved. WFOEs are becoming increasingly popular. Recently, more than 65% of newly approved FIEs have been WFOEs. With most of the regulatory restrictions on foreign ownership being lifted, a WFOE is the preferred vehicle for foreign investors if there is no compelling business reason for having a Chinese partner.

A WFOE offers several advantages over an EJV or CJV, including the following:

- The foreign investor(s) may have full control over the management and operation of the entity. In contrast, an EJV or CJV requires unanimous board approval for all major decisions, such as an increase or transfer of registered capital, an amendment to the entity’s articles of association, a merger, or termination or dissolution of the entity, which gives the Chinese partner(s) a veto right;
• Proprietary technology and know-how of the foreign investor(s) that are contributed or licensed to the WFOE may be better protected due to the full control of the company; and
• Less time and cost may be needed to establish a WFOE because no time needs to be wasted on negotiating lengthy JV contracts.

Because of the advantages of WFOEs, foreign investor(s) normally prefer to set up a WFOE instead of a JV, unless this legal structure is not an option, for example where Chinese laws mandate foreign investors must have a Chinese partner in order to invest in “restricted areas” such as the motor vehicle industry and banking, or where the Chinese partner has control of, or access to, a vital asset that a foreign investor does not have (for example, a valuable site, unique raw materials or distribution systems).

The capital contribution requirements for a WFOE are similar to that for an EJV.

Under amendments to the WFOE law made in 2000, WFOEs are no longer required to balance their foreign exchange or give preference to the use of domestic materials and fuel. In addition, WFOEs are not required to report their production and business plans to the government authorities. Finally, WFOEs are not required to export most of their products or use advanced technologies and equipment.

*Foreign Investment Companies Limited by Shares*

A FICLS is a form of FIE that is formed as a company limited by shares. Unlike an EJV, a CJV or a WFOE that cannot issue shares, the capital of a FICLS is divided into shares. Therefore, the FICLS is the only form of FIE that is potentially eligible for public listing.

A FICLS may be newly formed or it may be converted from an existing JV or WFOE. At least one Chinese shareholder is required. A FICLS may be established by means of promotion or by public offering. The minimum amount of registered capital of a FICLS is RMB 30 million, at least 25% of which shall be contributed by foreign investor(s).

The establishment of a FICLS is subject to the approval of the Ministry of Commerce in Beijing. It is generally difficult to get an approval for establish-
ing a FICLS. Among the four types of FIE, the FICLS is the least common type. In 2004, out of total 43,664 approved FIEs, there were only 43 FICLS.

**Chinese Holding Companies**

China now permits foreign investors to form China holding companies (CHCs), subject to the approval of the MOC. The CHC regulations aim to attract foreign investors with advanced technology and management expertise to China. A CHC may be formed as a WFOE or as an EJV and it must be a limited liability company with a minimum registered capital amount of at least US$30 million. Unlike other types of joint ventures and WFOEs, capital contributions to a CHC must be made in cash, and the injection of assets is not permitted. The capital must be fully paid up within two years after the business license is issued. If the foreign registered capital is at least 25%, the company may enjoy the same preferential treatments granted to FIEs.

Foreign and Chinese investors in CHCs must meet certain requirements. A foreign investor must meet either of the following requirements:

- In the year preceding the application, the investor’s total assets may not be less than US$400 million and the investor must have invested more than US$10 million in China; or
- The investor must have invested more than US$30 million in 10 or more enterprises in China that are engaged in the production or construction of infrastructure facilities.

A Chinese investor must meet both of the following requirements:

- The investor must have good creditworthiness; and
- The investor must have total assets of not less than RMB 100 million.

When the US$30 million registered capital level is met, CHCs are given the privilege to engage in the following activities:

- A CHC may support various lower-tier entities. For example, as a holding company, a CHC may assume all costs and recharge the expenses to lower-tier entities.
- A CHC may act as a centralized distribution and sourcing agent to save costs and to minimize duplicate sales and purchasing personnel. Cost reduction may yield direct tax benefits because production enterprises are granted tax exemptions and reductions in their initial years of operation.
In addition, costs may be recharged to lower-tier entities on a cost-sharing basis to maximize the tax deduction of each individual lower-tier entity.

- With the approval of the PBOC, CHCs may establish a finance company to provide funding and currency swap services to all lower-tier entities.
- A CHC may redirect dividends from subsidiaries in China to other PRC investment projects and obtain tax refunds from 40% to 100% if reinvested in technologically advanced or export-oriented enterprises.

Recently, however, because many of the above functions may be undertaken by a management company or a foreign investment commercial enterprise with much less registered capital, CHCs have started losing their popularity.

**Regional Headquarters Companies**

A Regional Headquarters Company (“RHQ”) is a type of company that may be used by a foreign investor to provide management services to its regional subsidiaries. An RHQ must take the form of either a CHC or of a management company. An RHQ must play a regional management role, that is, it must manage companies in more than one country. An RHQ generally cannot manage enterprises in mainland China alone. Hong Kong, Macau and Taiwan are treated as foreign jurisdictions for these purposes.

According to the CHC regulations, if a CHC meets the following requirements, it may apply for an RHQ status:

- The registered capital is at least US$100 million; or
- The registered capital is at least US$50 million, the total amount of the assets of its Chinese subsidiaries is at least RMB300 million during the year prior to the application and the total profit of the underlying subsidiaries is at least RMB100 million.

An RHQ may perform the following functions:

- Importing and selling the products of related parties;
- Importing raw materials and parts necessary for providing maintenance services in China;
- Undertaking services outsourced by affiliates both at home and abroad;
- Engaging in logistics and distribution services;
- Establishing financial companies to provide financial services to affiliates;
- Upon approval of the Ministry of Commerce, it may engage in contracting overseas projects, making investments abroad, and establishing financial lease companies and providing related services; and
- Other business upon approval.
Before the national RHQ rules were finalized, on 20 July 2002, the Shanghai Municipal Government issued a set of rules aimed at encouraging large multinational corporations with operations in Asia Pacific and greater investment or expansion plans in China to establish management offices in Shanghai that would allow them to consolidate financial support, information technology support, human resources management, sales and marketing support, technology support, general administrative support, research and development, and other management functions across the Asia Pacific region.

The rules provide that a Shanghai RHQ may take two corporate forms:
• A CHC with an RHQ status granted by the Shanghai Municipal Government; or
• A stand-alone management company with a minimum registered capital of US$2 million.

In support of an application for an RHQ under the Shanghai local rules, the following conditions must be satisfied:
• The foreign investor must have total assets of not less than US$400 million;
• The foreign investor must have made direct investments of US$30 million in China; and
• The RHQ will manage a minimum of three enterprises, at least one of which is outside of China.

*Foreign Investment Commercial Enterprise*

The MOC promulgated provisions on foreign investment in commercial areas in 2004. Subject to the approval of the MOC, foreign investors may set up Foreign Investment Commercial Enterprises (FICEs) after 11 December 2004.

A FICE may engage in the following activities:
• Sales agent and brokerage activities on a commission basis:
• Wholesale and retailing: and
• Franchising.
**Foreign Enterprises and Other Common Arrangements**

Foreign enterprises (FEs) may operate in China through representative offices and branches offices.

Other types of business arrangements include leasing and licensing arrangements, contract manufacturing, contracted projects, and direct sales.

**Representative Offices**

Foreign companies may establish representative offices in China. Representative offices may only engage in indirect operating activities, including liaison work, market research, general information gathering, and assistance in sourcing and sales of products. One exception applies to the representative offices of foreign law firms and accounting firms, which may actually conduct direct operating activities in China.

Representative offices may not employ local Chinese nationals directly and they must use semi-government sponsored agencies for hiring this type of personnel.

To establish a representative office, a foreign company needs to complete a formal registration process. The registration process has been simplified recently.

**Branch Offices**

Currently, only foreign financial institutions and foreign oil and gas companies may register branches in China with the approval of the relevant authorities. In practice, all other businesses are not allowed to establish branches in China due to the lack of clear regulations. Therefore, branches of foreign companies are uncommon in China.

**Other Arrangements**

**Leasing and Licensing Arrangements:** Leasing generally involves a foreign leasing company or an equipment manufacturer that provides machinery and equipment to a Chinese enterprise in return for fixed lease payments over a certain time period. For licensing of intangible assets, the payments are normally made in the form of royalties. License fees and royalties are subject to Chinese withholding tax and to business tax.
Contract Manufacturing: There are two basic types of contract manufacturing under current Chinese rules: “importing processing” and “consignment processing”. Under an importing processing arrangement, a Chinese contractor purchases raw materials from overseas, processes them into finished products, and sells products to contracted overseas customers under its own name. It holds legal title to the imported raw materials throughout the whole production cycle. The contractor earns a profit from product sales. Under a consignment processing arrangement, however, a Chinese contractor acts as a processor for the foreign consignor. The foreign consignor provides raw materials to the contractor on a consignment basis (thus at no charge), and the contractor processes the raw materials into finished products and returns the finished products to the foreign consignor for a processing fee. Under this arrangement, the foreign consignor holds the legal title to the raw materials and finished products throughout the production cycle. Contract processing typically enjoys import duty and VAT exemption and is commonly used to facilitate supply chain planning.

Contracted Projects: The term “contracted project” refers to any business activity involving the provision of design, construction, installation, assembly, consulting or other services performed in China by foreign entities. The term also includes the provision of services related to China’s offshore oil exploration and development programs. A foreign entity that carries out contracted projects in China is considered to have created a taxable establishment in China (unless exempt by tax treaties). As a result, it is required to register its presence with the relevant business administration authorities and tax authorities.

Direct Sales: Foreign manufacturers or sellers may sell goods directly to Chinese enterprises.
C.2 Mergers and Acquisitions

Types of Transactions
A merger occurs when two or more enterprises merge into one enterprise in accordance with the relevant laws and regulations.

FIEs in China may adopt one of the following two types of merger:
• Absorption: one or more enterprises merge into another enterprise with the latter being the surviving entity; and
• New establishment: two or more enterprises merge to become a new company. The original entities are dissolved in this transaction.

An acquisition normally takes one of the following forms:
• Acquiring the equity of an FIE;
• Acquiring the equity of an existing domestic company and converting it into an FIE;
• Acquiring the assets of a domestic company or an FIE; and
• Acquiring unlisted shares (state-owned shares and enterprise shares) of listed companies.

Another form of reorganization is the division, which occurs when an enterprise divides into two or more enterprises in accordance with the relevant laws and regulations. FIEs in China may engage in the following two types of division:
• Continuity: a company splits into two or more new companies and survives the division.
• Dissolution: a company divides into two or more new companies and dissolves itself.

Regulatory Procedures and Restrictions
A company involved in a merger or division must provide notification to its creditors and a public announcement. Notification is normally not required with respect to an acquisition. A merger or division is not allowed if the investors have not made their capital contributions in full. The parties to a merger or division must sign an agreement for the transaction, which must be approved by the parties’ investors, board of directors and shareholders. After signing the agreement, the parties must submit a merger or division application to the relevant government authorities for approval. After that, applications must
be submitted to the local office of the State Administration of Industry and Commerce and to the appropriate tax authorities for updating various registrations.

Mergers and acquisitions that result in over-concentration in the domestic market, unfair competition or damage to domestic consumers’ interests will be subject to an anti-trust review of the relevant authorities. Transactions subject to such review include the following situations:

1. The assets owned by a party to the transaction exceed RMB3 billion;
2. Current year sales in the domestic market of a party to the transaction exceed RMB1.5 billion;
3. The aggregate market share in the domestic market by a party to the transaction and its affiliated enterprises is at least 20%;
4. The aggregate market share in the domestic market by a party to the transaction and all of its affiliated enterprises in the domestic market will reach 25% as a result of the offshore merger or acquisition; or
5. As a result of the transaction, a party to the transaction will hold, directly or indirectly, equity of more than 15 FIEs engaged in related businesses within China.

Foreign investors in a merged or divided FIE must hold an equity interest of at least 25% of the registered capital. In a division, the sum of the registered capital of the divided FIEs must be equal to at least the total amount of the registered capital of the original company.

A merged FIE assumes full responsibility for all claims and debts of the dissolved FIE(s) as a result of the merger. Following a division, the divided FIEs assume the claims and debts of the original FIE, in accordance with the provisions of the division agreement. In the case of an assets acquisition, the legal liability of the acquired company does not carry over to the acquiring company; however, legal liability does carry over in the case of an equity acquisition.

**Tax Consequences**

For a discussion of the tax consequences of mergers and acquisitions, see Section C.7.
C.3 Corporate Taxes at a Glance

General Corporate Tax Rates

<table>
<thead>
<tr>
<th>Tax Type</th>
<th>Rate (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>National Corporate Income Tax Rate (%)</td>
<td>30 (a)</td>
</tr>
<tr>
<td>Local Corporate Income Tax Rate (%)</td>
<td>3 (a)</td>
</tr>
<tr>
<td>Capital Gains Tax Rate (%)</td>
<td>33 (b)</td>
</tr>
<tr>
<td>Branch Tax Rate (%)</td>
<td>33</td>
</tr>
<tr>
<td>Withholding Tax (%)</td>
<td></td>
</tr>
<tr>
<td>Dividends</td>
<td>10 (c)</td>
</tr>
<tr>
<td>Interest</td>
<td>10</td>
</tr>
<tr>
<td>Royalties from Patents, Know-how, etc</td>
<td>10</td>
</tr>
<tr>
<td>Branch Remittance Tax</td>
<td>0</td>
</tr>
<tr>
<td>Net Operating Losses (Years)</td>
<td></td>
</tr>
<tr>
<td>Carryback</td>
<td>0</td>
</tr>
<tr>
<td>Carryforward</td>
<td>5 years</td>
</tr>
</tbody>
</table>

(a) Lower rates may apply to foreign-owned businesses in certain specified areas in China.
(b) A 10% rate applies to non-residents.
(c) Dividends remitted abroad by FIEs and are exempt from withholding tax.

C.4 Taxes on Corporate Income and Gains

Corporate Income Tax

The Chinese income tax system discussed in this section refers to rules specifically applicable to foreign investment enterprises, including EJVs, CJVs and WFOEs and other forms of business activities and operations conducted by foreign companies. Domestic investment enterprises are subject to tax at a rate of 33% and are governed by a different set of tax rules.

All foreign investment enterprises (FIEs) and foreign enterprises (FEs) are subject to income tax under the Income Tax Law of the PRC for Foreign Investment Enterprises and Foreign Enterprises. An FIE is subject to tax on its worldwide income. However, a foreign tax credit is allowed for income taxes paid to other countries, limited to the Chinese income tax payable on the same income. For CJVs that are not formed as legal persons, the parties to the joint ventures may elect to be taxed separately on their share of the income received or, with the approval of the local tax bureau, to be taxed still as a single entity.
FEs include foreign companies, enterprises and other economic organizations that have China sourced income. FEs are subject to tax only on their income from China sources. The taxation of FEs depends on whether the enterprise has an establishment in China. FEs with establishments in China are subject to tax on a net income basis; however, FEs with no establishments in China are only liable to income tax on a withholding basis.

The term “establishment” is broadly defined as the following: a place of management; a branch; an office; a factory; a workshop; a mine or an oil and gas well or any other place of extraction of natural resources; a building site; a construction, assembly, installation or exploration project; a place for the provision of labor services; and business agents.

**Rates of Corporate Tax**

In general, FIEs and FEs with establishments in China are taxed at an effective rate of 33% (the national tax rate of 30% plus the local tax rate of 3%). Local governments have the discretion to levy the full 3% local tax even when the national tax is exempt or reduced due to tax incentives. On the other hand, the 3% local tax may be exempt or reduced even there are no national tax incentives.

In order to attract foreign investment, the Chinese government has introduced various tax incentives for foreign investment enterprises. The tax incentives are available subject to qualifying conditions such as the location of the enterprises, the nature of the business, the duration of operations and the amount of the total investment. The tax incentives mainly include reduced tax rates and tax holidays.

For a sample corporate tax calculation, see Appendix 6.

**Tax Incentives**

**Reduced Tax Rates**

Depending on the location, a reduced tax rate of 15% applies to FIEs and FEs with establishments in China located in five Special Economic Zones. The 15% rate also applies to FIEs engaged in production and manufacturing activities located in Pudong New District in Shanghai, Suzhou Industrial Park, Economic and Technology Development Zones, Free Trade Zones, Ex-
port Processing Zones, and other specified investment zones. FIEs engaged in production and manufacturing activities located within the coastal area and almost all big inland cities, are taxed at a reduced rate of 24%.

*Tax Holiday*
On the top of reduced tax rates, FIEs engaged in production and manufacturing activities may qualify for a five year tax holiday, that is, a two year tax exemption and a three year 50% tax reduction beginning from the venture’s first profit-making year, regardless of the location.

China also grants special tax concessions for certain priority industries, low-profit operations and projects in remote or economically depressed areas.

To be recognized as a production-oriented enterprise, an FIE’s annual sales income from production activities must exceed 50% of its total annual income.

*Reinvestment Tax Incentives*
Foreign investors that reinvest their share of dividends in the same investment venture or in another foreign investment venture for a period of five years or longer are entitled to a 40% refund of the tax paid on the dividend reinvested. The tax refund increases to 100% if the reinvestment is in an export-oriented or technologically advanced enterprise.

*Export-Oriented Enterprises and Technologically Advanced Enterprises*
An FIE that exports 70% or more of its total output value for any year may enjoy a further 50% tax reduction for that year after the end of the five year tax holiday. Enterprises that are already subject to a reduced tax rate of 15% and that are eligible for the reduction for export-oriented enterprises are subject to corporate income tax at a minimum rate of 10%.

If an FIE qualifies as a “technologically advanced enterprise,” after the five year tax holiday period, it is granted a three year extension of the 50% tax reduction.
Withholding Tax
An FE that does not have an establishment in the China but that derives income from China is subject to withholding tax. The types of income subject to withholding include:

- Dividends;
- Interest;
- Rental income and royalties; and
- Gains from the transfer of properties in China.

FEs that have Chinese establishments may also be subject to withholding tax on the above types of income if the income is not effectively connected with their Chinese establishments.

The withholding tax is withheld by the payer of a taxable payment. It is levied on the gross amount and generally no deductions are permitted.

The current withholding tax rate is 10% (reduced from the original 20% and effective since year 2000). For treaty-based reductions or exemptions, including a detailed list of treaty-based withholding tax rates, see Appendix 7.

Dividends paid by FIEs to their foreign investors are exempt from withholding tax.

Capital Gains and Losses
Capital gains are taxed as ordinary income and capital losses may be deducted as ordinary losses for FIEs. Capital gains of FEs, which include gains derived from the transfer of an equity interest in China, are subject to withholding tax at a rate of 10%.

Gains from real property transfers are also subject to the land value added tax (VAT) at a rate ranging from 30% to 60%.

Tax Reporting
The tax year in China is the calendar year. A company is required to submit a copy of its management accounts to the tax authorities every month. The corporate income tax return should be filed quarterly on or before the 15th day after the end of the quarter. An annual return accompanied by an audited financial must be submitted to the relevant tax authorities within four months.
after the end of the year. The local state tax bureau is the government agency responsible for the collection of corporate income tax. Failure to comply with these reporting requirements may result in the imposition of a fine.

**Foreign Tax Relief**
A tax credit is allowed for foreign taxes paid by FIEs to other countries, the amount of the credit not to exceed the relevant Chinese tax payable on such income. Excess foreign tax credits may be carried forward for a period of five years. China has concluded double taxation agreements with most European and Asia Pacific countries, Canada and the United States. The terms of most treaties are modeled on the United Nations Double Taxation Convention between Developed and Developing Countries, which encourages investment by industrialized countries in less developed countries. For a list of China’s double tax treaties with other countries, see Appendix 7.

**China Corporate Income Tax Reform**
Since 1994, domestic investment enterprises and FIEs have been subject to a different tax system in order to encourage foreign investment into China. In general, FIEs enjoy much more favorable tax treatment than domestic enterprises.

China’s economy has developed to a stage where creating a level playing field for both domestic and foreign-owned enterprises has become inevitable. As a result, China plans to unify the two sets of income tax law into one system in order to provide equal tax treatment to all enterprises, regardless of their ownership.

Although there is still some uncertainty, the new law has been included in the 2006 legislative plan and it is expected to become law in March 2007. It is anticipated that grandfathering provisions will apply such that existing investments should continue to benefit from the tax incentives that have already been granted for a certain period of time, for example, five years.

**C.5 Determination of Taxable Income**

**Starting Point for Determining Taxable Income**
Taxable income is defined as revenues less deductible expenses, based on accounts prepared in accordance with the relevant accounting rules. No dif-
ferences exist between tax and accounting methods for computing income. Taxable income includes dividends, bonuses, interest, royalties, rent and other income. However, dividends received by FIEs from other FIEs in China are exempt from tax.

**Deductions**
All necessary and reasonable expenses incurred in carrying on a business are deductible for tax purposes. Employee expenses are fully deductible. Entertainment expenses related to production or operations are deductible subject to limitations and they must be substantiated with supporting documentation. For head office expenses, only actual amounts that are paid, properly documented and verified by a CPA registered in the country of the head office, are deductible. For interest on loans, only reasonable amounts are deductible.

Non-deductible expenses include interest on equity capital, income tax payments including penalties and surcharges, royalties paid to the head office, management fees paid to related parties, and other expenses not related to production or operations.

**Inventories**
Inventory valuation is based on historical cost, computed using one of the following four methods: first-in, first-out (FIFO); moving average; weighted average; or last-in, first-out (LIFO). The principle of lower of cost or market value does not apply. A provision for stock obsolescence is generally not permitted, but write-offs for actual obsolescence are allowed.

**Provisions**
Only FIEs operating as financial institutions may establish bad debt allowances. However, the allowances may not exceed 3% of the year-end balance of loans receivable.

**Depreciation and Amortization Allowances**
Fixed assets related to an enterprise’s production and business operations may be depreciated for corporate income tax purposes. With effect from 1 July 2004, an FIE may choose the method used for depreciating tangible assets. In addition, the residual value of fixed assets may not be less than 10% of cost. However, if it can be proven that there is no expectation of value at the end of the asset’s useful life, the residual value may be 0%.
The following table lists minimum useful lives for certain assets.

<table>
<thead>
<tr>
<th>Asset</th>
<th>Years</th>
</tr>
</thead>
<tbody>
<tr>
<td>Buildings</td>
<td>20</td>
</tr>
<tr>
<td>Production equipment, trains and ships</td>
<td>10</td>
</tr>
<tr>
<td>Furniture, electronic equipment and other transportation equipment</td>
<td>5</td>
</tr>
</tbody>
</table>

Intangible assets, including technical know-how, patents and trademarks, are amortized over the contractual term or at least 10 years if a time period is not specified in the related purchase agreement.

Restrictions on Interest Deductions
Reasonable interest payments on loans are deductible. However, no deduction is allowed for shareholders’ loans if the registered capital pledged by the parties is not fully paid-up.

The debt-to-equity ratio rules discussed on page 25 must also be satisfied in the case of foreign currency borrowing.

Foreign Exchange Gains and Losses
Exchange gains made or losses incurred due to differences in exchange rates are taxable or deductible for the period in which they are realized.

Relief for Losses
Tax losses may be carried forward for up to five years. Carry backs are not allowed.

Related Companies

Transfer Pricing
The Chinese tax law includes rules on transfer pricing. Under these rules, all business transactions between related parties must be settled according to an “arm’s length” standard. If the parties fail to meet this requirement, the tax bureau may make reasonable adjustments by using one of the following methods:
• Comparable uncontrolled price;
• Reasonable profit margin;
• Cost-plus formula with a reasonable markup; or
• Other methods deemed appropriate by the tax authorities.
For the purposes of the transfer pricing rules, parties are related through direct or indirect ownership, common control by a third party or a relationship with a common interest. Inter-company transactions covered by the transfer pricing rules include sales or purchases of goods, technology transfers, provision of services, financing transactions and other business transactions.

China currently doesn’t have transfer pricing documentation requirements. However, the government is in the process of making rules in this area that it may issue them soon.

Consolidated Returns
In general, consolidated returns are not permitted. All companies must file separate tax returns. However, FIEs and FEs may adopt consolidated filing for units operating in different areas of China. To calculate their tax liability, these enterprises must apply the relevant tax rate for the location of each operating unit. Losses in one location may offset income in another location.

C.6 Other Significant Taxes

VAT
Value added tax (VAT) is levied on the import of goods, the sale of goods, and on the provision of consignment processing, repair and replacement services.

The standard VAT rate for most products is 17%, and a reduced rate of 13% applies to certain items. A VAT exemption is also sometimes available.

VAT taxpayers are divided into two categories: “general VAT taxpayers” and “small-scale VAT taxpayers” according to the scale of their business operations and the degree of sophistication of their accounting systems.

For a general VAT taxpayer, the VAT payable on sales of goods and supplies of taxable services is calculated as follows:

\[ \text{VAT payable} = \text{Output VAT (sales x the VAT rate)} - \text{Input VAT (purchases x the VAT rate)} \]

For small-scale VAT taxpayers, a simplified VAT calculation formula applies under which no credit or deduction is allowed for input tax. However, the tax
is calculated at a lower rate of 4% for trading enterprises or 6% for production and other enterprises.

The amount of VAT itself is not directly charged into the profit and loss account. Rather, VAT is reflected on the balance sheet.

For export sales, the Exemption, Credit and Refund (ECR) method is normally used to assess the potential VAT refund which is only applicable to general VAT taxpayers. Under the ECR method, export sales are “exempt” from VAT, relevant input VAT is “credited” against output VAT on domestic sales, and the remaining input VAT is “refundable” according to a specific formula.

The reform of the VAT system from a production-based to a consumption-based system that commenced in 2004 remains limited to certain industries in northeast China. However, it is expected that the reform will be expanded to other regions soon.

For additional discussion on VAT, see section B.5.

**Business Tax**

All entities and individuals that provide taxable services, including transportation, construction, finance, insurance, communication, education and entertainment, technical services, and other services are liable to business tax. Business tax also applies to the transfer of immovable and intangible property in China (albeit not to services). VAT and business tax are mutually exclusive.

Business tax is levied on gross turnover or receipts. Business tax is generally determined by applying the relevant tax rate to the gross turnover. No input credit is available.

The tax rate varies from 3% to 20% depending on the type of services provided. For leasing, technical services and financing (for example, loan interest), the applicable business tax rate is 5%. The 5% business tax rate also applies to the sale of immovable property and transfer of intangible assets. However, the business tax on technology transfers including licensing may be exempt.
Consumption Tax
Consumption tax is levied on the production or importation of certain products (considered to be luxuries) including automobiles, tires, cigarettes, alcohol, gasoline, cosmetics, and golf clubs. The rates vary product by product.

Stamp Duty
All parties that execute or receive dutiable documents in China are subject to stamp duty. Stamp duty is applicable on the gross contract sum. The stamp duty rate varies depending on each taxable item. For instance, a lease agreement is subject to a 0.1% stamp duty rate, while a sales contract is subject to a 0.03% stamp duty rate. Where items subject to different stamp duty rates have not been separately documented, the higher stamp duty rate applies on the total sum.

Land Value Added Tax
Sales of real property including land use rights are subject to a land valued added tax, which is similar to a real property gains tax in many countries. The rates range from 30% to 60%, depending on the amount of the gain.

Transfers of Intangible and Immovable Properties
Under a tax bureau notice, transfers of intangible properties include transfers of rights to use intangible properties in the PRC. A tax bureau notice apparently indicates that royalties received by foreign companies from licensing intangible properties to the PRC are subject to business tax. Transfers of technology, licensing of software and transfer of equity interests can be exempt from business tax.

C.7 Miscellaneous Tax Matters

Mergers
For a merger of two companies, including both acquisition mergers and dissolution mergers, no gain or loss is recognized for Chinese tax purposes. As a result of the transaction, all existing tax attributes of the old company, including unused tax losses, are carried forward to the new company. The new company does not obtain a step-up in basis of the underlying assets and liabilities. If both of the merging entities has benefited from different tax holiday periods, the combined entity continues to enjoy the available tax holidays separately, using a divisional accounting method.
Reorganizations
On the disposal of an interest in an FIE, which is an entity with foreign investment of not less than 25% of the registered capital, any gain derived by the foreign investor is subject to Chinese withholding tax at a rate of 10%.

The gain or loss generated from the transfer of an FIE investment is calculated in the following manner:

\[
\text{Gain / Loss} = \text{Transfer Price} - \text{Cost}
\]

The “transfer price” refers to the amount received by the transferor, including cash, non-monetary assets, and rights and interests or other forms of payment. Profits and reserves of the enterprise being transferred that are undistributed as of the date of the transfer may be deducted from the transfer price in calculating the gain or loss of the transferor. The “cost” refers to the total or original capital invested, plus any additional contributions made, as certified in the capital verification reports issued by a Chinese CPA confirming the date, amounts and types of capital contributions made.

In a group reorganization, if a foreign investor transfers an investment interest in an FIE to another company in its group that is either directly or indirectly 100% owned by the same foreign investor, or that is commonly 100% owned by the same foreign parent company, the transfer of investment may be made at cost, that is, no gain or loss is recognized. Accordingly, in this situation, the Chinese withholding tax does not apply.

Regardless of the tax treatment described above, any transfer of investment in an FIE must receive government approval, unless the transfer is completed offshore between two foreign companies and it does not involve the change of a registered shareholder in the FIE.

C.8 Financial Reporting and Auditing
All enterprises must maintain books or accounts for their business activities. At the end of each business year, an enterprise must submit its annual financial report to its shareholders’ meeting for approval or ratification. The annual financial report, which must be prepared using Chinese accounting rules, includes a balance sheet, a profit and loss account, a cash flow statement, a statement of profit appropriation, notes to the financial statements, supplementary statements and management’s commentary on the entity’s financial performance.
Enterprises are expected to prepare and present external financial reports that provide a “true and fair view.” In accordance with the relevant laws and regulations, enterprises must have their financial statements audited and certified by a CPA at the end of each financial year.

**Method of Accounting**

Enterprises must use double-entry bookkeeping and record transactions using the accrual method of accounting. Enterprises that carry out accounting activities, such as preparing accounting vouchers, recording accounting books and managing accounting records, must comply with the provisions contained in the Accounting Law of the PRC, the Basic Standards in Accounting Practice and the Management of Accounting Records. Management is responsible for exercising its judgment and making proper provisions. Enterprises must apply their adopted accounting practices and policies consistently from one period to another and may not change such practices and policies arbitrarily.

Enterprises must maintain their accounting records in RMB. If an enterprise’s operating income and expenses are primarily denominated in currencies other than RMB, the enterprise may choose any of the currencies used as its book currency. However, the enterprise’s financial statements must be converted into RMB. For exchange rate information, see Appendix 4.

**Sources of Accounting Standards**

FIEs and joint stock companies must prepare their financial statements in accordance with Chinese accounting standards and the Accounting System for Business Enterprises. The MOF also issues specific accounting standards regarding various industries and sectors.

**Fundamental Concepts**

In general, Chinese accounting principles conform to IAS. In the last few years, the Chinese government has eliminated most of the differences between Chinese accounting practices and IAS. China has adopted the IAS fundamental accounting concepts such as going concern, consistency, accrual, and matching of revenue and costs.

The basic accounting concepts include the characteristics of objectivity, relevance, comparability and reliability, which must be reflected in the accounting statements. In addition, the accounting principles of going concern, con-
 consistency, timeliness, accruals, prudence, matching, “substance over form” and materiality must be applied in preparing financial statements.

**Significant Accounting Rules**
Accounting records and reports must be prepared in accordance with Chinese accounting regulations and based on proper documentation. The latest accounting regulations are the new Accounting Standards for Enterprises (ASE) that were issued in early 2006. The new ASE will be effective on 1 January 2007 and the revised rules will apply to listed companies first.

Significant accounting rules that apply to FIEs and joint stock companies in China are described below.

**Recognition of Revenue**
Revenue from the sale of goods is recognized when all of the following conditions have been satisfied:

• The enterprise has transferred the significant risks and benefits of ownership of the goods to the buyer;
• The enterprise retains neither continuing management rights that are usually associated with ownership nor effective control over the goods sold;
• It is probable that the economic benefits associated with the transaction will flow to the enterprise; and
• The revenue and costs relating to the transaction can be measured reliably.

For revenue from services, the enterprise recognizes revenue using the percentage of completion method as of the balance sheet date if the outcome of the transaction involving the rendering of services may be estimated reliably. The percentage of completion method refers to the recognition of revenue and related expenses based on the percentage of completion of a transaction. Whether the outcome may be estimated reliably depends on whether certain conditions similar to those listed above have been satisfied.

**Pretax Profits**
Profits before taxes equal operating income plus investment income, subsidy income and nonoperating income, less nonoperating expenses. Nonoperating income and nonoperating expenses refer to the income earned and expenses incurred by an enterprise that have no direct connection to its operating activities. Examples include gains on the disposal of a fixed asset, net income from
penalties, losses from a fixed asset physical count, provisions recorded for impairment of a fixed asset and donations.

**Fixed Assets**
Fixed assets must be recorded at their cost when acquired. Cost includes the purchase price, customs duty, transportation and insurance expenses, and necessary expenses to be incurred before the assets are ready for the intended use.

The cost of a fixed asset under a finance lease is the lower of the fair market value of the leased asset at the beginning of the lease period and the present value of total minimum lease payments.

Subsequent expenditure relating to a fixed asset should be added to the carrying amount of the asset when the expenditure will result in expected future economic benefits. Examples include an extension of the useful life of the fixed asset, a substantial improvement in the quality of output, or a substantial reduction of the costs of the output. Otherwise, subsequent expenditure relating to a fixed asset should be recognized as an expense.

**Long-Term Investments**
Long-term investments are stated at the actual cash amount paid or the cost of the tangible or intangible assets contributed, as agreed in the investment contracts. An enterprise must review the value of its long-term investments periodically and value the investments at the lower of cost and the recoverable amount. If the recoverable amount is less than cost, a provision for diminution must be made for the difference.

**Investments in Other Enterprises**
If an investing enterprise has control, joint control or significant influence over an investee enterprise, the equity method must be used to account for the long-term equity investment. In general, if the investing enterprise controls 20% or more of the voting rights of the investee enterprise, or it has significant influence over the investee enterprise even though it holds less than 20% of the investees’ voting rights, the equity method must be used to account for the long-term equity investment. If the investing enterprise controls less than 20% of the voting rights of the investee enterprise, or it has no significant influence over the investee enterprise even though it controls more than 20%
of the voting rights of the investee, the cost method is used to account for the long-term investments.

**Depreciation**
Based on the nature and utilization method of fixed assets, an enterprise must determine a reasonable expected useful life and expected residual value for each asset, and select a reasonable depreciation method after considering technological development, and environmental and other factors. The available depreciation methods include the straight-line method, unit-of-production method, double declining balance method, sum-of-the-years-digits method. Once the method of depreciation of a fixed asset is determined, it must not be changed arbitrarily.

**Bad Debts**
Enterprises must set aside sufficient provisions for bad debts. Losses on bad debts are recognized when a debtor becomes bankrupt or dies and the bankrupt assets or legacy are insufficient for liquidation, or if a debtor has not settled its account for more than three years.

**Inventory Provisions**
At the end of each accounting period, inventory held by an enterprise must be valued at the lower of cost and net realizable value (NRV). If the NRV is less than cost, a NRV provision must be made for the difference. The condition of the inventory, such as whether the inventory is obsolete, damaged or slow moving, must be considered to determine the NRV provision.

**Intangible Assets**
Identifiable intangible assets, including patents, nonexclusive technologies, trademarks, copyrights and land use rights must be recorded at cost when acquired. The actual cost of an internally developed intangible asset that has completed the appropriate legal application procedures includes the registration fee incurred during the application process, attorney’s fees and related expenses. The cost of materials consumed, payroll and welfare expenses relating to personnel directly engaged in the research and development process, and rental and borrowing costs incurred during the development process are recorded as expenses when incurred.
The cost of an intangible asset is amortized evenly over the shortest of the following periods: its estimated useful life, the contract term or the period stipulated by legal regulations. If the contract or legal regulations do not specify a period, the amortization period may not exceed 10 years.

Preoperating Expenses
Except for the purchase or construction of fixed assets, all expenses incurred during the start-up period are accumulated as long-term deferred expenses. The entire amount is then charged to the profit and loss account in the month that the enterprise commences production or operations.

Sales Returns, Discounts and Allowances
Cash discounts are recognized as expenses when incurred. Sales rebates and discounts offset current period revenue when they occur. If an enterprise has already recognized the revenue relating to a sales return, the sales return offsets revenue in the period that the return occurred.

Foreign Currency Transactions
When an enterprise enters into a foreign currency transaction, the enterprise translates the foreign currency amounts into corresponding book currency amounts using either the exchange rates on the transaction date or the exchange rates at the beginning of each period.

The balances of various foreign currency accounts are translated into the book currency at the closing exchange rates at the end of each period. Exchange differences are charged to the profit and loss account as exchange gains or losses. Exchange differences arising during the preoperating period must be recorded as long-term deferred expenses. Exchange differences arising from borrowings used to construct or build fixed assets must be accounted for in accordance with regulations governing the accounting treatment for capitalized borrowing costs.

Liquidations
The rules regarding liquidations govern the contents of liquidation expenditure, the recognition of liquidation profits and losses, and the preparation and submission of financial statements during the liquidation period.
Events Occurring After the Balance Sheet Date

Events occurring after the balance sheet date that provide new or additional evidence to assist with the estimation of amounts relating to conditions existing at the balance sheet date should be regarded as adjusting events. Events occurring or existing after the balance sheet date that do not affect the conditions existing at the balance sheet date, but in respect of which the omission of a disclosure would affect the ability of the users of the financial statements to make a proper evaluation and decisions, should be regarded as non-adjusting events and they should be disclosed in the notes to the financial statements.

If events occurring after the balance sheet date indicate that the going concern assumption is no longer appropriate, the enterprise should not prepare the financial statements on a going concern basis.

Disclosure, Reporting and Filing Requirements

An enterprise must include the following items in its financial statements:

- Balance sheet;
- Income statement;
- Cash flow statement;
- Statement of profit appropriation; and
- Notes to the financial statements, supplementary statements and management’s commentary on the entity’s financial performance.

Certain statements are prepared monthly, while others are prepared quarterly or on a semiannual or annual basis. The Accounting Standards for Enterprises (ASE) regulate the contents of the financial reports, types and forms of the financial statements, and details of the notes to the financial statements. An enterprise may decide on the format of financial statements that are used for internal purposes.

The notes to the financial statements must contain the following disclosures:

- Explanation of non-compliance with any accounting concepts or standards;
- Details of significant accounting policies and estimates;
- Explanation of changes in significant accounting policies and estimates;
- Details of contingencies and post-balance sheet events;
- Disclosure of related party relationships and transactions;
- Details of transfers or disposals of assets;
• Details of business combinations and divisions;
• Details of significant items in the accounting statements, such as receivables, inventories and fixed assets; and
• Other disclosures that may help the reader understand the accounting statements.

The management’s commentary on the entity’s financial performance explains the following information about an enterprise:
• Profile of the business operation;
• Profits realized and distributed;
• Increase or decrease of the capital funds and their turnovers; and
• Details of any events with significant impact on the enterprise’s financial position, operation results and cash flows.

At the end of each business year, a company must submit its financial statements to the shareholders’ meeting for approval or ratification. Except for the first year of operation, annual financial statements must include comparative figures for two consecutive accounting years or two related accounting periods.

An accounting year generally is the calendar year. An FIE does not adopt the same accounting year as its parent company if the parent company’s accounting year does not end on 31 December.

An enterprise’s filing requirements are described in the following table.

<table>
<thead>
<tr>
<th>Report</th>
<th>Must be published within</th>
</tr>
</thead>
<tbody>
<tr>
<td>Monthly</td>
<td>6 days after the end of the month</td>
</tr>
<tr>
<td>Quarterly</td>
<td>15 days after the end of the quarter</td>
</tr>
<tr>
<td>Semi-annual</td>
<td>60 days after the end of the period</td>
</tr>
<tr>
<td>Annual</td>
<td>4 months after the end of the year</td>
</tr>
</tbody>
</table>
D. Individuals

D.1 Income Tax

Who Is Liable
In accordance with the Individual Income Tax (IIT) Law adopted by China’s NPC in 1993, individual income tax is imposed on all individuals, including both Chinese and foreign nationals residing in or deriving income from China.

Territoriality
Chinese residents are generally subject to tax on their worldwide income. Nonresidents are subject to tax on their China-source income only.

Definition of Resident
Chinese residents include the following persons:
• Individuals who maintain a permanent home in China; and
• Individuals who do not maintain a permanent home in China, but who reside in China for one year or longer.

Individuals are considered to have resided in China for one year if they reside in China for 365 days during one calendar year. In calculating the number of days an individual is present in China, temporary absences from China may not be excluded. A temporary absence is defined as a single absence from China for a period of no longer than 30 days, or as multiple absences from China for an aggregate of no longer than 90 days.

Individuals who are considered one to five-year tax residents are subject to Chinese individual income tax on income earned in China and on foreign income remitted to China during the period of residency.

Individuals who maintain a permanent home in China, and those who reside in China for five years or longer, are subject to Chinese individual income tax on their worldwide income, regardless of whether the income is remitted to China.
**Income Subject to Tax**

**Employment Income**
The IIT law imposes tax on employment compensation, which includes wages and salaries, foreign service or hardship allowances, cost of living and automobile allowances, tax reimbursements and bonuses. Nontaxable compensation includes employer-provided housing, paid home leave (limited to twice a year), relocation or moving costs, business related local transportation, and language training and children education expenses. Other employee expenses, such as meals and laundry, are taxable if paid in a lump sum as allowances and are nontaxable if reimbursed on presentation of receipts.

**Self-Employment Income**
Taxable income includes compensation for independent personal services performed in China, bonus payments and income specified as taxable by the MOF.

**Investment Income**
Interest, dividends and other investment income from Chinese sources are subject to tax at a flat rate of 20%, with no deductions allowed. However, dividends and bonuses paid on “B” shares and on “H” shares (shares of Chinese enterprises listed on foreign stock exchanges) issued by enterprises in China are tax-exempt.

Dividends paid by an FIE to its foreign shareholder(s) including individuals are exempt from withholding tax.

**Directors’ Fees**
Directors’ fees, excluding expense reimbursements received by foreign nationals from Chinese sources, are considered income from independent personal services. Fees of directors not normally resident in China are taxable as lump sums. The tax liability is computed by applying the rules outlined for income from independent personal services.

**Exempt Income**
The following types of income are exempt from tax:
- Prizes and awards for scientific, technological or cultural achievements;
- Welfare benefits, pensions and relief payments;
• Severance or retirement pay received from the government;
• Salaries of diplomatic officials of foreign embassies and consulates in China;
• Tax-free income as stipulated in tax treaties to which China is a party; and
• Other income that the MOF designates as tax-exempt.

**Redundancy Payments**

A lump-sum redundancy payment resulting from the termination of an employment contract includes compensation, cost of living allowances and other allowances. A redundancy payment can be exempt from individual income tax if the amount is less than three times the average salary of the local city in the preceding year. Any payment exceeding this amount is subject to individual income tax, which must be paid to the relevant tax bureau within seven days after the end of the taxable month.

A lump-sum payment may be averaged over an employee’s number of years of service, subject to a maximum of 12 years. The quotient is deemed to be the monthly amount of salary and bonus. The individual income tax is then computed in accordance with the statutory tax laws and regulations.

Actual contributions to housing fund, medical insurance, pension fund, and to an unemployment fund related to the redundancy payment, are deductible when computing the individual income tax liability of the lump-sum compensation.

If the terminated employee finds new employment, the individual’s salary and bonus related to the newly signed contract is not combined with the lump sum compensation that has already been subject to tax.

Lump sum redundancy payments received from state owned enterprises that were in liquidation are exempt from individual income tax.

**Taxation of Employer-Provided Stock Options**

Taxable income is recognized on the date an employee exercises an employer provided stock option. For foreign nationals, stock option income is taxable if it is considered attributable to employment in China. No clear rules determine the source of stock option income, but, in general, a stock option that is granted and vested during the employee’s assignment in China is considered
to be China-source taxable income. If the stock option cost is charged back to China, then the entire income is considered China-source income and therefore fully taxable in China.

The amount of taxable income is the difference between the fair market value of the stock and the exercise price. The taxable income is reported in the month of exercise as part of an employee’s compensation and it is subject to progressive tax rates that range from 5% to 45%. In addition, the employee may divide the total stock option income into the number of months that the employee has worked in China (but capped at 12) for the purpose of determining the applicable IIT rates.

**Capital Gains**

After deducting costs and related expenses, income derived from the sale or transfer of movable or immovable property in China is taxed at a flat rate of 20%.

Income derived from transfers of real property is also subject to land value added tax, which is levied at the following progressive rates.

<table>
<thead>
<tr>
<th>Gains in Excess of Cost Basis</th>
<th>Rate (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than 50%</td>
<td>30</td>
</tr>
<tr>
<td>50% to 100%</td>
<td>40</td>
</tr>
<tr>
<td>100% to 200%</td>
<td>50</td>
</tr>
<tr>
<td>More than 200%</td>
<td>60</td>
</tr>
</tbody>
</table>

Capital gains derived from transfers of “B” and “H” shares are exempt from tax.

Foreign individuals who do not have other income subject to Chinese individual income tax are subject to withholding tax at a rate of 20% on gains derived from the sale of equity in an FIE in China.

The applicable tax rate may be reduced for individuals resident in treaty countries.
**Deductions**

*Deductible Expenses*
Based on the latest amendment to the individual income tax law, an individual is allowed a flat deduction of RMB 1600 each month to compute net taxable income. Expatriate employees are allowed an additional deduction of RMB 3,200 per month. Social security contributions made to China are deductible. Approved charitable donations are also deductible.

For foreign expatriates, social security contributions made to their home countries are not deductible.

If an employer is responsible for paying an employee’s Chinese income tax liabilities, the employee’s taxable income is grossed up by the amount of the payment. Any hypothetical tax, which is an amount withheld by the employer as full or partial compensation for satisfying the employee’s Chinese tax liability, is allowed as a deduction in computing the employee’s net taxable income.

*Personal Deductions and Allowances*
On approval by the local tax bureau, employees who do not have a permanent residence in China and who have job responsibilities both within and outside China may allocate their income between sources in proportion to the services provided. For example, if an employee works 50% of the time in China, 50% of his or her salary is taxable in China. To qualify for this tax treatment, an employee must provide supporting documentation for the apportionment.

No distinction is made between married and single taxpayers. In addition, no relief by allowance or deduction is provided for dependents.

*Business Deductions*
A deduction of RMB 800 or 20% of income, whichever is higher, is allowed for independent personal services income, royalties, and rental or leasing income.
Rates

Income is not accumulated for purposes of calculating monthly tax liabilities. Income tax for individuals is computed on a monthly basis by applying the following progressive tax rates to employment income.

<table>
<thead>
<tr>
<th>Monthly Income</th>
<th>Not Exceeding</th>
<th>Tax on Lower</th>
<th>Rate on Excess</th>
</tr>
</thead>
<tbody>
<tr>
<td>Exceeding RMB</td>
<td>Not Exceeding RMB</td>
<td>Amount RMB</td>
<td>%</td>
</tr>
<tr>
<td>0</td>
<td>500</td>
<td>0</td>
<td>5</td>
</tr>
<tr>
<td>500</td>
<td>2,000</td>
<td>25</td>
<td>10</td>
</tr>
<tr>
<td>2,000</td>
<td>5,000</td>
<td>175</td>
<td>15</td>
</tr>
<tr>
<td>5,000</td>
<td>20,000</td>
<td>625</td>
<td>20</td>
</tr>
<tr>
<td>20,000</td>
<td>40,000</td>
<td>3,625</td>
<td>25</td>
</tr>
<tr>
<td>40,000</td>
<td>60,000</td>
<td>8,625</td>
<td>30</td>
</tr>
<tr>
<td>60,000</td>
<td>80,000</td>
<td>14,625</td>
<td>35</td>
</tr>
<tr>
<td>80,000</td>
<td>100,000</td>
<td>21,625</td>
<td>40</td>
</tr>
<tr>
<td>100,000</td>
<td>—</td>
<td>29,625</td>
<td>45</td>
</tr>
</tbody>
</table>

Independent personal services income, royalties and rental or leasing income is subject to tax at a flat rate of 20%.

Copyright income is taxed at a flat rate of 20%, with a deduction of RMB 800 or 20% of income, whichever is higher. A further 30% reduction of tax payable is allowed.

Additional tax may be levied on abnormally high single payments for labor services. For these purposes, taxable income in excess of RMB 20,000, but not exceeding RMB 50,000, is subject to an additional tax charge equal to 50% of the tax normally payable. Taxable income more than RMB 50,000 is subject to an additional tax charge equal to 100% of the tax normally payable.

For a sample individual income tax calculation, see Appendix 8.

Relief for Losses

No provisions exist for the carryover of losses.
Nonresidents
Individuals who do not maintain a permanent place of abode in China and who work in China fewer than 365 days in a calendar year are considered nonresidents and are subject to individual income tax under different rules, as described below.

Resident for 90 Days or Less
Individuals who reside in China continuously or intermittently for not more than 90 days during a calendar year are treated in the following manner:
• The expatriate is exempt from individual income tax if the salary is paid and borne by an overseas employer;
• Employment income paid or borne by the employer’s establishment in China is subject to individual income tax to the extent that the income is attributable to services actually performed in China. Normally, the tax liabilities are apportioned into “China” and “non-China” services, in accordance with the actual number of days the expatriate resides in China. An establishment for these purposes includes a representative office and the site of a contracted project in China; and
• The residency threshold is increased from 90 days to 183 days if the expatriate is resident, during the relevant calendar year, in a country that has concluded a double tax treaty with China (a tax treaty expatriate).

Residents for 90 to 364 Days
Individuals who reside in China for more than 90 days (183 days for tax treaty expatriates), but less than one year, are treated in the following manner:
• The expatriate is subject to individual income tax on employment income derived from services actually performed in China;
• Assessable income includes all employment income, whether it is paid or borne by an employer inside or outside China; and
• Employment income attributable to services performed outside China is exempt from individual income tax.

Income paid by an employer outside of China to an individual in this category is taxed in one of the following ways:
• The income is exempt from individual income tax if the individual resides in China for not more than 90 days (or 183 days for tax treaty expatriates) during a calendar year; or
• The income is subject to individual income tax if the period of residency
extends to more than 90 days (or 183 days for tax treaty expatriates) to the extent that the income is attributable to services performed in China.

**D.2 Other Taxes**

*Net Worth Tax*
China does not levy a net worth tax.

*Estate and Gift Taxes*
China does not levy estate and gift taxes.

*Real Estate Tax*
Owners of land or buildings in urban areas are subject to real estate tax. The tax is imposed on either the value of the property or on the rental income received from a lessee.

*Vehicle and Vessel License Tax*
Vehicle and vessel license tax is a local tax levy that applies to vehicles and certain types of vessels owned by individuals or enterprises in China.

**D.3 Social Security**
Chinese nationals are subject to social security taxes at an average rate of 50% gross income that is capped at three-times of city-wide average salary of the preceding year as published by the local government. China generally does not levy social security taxes on foreign nationals working in China. But employees from Hong Kong, Macau and Taiwan, who are on local labor contracts, are required to participate in the China social security program.

**D.4 Tax Filing and Payment Procedures**
The tax year for individuals is the calendar year. Spouses are taxed separately, not jointly, on all types of income.

All individuals must register with the local tax bureau or, for individuals engaged in offshore oil and gas exploration activities, with the local offshore oil tax bureau. Individuals subject to Chinese individual income tax must complete a tax registration form and provide an employer’s certification stating the amount of their compensation, along with copies of relevant passport pages to verify their dates of arrival.
Although the recipient of income is responsible for the payment of income tax, tax is generally collected through a withholding system under which the payer is the withholding agent. All taxpayers must file monthly income tax returns and pay the relevant tax to the local tax bureau, including those earning China-source income but not covered by the withholding system, and employees who are paid outside China. These returns must be filed within seven days after the end of the month.

Taxpayers with foreign-source income must file income tax returns and pay taxes due within 30 days after the end of the calendar year. Foreign taxes paid on this income are allowed as a tax credit, up to the amount of Chinese individual income tax levied on the same income.

Individuals who depart from China must pay all taxes within seven days prior to their departure and complete the relevant “deregistration” formality with the local tax authorities.

Late payments of tax are subject to a daily interest charge of 0.05%. A penalty of up to five times the amount of unpaid tax may be levied for tax evasion or for a refusal to pay tax.

**D.5 Double Tax Relief and Tax Treaties**

An individual subject to Chinese individual income tax on worldwide income may claim a foreign tax credit against income subject to tax in another country. The credit is limited to the Chinese tax payable on the same income.
China has entered into double tax treaties with many other countries. For a list of China’s double taxation treaties, see Appendix 7.

Under the treaties, remuneration derived from employment in China is generally exempt from Chinese individual income tax if all of the following conditions are met:

• The recipient is present in China for a period or periods not exceeding 183 days in the calendar year;
• The remuneration is paid by, or on behalf of, an employer that is not resident in China; and
• The remuneration is not borne by a permanent establishment or a fixed base maintained by the employer in China.

Under many of the treaties, income derived from independent professional services or other independent services is exempt from Chinese individual income tax if the recipient meets both of the following conditions:

• The recipient does not have a fixed base regularly available to him or her in China for the purpose of performing the services; and
• The recipient is present in China for a period, or periods, not exceeding 183 days in the relevant calendar year.

On 11 February 1998, Hong Kong and China signed a memorandum regarding the avoidance of double taxation of income. The arrangement is in effect for all income derived in China after 1 July 1998 and in Hong Kong after 1 April 1998. Under the arrangement, after 1 July 1998, a Hong Kong resident who spends fewer than 183 days in China during a calendar year is exempt from Chinese individual income tax if the income is not borne by or charged back to a China-registered entity or office and if the resident does not hold an official title in a China-registered entity or office.

Macao and China entered into a similar double taxation avoidance arrangement in 2003.

D.6 Visas

All foreign nationals must obtain permission from the relevant Chinese authorities to enter, leave, pass through or reside in China. The relevant authorities include Chinese diplomatic missions, consulates and other representatives in foreign countries, and the Ministry of Public Security, the Ministry of Foreign Affairs or local designated authorities within China.
Depending on the status and type of passport held by a foreign national, a diplomatic, courtesy, business, or ordinary visa may be issued.

Ordinary visas are designated by letters that correspond to the purposes of the individuals’ visits. The following are selected letter designations:

- **D**—Issued to a person who plans to reside permanently in China.
- **F**—Issued to a person who has been invited to visit China for no longer than six months for business, seminars and fact-finding purposes; for scientific, technical or cultural exchanges; for short-term continuing education or practical training; or for any other such activities.
- **G**—Issued to a person who passes through China in transit.
- **X**—Issued to a person who enters China for study, further education or practical training for six months or longer.
- **Z**—Issued to a person who enters China to take up employment and to that person’s accompanying family.
- **L**—Issued to a person who enters China as a tourist or for other private propose.

The only requirements for a foreign national to be self-employed in China are a valid work permit and a residence permit. No minimum amount of capital investment is required for self-employment.

**D.7 Visa Applications**

Foreign nationals who wish to enter China should apply for visas at a Chinese diplomatic mission or consulate or with other representatives in foreign countries authorized by the Ministry of Foreign Affairs. Under the following special circumstances, an application for a visa may be made at any designated entry point authorized by the Ministry of Public Security:

- The foreign person is invited, because of a late confirmation on the part of the Chinese party, to attend a trade fair in China;
- The foreign national is invited to submit a bid or to formally sign an economic or trade contract;
- The foreign national, pursuant to an agreement, visits China to conduct inspections of import or export products or for contract verification and acceptance;
- The foreign national is invited to perform equipment installation or to undertake emergency repairs;
- The foreign national is requested by a Chinese party to come to China for a settlement of claims;
• The foreign national is invited to visit China to provide scientific and technical consulting services;
• The foreign national is an additional or substitute member of a group that has already been issued visas;
• The foreign national comes to China to visit a seriously ill person or to arrange funeral matters;
• The foreign national is in direct transit but, for unavoidable reasons, cannot leave China within 24 hours; or
• The foreign national is invited to China but is unable to apply in time to the appropriate Chinese organizations abroad (listed above), and he or she holds a document issued by the designated authorities indicating that he or she is approved to apply for a visa at the port of entry.

The following documents must be submitted to apply for a visa:
• A valid passport or an equivalent certificate of identification;
• A completed visa application form with two recent passport-size photographs; and
• Other relevant documents relating to the entry or transit application, which vary according to the type of visa the foreign national is applying for:
  D—A residence confirmation form, which should be applied for by the applicant or an entrusted relative in China at the entry-exit control department of the municipal or county police security bureau where the applicant intends to reside.
  F—An invitation extended by an authorized unit.
  G—A valid visa for the country (region) to which the applicant intends to travel next or, in the absence of such a visa, an onward ticket.
  X—A certificate issued by the receiving unit or the relevant department in charge.
  Z—An employment approval certificate and employment visa letter issued by an authorized unit.
  L—A certificate or letter issued by the receiving tour agency or China and a round trip ticket.

**D.8 Residence Permits**

Foreign nationals may obtain residence permits valid for one to five years. A permit may be renewed for an unspecified number of times. A renewed permit is normally valid for one year.
D.9 Family and Personal Considerations

Family Members
Family members of a working expatriate do not automatically receive the same type of work visa as the expatriate and they must apply independently for visas. These applications may be completed when the expatriate applies for a work permit.

Subject to the decision of the local government, children of working expatriates may be required to obtain student visas to attend schools in China.

Marital Property Regime
No community property or other similar marital property regime is in effect in China.

Forced Heirship
Forced heirship rules do not apply in China.

Drivers’ Permits
China does not have driver’s license reciprocity with any country. Foreign nationals may not drive legally in China with their home country drivers’ licenses, but they may take written exams and exchange their licenses for Chinese licenses.
Glossary of Acronyms

The following is a partial list of acronyms used in this book.
CCP — Chinese Communist Party
CCPIT — China Council for the Promotion of International Trade
CHC — Chinese holding company
CJV — Cooperative or contractual joint venture
COE — Collective enterprise
CPA — Certified public accountant
CSRC — China Securities Regulatory Commission
EJV — Equity joint venture
ETF — Enforcement task force
FE — Foreign enterprise
FIE — Foreign investment enterprise
GDP — Gross domestic product
GMT — Greenwich Mean Time
IAS — International Accounting Standards
IIT Law — Individual Income Tax Law
IPR — Intellectual property right
ITA — Information Technology Agreement
MII — Ministry of Information Industry
MOC — Ministry of Commerce
MOF — Ministry of Finance
NPC — National People’s Congress
PBOC — People’s Bank of China
Appendices

Appendix 1: Useful Addresses and Telephone Numbers
When telephoning from an international location, the caller should use the international country code for China, 86, as a prefix. Unless otherwise noted, the following addresses are located in Beijing (direct dialing code 10).

<table>
<thead>
<tr>
<th>Government Ministries</th>
<th>Address</th>
<th>Telephone</th>
<th>Facsimile</th>
<th>Website</th>
</tr>
</thead>
<tbody>
<tr>
<td>China Council for Promotion of International Trade (CCPIT)</td>
<td>No. 1 Fuxingmenwai Street 100860</td>
<td>6801 3344</td>
<td>6803 0747</td>
<td><a href="http://www.ccpit.org">www.ccpit.org</a></td>
</tr>
<tr>
<td>Foreign Enterprises Service Corporation of Beijing (FESCO)</td>
<td>14 Chaoyangmen Nandajie Chaoyang District, 100020</td>
<td>8561 8888</td>
<td>8563 5020</td>
<td><a href="http://www.fesco.com.cn">www.fesco.com.cn</a></td>
</tr>
<tr>
<td>General Administration of Customs</td>
<td>Building East 6 Jianguomennei Dajie, 100730</td>
<td>6519 4114</td>
<td></td>
<td><a href="http://www.customs.gov.cn">www.customs.gov.cn</a></td>
</tr>
<tr>
<td>Ministry of Finance (MOF)</td>
<td>3 Nansanxiang, Sanlihe Xichengqu, 100820</td>
<td>6855 1114</td>
<td></td>
<td><a href="http://www.mof.gov.cn">www.mof.gov.cn</a></td>
</tr>
<tr>
<td>Ministry of Foreign Affairs</td>
<td>2 Chaoyangmen Nandajie Chaoyang District, 100701</td>
<td>6596 1114</td>
<td></td>
<td><a href="http://www.mfa.gov.cn">www.mfa.gov.cn</a></td>
</tr>
<tr>
<td>Ministry of Information Industry (MII)</td>
<td>13 Xi Chang’an Jie, 100804</td>
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<td></td>
<td>Telephone: 6601 4249</td>
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<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Website: <a href="http://www.mii.gov.cn">www.mii.gov.cn</a></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ministry of Justice</td>
<td>10 Chaoyangmen Nandajie</td>
<td></td>
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<td></td>
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<tr>
<td></td>
<td>Chaoyang District, 100020</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td></td>
<td>Telephone: 6520 5114</td>
<td></td>
<td></td>
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<tr>
<td></td>
<td>Website: <a href="http://www.moj.gov.cn">www.moj.gov.cn</a></td>
<td></td>
<td></td>
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<tr>
<td>Ministry of Labor and Social Security</td>
<td>12 Hepingli Zhongjie</td>
<td></td>
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<td></td>
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<tr>
<td></td>
<td>Dongcheng District, 100716</td>
<td></td>
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<td></td>
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<tr>
<td></td>
<td>Telephone: 8420 1114</td>
<td></td>
<td></td>
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<tr>
<td></td>
<td>Website: <a href="http://www.molss.gov.cn">www.molss.gov.cn</a></td>
<td></td>
<td></td>
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<tr>
<td>National Audit Office</td>
<td>1 Beiluyuan, Zhanlanlu</td>
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<td></td>
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<tr>
<td></td>
<td>Xicheng District, 100830</td>
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<td></td>
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<tr>
<td></td>
<td>Telephone: 6830 1114</td>
<td></td>
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<tr>
<td></td>
<td>Website: <a href="http://www.audit.gov.cn">www.audit.gov.cn</a></td>
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<tr>
<td>National Bureau of Statistics</td>
<td>75 Yuetan Nanjie, Sanlihe</td>
<td></td>
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<tr>
<td></td>
<td>Xicheng District, 100826</td>
<td></td>
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<tr>
<td></td>
<td>Telephone: 6711 2233</td>
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<tr>
<td></td>
<td>Facsimile: 6858 0964</td>
<td></td>
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</tr>
<tr>
<td></td>
<td>Website: <a href="http://www.stats.gov.cn">www.stats.gov.cn</a></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>People’s Bank of China (PBOC)</td>
<td>32 Chengfangjie</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td></td>
<td>Xicheng District, 100800</td>
<td></td>
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<td></td>
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<tr>
<td></td>
<td>Telephone: 6619 4114</td>
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<td></td>
<td>Facsimile: 6619 5370</td>
<td></td>
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<tr>
<td></td>
<td>Website: <a href="http://www.pbc.gov.cn">www.pbc.gov.cn</a></td>
<td></td>
<td></td>
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</tr>
<tr>
<td>State Administration of Foreign Exchange (SAFE)</td>
<td>Huarong Mansion, 18 Fuchenglu</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Haidian District, 100037</td>
<td></td>
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<td></td>
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<tr>
<td></td>
<td>Telephone: 6840 2255</td>
<td></td>
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</tr>
<tr>
<td></td>
<td>Website: <a href="http://www.safe.gov.cn">www.safe.gov.cn</a></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Agency</td>
<td>Address</td>
<td>District</td>
<td>Postal Code</td>
<td>Contact Information</td>
</tr>
<tr>
<td>----------------------------------------------------------</td>
<td>----------------------------------------------</td>
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<td>-------------------------</td>
</tr>
<tr>
<td>State Administration for Industry and Commerce (SAIC)</td>
<td>8 Sanlihe Donglu, Xicheng District, 100820</td>
<td>Xicheng</td>
<td>100820</td>
<td>Telephone: 6803 2233</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Facsimile: 6805 7994</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Website: <a href="http://www.saic.gov.cn">www.saic.gov.cn</a></td>
</tr>
<tr>
<td>State Administration of Taxation</td>
<td>5 Yangfangdian West Road Haidian District, 100038</td>
<td>Haidian</td>
<td>100038</td>
<td>Telephone: 6341 7114</td>
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<tr>
<td></td>
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<td></td>
<td></td>
<td>Website: <a href="http://www.chinatax.gov.cn">www.chinatax.gov.cn</a></td>
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<tr>
<td>State Development and Reform Commission</td>
<td>38 Yuetannanjie Xicheng District, 100824</td>
<td>Xicheng</td>
<td>100824</td>
<td>Telephone: 6850 1240</td>
</tr>
<tr>
<td></td>
<td></td>
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<td>Website: <a href="http://www.ndrc.gov.cn">www.ndrc.gov.cn</a></td>
</tr>
<tr>
<td>State Economic and Trade Commission</td>
<td>26 Xuanwumen Xidajie Xuanwu District, 100053</td>
<td>Xuanwu</td>
<td>100053</td>
<td>Telephone: 6319 2114</td>
</tr>
<tr>
<td></td>
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<td>Website: <a href="http://www.setc.gov.cn">www.setc.gov.cn</a></td>
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<tr>
<td>State Intellectual Property Office of the People's Republic of China</td>
<td>No. 6 Xitucheng Road Haidian District, 100088</td>
<td>Haidian</td>
<td>100088</td>
<td>Telephone: 6208 3114</td>
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<tr>
<td></td>
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<td></td>
<td>Website: <a href="http://www.sipo.gov.cn">www.sipo.gov.cn</a></td>
</tr>
<tr>
<td>Xinhua News Agency</td>
<td>57 West Street Xuanwumen, 100803</td>
<td></td>
<td>100803</td>
<td>Telephone: 6307 1114</td>
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<td></td>
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<td>Website: <a href="http://www.xinhuanet.com">www.xinhuanet.com</a></td>
</tr>
<tr>
<td>Private Organizations</td>
<td>Address</td>
<td>Contact Information</td>
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<td></td>
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<tr>
<td>--------------------------------------------</td>
<td>----------------------------------------------</td>
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<td></td>
<td></td>
</tr>
<tr>
<td>American Chamber of Commerce (Beijing)</td>
<td>China Resources Building, #1903</td>
<td>8 Jianguomenbei Ave., 100005</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Telephone: 8519-1920</td>
<td></td>
<td></td>
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<tr>
<td></td>
<td></td>
<td>Facsimile: 8519-1910</td>
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<td></td>
<td></td>
<td>Website: <a href="http://www.amcham-china.org.cn">www.amcham-china.org.cn</a></td>
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</tr>
<tr>
<td>Chinese Institute of Certified Public</td>
<td>6th Floor, Guangyuan Mansion</td>
<td>5 Guangyuanzha</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accountants (Beijing)</td>
<td></td>
<td>Haidian District, 100081</td>
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<tr>
<td></td>
<td></td>
<td>Telephone: 6872 1166</td>
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<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Website: <a href="http://www.cicpa.org.cn">www.cicpa.org.cn</a></td>
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</tr>
</tbody>
</table>
Appendix 2: China’s Provinces, Autonomous Regions, Municipalities and Special Administrative Regions

For administrative purposes, China is separated into 23 provinces, 5 autonomous regions, 4 directly administered municipalities and 2 special administrative regions.

### Provinces

<table>
<thead>
<tr>
<th>Anhui</th>
<th>Hebei</th>
<th>Jiangxi</th>
<th>Shandong</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fujian</td>
<td>Heilongjiang</td>
<td>Jilin</td>
<td>Sichuan</td>
</tr>
<tr>
<td>Gansu</td>
<td>Henan</td>
<td>Liaoning</td>
<td>Taiwan</td>
</tr>
<tr>
<td>Guangdong</td>
<td>Hubei</td>
<td>Qinghai</td>
<td>Yunnan</td>
</tr>
<tr>
<td>Guizhou</td>
<td>Hunan</td>
<td>Sha’anxi</td>
<td>Zhejiang</td>
</tr>
<tr>
<td>Hainan</td>
<td>Jiangsu</td>
<td>Shanxi</td>
<td></td>
</tr>
</tbody>
</table>

### Autonomous Regions

- Guangxi
- Neimengu
- Ningxia
- Xinjiang
- Tibet (Xizang)

### Municipalities

- Beijing
- Chongqing
- Shanghai
- Tianjin

### Special Administrative Regions

- Hong Kong
- Macau
Appendix 3: Economic Indicators

The following table presents key indicators of China’s economic performance for fiscal years from 2001 to 2004.

<table>
<thead>
<tr>
<th></th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>GNP (RMB billions)</td>
<td>9,573</td>
<td>10,394</td>
<td>11,660</td>
<td>13,622</td>
</tr>
<tr>
<td>Inflation (%)</td>
<td>0.7</td>
<td>(0.8)</td>
<td>1.2</td>
<td>3.9</td>
</tr>
<tr>
<td>Exports (US$ billions)</td>
<td>266.1</td>
<td>325.6</td>
<td>438.2</td>
<td>593.4</td>
</tr>
<tr>
<td>Imports (US$ billions)</td>
<td>243.6</td>
<td>295.2</td>
<td>412.8</td>
<td>561.4</td>
</tr>
<tr>
<td>Trade balance (US$ billions)</td>
<td>22.5</td>
<td>30.4</td>
<td>25.5</td>
<td>31.9</td>
</tr>
</tbody>
</table>

**Appendix 4: Exchange Rates**

The following table presents exchange rates of the renminbi yuan against selected major foreign currencies on 31 December 2002 through 2005.

<table>
<thead>
<tr>
<th>RMB per Unit of Foreign Currency</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australian dollar</td>
<td>4.6787</td>
<td>6.2013</td>
<td>6.4428</td>
<td>5.9066</td>
</tr>
<tr>
<td>Canadian dollar</td>
<td>5.2524</td>
<td>6.3974</td>
<td>6.8739</td>
<td>6.9631</td>
</tr>
<tr>
<td>Euro</td>
<td>8.636</td>
<td>10.3383</td>
<td>11.2627</td>
<td>9.5797</td>
</tr>
<tr>
<td>Japanese yen</td>
<td>0.069035</td>
<td>0.077263</td>
<td>0.079701</td>
<td>0.068716</td>
</tr>
<tr>
<td>Singapore dollar</td>
<td>4.7705</td>
<td>4.8586</td>
<td>5.055</td>
<td>4.8543</td>
</tr>
<tr>
<td>Swiss franc</td>
<td>5.9671</td>
<td>6.6678</td>
<td>7.3091</td>
<td>6.1375</td>
</tr>
<tr>
<td>U.S. dollar</td>
<td>8.2773</td>
<td>8.2767</td>
<td>8.2765</td>
<td>8.0702</td>
</tr>
</tbody>
</table>

Source: Bank of China
Appendix 5: Leading Exports and Imports

The following tables present China’s leading exports and imports in 2005.

### Exports

<table>
<thead>
<tr>
<th>Exports</th>
<th>US$ (millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Electrical products</td>
<td>426,750</td>
</tr>
<tr>
<td>High-tech products</td>
<td>218,250</td>
</tr>
<tr>
<td>Automatic Data Processing equipment</td>
<td>76,310</td>
</tr>
<tr>
<td>Clothes and accessories</td>
<td>73,880</td>
</tr>
<tr>
<td>Textiles and fabrics</td>
<td>41,130</td>
</tr>
<tr>
<td>Wireless telephones</td>
<td>20,640</td>
</tr>
<tr>
<td>Footwear</td>
<td>19,050</td>
</tr>
<tr>
<td>Accessories of telecommunication products</td>
<td>18,140</td>
</tr>
<tr>
<td>Integrated Circuits and microelectronics parts</td>
<td>14,390</td>
</tr>
</tbody>
</table>

### Imports

<table>
<thead>
<tr>
<th>Imports</th>
<th>US$ (millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Electrical products</td>
<td>350,380</td>
</tr>
<tr>
<td>High-tech products</td>
<td>197,710</td>
</tr>
<tr>
<td>Integrated circuits and microelectronics parts</td>
<td>81,550</td>
</tr>
<tr>
<td>Crude oil</td>
<td>47,720</td>
</tr>
<tr>
<td>LCD</td>
<td>27,510</td>
</tr>
<tr>
<td>Steels</td>
<td>24,610</td>
</tr>
<tr>
<td>Plastic</td>
<td>24,250</td>
</tr>
<tr>
<td>Iron ore</td>
<td>18,370</td>
</tr>
</tbody>
</table>

Source: www.customs.gov.cn
### Appendix 6: Corporate Tax Calculation

The following is a sample corporate income tax calculation for a manufacturing FIE in Pudong New District, Shanghai.

<table>
<thead>
<tr>
<th></th>
<th>$RMB$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>5,000,000</td>
</tr>
<tr>
<td>Cost of Goods Sold</td>
<td>(2,000,000)</td>
</tr>
<tr>
<td>Selling Expense</td>
<td>(400,000)</td>
</tr>
<tr>
<td>G&amp;A Expense</td>
<td>(500,000)</td>
</tr>
<tr>
<td>Finance Expense</td>
<td>(100,000)</td>
</tr>
<tr>
<td>Other Operating expenses</td>
<td>(50,000)</td>
</tr>
<tr>
<td>Profit Before Tax</td>
<td>1,950,000</td>
</tr>
<tr>
<td>Corporate Income Tax Rate</td>
<td>15%</td>
</tr>
<tr>
<td>CIT payable</td>
<td>292,500</td>
</tr>
<tr>
<td>Country</td>
<td>Dividends %</td>
</tr>
<tr>
<td>------------------</td>
<td>-------------</td>
</tr>
<tr>
<td>Albania</td>
<td>10</td>
</tr>
<tr>
<td>Armenia</td>
<td>5/10</td>
</tr>
<tr>
<td>Australia</td>
<td>10</td>
</tr>
<tr>
<td>Austria</td>
<td>10 (e)</td>
</tr>
<tr>
<td>Azerbaijan</td>
<td>10</td>
</tr>
<tr>
<td>Barbados</td>
<td>5</td>
</tr>
<tr>
<td>Bangladesh</td>
<td>10</td>
</tr>
<tr>
<td>Belarus</td>
<td>10</td>
</tr>
<tr>
<td>Belgium</td>
<td>10</td>
</tr>
<tr>
<td>Brazil</td>
<td>10</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>10</td>
</tr>
<tr>
<td>Canada</td>
<td>10</td>
</tr>
<tr>
<td>Cyprus</td>
<td>10</td>
</tr>
<tr>
<td>Czechoslovakia (f)</td>
<td>10</td>
</tr>
<tr>
<td>Denmark</td>
<td>10</td>
</tr>
<tr>
<td>Estonia</td>
<td>5/10</td>
</tr>
<tr>
<td>Finland</td>
<td>10</td>
</tr>
<tr>
<td>France</td>
<td>10</td>
</tr>
<tr>
<td>Gambia</td>
<td>10</td>
</tr>
<tr>
<td>Georgia</td>
<td>10 (h)</td>
</tr>
<tr>
<td>Germany</td>
<td>10</td>
</tr>
<tr>
<td>Hungary</td>
<td>10</td>
</tr>
<tr>
<td>Iceland</td>
<td>5/10</td>
</tr>
<tr>
<td>India</td>
<td>10</td>
</tr>
<tr>
<td>Ireland</td>
<td>5/10</td>
</tr>
<tr>
<td>Country</td>
<td>Dividends</td>
</tr>
<tr>
<td>-------------------------</td>
<td>-----------</td>
</tr>
<tr>
<td>Israel</td>
<td>10</td>
</tr>
<tr>
<td>Italy</td>
<td>10</td>
</tr>
<tr>
<td>Jamaica</td>
<td>5</td>
</tr>
<tr>
<td>Japan</td>
<td>10</td>
</tr>
<tr>
<td>Korea</td>
<td>5/10</td>
</tr>
<tr>
<td>Kuwait</td>
<td>5</td>
</tr>
<tr>
<td>Latvia</td>
<td>5/10</td>
</tr>
<tr>
<td>Lithuania</td>
<td>5/10</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>5/10</td>
</tr>
<tr>
<td>Macedonia</td>
<td>5</td>
</tr>
<tr>
<td>Malaysia</td>
<td>10</td>
</tr>
<tr>
<td>Malta</td>
<td>10</td>
</tr>
<tr>
<td>Mauritius</td>
<td>5</td>
</tr>
<tr>
<td>Mexico</td>
<td>5</td>
</tr>
<tr>
<td>Mongolia</td>
<td>5</td>
</tr>
<tr>
<td>Netherlands</td>
<td>10</td>
</tr>
<tr>
<td>New Zealand</td>
<td>10</td>
</tr>
<tr>
<td>Norway</td>
<td>10</td>
</tr>
<tr>
<td>Pakistan</td>
<td>10</td>
</tr>
<tr>
<td>Philippines</td>
<td>10</td>
</tr>
<tr>
<td>Portugal</td>
<td>10</td>
</tr>
<tr>
<td>Romania</td>
<td>10</td>
</tr>
<tr>
<td>Russian Federation</td>
<td>10</td>
</tr>
<tr>
<td>Seychelles</td>
<td>5</td>
</tr>
<tr>
<td>Singapore</td>
<td>10 (c)</td>
</tr>
<tr>
<td>Slovak Republic</td>
<td>10</td>
</tr>
<tr>
<td>Country</td>
<td>Dividends</td>
</tr>
<tr>
<td>--------------------</td>
<td>-----------</td>
</tr>
<tr>
<td>Slovenia</td>
<td>5</td>
</tr>
<tr>
<td>South Africa</td>
<td>5</td>
</tr>
<tr>
<td>Spain</td>
<td>10</td>
</tr>
<tr>
<td>Sri Lankan</td>
<td>10</td>
</tr>
<tr>
<td>Sweden</td>
<td>10</td>
</tr>
<tr>
<td>Switzerland</td>
<td>10</td>
</tr>
<tr>
<td>Thailand</td>
<td>10</td>
</tr>
<tr>
<td>Turkey</td>
<td>10</td>
</tr>
<tr>
<td>Ukraine</td>
<td>5/10</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>10</td>
</tr>
<tr>
<td>United States</td>
<td>10</td>
</tr>
<tr>
<td>Uzbekistan</td>
<td>10</td>
</tr>
<tr>
<td>Venezuela</td>
<td>10</td>
</tr>
<tr>
<td>Vietnam</td>
<td>10</td>
</tr>
<tr>
<td>Yugoslavia (g)</td>
<td>5</td>
</tr>
<tr>
<td>Nontreaty countries</td>
<td>10</td>
</tr>
</tbody>
</table>

(a) The withholding tax rate is 10%, but for royalties paid for the use of, or the right to use, industrial, commercial or scientific equipment, the rate is applied to only 60% of the royalties paid.

(b) The withholding tax rate is 10%, but for royalties paid for the rental of industrial, commercial or scientific equipment, the rate is applied to only 70% of the royalties paid.

(c) The withholding tax rate is reduced to 7% if the recipient is a company or partnership that holds directly at least 25% of the shares of the payer of the dividends.

(d) The withholding tax rate is reduced to 7% for interest paid to banks or financial institutions.

(e) The withholding tax rate is reduced to 7% if the recipient holds directly at least 25% of the voting shares of the payer of the dividends.

(f) China is honoring the Czechoslovakia treaty with respect to the Czech and Slovak Republics until new treaties are signed.

(g) This is a treaty between China and the Federal Republic of Yugoslavia.
(h) The withholding tax rate is reduced to 0% if the recipient is a company that holds directly or indirectly at least 50% of the shares of the payer of the dividends or has invested in the said company for up to two million euros.

(i) The withholding tax rate is reduced to 5% for interest paid to banks or financial institutions.

China has signed double tax treaties with Croatia, Indonesia, Kazakhstan, Myanmar, Papua New Guinea, Tunisia and the United Arab Emirates, but these treaties have not yet been ratified. Signed double tax treaties with Mexico, Azerbaijan, Georgia, Venuzuela, Sri Lankan, and Albania came into force on 1 January 2006.
Appendix 8: Individual Income Tax Calculation

The following example illustrates the calculation of monthly individual income tax payable by a foreign individual receiving monthly employment income of RMB 12,000 using the gross-up and the non-gross-up methods.

### Individual Income Tax Rates

<table>
<thead>
<tr>
<th>(A) Gross-up Taxable Income or Income After Standard Deduction for Non-Gross up Method</th>
<th>(B) Income After Standard Deduction for Gross-up Method</th>
<th>(C) Effective Tax Rate</th>
<th>(D) Quick Reckoning Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not Exceeding RMB</td>
<td>Not Exceeding RMB</td>
<td>Not Exceeding RMB</td>
<td>%</td>
</tr>
<tr>
<td>0</td>
<td>500</td>
<td>0</td>
<td>475</td>
</tr>
<tr>
<td>500</td>
<td>2,000</td>
<td>475</td>
<td>1,825</td>
</tr>
<tr>
<td>2,000</td>
<td>5,000</td>
<td>1,825</td>
<td>4,375</td>
</tr>
<tr>
<td>5,000</td>
<td>20,000</td>
<td>4,375</td>
<td>16,375</td>
</tr>
<tr>
<td>20,000</td>
<td>40,000</td>
<td>16,375</td>
<td>31,375</td>
</tr>
<tr>
<td>40,000</td>
<td>60,000</td>
<td>31,375</td>
<td>45,375</td>
</tr>
<tr>
<td>60,000</td>
<td>80,000</td>
<td>45,375</td>
<td>58,375</td>
</tr>
<tr>
<td>80,000</td>
<td>100,000</td>
<td>58,375</td>
<td>70,375</td>
</tr>
<tr>
<td>100,000</td>
<td>—</td>
<td>70,375</td>
<td>—</td>
</tr>
</tbody>
</table>
**Gross-up Method**
The following calculation illustrates the gross-up method, which is used if the employee’s tax liability is borne by the employer.

Gross-up taxable income = Income after standard deduction + Gross-up amount

Gross-up taxable income = (Income after standard deduction per Column B - D) / (1-C)

Gross-up taxable income = (RMB 12,000 - RMB 4,000 - RMB 375) / (1 - 20%) = RMB 9,531.25

Tax Payable = (Gross-up taxable income per Column A x C) - D Tax payable
= (RMB 9,531.25 x 20%) - RMB 375 = RMB 1,531.25

**Non-gross-up Method**
The following calculation illustrates the non-gross-up method, which is used if the tax liability is borne by the employee.

Tax Payable = (Income after standard deduction per Column A x C) - D Tax payable
= (RMB 12,000 - RMB 4,000 x 20%) - RMB 375 = RMB 1,225.00
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The Ernst & Young Hong Kong and China practice is managed as a single country practice. We established our office in Hong Kong in 1973. In 1981, we were one of the first international professional service firms permitted by the Chinese government to establish a representative office in Beijing. Today, we are one of the leading professional services firms in China with over 5,000 professionals and support staff in our 10 offices located throughout the country.

Serving both domestic and multinational companies, we hold leadership positions in many service areas and have a reputation for our proactive approach to serving our clients.

We are now the auditor of more than 190 public companies listed on the HK Stock Exchange. Our clients in China are among the leaders in major industries and include many of the largest Chinese companies. We are the leader in IPOs. We acted as the reporting accountant for 30% of all new listings on the HK Stock Exchange between 1996 and 2005, and most of these companies are based in mainland China.

Throughout these years, we have successfully assisted many of our multinational clients to invest and expand in China. Our knowledge, experience and our cooperative relationships, with many Chinese government agencies provide invaluable assistance to our clients in achieving their business or investment objectives.

In addition to audit, Ernst & Young has a very strong tax team in both Hong Kong and China. Our tax professionals are knowledgeable about the various national and local tax laws, and have experience working with various levels of the tax authorities in the country and cities where you do business.
Ernst & Young professionals in China are experienced in all aspects of business services, particularly in the following areas:

- **Tax Advisory Services**: We provide a full range of tax services. We help align our clients’ tax strategies with their business needs and assist them in meeting their compliance obligations wherever they arise. Our services include Corporate Tax Services, Human Capital Services, Transfer Pricing, Customs and International Trade Services, and Transaction Tax.

- **Assurance and Advisory Business Services**: We provide a full range of AABS, anchored by Assurance Services with related advisory services in the areas of Business Risk Services, Technology & Security Risk Services, and Fraud Investigation and Dispute Services.

- **Transaction Advisory Services**: The right transaction provides companies the opportunity to enhance growth, competitiveness and profitability. We help evaluate, structure and execute the deals our clients need. Our services include Transaction Management, Capital Management, and Corporate Development Advisory.
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• The Global Executive: An annual publication summarizing the personal tax systems and immigration rules and procedures in more than 130 countries.
• Doing Business In: A series of books that survey the investment climate, taxation, forms of business organization, and business and accounting practices in more than 50 countries.

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