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For more information about the *China Insider International*, please contact:

Zigurds G Kronbergs
International Tax Services Coordinator
BDO Global Coordination BV

Phone: +32 2 778 0141

e-mail: zkronbergs@bdoglobal.com



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I. CORPORATE INCOME TAX

The New Enterprise Income Tax Law

Following the implementation of China's new Enterprise Income Tax Law (the 'new EITL'), Chinese government agencies, mainly including the Ministry of Finance (the 'MoF') and the State Administration of Taxation (the 'SAT'), have been issuing a series of circulars to provide for further details in respect of enterprise income tax ("EIT") since January 2008, including but not limited to:

- Exemption from withholding tax on specific dividends
- Exemption from withholding tax on specific royalties, interest, etc.
- EIT refunds for specific after-tax profit reinvestment completed before 2008
- Effective tax rates for 50%-tax reduction enterprises within a five-year transitional period
- EIT repayment due to the change of business nature or operating term from 2008 onwards
- Tax incentives granted to the software-development industry
- Tax incentives granted to the integrated-circuit industry
- Tax incentives granted to the security investment-fund industry
- Certain circumstances for adopting the deemed-profit method
- Prepayment method for former high-new technology enterprises
- Prepayment method for qualified small-scale enterprises
- New administrative system for head offices and their branches across provinces

Exemption from Withholding Tax on Specific Dividends

With the approval of the State Council, the MoF and the SAT jointly promulgated a circular *Caishui* (2008) No. 1 on 22 February 2008 ('Circular 1'), clarifying that undistributed profits generated by a foreign-investment enterprise ('FIE') prior to 1 January 2008, but paid to its foreign investor/investors from 2008 onwards, are to be exempt from EIT, while newly increased profits derived by an FIE from 2008 onwards are to be subject to EIT when they are distributed to its foreign investor/investors.

Exemption from Withholding Tax on Specific Royalties, Interest, etc.

Based on a circular *Guoshuifa* (2008) No. 23 issued by the SAT on 27 February 2008 ('Circular 23'), with the approval of the tax authorities, a foreign enterprise that derives income from assigning proprietary technology or providing

a loan, etc. to a Chinese party may be continuously exempt from EIT on that income until the expiry of the relevant agreement (excluding extension of the agreement, supplementary agreement or expansion clauses) if the agreement had been signed by the end of 2007 and complied with the requirements for tax exemption stipulated in the old Foreign-Investment Enterprise and Foreign-Enterprise Income Tax Law of the People's Republic of China (hereinafter referred to as the 'old FIETL').

EIT Refunds for Specific Reinvestments of After-Tax Profits

Pursuant to Circular 23, a foreign investor that directly uses its after-tax profits gained from an FIE as capital either to increase the FIE's registered capital or to establish another FIE may apply for a tax refund for the reinvestment of after-tax profits in accordance with the old FIETL, on condition that the reinvestment had been completed and the change of the FIE's registered capital or the incorporation of the new FIE had been registered with the competent industrial and commercial administration department by the end of 2007. However, there are no tax refunds for the reinvestment of profits generated during 2007 but pre-distributed by the end of 2007.

Effective Tax Rates for Certain 50%-Tax-Reduction Enterprises

According to the circular *Caishui* (2008) No. 21, jointly issued by the MoF and the SAT on 13 February 2008, an enterprise that was previously subject to a tax rate of 15%, 24% or 33% but is currently enjoying the transitional 50%-tax-reduction treatment in accordance with the circular *Guofa* (2007) No. 39 will be liable to 50% of the EIT payable calculated at the transitional tax rate prescribed in Circular 39. Thus, the effective tax rate is regarded as half of the transitional tax rate, which is set out below:

Transitional period	Previous rate: 15%		Previous rate: 24% or 33%	
	Transitional rate	Effective rate	Tax rate	Effective rate
2008	18%	9%	25%	12.5%
2009	20%	10%	25%	12.5%
2010	22%	11%	25%	12.5%
2011	24%	12%	25%	12.5%
2012	25%	12.5%	25%	12.5%

EIT Repayment due to the Change of Business Nature or Operating Term

Pursuant to Circular 23, an FIE is required to repay the amount of tax already exempted or reduced (including that exempted or reduced within the preferential transitional period) in accordance with the old FIETL,

longer meets relevant requirements stated in the old FIETL due to the change of its business nature or operating term. For example, although a production-oriented FIE has already enjoyed the tax holiday of so-called “two-year exemption, and three-year 50% rate reduction”, it will be liable for repaying the amount of tax exempted or reduced in connection with the tax holiday only if it terminates the business operations in or after 2008 when its actual operating period is less than ten years (except for special events). Therefore, FIEs must take the aforesaid tax factor into account when considering changing their business nature or shortening their operating term.

Tax Incentives for the Software-Development Industry

Circular 1 provides a series of income-tax incentives to the software-development industry, including:

- VAT refunds received by a software-development enterprise will not be included in taxable income, but they should be used to develop software products and expand reproduction.
- Upon verification, a software-development enterprise newly established in China will be exempt from EIT for two years beginning from its first profit-making year, and will be eligible for a 50% tax reduction for the subsequent three years.
- A key software-development enterprise listed as such in the State’s plans will be entitled to a reduced income tax rate of 10% if it fails to benefit from tax-exemption treatment within the tax year.
- Employee-training expenses incurred by a software-development enterprise will be deductible from taxable income on an actual basis.
- Subject to the approval of the tax authorities, the depreciation period or the amortisation period for software purchased by an enterprise may be shortened to a minimum of two years for tax purposes, provided that the purchased software meets the conditions of recognition of fixed assets or intangible assets.

Tax Incentives for the Integrated-Circuit Industry

Under Circular 1, a series of income-tax incentives is also granted to the integrated-circuit (‘IC’) industry, including the following:

- IC design enterprises are treated as software-development enterprises and will be eligible for the abovementioned preferential EIT policies applicable to software-development enterprises.
- Upon approval by the tax authorities, the depreciation period for the production equipment of a production-oriented IC enterprise may be shortened to a minimum of three years for tax purposes.

- A production-oriented IC enterprise may pay EIT at a reduced tax rate of 15% if the amount of its total investments exceeds RMB 8000 million (approximately EUR 720 million) or the line-width of IC products it manufactures is less than 0.25µm. Such production-oriented IC enterprises will be entitled to exemption from EIT for five years starting from their first profit-making year and to a 50% tax reduction for the subsequent five years on condition that the operating term of the enterprise is over 15 years.
- Upon verification, a production-oriented enterprise manufacturing IC products with a line-width of not more than 0.8µm will be entitled to exemption from EIT for two years commencing from its first profit-making year and to a 50% tax reduction for the subsequent three years. However, this relief will not be applicable to enterprises if they have already enjoyed the two-year exemption plus three-year 50% rate reduction tax holiday from their first profit-making year.
- From 1 January 2008 to the end of 2010, the investors in a production-oriented IC enterprise or an IC encapsulation enterprise may apply for a refund of 40% of EIT already paid on the reinvested amount if they use their after-tax profits as investment to increase the enterprise’s registered capital or set up another production-oriented IC enterprise or IC encapsulation enterprise with an operating period of at least five years. However, the amount of tax already refunded must be repaid to the tax authorities if the amount of the reinvestments is withdrawn within five years of the commencement of the reinvestment.
- From 1 January 2008 to the end of 2010, up to 80% of EIT already paid on the reinvested amount may be refunded to domestic or foreign economic organisations (as investors) if they use their after-tax profits as capital to incorporate production-oriented IC enterprises, IC encapsulation enterprises or software-development enterprises with an operating period of not less than five years in western areas of China. However, the amount of tax already refunded must be repaid to the tax authorities if the amount of the reinvestments is withdrawn within five years of the commencement of the reinvestment.

Tax Incentives for the Security Investment-Fund Industry

According to Circular 1, the security investment-fund industry may enjoy the following tax-exemption treatment:

- Income received by a security investment fund from the securities market will be provisionally exempt from EIT, including income generated from stock or bond trading, dividends, interest from bonds, and other income.

- Income gained by the investor/investors from the distribution of a security investment fund will be provisionally excluded from EIT.
- Income derived from stock or bond trading from the use of funds by security investment-fund managers will be provisionally exempt from EIT.

Certain Circumstances for Adopting the Deemed-Profit Method

Pursuant to Circular *Guoshuifa* (2008) No. 30 issued by the SAT and dated 6 March 2008, all resident enterprises except for those engaged in special industries, and those over a certain scale, will be subject to a deemed-profit method for the purpose of determining EIT by the tax authorities if any of the following circumstances occurs:

- The taxpayer has not set up accounting books and records in accordance with laws and regulations.
- The taxpayer may have set up accounting books and records in accordance with laws and regulations but has failed to maintain them.
- The taxpayer has destroyed accounting books and records without permission or refuses to provide tax documents.
- Although accounting books and records are kept, the tax authorities have difficulty in performing a tax audit because the accounting maintenance and recording is inadequate or the vouchers for revenues, costs, or expenses are incomplete.
- The taxpayer fails for a second time to submit tax returns within the required time limit after having previously failed to file tax returns in time upon the occurrence of a tax liability.
- The value of taxable income already filed is unjustifiably low.

Thus, in practice enterprises must conduct their accounting and tax affairs in an appropriate way so as to avoid becoming subject to the deemed-profit method.

Prepayment Method for Former High-New Technology Enterprises

The new EITL provides that a preferential tax rate of 15% will be applicable to a 'high-new technology enterprise specifically supported by the State' ('HNTE'). According to Circular *Guoshuifa* (2008) No. 17 published by the SAT on 30 January 2008, a former high-new technology enterprise verified before 1 January 2008 must prepay EIT at 25% provisionally before it is recognised as an HNTE in accordance with the new EITL and related regulations.

It is likely that those former high-new technology enterprises will not be recognised as HNTEs if they do not own core proprietary intellectual-property rights.

Prepayment Method for Qualifying Small-Scale Enterprises

The new EITL also provides that a reduced rate of 20% is to be applied to a small-scale enterprise. In accordance with Circular *Guoshuifan* (2008) No. 251 issued by the SAT on 21 March 2008, a qualifying small-scale enterprise may prepay income tax of an amount equal to the difference between its taxable income times a tax rate of 25% and its taxable income times 5%.

When prepaying EIT for the first time in each tax year, an enterprise must submit relevant supporting documents (certifying that it has complied with the qualifying conditions for small-scale enterprises in the last year) to the tax authorities for review. Where the tax authorities, after review, confirm that the enterprise fails to meet the conditions, the enterprise will not be entitled to use the above method to calculate and prepay EIT payable (i.e. the 5% reduction is not allowed). Furthermore, the tax authorities will, during the annual EIT settlement period, require the enterprise to pay the amount of tax reduced (i.e. the 5% reduction) if after the tax year ends, they confirm that the enterprise has failed to satisfy all the conditions during the tax year.

Based on the Implementation Regulations for the new EITL, a qualifying small-scale enterprise is an enterprise that is engaged in non-restricted and non-prohibited industry and meets the following criteria: (a) for industrial enterprises, the annual taxable income, the amount of total assets, and the number of employees does not exceed RMB 0.3 million (approximately EUR 27 000), RMB 30 million (approximately EUR 2.701 million), and 100 respectively; and (b) for other enterprises, the annual taxable income, the amount of total assets, and the number of staff does not exceed RMB 0.3 million, RMB 10 million (approximately EUR 900 350), and 80 respectively.

In sum, small-scale enterprises that only earn small profits will check whether or not the relevant conditions can be met. If positive, they may apply for a reduced tax rate of 20% when submitting monthly or quarterly tax returns for the first time in the tax year.

New Administrative System for Head Offices and Their Branches across Provinces

Under the new EITL, an enterprise will compute and pay EIT on a consolidated basis if it has established one or more business entities without their own legal personality (e.g. branches) (collectively the 'Branches') in China. In this connection, the SAT issued Circular *Guoshuifa* (2008) No. 28 on 10 March 2008 ('Circular 28'). Circular 28 provides for a new provisional administrative system for levying and collection of EIT for enterprises carrying on business by establishing Branches across provinces. Circular 28 contains 41 paragraphs, under which:

- An enterprise will calculate taxable income and EIT payable on a consolidated basis.
- The head office and the Branches will prepay EIT to their respective local tax authorities monthly or quarterly in accordance with Circular 28. More precisely, 50% of the consolidated EIT payable will be prepaid by the head office, and the remaining will be allocated between the Branches and then prepaid respectively.

After the end of the tax year, the head office will be responsible for the annual EIT returns and final settlement, including calculating annual EIT payable on a consolidated basis. The difference between the annual consolidated EIT payable and the total provisional tax already paid by the head office and the Branches by instalments will be settled (refunded or paid up)

Standardisation of Transfer-Pricing Analysis and Investigation Procedures

The State Administration of Taxation (SAT) has released two statutory notices in order to help local tax offices to standardise transfer-pricing analyses and transfer-pricing investigation procedures. Circular 236 aims at the profitability of foreign-investment enterprises (FIEs) and foreign enterprises (FEs) whose sole business consists of manufacturing in China for their offshore parent companies. According to internationally accepted transfer-pricing principles, sole manufacturing enterprises that are not involved in the process of decision-making, market development, sales and marketing usually do not bear the consequences of mistakes in decision-making, inefficient use of manufacturing capacity or poor sales performance. Therefore, FIEs and FEs should maintain a certain level of profitability and should not incur losses. As far as enterprises of poor profitability or even suffering losses are concerned, the local tax offices should determine the proper level of profitability by means of an arm's length comparison. With the assistance of circular 363, the SAT strives for an increase in quality of functional and financial analyses submitted by enterprises and the local tax offices to the SAT during transfer-pricing audits. The SAT has prescribed three standard analysis forms. The first form ('Enterprise Functional and Risk Analysis Form') includes a comprehensive list of the functions performed and the risks assumed and should be completed by the enterprise under investigation for transfer-pricing compliance. In this connection, the enterprise should consider five main categories such as R&D, manufacturing, marketing, sales and distribution and management and other services. On the basis of the contents of the first form completed by the enterprise, the local tax office has to complete the second form ('Recognition Form on Enterprise Functional and Risk Analysis'). In the process, the local tax office has to assess

the scope of functions performed as well as the scope of risks borne by the enterprise under investigation. Apart from that, the local tax office has to complete the third form ('Financial Analysis Form on Related-Party Transactions'), which indicates the allocation of revenue and expenses among different transactions (transactions between related or unrelated parties, cross-border or domestic transactions).

II. DOUBLE TAX TREATIES

New China/Singapore Treaty

China and Singapore have signed a new double taxation treaty, which replaces the current agreement. The new agreement took effect on 1 January 2008. Negotiations took place because Singapore was eager to receive the same benefits offered to Hong Kong under the China-Hong Kong treaty. The new treaty brings basically three major changes to the original version. First, the rates of withholding tax on dividends are reduced from 7% to 5% for shareholders with more than 25% of the company's shares and from 12% to 10% for all other shareholders. Additionally, the withholding-tax rate on lease payments for industrial, commercial or scientific equipment is reduced from 10% to 6%. Gains from sales of shares in Chinese companies will be subject to Chinese taxation only if the taxpayer held at least 25% of the share capital of the company in the past 12 months. Capital gains arising from the sale of shares of a company whose assets directly or indirectly principally consisted of Chinese immovable property are from now on only taxable if at least half of the company's share value is represented by this immovable property in China.

The Singapore Government is convinced that this new agreement will strengthen the economic link between the two countries. Some observers expect that more investment in China will now be routed through Singapore holding companies. Whether this would indeed be more profitable than making use of Hong Kong-based investment vehicles cannot yet be decided. This is particularly arguable in the light of recent government proposals in Hong Kong to cut back tax rates significantly, improve governmental support schemes and facilitate investment by Hong Kong companies in Mainland China.

III. TURNOVER TAXES AND CUSTOMS DUTY

VAT Reforms in China

In May and June of 2007, the Ministry of Finance (MOF) and the State Administration of Taxation (SAT) launched two important reforms for redesigning China's VAT system. On the one hand, the authorities expanded

the experimental VAT reform currently applicable only in the North-Eastern part of the country to the central Chinese provinces. On the other, MOF and SAT issued an administrative directive that introduces significant changes to China's export VAT refund rates.

VAT reform expansion

The current national VAT system does not allow for input VAT credits on the acquisition of fixed assets. This leads to discrimination against manufacturing companies, which are often unable to upgrade their equipment. Especially wholly Chinese-owned companies have to bear the brunt of this inequity, as they are not normally endowed with as much liquid capital as foreign enterprises, which can usually fall back on large international corporations. The existing system also reduces the amount of VAT refunds available for exported goods, which subsequently affects the competitiveness of Chinese enterprises in international markets. The VAT reform, therefore, allows enterprises in certain industries and specific regions to claim a credit for their input VAT on qualifying fixed assets to offset against output VAT. Although the Chinese authorities have refrained from considering input VAT in every case of fixed-asset purchases, the expansion of the reform to central China is at least a start.

Features of the expanded reform

The new circular not only expands the reform programme regionally but also as regards content. In particular, the number of benefiting industries exceeds that of the original reform steps taken in North-Eastern China. The circular covers 26 cities in 6 provinces. Companies may claim an input VAT credit if they are primarily engaged in one of the following eight industry sectors:

- Equipment manufacturing
- Petrochemicals
- Metallurgy
- Car manufacture
- Farm products
- Electricity
- Mining and
- High and new technology

Primarily 'engaged' in this context means that at least 50% of the taxpayer's gross revenue must be generated from business operations in the sectors listed. In terms of purchases for which input credits may be claimed, the circular allows tax credits for input VAT associated with:

- fixed assets that are purchased, donated, or contributed as a capital investment in-kind,
- goods or taxable services that are purchased for self-construction, including the extension and installation of qualifying fixed assets by the taxpayer,

- fixed assets acquired through financial leasing in a transaction that is subject to VAT and
- transportation costs associated with the acquisition of qualifying fixed assets.

The input VAT credit is, however, capped by the year-to-year increase in VAT payable during the same tax period. The excess of this VAT-payable increase and the qualifying input VAT credit can be carried forward for future credits. In accordance with the unification of income taxation of Chinese and Foreign-Investment Enterprises (FIEs) the current VAT refunds granted to FIEs for purchasing domestic equipment will also be abolished.

Observation

Chinese authorities are following two main goals with the expansion of the reform. First, they wish to stimulate investment in the rather poor central provinces of China. Second, they are giving the VAT reform a trial run in a wider region and for more industry sectors. This way, SAT and MOF are able to study the impact of the reform on a wider scale. China is, nevertheless, cautious in introducing comprehensive VAT reforms. This is most likely determined by its fear of losing tax revenues but needs to be overcome if it wants to stay competitive in the international arena.

Interestingly, this catalogue of possible VAT credits, at least in part, matches the tax incentives included in the new Enterprise Income Tax Law. In the long run, a balancing of both taxes will be necessary to prevent further disadvantages for Chinese companies as well as FIEs in China as compared to international competitors. Therefore, MOF and SAT are expected to roll out the VAT reform to the rest of China in the near future. The next step would then be to introduce a direct credit method that does not differentiate between regions and industry sectors but treats all taxpayers alike. However, when and if this will ever be adopted is not certain at the moment.

Adjustments to VAT export refund rates

With the issuing of their June circular on adjustments of the previous VAT export refund rates, MOF and SAT intended to battle China's excessive, internationally often criticised trade surplus as well as the concerns of resource preservation and environmental protection, problems which have recently become increasingly severe for China and the Chinese market.

The current Chinese VAT régime entitles exporters of goods to obtain refunds of their input VAT incurred in the import purchase and production stages. The amount of the refund depends heavily on the rate applicable to the specified types of goods. The circular contains a catalogue of 2831 types of commodities affected by the amendments regarding VAT refund rates, which generally include:

- Construction materials;
- Base metals, minerals and their products;
- Chemical products;
- Animal and vegetable products;
- Garment and textile articles; and
- Electrical and mechanical appliances.

Cancellation of VAT rebates

The export VAT refund for 553 products is to be cancelled, i.e. the refund rate is reduced to 0%. This list of products predominantly includes cement, specified organic/inorganic chemicals, specified pharmaceutical products, etc, which have previously been entitled to refund rates of between 5% and 17%. Additionally, these commodities may even face domestic sales VAT. There are, however, different assessing practices in different localities so far.

Reduction in export VAT refund rates

For another 2268 product types, export VAT refund rates will be reduced to 5%. These products include vegetable oil, again certain organic/inorganic chemicals, plastics, rubber, nickel, lead, footwear, base metal tools, trailers, etc, currently rated up to 17%.

VAT exemption on exports

The export of specified products such as groundnuts, oil paintings or stamps will be treated as VAT-exempt supplies.

Observation

Foreign investors can only be encouraged to contact their local advisers concerning these latest changes to the refund rates system. The catalogue of products is vast and needs to be examined closely. Companies manufacturing in China are likely to face a tremendous increase in export costs. Moreover, foreign buyers will have to pay more for Chinese products as exporters will have to compensate for these abolitions. This might arguably diminish China's 'world factory' profile.

By means of these modifications, China also reduces the incentive to export in favour of a focus on the domestic market. This way, China's trade surplus of approximately 83.1% in the first five months of 2007, as compared to the same period last year, is supposed to be decreased. Even though the effectiveness of such modifications is yet unclear, it cannot be ruled out that China will make use of further export VAT refund modifications in order to slow down the growing number of exports and to steer the country's development. Consequently, expected improvements of the VAT system for exporting companies attributed to the VAT reform expansion mentioned earlier are thwarted by these restrictions of refundable VAT.

IV. EXPATRIATES

People's Republic of China Tightens Expat Income Tax Assessment

The number of foreign employees working in China now exceeds 180 000. However, far from all of them pay the legally required extent of taxes on their wages and salaries. As a basic rule, the worldwide income of those expatriates who either have a residence in China or stay for more than one year is subject to Chinese taxation. In contrast, those employees who do not establish a residence in China and who leave before one year is over only have to pay taxes on those earnings that are derived in China.

In addition, non-cash benefits like accommodation allowances or company cars must be submitted to taxation. Foreigners who work in the People's Republic must expect stricter inspections when it comes to income tax assessment in the future.

To make for greater transparency regarding expatriate income, the Chinese State Administration of Taxation and the Immigration Authority increasingly track the duration of stay and whereabouts of managers by using computer-based methods. Moreover, German and Chinese tax offices increasingly cooperate with each other to fight abuse. German tax offices also increasingly demand proof from returning expatriates that all taxes due in China were appropriately paid in China.

In the course of the past years, China has introduced new laws and regulations, e.g. the Individual Income Tax Clarification Act and the Circular of the State Administration of Taxation on Intensifying the Administration of Archival Materials concerning the Individual Income Tax on Foreigners, which governs the cross-linking of customs and immigration authorities in detail with regard to the collection of data.

The Provisional Individual Income Tax Self-Reporting Regulations govern a separate duty to give notice if the annual remuneration of an expat exceeds RMB 120 000 (approximately EUR 10 800). This obligation to disclose also applies to taxpayers whose income derives from more than one source within China and taxpayers who generate income outside the People's Republic.

Thus, internationally operating companies who dispatch employees to China for more than 183 days of the fiscal year and, therefore, expose them to the obligation to pay Chinese income tax it are recommended to include the obligation to provide appropriate information about the tax due in their employment contracts. For countries that do not have a double tax treaty with China, this term is reduced to 90 days. Aside from this, some jobs, e.g. 'senior manager' already trigger income tax as of the very first day.

V. ACCOUNTING AND AUDITING

China drops IFRS accounting for listed enterprises

The China Securities and Regulatory Commission, CSRC, has revoked its request to enterprises listed on Chinese stock exchanges and issuing B-shares, to publish financial statements in compliance with IFRS in addition to Chinese Accounting Standards, CAS. B-shares are securities, traded in US dollars, which could solely be purchased by foreign investors until quite recently. Currently, 109 out of the 1477 enterprises listed on the stock exchanges of Shanghai and Shenzhen have issued B-shares.

In February 2006, the Ministry of Finance announced the adoption of the new Chinese Accounting Standards, CAS. The CAS consist of an elementary standard, as well as 38 new Chinese accounting standards. They are based on the IFRS and, apart from some exceptions, correspond to them. The CAS have come into affect in 2007, forcing listed Chinese enterprises to implement them while enabling non-listed Chinese enterprises to choose whether to apply the new standards or not. Due to the comparability of the CAS and the IFRS, double reporting is expendable, as the CSRC has determined.

As a result of the implementation of the new accounting and auditing standards, the requirements for listed enterprises and, according to this, for auditing companies, will be subject to adjustments to the international standards this year. Seeing that, the former requirements concerning the publication of information will be abolished. Consequently, enterprises can prepare their financial statements according to the new CAS without being obligated to draw up IFRS accounts.

Risk management in Chinese enterprises

Nowadays, sound risk management is considered to be a key success factor for any organisation. The general types of risk are credit risk, market and interest-rate risk, liquidity risk, operational risk, legal and compliance risk, strategic risk and reputation risk.

Chinese enterprises have notably improved their corporate risk management over recent years. However, compared with advanced international companies, Chinese enterprises still have a lot of room for improvement with regard to risk management. Our various audit and due-diligence engagements show that many Chinese companies have major deficiencies in terms of risk management, as the following experiences illustrate.

Credit risk is associated with the failure of a counterparty to meet its obligations from a contract. Respective risk management includes limiting an enterprise's maximum exposure to customers, customer groups, markets or products. When having a glance at a Chinese company's open-item list, it is very common to find extraordinarily large trade receivables or items that are significantly overdue. However, few Chinese companies have established sound

processes of debt collection and recovery. Moreover, in China it is troublesome to obtain and execute an executory title.

Market risk arises from movements of foreign-exchange rates, interest rates or commodity prices. According to our experience, Chinese companies are primarily equity-financed, which allows them to pay little attention to interest-rate risk. Still, more and more Chinese enterprises seek advantages from leveraged financing. Nonetheless, we have found that they are often not fully aware of the effects on their overall risk position resulting from interest rate volatilities. However, due to capital-market restrictions it is not trouble-free for Chinese companies to take advantage of hedge instruments, i.e. interest rate or commodity derivatives.

Liquidity risk relates to an enterprise's ability fully to meet all due payment obligations without being forced to liquidise assets on short-term notice. We have observed that Chinese companies, primarily funded through equity (e.g. from capital paid in or an IPO), trade credit or intercompany loans, show adequate levels of liquidity. However, genuine liquidity management was often not present. The reason is that many managers believe their company generates sufficient cash from daily operations. This point of view ignores the threats from adverse market conditions or defaults of trade creditors. Also opportunities are disregarded, e.g. from the optimisation of return through investing surplus cash profitably.

Operational risk refers to potential losses from the inadequacy or even failure of internal processes, people or systems as well as from external events. We have observed that insurance coverage is often sufficient to absorb some losses from operational risk. We believe that in Chinese companies substantial operational risk primarily results from improper segregation of duties. Furthermore, very few companies had an emergency plan or operation-continuity plan to maintain their business in the event of a disaster, system failure or fraud. In this context many companies also lack suitable back-up facilities to substitute failing systems.

Strategic risk is generally the risk from negative impacts on financial performance and market position due to poor strategic decisions, insufficient execution of business strategies and inflexibility to changing market conditions. In many cases we found it to be striking that enterprises have rather undifferentiated product portfolios and depend on very few key customers. Hence, many Chinese companies show weaknesses with regard to the ability to adapt their strategies to possible technological advances and, thus, changing market conditions.

Reputation risk generally refers to threats from unfavourable publicity on an enterprise's activities, no matter if true or not. Those enterprises aiming at an IPO in a reputable stock market or planning to bring their products to western markets should be particularly aware of the importance of reputation for investors and customers. However, we have found various examples of ways in which Chinese enterprises compromise their reputation. Examples are

disregard of western ethical standards with regard to environmental protection, work safety or workers' social standards. Also, substandard product quality – or even worse, products that are harmful to health – may damage a company's reputation. Last but not least, the violation of intellectual property is an everlasting issue of concern.

Legal risk relates to unenforceable contracts and lawsuits, while compliance risk is the risk of legal sanctions caused by non-compliance with applicable laws, regulations and practices. Our engagements have brought to light various examples of potentially harmful non-compliance. In one case the required business licence had not been obtained, in another case Chinese law prohibited a company, which had just recently acquired foreign investment, from continuing its business. Non-compliance is also a problem with regard to tax compliance. In several cases the company's tax status was unclear, which led to uncertainty in terms of substantial tax back duties or future tax rates. Other cases showed improper tax registration and under-reporting of tax liabilities. Violation of intellectual-property rights is another problem. Hence, experience shows that it is absolutely necessary to have a professional legal due-diligence investigation performed before taking up a participation in a Chinese company.

The illustrations above show the need to improve Chinese companies' attitude towards risk management. With reference to international practices the enhancement of good risk management includes some initiatives. First is to construct an adequate supervisory environment. This requires the setting-up of binding business rules and cultivating an environment of risk management and internal controls. The supervisory board represents the interests of the enterprise's shareholders and has the ultimate responsibility for risk management. The board is responsible for establishing adequate risk-management strategies and for effectively implementing these strategies. In complex organisations it may be advisable to establish a standing risk committee to supervise fundamental risk management policies.

The executive management's responsibility is to implement and enforce the risk-management policies, procedures and risk limits, according to the risk-management strategy. However, many Chinese companies have not appointed an executive manager responsible for risk management. There is a need for a Chief Risk Manager, appointed to give a direction to the risk-management framework and to supervise the management of operational, legal and compliance as well as credit, market and reputation risk. The Chief Financial Officer should take responsibility for interest, liquidity and strategic risk.

Before investing in a participation in a Chinese company, investors should be aware of these potential deficiencies. Professional advice is recommended to review a company's risk-management system as a first step. This can be performed as a stand-alone engagement or be part of a financial or

legal due-diligence investigation. Then, according to our experience, Chinese companies have to be made aware of the necessity of adequate risk management. The final step is to provide professional advice to support the company in establishing a proper risk-management environment as well as implementing the necessary methods and procedures.

Protection from Fraud in Chinese Undertakings

The leading industrial nations adhere to business operations and corporate governance built upon stringent accounting and auditing requirements and certain legal disclosures. Chinese business has, for centuries, been built upon connections and verbal confirmations. Due to these differences and lack of corporate transparency when doing business in China, fraud issues have to be considered with special care.

In its direct form, the most frequently committed types of fraud include embezzlement of assets, ghosting of work hours, falsification of financial statements, bills, certifications and cheques or overpayment of salary. This kind of fraud is relatively easy to detect for forensic experts. The indirect-fraud cases comprise various forms of nepotism, the establishment by local joint-venture (JV) partners of competing companies to the JV itself, or even supplier contracts where the supplier is in fact the JV partner's own private company or an employee's relative. Foreign investors encounter most problems in detecting this type of fraud.

Many investors seem to treat their foreign investments in Chinese businesses as 'outposts', essentially ignoring all the management training and processes that have proven integral in the more developed economies of the world. This may be due to a lack of 'hands-on' management, language and cultural differences, or simply a misunderstanding of the business environment. The real cause of a failed investment in China actually involves unscrupulous behaviour and misinformation.

Sometimes potential Chinese partners simply present fraudulent accounting books and financial statements, false bank statements and even illegal contracts. With this in mind, it is suggested that foreign investors conduct a thorough business due-diligence investigation before entering into any business negotiation or contracts. Part of this process should include a background and credit check on the partners, their business and, depending on the industry, licences and solidity of standing with relevant local and state Government departments.

Often investors maintain only small finance teams in their Chinese companies. In such cases, there may not be the personnel nor the resources to adequately ensure segregation of duties or audit-trail procedures. As a result, there are many occasions where money has easily been siphoned off to individual employees and Chinese partners' bank accounts. This can happen, for example, by the creation of fictitious vendors or reimbursement of costs for deliveries that have never been made or

services that have not been rendered. The detection of this type of fraud is all but impossible to detect as cheques are the most commonly used payment method. The possibilities for entering the Chinese market are limited. Therefore most of the foreign investors decide in favour of joint ventures to act in good faith. So the management team in many investments in China is often decided by JV partners or through hiring of local staff who have the appropriate experience and education to deal with both the Chinese business environment and Western management principles. Consequently, the company loses control, which may manifest itself in a multitude of problems, such as a rogue JV project, misuse of company funds and even the potential for the company to become involved in illegal activities such as trading in activities without appropriate business licences. The exposure to this fraud risk can be limited by delegating the Chief Financial Officer (CFO) or/and the Chief Operating Officer (COO). This ensures day-to-day control over both financial and operational policies. It forces the preparation of separate financial reports (for Head Office) under International Accounting Standards or overseas accounting standards. A further safeguard is to appoint an independent accountant for compliance purposes. Aside from the management team, the structure of the company and articles of association, and internal control procedures play an integral rôle in ensuring control of the company and in limiting exposure to management fraud. Nearly all companies from the leading industrial nations, and indeed regulatory bodies, have control mechanisms to limit the extent of fraud. These include internal controls such as authorisation levels, segregation of duties, job rotation, fraud hotlines, employee training, ethics programmes, tendering processes for contracts and internal audits, and more importantly regulatory requirements such as disclosure of conflicts of interest or external audits. The end-result is a much tighter corporate governance environment and greater operational transparency. Internal audits carried out on a regular basis are also an essential tool in fraud prevention. Internal audits and system audits can uncover lack of internal controls and weaknesses, areas for potential fraud and audit-trail compliance. As a protection tool, clauses requiring countersignature of major investment contracts, competitive tendering obligations should be implemented in the Chinese undertaking. Such measures also serve to dissuade local management from fraudulent activities and set clear guidelines and rules. Through conducting a thorough business due-diligence investigation, undertaking annual internal and external audits, instituting appropriate management controls and implementing safe corporate structures, foreign firms may be able to limit their exposure to business fraud in China.

VI. BANKING AND FINANCE

New Tax Rules for Restructuring within the Banking Sector

Banking law background

Due to the expiration of a five-year transition period included in the WTO accession treaty, the People's Republic of China (China) was forced to allow foreign banks extensive access to the domestic market as of 11 December 2006. This door had previously been ajar by the merest fraction. According to the new "Regulations regarding administration of wholly foreign owned banks" as amended on 11 November 2006, foreign banks are now authorised to deal in foreign exchange and RMB (Chinese currency) business if certain requirements are met. This now applies without even having to consider any quota arrangement for the RMB deposit-related business with domestic customers. Thus, the Chinese banking sector is now open to foreign banks.

This longed for opening of the Chinese banking sector puts foreign financial institutions on the spot. Chinese citizens' savings supposedly now exceed USD 1.7 million million (EUR 1.073 million million). However, until now, the conduct of RMB-deposit business was exclusively reserved to Chinese banks. For the most part, foreign banks were acting via subsidiaries in China. According to a report of the China Banking Regulatory Commission (CBRC), 14 foreign-capital-only or Chinese-foreign joint-venture bank institutions had already been registered in China in late 2006. These institutions established a total of 19 branch offices and representative offices throughout the country. Furthermore, there were 74 foreign banks with 200 branch offices and 79 representative offices in 25 Chinese cities.

In order to be able to offer Chinese customers regular bank services – among them RMB, credit card and investment business – foreign banks are required under the new regulations to establish a subsidiary in the form of a wholly foreign-owned enterprise (WFOE) or a joint venture with a Chinese partner. The minimum share capital for such an institution is RMB 1000 million (approx. EUR 100 million). As an alternative, it is admissible to acquire a participation in an existing Chinese banking corporation. Some of the associated questions were regulated by the "Temporary actions with regard to capital investments of foreign financial institutions in local financial institutions" issued by the CBRC on 8 December 2006.

Tax treatment

On 26 March 2007, the Ministry of Finance and the State Administration of Taxation issued a "Notice on the Tax Issues concerning the Restructuring of Foreign Bank Branches into Solely Foreign-invested Banks" (Az. *Cai shui* [2007] no. 45) in order to sweeten the tax consequences of restructuring Chinese bank branches. The Notice includes the following essential regulations:

- No business tax or VAT is levied on the transfer of enterprise property rights or stock rights upon restructuring

- No further stamp duty is due for transfer of contracts and accounts connected with the restructuring
- Property tax due as a result of the transfer of rights to buildings may be waived in full or in part
- According to the regulations of a notice issued by the State Administration of Taxation on tax treatment of transferred shares, shares are transferred at carrying amount (*Guo Shui* [1997] no. 207)
- Carried-forward losses of the bank branch may be transferred to the newly established banking enterprise and set off against profits
- Subsequent to the restructuring, the newly established banking enterprise may – until expiration of the applicable term – further utilise those tax reliefs or exemptions that were either utilised by the bank branch in accordance with the regulations of the Corporate Tax Act for foreign-owned enterprises or which the branch was entitled to but had not utilised prior to restructuring.
- After transformation of several branches into a single banking enterprise, headquarters will be subject to corporate income tax. Thus, it is possible to file consolidated tax returns for these branches though not for the branches of other group companies.

Considerations regarding design strategies

At a first glance, the possibility of adjusting the book values seems to be quite generous and appealing. However, it needs to be taken into account that the situation for foreign-owned enterprises in China will significantly change for the worse in the course the recent tax reform. The differentiation between foreign and domestically owned enterprises was lifted. Tax benefits for investments in special economic zones and, in particular, the ‘tax holidays’ for the first profitable years after overcoming losses due to teething troubles and the following two years (50% of the applicable tax rate) ceased to exist. A uniform corporate income tax rate of 25% applies to both domestically and foreign-owned enterprises. As regards ‘protection of confidence’, the new Corporate Income Tax Act provides for a five-year transition period. During these five years, the special tax benefits for foreign-owned enterprises still apply. Due to the fact that branches of foreign banks were typically established in special economic zones, they did not pay the nominal tax rate of 33% but benefited from reduced special rates with reductions of the rate to as little as 15%. However, those benefits will disappear once the branches are transferred to or restructured into Chinese banking enterprises as this newly established banking enterprise is only subject to the new tax law uniformly applicable to both domestically and foreign-owned enterprises. Hence, it may be advisable to exploit the possibility of disclosing all unrealised appreciation subject to the lower tax rate prior to restructuring in order to generate additional ‘post step-up’ amortisation and depreciation potential for the banking

enterprise then subject to the higher uniform tax rate as far as amortisable and depreciable assets are concerned.

VII. ECONOMIC POLICY AND FOREIGN INVESTMENT IN CHINA

Bubble in the Chinese Real-Estate Market

A booming construction industry and increasing apartment prices on the one hand and slow property sales on the other hand, have led to a bubble in the Chinese real-estate market. Attempts by the Chinese government to cool down the property market have not yet been successful.

As many as 10% of the houses and apartments built in Shanghai in 2006 have not yet been rented or sold. Despite all these signs of a weakening market, building activities are continuing and more apartments and houses than needed are built. It is arguable if the demand will outrun the supply eventually.

For three years now the government has been trying to cool down the property market by taking counter-measures such as for example raising the interest rate several times or imposing restrictions on foreign investors. Rents, however, are still continuing to rise and last year were about 6.4% higher than in 2006. Despite the growing number of available apartments and houses, there is no sufficient housing space regular employees can afford. About EUR 500 000 million was invested in property from January to May 2007, of which only 4% was invested in modestly priced property. The government is planning to restrict the uncontrolled construction of large housing space in order to give the general public a chance to buy and own property. Therefore, 70% of newly built apartments will be restricted to a maximum size of 90m² in future.

In spite of the counter-measures by the government, major events like the 2008 Olympic Games or the 2010 Expo in Shanghai will further intensify this situation. The most expensive office buildings are being built in Shanghai at the moment with rents of above EUR 70 per m², compared to EUR 50 in New York and EUR 40 in Frankfurt.

Because of the country’s continuous economic growth, investors regard China as an attractive market for investment and property funds from all over the world are interested in China. Therefore, it is assumed that China will become one of the leading markets worldwide in the next couple of years beside the US, Japan, the UK and Germany. However, one has to consider that there might be setbacks when investing in the Chinese real-estate market. The fast development of the property market and the ambition to earn money quickly with the booming construction industry, has quite often led to a neglect of quality, for example.

Sector Report: Retail

The importance of China’s retail market as a strategic destination has increased rapidly and continues to do so. A gradually liberalised environment and the influx of foreign retailers have contributed greatly to the modernisation

of the industry. Domestic champions such as Brilliance Group and Dalian Dashang burst onto the scene at the same time as leading international retailers such as Carrefour, Wal-Mart and B&Q arrived, benefiting from the gradual opening of the sector to foreign investment from 1992. The total opening of the sector came at the end of 2004, in line with China's pledge to the World Trade Organisation (WTO) to do so after a three-year transition. Since then, geographical restrictions and limits on ownership of retail operations have been lifted for foreign investors. China is now the seventh largest consumer market in the world. The Ministry of Commerce believes that retail sales will continue to rise and the sector will consolidate. This is not just true for coastal cities, but also for the inland provinces and urban areas, and will also be true for the countryside in due course. While domestic giants dominate the league table of the top chain stores, international retailers such as Carrefour and Metro are expanding. Other new arrivals have resorted to acquisition to enlarge their stakes (Wal-Mart, B&Q) or to seek fast entry into the market (Tesco and Best Buy). No one retailer, however, has secured a dominant presence, or a nationwide brand name or position. This in itself is one of the main driving factors for domestic and international retailers to exploit the potentials in the market.

Key themes

- **Stronger second wave of foreign arrivals**

Sales by foreign retail and food chains account at the moment for just 3% of retail sales. But since 2004 the number of foreign retailers has grown significantly. The wholly foreign-owned enterprise (WFOE) has replaced the joint venture (JV) as the main entry vehicle. Some two-thirds of new companies approved by Mofcom in 2005 were WFOEs. Tesco is a leading example of the second-wave arrivals. The company broke into the Chinese market by acquiring a 50% stake in the Tingxin Holding Corp's Hymall chain stores, worth GBP 140 million (approximately EUR 175 million) in 2004. This was followed by the acquisition of a further 40%, at a cost of GBP 180 million (EUR 225 million). Tesco Hymall has 44 hypermarkets. Tesco opened its first own-brand store in Beijing in January 2007. Half of the top 50 international retailers have set up a presence in China. More mid-market retailers, such as fashion brand Zara, may well also expand fast to take their share of the pie.

- **Surge In M&A**

Whilst most businesses in the retail sector grow organically, in recent years growing by merger and acquisition is proving to be a popular option. In 2005 alone some 10 acquisitions involving the top 10 domestic retailers were carried out. Foreign retailers are also following the trend to snap up competitors or smaller chains. Examples are B&Q's acquisition of OBI, as well as Wal-Mart's effort to acquire Trust-Mart. The upshot of this trend is that the sector will be concentrated in the hands of fewer players. Compared to organic growth, M&As give retailers the advantage

of breaking into relatively competitive and saturated primary markets, snapping up prime locations, and tapping into local supply chains in secondary markets in a quicker and less costly way. However, there are risks associated with such a strategy, ranging from possible overvaluation of assets to unrealistic expectations of market potential. Another potential issue is how the merged companies integrate and to what extent genuine synergies can be realised. Some retailers are choosing a 'dual brand' approach, to get the best of both.

- **Competition in the FMCG sector**

As for the fast-moving consumer goods (FMCG) segment of the market, hypermarkets and supermarkets have enjoyed the most growth and innovation so far, owing to their concentrated development along the eastern coastal cities, especially by foreign brands. Facing up to this intense competition, retailers have started to use a combination of formats (hypermarkets, supermarkets, convenience shops, discount stores) to penetrate further into first-tier cities. Given their strategic importance (and despite the growing saturation of hypermarkets in the first-tier cities) retailers are still aggressively tapping the great potential in retail sales and profit in locations closer to the denser residential areas. Chinese consumers tend to shop more than once during the week and prefer fresh produce for daily cooking. Given the low rate of private car ownership, public transport and bicycles are widely used for shopping for food, and thus hypermarkets have a much smaller catchment area than those in the West. Companies such as Carrefour have exploited locations where supermarkets (3000m²-5000m² in size) are built by opening neighbourhood convenience shops to capture consumers' 'top-up' shopping. The multiformat strategy provides a clear competitive advantage for retailers in capturing consumers, and further consolidating their market share.

- **Go west**

With effect from 11 December 2004, international and domestic retailers were put on a level footing when the retail sector became totally open. Since then, retailers' expansion further inland has been gaining momentum. However, it has not all been smooth sailing. Retailers have found difficulties coping with segmented regional markets, less-developed infrastructure and inefficient supply systems. Consumer behaviour in China also displays great regional variations, and there is a less affluent population with lower spending power. The Chinese government's campaign to develop the interior under its 'go west' policy has seen huge funding pumped into the region to build road links, railways and other infrastructure. However, it will take time for these efforts to meet the growing demand. Any strategy for growth that might be adopted by retailers, be it organic growth, merger and acquisition, or franchising, will meet the obstacles of underdeveloped infrastructure, varied regional customs and regulatory frameworks, and comparatively underdeveloped retail trade in these regions.

