Doing Business in China 2008

November 2008

BDO International

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Introduction

The aim of this publication, which has been prepared for the exclusive use of BDO Member Firms and their clients and prospective clients is to provide background information for setting up and running a business in China, in compliance with the legislation in force on 2 June 2008. It is of use to anyone who is thinking of establishing a business in China in whatever forms are open to foreign investors, and to anyone who is considering coming to work in China.

This publication describes the business environment in the People's Republic of China ('China') and outlines the financial and legal implications of running, or working for, a Chinese business. The most important issues are included, but it is not feasible to discuss every subject in detail within this format. Accordingly, *Doing Business in China* 2008 is written in general terms and is not intended to be comprehensive. If you would like to know more, please contact the BDO Member Firms with which you normally deal, who can provide you with information on any further issues and on the impact of any legislation subsequent to 2 June 2008.

BDO International is a world wide network of public accounting firms, called BDO Member Firms, serving international clients. Each BDO Member Firm is an independent legal entity in its own country. The network is coordinated by BDO Global Coordination BV, incorporated in the Netherlands, with its statutory seat in Eindhoven (trade register registration number 33205251) and with an office at Boulevard de la Woluwe 60, 1200 Brussels, Belgium, where the International Executive Office is located.

Founded in Europe in 1963, it has grown to be the fifth largest in the world – the BDO network now has 629 offices in 111 countries, with more than 31,500 partners and staff providing professional auditing, accounting, tax and consulting services on every continent.

BDO's special skills lie in applying its local knowledge, experience and understanding of the international context to provide an integrated global service. In BDO, common operating and quality control procedures are not a constraint on innovation and independence of thought, but the starting point. It is a vigorous organisation committed to total client service.

BDO's reputation derives from consistently offering imaginative and objective advice within the client's time constraints. BDO Member Firms take pride in their clients' success and their relationships with them. It is a personal relationship that combines the benefits of professional knowledge, integrity and an entrepreneurial approach, with an understanding of a client's business and an ability to communicate effectively. This ensures the highest-quality objective professional service, tailored to meet the individual needs of every client, whether they be governments, multinational companies, national or local businesses, or private individuals.

Doing Business in China 2008 has been written jointly by the five BDO Member Firms in China. Their contact details may be found on page 29 of this publication.

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1. The business environment

General information

Geography

The People's Republic of China, called China for the purposes of this booklet, is situated in the eastern part of Asia, on the west coast of the Pacific Ocean. China has a total land area of 9.6 million km^2, in land area smaller only than Russia and Canada. From north to south, it measures some 5500 km, stretching from the central line of the Heilong River north of the town of Mohe to the Zengmu Reef at the southern-most tip of the Nansha Islands. From west to east, the territory of China extends about 5200 km from the Palmers to the confluence of the Heilong and Wusuli rivers.

China's land border is 22 800 km long. The nation is bordered by North Korea in the east; Mongolia in the north; Russia in the north-east; by Kazakhstan, Kyrgyzstan and Tadzhikistan in the north-west; by Afghanistan, Pakistan, India, Nepal and Bhutan in the west and southwest; and by Burma (Myanmar), Laos and Vietnam in the south. Across the seas to the east and south-east are the Republic of Korea (South Korea), Japan, the Philippines, Brunei, Malaysia, and Indonesia.

The Chinese mainland is flanked by the Bohai, the Huanghai (Yellow Sea), and the East China and South China seas. The territorial waters of China extend 12 nautical miles out from the base line drawn where China's land territories and interior waters border the sea. More than 5000 islands are scattered over China's vast territorial seas.

China is the most populous country in the world, with a population of approximately 1300 million.

The capital city of China is Beijing (pop:16.33 million). Other main cities are Chongqing (28.16 million), Shanghai (18.58 million), Tianjin (11.15 million), Guangzhou (10.04 million) and Shenzhen (14 million). All population figures are estimates.

Government

The highest authority under the law in China belongs to the legislative body, the National People's Congress. Its members are elected by municipal, regional and provincial people's congresses to serve five-year terms. The National People's Congress elects the Chairman, who is Head of State. Currently, the Chairman is Mr Hu Jintao. Executive power is exercised by the State Council, presided over by the Prime Minister (currently Mr Wen Jiabao).

The Communist Party of China is the sole ruling party of the People's Republic of China.

According to the Chinese Constitution, administrative divisions fall into three basic categories:

- provinces (include autonomous regions and municipalities under the jurisdiction of the Central Government)
- counties (include autonomous counties and cities)
- townships – the grassroots administrative units in the country.

People of the ethnic minorities live in communities in the autonomous regions and autonomous prefectures or counties, which are inseparable parts of China. Special administrative areas may also be established in areas where the government deems necessary. The government may also make some adjustments or changes in the boundaries of autonomous administrative areas whenever the need arises for upgrading administrative work or for economic development purposes. The government may also make such boundary adjustments or changes with a view to enhancing the unity of various ethnic groups.

There are now 32 (including Taiwan) provincial-level administrative areas, including 23 provinces, five autonomous regions and four municipalities. The seats of government of the administrative areas are called provincial or regional capitals. The seat of the Central Government is in Beijing, the capital of the People's Republic of China.

Hong Kong, which had been a British colony, was returned to China on 1 July 1997 with the status of a Special Administrative Region, as was the former Portuguese colony of Macau on 20 December 1999. Both Hong Kong and Macau have business regulatory and taxation laws separate from those of China. For investment and taxation purposes, companies incorporated in Hong Kong and Macau are regarded as foreign companies. This publication does not cover the business or taxation system in Hong Kong or in Macau, or indeed in Taiwan.

Language

Putonghua (Mandarin) is the official language, but there are many dialects such as Shanghainese, Cantonese or Fukienese etc. After Chinese, English is the second most widely taught and spoken language, especially among younger people.

Currency

The official currency is the *renminbi* (RMB), which is convertible only in Hong Kong (within limits) and is not freely convertible in other international exchange markets. At the time of going to press (November 2008), the official exchange rate of the *renminbi* against the euro was EUR 1 = RMB 8.7254 and against the US dollar was USD 1 = RMB 6.8250.

Measures and time zones

The metric system of measurement is used. Temperatures are recorded in degrees Celsius.

Business entities

Forms of business organisation for foreign investors

Foreign direct investment in China is generally in the following forms (which are collectively referred to as 'foreign-investment enterprises'):

- Sino-foreign equity joint ventures
- Sino-foreign cooperative joint ventures
- Wholly foreign-owned enterprises.

Sino-foreign equity joint venture

Sino-foreign equity joint-venture enterprises are enterprises established in China with joint investment from foreign companies, enterprises and other economic organisations or individuals as well as from Chinese companies, enterprises or other economic organisations. Parties participating in this kind of joint venture are jointly responsible for operations, risks and profits and losses proportionate to the amount of capital they have invested.

Generally, the ratio of investment offered by the foreign party should not be lower than 25%. The profit-sharing ratio between the parties is the same as their equity-contribution ratio to the enterprise. The corporate form of the Sino-foreign joint venture is the limited-liability company, with a board of directors as its supreme decision-making body.

Sino-foreign cooperative joint venture

Cooperative joint ventures are also known as contractual joint ventures. These are enterprises established in China with investment jointly offered by foreign and Chinese parties. They differ from Sino-foreign equity joint ventures in that profits are not shared in accordance with the ratio of the capital investment of the parties to the enterprise. The rights and obligations of all parties participating in the cooperative venture, including the profit-sharing ratio, are all defined in the joint-venture contract.

Wholly foreign-owned enterprise

This kind of enterprise is wholly owned by foreign investors. The major advantage of a wholly foreign-owned enterprise is that the foreign investor has full autonomy over the operations of the enterprise and enjoys the economic result in its entirety. Wholly foreign-owned enterprises are still not allowed in some business sectors, but these sectors are diminishing as China continues to open up industries to foreigners under its commitment for accession to the WTO. For example, starting from 11 December 2004, foreign investors were allowed to establish wholly foreign-owned enterprises to engage in distribution business.

Investment companies

An investment company is a special type of foreign-investment enterprise. Essentially, it is a Chinese holding company established by foreign investors to hold the equity interests in foreign-investment enterprises. There are stringent eligibility requirements regarding the level of the group's global asset base and committed scale of investment into China. The scope of business is restricted to approved activities. These activities mostly relate to trading of goods manufactured by its subsidiary companies and the rendering of management and certain business-support functions to group companies in China.

There are also other forms of business operations in China for foreign investors, examples of which are set out below.

Contract-processing arrangement

Under a contract-processing arrangement, a foreign party contracts with a Chinese processing factory to produce goods on its behalf, with the latter earning a processing fee. The foreign party will generally supply the raw materials, production equipment, technology and supervision. All goods, including raw materials, work in progress and finished goods, belong to the foreign party. Upon completion of manufacturing, the finished goods are exported out of China to the foreign party.

Representative office

A representative office can be set up by a foreign company to perform auxiliary and preparatory activities, such as market surveys, liaison and coordination. Generally a representative office is not permitted to carry out direct business activities (there are exceptions for particular industries).

Branches

A branch is regarded as an establishment of a foreign enterprise and not as a separate legal entity. Foreign companies may set up Chinese branches of foreign companies permitted in a very small number of industries only, prime examples of which are banking and insurance.

Labour relations and working conditions

Employment law and local regulations

Implemented on 5 July 1994, the PRC Labour Law applies nationwide and regulates employer-employee relationships and employees' basic rights. Article 106 of the Labour Law, however, delegates to provincial local governments the authority to issue detailed implementation rulings.

On 29 June 2007, the Chinese government passed the new Labour Contract Law (LCL), which has been implemented since 1 January 2008. The LCL emphasises the legal protection of the employees' rights and combat potential exploitation amid China's whirlwind economic development. Albeit introducing more stringent regulation, the LCL offers more comprehensive guidance on the employment relationship, which previously tends to be quite ambiguous and subjective to local jurisdiction.

Employment control

An enterprise and an individual should enter into a written employment contract within one month after the date on which the employee commences work**.** The contract may be of a collective nature or on an individual basis. It should contain the following clauses:

- term of employment contract
- details of work
- labour protection and working conditions
- remuneration
- working time and annual leave
- social insurance

Term of employment contract

The term of an employment contract can be fixed or flexible or by reference to the completion of a specific amount of work. An employer may stipulate only one probation period with any given employee. The longest probation period may not exceed six months.

Working hours

The state practises a working-hour system under which workers work for no more than eight hours a day and no more than 44 hours a week on average. However, if the situation requires, and with the employee's consent, the employer may extend the working period by three hours per day up to a maximum of a further 36 hours per month.

Statutory public holidays

Statutory public holidays include:

- New Year's Day (1 January)
- Spring Festival (Chinese New Year)
- Ching Ming Festival (5 April)
- International Labour Day (1 May)
- The Dragon Boat Festival (8 June)
- Mid-Autumn Festival (14 September)
- National Day (1 October)

Working conditions and employment protection

Enterprises are required by law to ensure that working conditions comply with the state's safety and sanitary standards. Special provisions are made in the Labour Law to protect female workers and junior workers (aged 16-18 years). For example, the minimum maternity leave is 90 days and enterprises are not allowed to employ young people under the age of 16. Non-compliance will incur penalties and, in serious cases, lead to the revocation of the employer's business licence.

Wages

Wages paid to workers must not be less than the local minimum standard wage. This varies depending on the area. It is determined by the provinces, autonomous regions and municipal People's Government and is reported to the State Council for record-keeping purposes.

Trade unions

All workers have the right to join or organise a trade union that represents and protects the legal rights and interests of workers and carries out its activities independently. An enterprise, including a foreign-investment enterprise, is required to contribute 2% of its employees' total wages to the relevant trade union.

Employment of local workers

A representative office is prohibited from employing local workers directly. Instead, it must employ local staff through an authorised employment agency such as the Foreign Enterprise Service Corporation (FESCO). Legally, the employer-employee relationship is one between FESCO and the individual and FESCO provides the services to the representative office.

Foreign-investment enterprises, on the other hand, are allowed to employ local staff directly.

Work permits for expatriate employees

A work permit is required for a foreign national intending to take up employment in China. Foreigners have to apply for a visa at a Chinese consulate before entering China. On entering China, all foreigners must register with the local registration office at their place of residence, and obtain a work permit. After that, a residence permit should be obtained from the relevant authorities.

Legal system

The People's Republic of China has established a formal legal system since its proclamation in 1949. There are four levels of people's courts: local, intermediate, high and the Supreme Court. There are also courts for maritime and military issues.

2. Finance and investment

The economy in general

Since the foundation of the People's Republic of China in 1949, China has made great achievements in the fields of economic and social development. It has witnessed tremendous changes especially after adopting a policy of openness in early 1979 and organising its workforce and production facilities on more competitive, market-oriented lines.

Trade and cooperation between China and the rest of the world has also improved and foreign-funded enterprises are playing a greater rôle in the country's export trade. China is becoming more integrated into the world economy and foreign-exchange reserves have increased with the rapid growth of trade.

Foreign investment in China has come from Hong Kong and Taiwan, the United States, Japan, South East Asia and Europe. In recent years, a series of significant reforms have been implemented in the fiscal system, in banking, investment, foreign exchange, foreign trade, etc. The 'Catalogue for the Guidance of Foreign Investment Industries' was issued, which lists newly expanded industries open to foreign investment and the kind of projects to be encouraged. A number of industries have been given top priority in future economic development, namely, infrastructure projects such as transportation, telecommunications, energy and environmental protection and key industries such as machinery, electronics, petrochemicals, and automobiles. The Chinese government will grant financial, legislative and administrative support to these industries and foreign investment in them is encouraged.

With insufficient capital and an under-developed market mechanism, China is still fighting to get rid of the typical low value-added economic structure in its intended move to a developed economy.

Problems that remain to be tackled include:

- the weak position of its agricultural sector
- inefficient large state-owned enterprises
- problems resulting from uneven development on the east coast and the western interior.

The Chinese government is making every effort to find solutions to these problems.

On 11 December 2001, China became a member of the World Trade Organisation (WTO). China has been significantly reducing its tariff rates for a vast number of products and rapidly opening up various business sectors to foreign investment in recent years.

Regulation of business

The establishment of a foreign-investment enterprise is subject to examination and approval by the Ministry of Commerce of the People's Republic of China. The establishment of a foreign-investment enterprise should be in accordance with the Regulations on Foreign Investment Guidelines and the Catalogue for the Guidance of Foreign Investment Industries. There are also some trades that may only be carried out after a special licence has been granted.

The banking system

Banking and financial institutions

At present, Chinese financial institutions consist of banking and non-banking financial institutions.

Banking institutions include commercial banks and policy banks. The Bank of China, the Industrial and Commercial Bank of China, the Agricultural Bank of China and the China Construction Bank are the major commercial banks in China. There are also local commercial banks, banks with foreign investment and branches of foreign banks. At present, there are three policy banks in China, namely, the National Development Bank of China, the Import & Export Bank of China and the Agricultural Development Bank of China. These are state-owned institutions.

Non-banking financial institutions

Non-banking financial institutions include insurance companies and security companies.

Insurance

The China Insurance Regulatory Committee is in charge of all supervision of insurance companies in China.

China's insurance industry is gradually becoming more open. As part of its WTO accession commitment, China is loosening restrictions on foreign insurance companies regarding geographic limitations, scope of business, prudence criteria and scale of investment.

Securities

The China Securities Regulatory Committee plays the rôle of the regulating body of the securities industry.

Stock exchanges have been established in Shanghai and Shenzhen.

Shares in the Chinese stock exchanges are in the form of "A" shares and "B" shares. "A" shares are only issued to and traded by Chinese nationals in *renminbi*. "B" shares, while denominated in *renminbi*, are traded in foreign currency. Foreigners as well as Chinese nationals possessing foreign currency are allowed to trade "B" shares. Starting from 2003, under the Qualified Foreign Institution Investor (QFII) Scheme, foreigners can gain access to "A" shares through a QFII.

Accounting and audit requirements

Accounting requirements

The governing body of the accounting profession is the Chinese Institute of Certified Public Accountants (*Zhong Guo Zhu Ce Kuai Ji Shi Xie Hui*), which is controlled and administered by the Ministry of Finance. Enterprises with foreign investment must comply with PRC accounting law and regulations. These accounting regulations are generally close to internationally recognised accounting standards, although differences exist. Audits are required for enterprises with foreign investment.

In December 2001, China officially became a member of the World Trade Organisation (WTO). China has been working towards this goal since the 1980s through the development of its economic, financial, social and political sectors, and in recent years China has played a significant rôle in the global economy. It has also sped up the pace of reform of its accounting systems in order to meet the needs of potential investors, creditors and the public for more transparent and reliable accounting information.

The legal system of accounting

Chinese accounting standards were formulated by the Ministry of Finance. The China Accounting Standards Commission acts as a consulting organisation, and has limited responsibilities during the formulation process of the standards.

A foreign-investment enterprise (FIE) must observe a number of important regulations. These mainly include the PRC Accounting Law, Company Law and the Accounting Standards for Business Enterprises. These accounting regulations are generally close to internationally recognised accounting standards, although there are differences.

Audits are required for enterprises with foreign investment.

Accounting requirements

Up to now, the Ministry of Finance has issued 38 accounting standards applicable to various industries and sectors. The launch of the Accounting System for Insurance Companies in 2006 and the Accounting System for Securities Companies in 2006 has attracted much attention from public and foreign investors.

In the past few years, the Chinese authorities have eliminated, as far as possible, the gap between PRC accounting standards and International Financial Reporting Standards (IFRS). The following is a profile of the basic requirements.

Accounting books and records

Books and records must be maintained in accordance with the relevant regulations, FIEs must, in general, retain their accounting records for at least 10 years.

Reporting currency

The *renminbi* is the base currency for ledgers and financial reports. For enterprises using currencies other than *renminbi* in their business transactions, one of these foreign currencies can be used as the bookkeeping base currency. However, the financial reports are required to be shown in *renminbi*, i.e. translated from the foreign currency.

Language

Accounting records must be maintained in Chinese. Ethnic minorities may use their dialects or languages whilst FIEs may choose to use Chinese alone or a combination of Chinese and a foreign language.

Accounting period

The accounting period in China is stipulated to be from 1 January to 31 December.

Accounting offices and personnel

The PRC Accounting Law incorporates some provisions in relation to the appointment of accounting personnel, their responsibilities and qualifications. Businesses should set up their accounting office and designate an accountant-in-charge according to their accounting needs. Small companies may entrust a qualified agent (for example, a public accounting firm) with their accounts. A cashier may not be in charge of auditing, keeping accounting records or keeping the revenue, expenses or claims and liability accounts at the same time.

Accounting software

FIEs in China may purchase an off-the-shelf accounting package or develop a tailor-made one. The financial reports generated by the accounting software must meet the requirements of the finance bureau in China.

Financial statements

An FIE should prepare a balance sheet, statement of income and profit appropriation and statement of cash flow and submit these (on a quarterly and annual basis) to the finance and tax offices.

A balance sheet is an accounting statement that reflects the financial position of an enterprise at a specific date. Items on the balance sheet should be grouped according to the categories of assets, liabilities and owners' equity, and must be shown item by item.

A statement of income and profit appropriation is an accounting statement that reflects the operating results of an enterprise within an accounting period, as well as their distribution. Items of the income statement should be arranged according to the derivation and distribution of profit, and must be enumerated separately. Items regarding profit appropriation may be shown separately in a statement of profit appropriation.

A statement of cash flow reflects the sources and applications of cash flows in operating activities, financing activities and investing activities. The direct method of preparing the cash flow statement is required in China. A reconciliation between the net profit and operating cash flow must also be disclosed in that statement. Where there are major non-cash transactions, a supplementary note is needed.

Financial statements should include comparative financial information for the corresponding previous accounting period. If the classification and contents of statement items of the previous accounting period are different from those of the current period, such items should be adjusted to conform to those of the current period.

Consolidated financial statements must be prepared by an enterprise (the parent company) that owns 50% or more of the total capital of the enterprise in which it has invested (the subsidiary) or over which it has the right of control.

Notes to the financial statements include:

- the accounting methods adopted for the current and previous accounting periods
- changes in accounting treatments between the current and prior periods, including the reasons for these, and their impact on the financial performance and status of the enterprise
- a description of unusual items
- detailed information relating to major items listed in the accounting statements
- any other explanations necessary to provide users with a clear view and understanding of the financial statements

Statutory audit

An FIE is required to engage a Chinese public accounting firm to undertake an annual statutory audit of its financial statements in accordance with Chinese auditing standards. The annual income tax return supported by the auditor's report is due for filing with the tax bureau within five months after the year end.

Representative office

A representative office is in general not allowed to engage in direct business activities and receive business income (there are exceptions for particular industries). The accounting records are much simpler, containing cash and bankbooks, expense and asset accounts. A representative office taxed on an expense basis is nevertheless required to engage a Chinese public accounting firm for an expense audit report for tax reporting purposes.

PRC *accounting standards and* IFRS

Since China began its economic reform 20 years ago, the Chinese government has been pursuing the goal of enhancing its accounting systems. The focus of the qualitative characteristics is in line with the evolution of its market economy, economic reform and the opening-up of its market. It is to be hoped that, following accession to the WTO and with more effort from the accounting profession, China will be able to formulate a set of complete accounting standards within the next few years. These should correspond closely to the IFRS and, at the same time, reflect the unique features of China's economic and social environments.

On 15 February 2006, the China Ministry of Finance (the “MoF”) formally issued the Accounting Standards for Business Enterprises (“ASBEs”) which consist of a new Basic Standard and 38 Specific ASBEs. The ASBEs cover nearly all of the topics under the current International Financial Reporting Standards (IFRS) literature and became mandatory for listed Chinese enterprises from 1 January 2007. Other Chinese enterprises are also encouraged to apply the ASBEs. These standards are substantially in line with IFRS, except for certain modifications that reflect China’s unique circumstances and environment.

Exchange controls

China's foreign exchange receipts and payments come under the foreign-currency current account and foreign-currency capital account. The current account covers trade items, labour-service receipts and other payments that are not capital in nature. Foreign-currency remittance in respect of certain specified transactions under the current account requires the approval of the State Administration of Foreign Exchange (SAFE). Remittance for transactions not so specified, such as purchases of trade goods in the ordinary course of business transactions, does not require the approval of SAFE. Designated banks can process the remittance upon the examination of satisfactory supporting documentation. The capital account covers foreign-exchange receipts and payments in respect of direct investment, loans of all kinds, securities investments, etc. Strict SAFE control is exercised over foreign-currency remittances in respect of transactions under the capital account.

Foreign-currency exchange control

Foreign-currency exchange is monitored by the State Administration of Foreign Exchange and the People's Bank of China. For enterprises and individuals, revenue and expenses in foreign currencies have to be deposited with, or withdrawn from, their accounts with the Bank of China or other authorised banks. After-tax profits of foreign-investment enterprises or after-tax income of foreign individuals can be remitted outside China.

Authority responsible for foreign investment

The government authority directly concerned with foreign direct investment is the Ministry of Commerce (MOC) and its local counterparts. MOC is responsible for the formulation of policies and regulations governing foreign investment. The *Catalogue for the Guidance of Foreign Investment Industries* promoted jointly by MOC and the National Development and Reform Commission is essential reading. Investors will need to find out whether their intended project is classified under an 'encouraged', 'restricted' or 'prohibited' industry by the Chinese Government.

Import and export controls

As part of its WTO commitments, China is gradually removing all non-tariff measures (such as quotas, licences and special tenders) for many import items. Some items have already been freed from quota management and licensing control since 2002. In addition, China has lowered its import duties of a large number of goods in recent years.

Social insurance

Social insurance is a mandatory, non-profit social security system established by law in China. It is administered by the labour and social security departments. There are five types of social insurance in China: old-age, medical, unemployment, work-related injury and maternity. Among these, the premiums for old-age, medical and unemployment insurance are jointly contributed by the enterprise and the individual, whereas work-related injury and maternity

insurance premiums are the sole responsibility of the enterprise. All enterprises must register with the local social insurance institution, participate in social insurance schemes and pay social insurance premiums on a monthly basis.

Patents and trade marks

Applications for trademark registration are handled in accordance with China's Trademark Law and the Implementation Regulations of the Trademark Law.

Patent applications are subject to examination and approval in China in accordance with its Patent Law and the Implementation Regulations of the Patent Law. For invention patents, early announcement of the application can be made upon request. Foreign-investment enterprises applying for patents may either submit their applications directly or appoint designated patent agents.

Environmental protection

The construction of industrial and commercial buildings is subject to prior authorisation to safeguard public health and safety. Authorisation is also required to drain effluent water and for the disposal or transportation of waste.

3. The tax system

The tax structure

Taxes are levied by the state and local governments in China. There are 23 taxes in China under the current tax system and 15 of them are applicable to enterprises with foreign investment, foreign enterprises and foreigners. The most important taxes are corporate income tax, value-added tax and business tax. The other taxes are consumption tax, customs duty, individual income tax, stamp duty, resource tax, land appreciation tax, vehicle acquisition tax, urban real estate tax, vessel tonnage tax, deed tax, slaughter tax and vehicle and vessel usage licence plate tax.

Administration

China currently maintains two separate tax collection and administration bodies, namely the State Tax Bureau and Local Tax Bureau, responsible for the collection and administration of taxes. The main taxes for which state tax bureaux in various localities are responsible include corporate income tax and value-added tax; while business tax and individual income tax are among the taxes collected by the local tax bureaux. The State Administration of Taxation in Beijing oversees tax collection and administration matters nationwide.

4. Taxes on business

Taxation of representative offices

The China State Administration of Taxation (SAT) issued a circular in March 2003 to tighten the tax administration of representative offices (ROs) in China. The circular, *Guoshuifa* (2003) No.28, took effect on 1 July 2003.

The circular provides guidelines for ROs engaging in consultancy services, such as general business consultancy, legal, taxation, accounting and auditing etc. The circular also clarifies the taxation basis for ROs and their head offices engaging in taxable activities in the PRC.

According to tax circular *Guoshuifa* [1996] No. 165, SAT uses three methods for determining the taxes payable by ROs. The most common method is the 'cost-plus method' where the Chinese-source gross income of a RO is computed based on its operating expenses.

In general, ROs may not operate for profit and can only conduct ancillary and coordinating activities for their head offices. Accordingly, most ROs are cost centres and do not derive income.

Pursuant to the March 2003 circular the cost-plus method no longer applies to ROs that engage in business consultancy, legal, taxation, accounting and auditing services. Instead, these ROs are required to keep proper books and accounts, and to compute the relevant taxable income for tax filing purposes.

ROs representing foreign companies that engage in trading (including direct trading or trading as an agent), advertising, and travel agency services should pay tax based on the cost-plus method (i.e. pay taxes on deemed income calculated based on operating expenses).

ROs that engage in taxable activities in the PRC, such as ROs of banks, financial institutions, transport companies etc, should pay tax based on their actual income derived in China, which includes income received by the head offices.

Under *Guoshuifa* [1996] No.165, some ROs such as those set up by foreign government agencies, international organisations, non-profit making institutions and community groups are still eligible for exemption from tax. Exemption applications should be submitted to the tax authorities for approval, with supporting documentation issued by the authorities in their countries of origin confirming the nature of their operations. The PRC tax authorities will verify the status of these ROs and grant tax exemptions where appropriate.

Corporate income tax

The National People's Congress of China passed the New Enterprise Income Tax Law ("EIT") on 16 March 2007. The New EIT Law and its detailed implementation rules came into effect on 1 January 2008.

The New EIT Law replaced the old Foreign Enterprise Income Tax Law, which is applicable to foreign-investment enterprises and foreign enterprises, and the old Enterprise Income Tax Law, which is applicable to domestic Chinese enterprises. From 1 January 2008, all enterprises in China, whether foreign or domestically owned, are on a level playing field and governed by the New EIT Law and its detailed implementation rules.

Under the New EIT Law, the concept of 'resident enterprise' has been introduced. Resident enterprises are enterprises established under PRC laws and regulations or enterprises established under foreign laws and regulations but whose effective management is based in China. Non-resident enterprises are enterprises (established under foreign laws) which do not have a place of effective management in China but have an establishment/place of business in China, or those that do not have an establishment/place of business in China but derive income from China.

A resident enterprise is subject to tax on its worldwide income. A non-resident enterprise is subject to tax on income derived from its establishment or place of business in China and income earned outside China that is effectively connected with its establishment or place of business in China. Non-resident enterprises without an establishment or place of business in China or which have an establishment or place of business but whose relevant income is not effectively connected with the establishment or place of business in China, are subject to withholding tax on dividends, interest, rentals, royalties, capital gains or other income derived from sources in China.

Taxable profits are computed in accordance with the New EIT Law and relevant regulations regarding revenue recognition and expense deduction. That is, the calculation of taxable profit is based on the profit figure in the financial statements, adjusted for non-deductible and non-taxable items. Major adjustments include depreciation, amortisation, capitalised interest, excess entertainment expenses, interest and penalties on late or unpaid taxes, expenses not related to operations etc.

The standard tax rate under the New EIT Law is 25%. A reduced tax rate of 20% is available to small-scale enterprises deriving small profits. Recognized Hi-Tech enterprises that are encouraged by the country enjoy a reduced tax rate of 15%.

Tax incentives

The tax incentives under the New EIT Law are technology and industry-focused, and these tax incentives apply across the nation rather than being location-oriented. The tax holiday incentives for manufacturing and exporting FIEs (i.e. the 2-year exemption and 3-year at half rate tax holiday and extended tax holiday) and many location-based tax rate reductions and dividend reinvestment tax refund are no longer available under the New EIT Law. Broadly, the major tax incentives under the New EIT Law include:

- tax exemption or reduction for enterprises deriving income from:
  - agriculture, animal husbandry, forestry and fishery industries
  - encouraged infrastructure projects;
  - qualifying environmental protection, energy or water-saving projects;
  - qualifying technology transfers.
- a tax-rate reduction to 15% for recognised Hi-Tech enterprises as mentioned above
- venture-capital enterprises making 'encouraged' investments may be eligible to reduce taxable income by an amount equal to a percentage of the investment
- income derived by enterprises engaged in comprehensive utilisation of specified resources to produce stipulated products may be reduced when calculating their taxable income
- a percentage of the investment by an enterprise in purchasing equipment specifically for the purpose of environmental protection, production safety or energy or water saving can be set off against its tax payable
- super-deductions are available for:
  - qualifying R & D expenditure
  - salaries and wages of the disabled and qualified unemployed persons

Withholding Tax Rate (Subject to treaty reduction)

The standard withholding tax rate under the New EIT Law is 20%. However, the withholding tax rate is currently reduced to 10% for Chinese-source dividends, interest, rental, royalties and capital gains derived by non-resident enterprises.

Divdend repatriation from a foreign-investment enterprise to its foreign investor is no longer exempt from withholding tax under the New EIT Law.

Anti-avoidance provisions

In addition to existing transfer pricing rules, the New EIT Law introduces a number of anti-avoidance provisions including:

- controlled foreign company (CFC) rules to include in taxable income of a resident enterprise its share of undistributed profits of a controlled foreign company in a low-tax jurisdiction.
- a general anti-tax avoidance provision that empowers the tax authorities to make adjustments in cases where enterprises implement arrangements that serve no reasonable commercial purpose.
- thin capitalisation rules to limit interest deductions.

Transfer Pricing

The transfer pricing rules provided under the New PRC EIT Law contain several new concepts, including the following:

- an annual related-party transactions report must be filed when the annual EIT return is filed with the tax authority;
- cost allocation for joint R&D cost incurred and the provision of services must be conducted at an arm's length basis;
- any enterprises that have transacted with an enterprise under investigation must provide related information on demand;
- enterprises may enter into advance pricing agreements with the tax authorities;
- in addition to transfer pricing adjustments, interest will also be imposed.

Turnover taxes

From 1 January 1994, China has a turnover tax system, which comprises mainly value-added tax, business tax and consumption tax.

Value-added tax (VAT)

Scope of charge

According to the PRC Provisional Regulations for VAT (the Provisional Regulations), VAT applies to individuals and enterprises on the importation of movable goods into China, the sale of movable goods in China and the provision of processing and repair services in China.

VAT taxpayers can be divided into general taxpayers and small taxpayers.

Small taxpayers

The following taxpayers should be regarded as small taxpayers:

- those engaged in the production of goods or in the provision of taxable services (processing and repair services) as their sole or principal business and whose annual taxable turnover is less than RMB 1 000 000 (EUR 114 600 ; USD 146 525); or
- Those is engaged in wholesaling or retailing of goods and whose annual taxable turnover is less than RMB 1 800 000 (EUR 206 300; USD 263 725).

General taxpayers

Taxpayers with an annual turnover that exceeds the above thresholds are considered as general taxpayers. These taxpayers should register and obtain an approval from the tax authorities for this status.

VAT *rate*

The standard VAT rate for is 17%.

A reduced VAT rate of 13% is applicable to grains, edible plant oil, utilities, publications and certain agricultural products.

The VAT rate applicable to a small taxpayer is 4% or 6%. The 6% rate applies generally to taxpayers engaged in the production of goods or the provision of taxable services, but small taxpayers engaged in the wholesale or retail of goods are subject to the 4% rate.

Calculating VAT payable

For general taxpayers, the VAT payable in respect of any taxable period is simply obtained by deducting input VAT from output VAT.

However, small taxpayers are not permitted to deduct input VAT. Their VAT payable is based on their taxable turnover multiplied by the relevant percentage.

Special VAT invoices

General taxpayers should purchase special VAT invoices from the tax authorities. Small taxpayers and non-VAT taxpayers generally cannot purchase or use such invoices. General taxpayers selling taxable items must issue special VAT invoices to the buyer. However, for the sale of taxable items to consumers and the sale of tax-free goods or goods for export, no special VAT invoices should be issued. It is also not mandatory to issue special VAT invoices for the sale of taxable items to small-scale taxpayers. Special VAT invoices that are not up to specifications may not be used to claim deduction for input VAT.

Export VAT refund – Exemption, Credit and Refund Method for Manufacturing Enterprises

Export goods attract a zero rate of VAT. Taxpayers exporting goods at the zero rate will not incur any tax upon exporting. In addition, they can apply for a tax refund in relation to the purchase or manufacture of the exported goods on which VAT has previously been paid. Manufacturing enterprises that manufacture and export goods are subject to VAT based on the 'Exemption, Credit and Refund method. The *exemption* refers to the exemption of VAT for export of self-manufactured products. The *credit* means the deduction of input VAT on the raw materials, accessories, fuel and power consumed for producing the exported goods against output VAT on domestic sales. The *refund* means that if the input VAT of self-manufactured products is larger than the VAT payable, the difference, subject to a limit, could be refunded.

Export VAT refund rates have been revised several times by the Chinese Government and they currently range from 5% to 17%, depending on the type of the exported goods. The reduction of VAT refund rate means that there is an increase of exports costs and reduction of profit margins.

Business tax

Scope of charge

Any individual or entity that engages in the provision of services (other than processing and repairing), transfers intangible assets or sells immovable properties in China is subject to business tax in accordance with the PRC Provisional Regulations for Business Tax.

Rates

Rates range from 3% to 20% depending on the nature of services or other taxable items.

Table 1: Rates of business tax

Nature of service	Rate of tax
Transportation	3%
Construction and engineering	
Post and telecommunications	
Culture and sports	
Assignment of intangibles	5%
Sale of immovable property	
Financial services	
Entertainment	5%-20%
Bars, clubs, golf clubs, bowling alleys	20%

Consumption tax (excise duty)

Scope of charge

Consumption tax is levied on taxable consumer goods sold in China by enterprises and individuals engaged in the production, subcontracted processing or importation of the following 14 items of goods:

- cigarettes
- alcoholic drinks and alcohol
- cosmetics
- fine jewellery and precious stones
- firecrackers and fireworks
- refined oils
- motor-vehicle tyres
- motorcycles
- small motor cars
- golf balls and golf equipment.
- luxury watches
- yachts
- disposable wooden chopsticks
- solid wood flooring

Taxable items and rates

Consumption tax is payable at rates ranging from 3% to 45%. It is levied by value (*ad valorem* tariff), but for yellow spirits, beer, petrol and diesel, it is levied by volume.

5. Taxes on individuals

Taxation of individuals

Income derived by individuals is subject to individual income tax. There is no gift or inheritance tax.

Individual income tax

The Individual Income Tax (IIT) Law provides that IIT is to be levied on the following income:

- wages and salaries
- income from individual household business
- income from contracting for or leasing the operation of enterprises or institutions
- income from personal services
- income from author's remuneration
- royalties
- interest, dividends and bonuses
- income from the letting of property
- income from the transfer of property
- casual income
- other income specified as taxable by the Ministry of Finance.

Expatriate Tax

Foreign individuals residing in China for less than one year are subject to tax only on Chinese-source income. Remuneration from foreign employers to individuals working in the PRC is exempt from tax if the individual resides in China for less than 90 days (or 183 days if the individual is protected under a double tax treaty or double tax arrangement) in a year, provided the remuneration is not borne by an establishment in China.

Employees of foreign employers can reduce their IIT liability to reflect the actual number of days residing in China if certain criteria are met.

Individuals who are not domiciled in the China but reside in China between one to five years may, with approval, pay tax only on their Chinese-source income and non-Chinese-source income, payment of which is borne by Chinese establishments. Commencing in the sixth year after residing in China for five consecutive full years, their worldwide income will be taxed.

Certain employment benefits to expatriate employees are specifically treated as not being taxable under the relevant China IIT regulations.

Wages and salaries

Generally, all wages and salaries received by an individual are subject to IIT in China. However, a monthly deduction of RMB 2000 (EUR 230; USD 295) (RMB 4800 (EUR 550; USD 700) for foreigners) is allowed in calculating the amount of IIT payable on wage and salaries.

IIT is levied on wages and salaries at progressive rates. Where the IIT is borne by the employee, the following formula can be applied to arrive at the tax payable:

(monthly income – monthly deduction) x applicable tax rate – quick reckoning deduction

The applicable tax rates and quick reckoning deductions are shown in Figure 2 below.

Table 2: Rates of IIT on earnings

	Monthly income (net of monthly deduction)	Tax rate	Quick reckoning deduction
Below	500	5%	0
	500-2000	10%	25
	2000-5000	15%	125
	5000-20 000	20%	375
	20 000-40 000	25%	1375
	40 000-60 000	30%	3375
	60 000-80 000	35%	6375
	80 000-100 000	40%	10 375
Over	100 000	45%	15 375

Employers are obliged to withhold IIT from salary payments and account for the deductions monthly in their IIT return to the relevant tax bureau. The tax bureau has the power to impose penalties and/or late-payment surcharges on the employer and/or the employee in the event of any late payment or underpayment.

Other income

Different rates apply to income other than employment income. The payer of the income is obliged to withhold the relevant tax from payments of taxable income to an individual and file monthly IIT returns with the relevant tax bureau. In the absence of withholding by the payer, the individual concerned must file a tax return.

6. Other taxes

Land appreciation tax (LAT)

Scope of charge

Land appreciation tax is levied on units, enterprises and individuals on income derived from the transfer of land-use rights, buildings and their attached facilities.

Calculation of LAT

LAT is assessed at a prescribed tax rate on the basis of the gain derived by the taxpayer from the transfer of real estate.

The gain is the balance of proceeds received by the taxpayer on the transfer of real estate, after deducting all deductible items.

Deductible items for the transfer of land-use rights include amounts paid for the acquisition of land-use rights, costs and expenses for the development of land, taxes and fees related to the transfer of real estate, and other deductible items as stipulated by the Ministry of Finance.

Deductible items for the transfer of new properties and buildings include amounts paid for the acquisition of land-use rights, costs and expenses for the construction of new buildings, taxes and fees related to the transfer of real estate, and other deductible items as stipulated by the Ministry of Finance.

Deductible items for the transfer of used properties and buildings include the assessed value of the properties and buildings, the land price paid for the acquisition of land-use rights, expenses as stipulated by the state, certain taxes and fees payable on the transfer and other deductible items as stipulated by the Ministry of Finance.

Tax rates

Land appreciation tax is levied at progressive rates at four levels, depending on the extent to which the gain exceeds a certain percentage of the sum of deductible items.

For that part of the gain not exceeding 50% of the sum of deductible items, the tax rate is 30%; for that part of the appreciation amount exceeding 50%, but not exceeding 100%, of the sum of deductible items, the tax rate is 40%; for that part of the appreciation amount exceeding 100%, but not exceeding 200%, of the sum of deductible items, the tax rate is 50%; and for that part of the appreciation amount exceeding 200% of the sum of deductible items, the tax rate is 60%.

Table 4: Rates of land appreciation tax

Extent to which gain exceeds sum of deductible items	Tax rate on that part
≤ 50%	30%
> 50% ≤ 100%	40%
> 100% ≤ 200%	50%
> 200%	60%

Urban real estate tax

Depending on location, real estate owned by foreign-investment enterprises and foreign nationals is taxed at the rate of 1.2% after making a one-off deduction of 10%-30% of the original value of the property, or at the rate of 12% of rental income, depending on the local authority concerned.

Stamp duty

Documents subject to stamp duty in China include contracts or documents in the nature of a contract in regard to purchase and sale transactions, contracted processing, contracted construction projects, property leasing, goods transportation, warehousing, loans, property insurance, technical contracts; documents of transfer of property title; business account books; certificates and licences; and other documents determined by the Ministry of Finance to be taxable. The stamp duty rate ranges from a nominal RMB 5 to 0.1% of the transaction value, payable by each of the parties to the transaction.

Customs duty

Customs duty is levied by the customs authorities on commercial commodities or articles entering or leaving China's national boundaries or customs territories.

Payers of customs duty on commercial commodities are consignees of imports and consignors of exports. The former have to pay import tariffs while the latter have to pay export tariffs. Payers of customs duty on articles include incoming passengers carrying personal luggage and articles, service attendants on different modes of transport carrying personal articles, owners of gifts and personal articles that enter China through other means, and addressees of incoming personal mail.

China adopts a two-column tariff for imports: a general rate and a preferential rate. The general tariff rate applies to goods from countries and regions that have not signed reciprocal tariff agreements with China, while the preferential tariff rate applies to goods from countries and regions that have signed such agreements with China. Specific duties, compound duties and sliding tariffs are levied on a selected number of imported goods.

For exports, customs duty is not divided into general or preferential rates. In addition, only few items are subject to customs duty when they are exported out of China.

The dutiable value of imported goods in general is their CIF price while the dutiable value of exports is their FOB price.

Customs duty incentives

Import processing arrangement

A production foreign-investment enterprise ("production FIE") in the PRC can conduct export sales through an arrangement known as "import processing", which requires regulatory approval and control.

The import processing arrangement offers an advantage in that raw materials imported are exempt from customs duty and import VAT, provided that the goods made from these tax-free imported raw materials are exported. In this regard, the goods (from raw materials to work-in-progress to finished goods) are bonded and there is a strict system of documentary control, such as production contracts and customs log books, etc.

Importation of own-use equipment

Production FIEs can be exempt from customs duty and import VAT for the importation of equipment (including spare parts and related technology) for own-use if all of the following conditions are met:

- the total amount of the imported equipment is within the total investment of the production FIE
- the production FIE is classified as an "encouraged" type of business as defined in the Catalogue for the Guidance of Foreign Investment Industries and
- the imported equipment is not one of the items listed in the "Non-exempted Equipment List"

7. Social security contributions

Social security contributions are payable both by the employer and by the employee. Currently, expatriate employees (other than certain residents of Taiwan, Hong Kong or Macau) working in China are not required to participate in social security programmes in China.

Both rates and the number of funds to which contributions must be paid differ from one local authority to another. For example, in Shanghai the types of contributions and the respective rates are as follows:

Table 3: Social security contribution rates in Shanghai

Type of contribution	Employer's rate	Employee's rate
Pension insurance	22%	8%
Medical insurance	12%	2%
Industrial accident insurance	0.5%	0%
Unemployment insurance	2%	1%
Total	**36.5%**	**11%**

The rates are applied to the monthly salary of an employee, subject to the prescribed upper and lower limits. The current upper and lower limits for Shanghai are 60% and 300% respectively of the average monthly salary in Shanghai in the previous year.

Contributions are withheld by the employer and accounted for to the social security bureau. Late-payment surcharges and penalties may be imposed in the event of late payment or underpayment of social security contributions.

8. BDO China Firms

BDO International is represented in China by five Member Firms, four in Mainland China and one in the Hong Kong Special Administrative Region.

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Double Taxation Agreements

The People's Republic of China has income and capital tax treaties with the following jurisdictions:

Albania	Iceland	Pakistan
Algeria	India	Papua New Guinea
Armenia	Indonesia	Philippines
Australia	Iran	Poland
Austria	Ireland	Portugal
Azerbaijan	Israel	Romania
Bahrain	Italy	Russia
Bangladesh	Jamaica	Serbia
Barbados	Japan	Seychelles
Belarus	Kazakhstan	Singapore
Belgium	Korea (South)	Slovakia[2]
Bosnia Herzegovina[1]	Kuwait	Slovenia
Brazil	Kyrgyzstan	South Africa
Brunei	Laos	Spain
Bulgaria	Latvia	Sri Lanka
Canada	Lithuania	Sudan
Croatia	Luxembourg	Sweden
Cuba	Macau	Switzerland
Cyprus	Macedonia	Thailand
Czech Republic[2]	Malaysia	Trinidad and Tobago
Denmark	Malta	Tunisia
Egypt	Mauritius	Turkey
Estonia	Mexico	Ukraine
Finland	Moldova	United Arab Emirates
France	Mongolia	United Kingdom
Germany	Morocco	United States
Georgia	Netherlands	Uzbekistan
Greece	New Zealand	Venezuela
Hong Kong	Norway	Vietnam
Hungary	Oman	

[1] The treaty with the former Yugoslavia

[2] The treaty with the former Czechoslovakia

A treaty has also been concluded with Saudi Arabia, but it is not yet in force.

Social security treaties

China currently has only one social security treaty, that with Germany.

BDO Member Firm Offices

BDO Member Firms have offices in the following countries:

Angola	Hong Kong	Peru
Argentina	Hungary	Philippines
Aruba	India	Poland
Australia	Indonesia	Portugal
Austria	Ireland	Qatar
Bahamas	Isle of Man	Reunion
Bahrain	Israel	Romania
Belgium	Italy	Russia
Bolivia	Jamaica	Saudi Arabia
Botswana	Japan	Senegal
Brazil	Jersey	Serbia
British Virgin Islands	Jordan	Seychelles
Bulgaria	Kazakhstan	Singapore
Canada	Korea	Slovakia
Cape Verde	Kuwait	Slovenia
Cayman Islands	Latvia	South Africa
Chile	Lebanon	Spain
China (PRC)	Liechtenstein	Sri Lanka
Colombia	Lithuania	Suriname
Comoros	Luxembourg	Sweden
Croatia	Madagascar	Switzerland
Cyprus	Malaysia	Taiwan
Czech Republic	Malta	Thailand
Denmark	Mauritius	Trinidad & Tobago
Dominican Republic	Mexico	Tunisia
Ecuador	Morocco	Turkey
Egypt	Mozambique	Turkmenistan
El Salvador	Namibia	Ukraine
Estonia	Netherlands	United Arab Emirates
Fiji	Netherlands Antilles	United Kingdom
Finland	New Zealand	United States of America
France	Nigeria	Uruguay
Germany	Norway	Vanuatu
Gibraltar	Oman	Venezuela
Greece	Pakistan	Vietnam
Guatemala	Panama	Zambia
Guernsey	Paraguay	Zimbabwe

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