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CHINA

Legal Bulletin

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Executive Summary

Implementing Rules for the New Corporate Income Tax Regime

China implemented a new regime for corporate income tax on January 1 2008, based on the Corporate Income Tax Law as well as implementing rules published last December. Changes to the previous tax structure are substantial, and Senior Client Service Manager Maarten Roos addresses some of the more significant changes affecting business in China. Preferential Status, Deductions, and Offshore PRC residents are 3 categories that he takes a look into, providing some important clarifications that will help you stay ahead of the tax curve.

By Maarten Roos / Zachary Wortham

EU Regulations: Reach and the Effect on Chinese Business

Recent regulations passed in the EU will have serious implications on those businesses exporting products into the EU, as they will have to provide their EU counterparts with more detailed information on the exact make-up of their product. The effects will unlikely be felt immediately in China, but manufacturers will need to start making preparations soon.

By Maarten Roos

NEWS FLASH

Cross-boarder Capital Flow tightened by SAFE

The State Administration for Foreign Exchange (SAFE) recently announced that it will carry out checks on cross-border capital flow, focusing particularly on how foreign currency being converted into yuan is being used in China. China faces pressure from its increasing foreign exchange reserves as the trade surplus continues to grow. At the end of 2007, Chinese foreign exchange reserves reached \$1.53 trillion, up 43.3 per cent year-on-year. The government has taken measures to redress the trade imbalance, is closely monitoring the inflow of funds, and also has encouraged companies and individuals to hold on to foreign currency and invest abroad. In August of 2007, the Chinese government removed limits on companies converting foreign exchange holdings into yuan, allowing companies to hold all revenue from trade as foreign currency instead of converting part of it to yuan. The government is also increasing checks for illegal capital inflow in the form of short-term foreign borrowing and speculative capital.

Discussion and Tax Strategy for Expatriate Directors and Senior Management in China

As foreign investments in China increase, investors are sending foreign managers to work as directors and senior managers in their subsidiaries in China. These foreign managers are being paid by the subsidiaries in China as well as by the foreign investor and therefore the question of how PRC taxes should be settled for these types of employees is a serious one. In our upcoming March Newsletter labor and tax experts, Pan Lidong and Lu Yunguang, will provide answers on how these directors and senior management will be affected by the new PRC tax regulations and what strategies companies should use to minimize liabilities while complying with tax regulations.

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Implementing Rules for the New Corporate Income Tax Regime



Implementing Rules Clarify New Corporate Income Tax Regime

Over the past year, companies in China have been preparing for the new *Corporate Income Tax Law of the Peoples Republic of China* to radically change the way their income is taxed starting 1 January 2008. In our March / April 2007 issue of the Legal Bulletin, we summarized some of the key issues effecting foreign-invested and non-resident foreign companies, and looked ahead to what the detailed implementing rules would further clarify. On 6 December 2007, the State Council, Ministry of Finance and State Administration of Taxation issued the *Detailed Implementing Rules for the Corporate Income Tax Law* replacing versions from 1991 and 1994, and effective as of 1 January 2008.

Although a number of issues will be dealt with in separate circulars in the near future, the Implementing Rules are a first and important step towards clarifying and detailing the Corporate Income Tax Law. Companies are advised to study it carefully, to review how its clauses will affect current and future practices. To make this easier, we summarize some of the most important clauses.

Preferential Tax Treatments

The Corporate Income Tax Law is most notable for treating Chinese- and foreign-invested enterprises equally. Preferential treatment for companies engaging in certain kinds of activities, and for companies established in certain zones or areas, has largely been abolished. The majority of companies will now be taxed at a flat rate of 25% on taxable income.

Nonetheless, some exceptions continue to exist. We summarize those further clarified in the Implementing Rules which are the most relevant to foreign investors.

- (1) Basic public infrastructure projects specifically supported by the State (as per the relevant Catalogue), and environmental protection, energy, and water conservation projects meeting specified criteria will be tax-exempt for three years starting from the first year of profits, then taxed at 12.5% for the next three years.
- (2) Small-scale companies will be taxed at 20% if they engage in non-restricted (and non-prohibited) industries, and meet one of the following conditions; manufacturing enterprises must have an annual taxable income that does not exceed RMB 300,000, the number of employees can not exceed 100, and total assets can not

exceed RMB 30 million; non-manufacturing enterprises must have an annual taxable income that does not exceed RMB 300,000, the number of employees can not exceed 80, and total assets can not exceed RMB 10 million.

- (3) High / New Technology Enterprises as approved by the State will be taxed at 15% if they own core proprietary intellectual property rights, and fulfill a number of conditions relating to minimum R&D expenses, income from high/new tech products (services), proportion of employees that are technicians, and possibly others as decided in separate regulations. Existing companies with new / high technology status will have to go through a renewed approval procedure.

In a circular of 26 December 2007, Guofa [2007] No.39, the State Council confirmed that for those foreign-invested companies established before 16 March 2007 and previously enjoying a preferential rate, tax rates would be increased to 25% only gradually, while unused holidays could be claimed until their expiration date. If holidays have not yet been commenced due to previous losses, the tax holiday period will commence in 2008.

Preferential tax policies for companies in the Western Region will continue to apply, meaning that enterprises previously enjoying an income tax rate of 15% can continue to enjoy the same until 2010, while those companies eligible for a 2+3 tax holiday can also continue to enjoy the tax holiday until it expires.

Another Circular of 26 December 2007, Guofa [2007] No.40, provides further advantages for High / New Technology Enterprises established in one of the Special Economic Zones (Shenzhen, Zhuhai, Shantou, Xiamen, Hainan) or Pudong New Area. Income generated in that zone will be tax-exempt for 2 years from the first income-generating year, and be taxed at 12.5% for a further three years on income generated in the zone or area.

Withholding tax on dividends

Until now, foreign-invested enterprises have been exempted from a withholding tax on dividends remitted to their foreign shareholders abroad. Under the Implementing Rules, this exemption has been lifted, and a withholding tax of 10% will apply on all dividends paid to foreign shareholders. The only exceptions are made for dividend payments to investors which are located in jurisdictions with a preferential tax treaty, such as Hong Kong (at 5%), Mauritius and Barbados.

GOVERNMENT ACTION
New Service Industry Assc. and Aid to the Real Estate Sector

Service Industry Association Launched in China

China recently launched a service trade association under the banner of *the enterprises and for the enterprises* to empower and regulate the service industry. In recent years, boosting the service industry has become a common concern of governments and enterprises alike. After years of efforts, China has gradually opened up to the outside world and has formed a multi-level service sector. In 1982, the import and export volume of the service sector stood at USD \$4.4 billion, while the 2006 figure was USD \$191.7 billion, a 43-fold increase in 24 years. In 2006, China was ranked eighth globally in terms of service trade exports and seventh in imports, compared to ranking 28 and 40, respectively, in 1982.

Low Income Housing to Receive Aid

As the property market in China continues to boom and with property prices in 70 large and medium cities jumping by 10.2 per cent in the fourth quarter from a year earlier, banking regulators in China are trying to help low-cost housing developers obtain loans and to encourage construction. Under new rules, banks can give loans for low-cost housing if developers raise 30 per cent of the total capital. This compares with the 35 per cent required for commercial housing developers. Banks can also offer low income housing developers low-interest loans at 90 per cent of the benchmark lending rate, which currently stands at 7.47 per cent a year. The central bank also expanded its list of loan providers for this category from just State-owned banks to all financial institutions, including joint-stock banks. The new rules are expected to boost property developers and took effect on 7 January.

Implementing Rules for the New Corporate Income Tax Regime cont.



The withholding tax in effect means that for the first time, foreign-invested enterprises are in fact taxed more heavily than their local counterparts. Foreign investors should look more carefully at tax-efficient structuring of their investments.

Deductions

The Implementing Rules provide considerable detail on the reasonable expenses generated for the production of income which are tax deductible. Companies should particularly take note of new caps for a number of items:

- Up to 60% of expenses for business entertainment, capped at 0.5% of the company's business / sales income.

- Expenses for advertisement and business promotion, capped at 15% of the company's business / sales income. Special treatment for certain industries may be agreed to by competent authorities, if justifiable.

Sponsorship expenses of a non-advertising nature are no longer tax-deductible. Items that do remain deductible include charitable donations (under conditions), most types of insurance premiums, funds used to protect the environment, reasonable staff wages and welfare expenditure (capped at 14% of total wages and salaries), certain currency losses, borrowing costs (subject to thin-

capitalization rules for related companies), and so forth.

Other benefits may be sought for the following:

- Income from qualified technology transfer is deductible, up to RMB 5 million per year.

- 10% of income derived from the comprehensive utilization of resources as per the Catalogue of Income Tax Incentives for the Comprehensive Utilization of Resources may be tax-exempt.

- A tax credit of 10% may apply for investments in certain environmental protection equipment, energy and water conservation equipment, and production safety equipment.

Offshore PRC tax residents

The Corporate Income Tax Law provides that offshore companies with effective management in China shall be regarded as Chinese tax residents. The Implementing Rules define effective management as the actual exercising of overall management and control over the production and business, personnel, accounting, properties etc. of a company. As this definition is very general, officials will likely continue to exercise considerable discretion in deciding whether a company's income should be taxed in China or not.

Chinese companies that use so-called round-trip investment structures to minimize tax liabilities will be at a higher risk than before. On the other hand, all foreign companies with management in China will have to review their operations to understand the risks in regard to tax liabilities.

Conclusions

The new Corporate Income Tax Law drastically overhauled China's income tax regime, and the Implementing Rules are a first step in defining and clarifying many new aspects of that regime. The picture is by no means complete, as regulations and circulars in the coming months will fill up many of the gaps. Nonetheless, companies should be reviewing their strategies in China to ensure that their operations are tax efficient. The new regime means a hardening of the climate for foreign-invested enterprises in particular; companies will be wise to review the law carefully to take advantage of any opportunities it provides.

By Maarten Roos / Zachary Wortham

EU Regulations; REACH and the Effect on Chinese Business

Alert: Eu Regulations To Effect Chinese Exporters

On 1 June 2007, new regulations came into effect in the European Union that deal with the Registration, Evaluation, Authorization and Restriction of Chemicals (REACH). The REACH regulations are designed to regulate chemicals and their safe use in the EU, and will have a lasting effect on exporters to the EU across a broad range of industries including chemicals, printing, textile and apparel, consumer electronics and household appliances. Furthermore, other jurisdictions including the United States are working on systems based on the same model. Thus Chinese exporters should take notice!

The aim of REACH is to build a system to monitor the use of chemical substances in all kinds of products in the EU, to ensure a high level of protection for human health. The burden it places on manufacturers and importers is to know what kind of chemical substances their products contain. Among other requirements, it will mandate that manufacturers and importers register with the central European Chemical Agency (ECHA) all chemical substances, preparations or articles with such substances, if they are manufactured in or imported into the EU in quantities of more than 1 ton per year. For substances manufactured or imported in quantities of more than 10 tons a year, a chemical safety report will have to be provided.

What does this mean for Chinese manufacturers / exporters?

Since the REACH regulations will require importers in the EU to provide detailed information on chemical substances in their products, companies all the way down the supply chain will need to provide detailed information on the substances that they add to products. In the medium- to long-term, this means that producers and exporters who cannot provide such information could lose market share. As similar systems are likely to be adopted in other jurisdictions as well, Chinese companies will gradually be forced to become fully transparent, and improve their production processes.

EU Regulations; REACH and the Effect on Chinese Business



Foreign companies doing business with Chinese counterparts, and foreign-invested companies that buy from Chinese suppliers, are wise to make necessary preparations. A good first step would be to include relevant clauses in supply contracts to ensure that suppliers are responsible for providing all necessary information and then following that up by selecting suppliers that can provide such information, and refusing to do business with

those that cannot.

At this point, even as the REACH regulations are being implemented, many companies remain unaware of the likely impact of REACH on their business. More information can be found at http://ec.europa.eu/environment/chemicals/reach/reach_intro.htm.

By Maarten Roos

ABN AMRO: Business Banking Case Study

The Internationalization of a Chinese SME.

China has for some time now been one of the worlds hottest places to be, and our focus on foreign enterprises entering China reflects this. Nonetheless, an increasing number of Chinese companies are internationalizing their operations to compete in the global arena. The most notable Chinese successes in recent years include Haiwen, Haier, Cosco, Lenovo and TCL, however many small and medium-sized enterprises (SMEs) are also finding their way abroad.

One notable story, recently reported by global financial institution ABN AMROs Shenzhen office, concerns a Shenzhen producer and distributor of mooncakes and other confectionaries. Established in 1994 and initially focusing on the Guangdong market, by 2006 Angel Food was one of the countrys market leaders. With international certifications including the ISO9002 and FDA approval, it was not only retailing through 3,600 sales points in China, but also successfully tackling international markets. But like many of its peers in this sector, continuing its expansion was a challenge especially financially. To ensure sufficient working capital to pre-pay suppliers for raw material procurement and financing a long tenor of 120-150 days of accounts receivables from its large client-base, it turned to ABN AMRO for a working capital facility, which also provided it with a suit of foreign

exchange products with which Angel Food could manage its foreign currency income to hedge against depreciation risks of the US dollar versus the Renminbi.

With the above facilities in place, it could report an increase in turnover and net profit of 180% and 46% respectively, and in July 2007 made its debut on the Singapore stock market. The raised S\$28 million (approx. USD 19 million) will be used to expand production capacity and finance M&A projects. From the startling rise of Chinese SMEs such as Angel Food, we can draw a number of valuable lessons. One of the most important is that while China is taking an increasingly important position in the global strategies of internationally leading SMEs, their Chinese counterparts are starting to compete on the same level. And with the right level of services whether financial, legal or otherwise these Chinese enterprises in their niche markets may well become the leaders of tomorrow.

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This newsletter is published by the Corporate & Commercial Group of Wang Jing & Co, a PRC law firm assisting Chinese and multinational clients in business operations in China and abroad.

WANG JING & Co. UPDATE: Shanghai and Tianjin Offices

The head office of Wang Jing & Co. in Guangzhou, is widely known as a full service office, with an excellent reputation for general corporate, commercial and IP work. However, the Wang Jing & Co. Shanghai and Tianjin offices also have excellent teams that focus on corporate / commercial matters.

In Shanghai, partner Mr. Chen Xin leads a team that deals with projects related to foreign direct investment, contracts and commercial litigation. In addition, he focuses on two niche practice areas: liability insurance, and ship building, sale and finance.



The Tianjin office, led by partner Ms. Zou Zongcui, works as a retainer to dozens of Japanese and European investment projects in Tianjin, offering advice on commercial contracts, labor issues, real estate, and intellectual property, and representing them in arbitration and litigation.



For more information on our Shanghai and Tianjin offices, including recent some cases in the above-mentioned practice areas, can be found at www.wjnc.com.