



Crossing international
boundaries

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TAX FLASH
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ECONOMIC OUTLOOK OF CHINA - 2011

During 2006 to 2010, China has great achievements in economic and social development. The objectives and tasks of the 11th Five-Year Plan were also successfully completed.

The Communist Party of China (“CPC”) Central Committee issued a Proposal on formulating the 12th Five-Year Plan (2011 to 2015) on the national economic and social development. This Proposal (i.e. 12th Five-Year Plan) was adopted at the fifth Session of the 17th CPC Central Committee on 18 October 2010. Establishing a well-off society and developing China’s economy would be the major objectives for the 12th Five-Year Plan.

Changes in the accounting and auditing standards, the taxation policies as well as policies for foreign direct investments, outbound investment and internationalisation of Renminbi are anticipated. In this Tax Flash, we highlight the development in these areas.

I. The Twelfth Five-Year Plan (The 12th Five-Year Plan)

The Proposal of the 12th Five-Year Plan (2011 – 2015) was adopted at the fifth session of the 17th CPC Central Committee on 18 October 2010. A detailed plan will be released in the first quarter of 2011 after approval by the National People’s Congress.

The theme of the 12th Five-Year Plan is to balance wealth distribution; transform the economic development strategically; improve social infrastructure and enhance environmental protection. Details of the proposed 12th Five-Year Plan are highlighted as follows:

- Adjust the economic structure strategically
 - expand the domestic demand
 - encourage economic growth by consumption, investment and exports
 - strengthen the fundamental role of agriculture
 - develop new production and services industries
 - organize urban and rural development
 - promote urbanization
 - introduce 7 new strategic industries
 - (1) New generation information technology;
 - (2) Energy saving and environmental protection;
 - (3) New energy;
 - (4) Biology;
 - (5) High end equipment manufacturing;
 - (6) New materials; and
 - (7) New energy cars

- Improve and develop scientific and technological progress
 - modernization for the level of education
 - train up innovation talents and strengthen their independent capabilities
 - promote major scientific and technological development
 - improve the quality of workers and focus on management regarding innovation

- Improve the livelihood of the residents
 - improve employment environment
 - promote the equalization of basic public services
 - balance the wealth distribution

- Develop an energy efficient and environment friendly society
 - implement the conservation of resources and protecting the environment
 - save energy and reduce greenhouse gas emissions intensity
 - develop sustainable economy
 - promote low-carbon emission technologies
 - promote economic and social development
 - coordinate the relationship of population, resources and environment in order to maintain sustainable development

- Reform and opening up the economic, political, cultural, and social sectors
 - develop strategic and proactive guidance plan to deploy based on the current and any potential further international financial crisis
 - set the main economic and social development objectives in the next five years, including:
 - (1) to maintain stable and rapid economic growth
 - (2) to enhance the development in economic restructuring
 - (3) to increase the income of people who live in rural areas at a relatively fast rate
 - (4) to enhance the development of social infrastructure
 - (5) to aim at continuous reform to open up the economic, political, cultural, and social sectors

II. Foreign Direct Investment

For the past 30 years, foreign direct investment (“FDI”) has played an important role in contributing to China’s economic and trade development. The Chinese government has introduced different policies in attracting FDI and it is anticipated that there will be no significant change on the policies of FDI.

- Statistical data of current FDI

According to the Regular Press Conference of the Ministry of Commerce (“MOFCOM”) on 15 December 2010 (“Press Conference”), 24,302 new foreign enterprises were established in China by the end of November 2010. The amount of FDI for the period from January to November 2010 is summarized as follows:-

<u>Industries</u>	<u>Amount of FDI</u> <u>(US\$ billion)</u>
Service sector	41.14
Manufacturing sector	43.99
Agriculture, forestry, husbandry, and fishery sectors	1.69

The FDI mainly came from Hong Kong, Taiwan, Singapore, Japan, USA, South Korea, Britain, France, Holland and Germany.

➤ Government policies to attract FDI

In 2010, the Chinese government has created a more open, fair, convenient and friendly environment for FDI.

In order to attract foreign investments flow into the high-end manufacturing industries, modern services industries, new energy and energy-conserving & environment-friendly industries, the Chinese government has actively implemented the “Opinions on Further Improving the Work of Foreign Capital Utilization by the State Council” and revised the “Catalogue of Industries for Guiding Foreign Investment”. Besides, the idea of opening up finance, logistics, education, medical, tourism and other services sectors etc have also been proposed in the 12th Five-Year Plan.

With respect to the regional policies, the Chinese government has promulgated a series of policies to reinforce the implementation of the strategies regarding industry relocation and the opening up in the coastal areas. In order to support the construction of specialized investment teams in central and western regions, the “Catalogue of Advantaged Industries for Foreign Investment in Central-Western Region and the Development of Industry Cluster Zone” is being revised.

For the reforming of the foreign investment management mechanism, the MOFCOM has implemented the “Opinions on Further Improving the Work of Foreign Capital Utilization by the State Council” and the “Circular on Delegating the Examination and Approval Power for Foreign Investment” to simplify the application procedures.

Though FDI still takes an important role in Chinese economic reform, the Chinese government discourages any foreign enterprise monopolizing the market through mergers and acquisition. In line with the central government policy, an anti-monopoly law was issued in 2008 (http://www.gov.cn/flfg/2007-08/30/content_732591.htm) to prevent monopolistic behaviour, protect fair competition, improve economic efficiency and promote the healthy development of socialist market economy. It is anticipated additional measures will be issued to further enforce the anti-monopoly law.

II. Outbound Investment

In the 10th Five-Year Plan (2001 to 2005), the Chinese government has announced the “go global policy” to encourage the Chinese entities to invest overseas. In line with the economic globalization and the RMB internationalisation, the expansion of overseas investment would be prioritised in the 12th Five-Year Plan.

➤ Statistical data of current outbound investment

According to the Press Conference of MOFCOM, China's domestic investors had directly invested in 2,786 overseas companies in 122 countries and regions for the period from January to November 2010. By the end of November 2010, a cumulative non-financial outward direct investment ("ODI") totalled US\$247.3 billion. With respect to the ODI through acquisition, it was valued around US\$17.5 billion.

Chinese entities also actively engage in overseas construction and engineering projects. In the first 11 months of 2010, the total revenue for Chinese foreign contracted projects totalled US\$74.25 billion and the value of newly signed contracts in November 2010 was US\$14.95 billion. These contracted projects had created 617 thousand jobs in respective foreign countries. By the end of November 2010, around 839 thousand Chinese citizens worked abroad.

➤ Geographical and industrial distribution

ODI mainly flows into Hong Kong, Cayman Islands, Australia, British Virgin Islands, Sweden, USA, Canada, Russia and Brazil, etc. Nearly 90% of the ODI flows into the commercial service, mining, manufacturing, transportation, retailing and wholesaling sectors.

➤ New regulations to strengthen the "go global policy"

1. The MOFCOM has launched and reformed the following measures and regulations in order to strengthen the administration for the "go global policy"

- Measures for the Administration of Investment in Taiwan by Chinese Entities and Opinions on Encouraging and Supporting Overseas Merger & Acquisition by Service Outsourcing Entities
- Implementation of Regulation on Administration of Foreign Contracted Projects
- Administration Measures on Bidding Permission (Negotiation) of Foreign Contracted Projects and Procedures on Violations of Law and Regulations on Foreign Contracted Projects
- Regulations on Foreign Contracted Projects
- Administrative Regulations on Foreign Cooperation in Labour Services
- The Trial Procedures for Public Service Platform Construction of Foreign Cooperation in Labour Service
- The Trial Procedures for Poor Credit Record System of Foreign Cooperation in Labour Service.

2. In order for the Chinese entities to have a better understanding on overseas investment, public information has also been released including:

- Catalogue for the Guidance of Outward Investment Industries in Other Countries (2010) (http://www.fdi.gov.cn/pub/FDI_EN/Laws/law_en_info.jsp?docid=87372)
 - Guide for Outward Investment in Other Countries and Regions (2010) (<http://fec.mofcom.gov.cn/gbzn/gobiezhinan.shtml>)
 - Report on the Development of China's Foreign Investment and Cooperation (2010) (http://cn.chinagate.cn/webcast/2010-11/01/content_21247271.htm)
3. Business training programs have been proposed to be held by the MOFCOM to increase the knowledge of outbound investment.
 4. The following guideline and regulations have also been proposed and released in order to prevent/minimize the risks:-
 - Guidelines on Staff of Overseas Chinese-funded Entities
 - Development of Injury Medical Insurance and Additional Medical Assistance Insurance of Overseas Chinese-funded Entities and their Staff
 - Administrative Regulations on Safety of Chinese-funded Entities and their Staff

“Go global policy” is a major measure in the coming next five years. Fiscal policies and regulations e.g. Chinese Oversea Direct Investment Environment Protection Guidelines are anticipated to be proposed and issued. In addition, the Chinese entities would be allowed to use Renminbi directly to invest overseas through mergers and acquisition, establishment and direct equity investment.

IV. Accounting and Auditing

Despite its size in terms of market capitalization and initial public offering (“IPO”) funds raised, the Chinese capital market is still not recognized as part of the international playing field. The Chinese government has committed to make Shanghai an international financial centre by 2020. Changes on accounting and auditing standards are anticipated.

➤ **Convergence with International Financial Reporting Standards (“IFRSs”)**

In 2006, the Ministry of Finance (“MoF”) released a set of new Chinese Accounting Standards for Business Enterprises (“CASBE”) and Auditing Standards for Certified Public Accountants to affirm that China is committed to convergence with IFRSs, as set by the International Accounting Standards Board.

To ensure smooth implementation, the MoF has promoted the standards to the public and has executed some strategies for training up the accounting professionals nationwide. The MoF has also set the accounting systems for listed companies and the auditing standards systems for Certified Public Accountants (“CPAs”) for continuous tracking and monitoring.

In 2009, the MoF has revised the existing auditing standards to achieve the convergence with the clarified International Standards on Auditing and has updated the code of ethics for CPAs to cover all the requirements of the ethical standards released by the International Ethics Standards Board for Accountants. These reforms encourage Chinese accounting firms and Chinese entities to develop international networks, enhance governance and professional skills as well as to improve the transparency and quality of the accounting information.

In complying with the principle of full convergence with the international accounting and auditing standards, a roadmap regarding the achievements of the accounting reform in China has been issued in April 2010. According to the roadmap, the revision of CASBE project should be finalized by the end of 2011. Meanwhile, extensive promotion of using new CASBE and training accounting professionals should be arranged to ensure that all listed and non-listed large and medium size enterprises could implement the new CASBE effectively and efficiently.

➤ **Convergence of CASBE and Hong Kong Financial Reporting Standards (“HKFRS”)**

The China Accounting Standards Committee signed a joint declaration with the Hong Kong Institute of Certified Public Accountants (“HKICPA”) in 2006 and 2007 in respect of the status of substantial convergence between CASBE and HKFRS. Since then, both parties have worked closely to maintain convergence between the two standards adopted in the joint declaration.

On 10 December 2010, the Hong Kong Exchanges and Clearing Limited and the MoF announced that effective from accounting periods ended on 31 December 2010, companies incorporated in China and listed in Hong Kong can have an option to present financial statements using CASBE and audited by an approved mainland audit firm.

The proposed framework was developed by the relevant authorities in China and Hong Kong regulatory bodies, including the Financial Services and the Treasury Bureau; the Securities and Future Commission, the Financial Reporting Council, the Hong Kong Institute of Certified Public Accountants HKICPA and the Stock Exchange of Hong Kong Limited, on the basis of reciprocity, which are detailed as follows:-

- The framework provides an option for Chinese entities to choose to prepare their financial statements, including those for IPOs and periodic reports, using CASBE;
- The framework allows Chinese auditing firms vetted, nominated and endorsed by the MoF and the Securities Regulatory Commission to act as auditors of those Chinese entities using CASBE;
- The framework provides for a reciprocal arrangement to allow Hong Kong incorporated or registered companies listed in China to choose to prepare their financial statements, including those for IPOs and periodic reports, using HKFRS/IFRS and be audited by Hong Kong audit firms that are vetted, nominated, endorsed and registered with the HKICPA and which use Hong Kong Standards on Auditing or International Standards on Auditing when conducting their audits.

These new measures would reduce the compliance costs of the Chinese entities listed in Hong Kong; and help attract more Chinese entities listings and thus, benefiting Hong Kong’s development as China’s global financial centre and the fund raising platform in the region.

V. Taxation

Taxation is an effective fiscal tool which affects economic growth and development. The following taxation policies are proposed to be reformed in the near future in order to strengthen the taxation system.

➤ Individual Income Tax (“IIT”)

The Chinese government proposed to reduce the IIT on low to middle income group in 2011 and an outline has been drafted by the MoF and the State Administration of Taxation (“SAT”). The purpose of the IIT reform is to reduce the income gap between the wealthy and the low to middle income earners.

Basically, the nine levels of the current progressive tax rate are anticipated to be reduced and the intervals between each level are to be widened in order to ease financial pressure of the taxpayers.

➤ Value Added Tax (“VAT”) and Business Tax (“BT”)

Currently, BT is imposed on the services income and VAT is imposed on the sales of tangible goods, processing activities as well as importing of tangible goods. Due to the separation of the VAT and BT systems, some of the Chinese entities e.g. logistic companies are suffering from double taxation. In order to promote the development of the services sector, the Chinese government has published an initial plan to develop a credit system for BT.

➤ Property Tax

Facing the continuous price appreciation on properties, residential property tax will be introduced in China. The regulation is being revised by the MoF and the SAT.

A trial plan has been launched in Shanghai and Chongqing in early 2011. For Shanghai, the property tax may be imposed on newly-built ordinary residential housing. For Chongqing, the property tax may be imposed on luxury home and villas.

➤ Consumption Tax (“CT”) and Resources Tax (“RT”)

The Chinese government has proposed to adjust the scope of consumption tax in line with its industry development policy. The respective tax revenue would be used to promote energy conservation and guide the rational consumption.

In order to promote the resources conservation and the environmental protection, reform of resources tax has also been proposed.

➤ Transfer Pricing

On 30 December 2010, the SAT issued the first annual Advance Pricing Arrangement (“APA”) report to describe the mechanisms, procedures, and implementation of the APA program in China in respect of transfer pricing.

The purpose of issuance of the APA report is intended to provide guidelines to enterprises interested in entering into APA with the Chinese tax authorities, and to serve as a reference for competent authorities of other countries and the general public to better understand the APA program in China.

In order to standardize the management, improve the transparency and expand the publicity of APA, the SAT will prepare and release the APA report annually and timely.

VI. Internationalisation of Renminbi (“RMB”)

Currently, in theory, RMB is freely convertible for current account items while stringent controls are imposed on capital account items. As a result of the global financial tsunami, internationalisation of RMB has become a major agenda item of the Chinese government. Measures have been introduced to propel RMB to be an internationally accepted settlement currency, investment currency and reserve currency.

➤ Settlement currency

On 29 September 2010, the People's Bank of China (“PBOC”) issued, “Measures for the Administration of the RMB Settlement Accounts of Overseas Institutions” (“the Measures”) in order to further develop the cross border trade. Under the Measures, overseas institutions incorporated in Hong Kong, Macau and Taiwan can apply for a RMB settlement account for conducting its overseas RMB transactions in accordance with the relevant laws and requirements provided that such overseas RMB account cannot be used for cash dealing services. The funds therein shall not be converted into foreign currency, unless otherwise approved by PBOC or expressly stipulated by laws. Besides, the Measures also stipulate that overseas institutions satisfying the conditions may select their own designated banks in China to open the RMB settlement account.

China also signed agreements with its neighbouring countries e.g. Russia, Mongolia, Vietnam, and Myanmar, allowing the use of RMB for settlement of trading transactions for expanding the role of RMB in the international trade market.

➤ Investment currency

For the capital account transactions, provisional rules governing the issuance of RMB-denominated bonds by international development institutions were released by the Chinese government. With respect to the management of foreign exchange reserves, the PBOC has signed a number of currency swap agreements with a host of countries, which agreed to exchange RMB with respective counterparty currencies. In addition, a “Pilot Scheme for Settlement of ODI in RMB” (“Pilot Scheme for ODI”) has been issued on 6 January 2011. Under the Pilot Scheme for ODI, Chinese entities can conduct ODI using RMB through mergers and acquisition, establishment and direct equity investment without the need for purchasing foreign exchange notes in banks or converting funds into foreign currencies prior to investment.

➤ Reserve currency

Currently, US Dollars is the global reserve currency. Most of the commodities such as oil, gold and silver are quoted in US Dollars. Most governments hold significant US Dollars as their foreign exchange reserves. As a long term goal, within the next 5 to 10 years, the Chinese government aims to position RMB to become a freely convertible currency and therefore an internationally accepted reserve currency.

➤ Hong Kong as a RMB offshore centre

Hong Kong serves as a global centre for trade, finance, business and communications. In order to attract investment, Hong Kong government makes no distinction between foreign and local companies, and maintains a policy of minimal red tape and interference. It

imposes no exchange controls and very few restrictions on foreign investment. Due to these favourable conditions, offshore RMB trade settlement and finance would likely be concentrated in Hong Kong. According to the press releases issued by Hong Kong Monetary Authority on 13 January 2011, nearly 69% (i.e. US\$38.6 billion) and 63% (US\$35.6 billion) of China's total ODI was invested in Hong Kong or through Hong Kong to other parts of the world in 2008 and 2009 respectively.

Under the Pilot Scheme for ODI, the Hong Kong branches and correspondent banks of China's banks are allowed to obtain RMB funds from the Mainland and issue RMB-denominated loans to Chinese enterprises for overseas projects and equity investments. In addition, Chinese entities would also conduct overseas investment through Hong Kong and avail of the multi-currency and multi-functional financial platform in Hong Kong for the related financing and fund management activities.

VII. Conclusion

Macro economics tools have been used extensively by the Chinese government in driving the economic growth and development of the country. Gross Domestic Product is the primary yardstick to measure economic growth (although it is difficult to measure development directly). Inflation is another important indicator to which the Chinese government pays attention.

To sustain the continuous economic growth, the Chinese economy would rely on the domestic consumption, investment (FDI, domestic investment and ODI) as well as exports. To stimulate domestic consumption, salary level (government agencies and state owned enterprises in the first place) will be increased in the 12th Five-year plan. Lowering the individual income tax rates would also help to increase the net disposable income of the residents. Administrative and tax measures will be introduced to control the surge of real estate prices, so as to increase the net disposable income of the residents as well. Investment in the 7 strategic industries would be promoted. New tax incentives will be introduced accordingly. Export VAT refund rates will be adjusted to promote export activities which are high value added and/or efficient in low consumption of energy/natural resources.

Bank reserve ratio and interest rate would be adjusted to avoid overheating of the economy. RMB will not become freely convertible in the coming five years. Policies will be formulated to align the banking system, stock exchanges and the foreign exchange system with international practice.

Ongoing urbanisation process, local "xian" competition and the open-door policy will foster an environment for China to achieve a sustainable high growth rate.

RSM NELSON WHEELER TAX ADVISORY LIMITED

RSM Nelson Wheeler's dedicated and experienced tax specialists can:

- Advise on tax efficient holding and operational structures for new cross-border investment, including the formation of Hong Kong and Chinese business entities
- Review existing cross-border investment structures, advise on identified deficiencies, quantify any potential exposure from such deficiencies, and further advise on restructuring approach and procedures
- Assist clients to discuss and clarify matters with tax officials, including transfer pricing and advance rulings
- Act as client representative in tax audits and tax investigations
- Provide transaction support services on mergers and acquisitions, including tax due diligence, deal structure advice, tax health checks, related human resources arrangements and other tax compliance and consultation services
- Advise on human resources and structuring employment arrangements in a tax-efficient manner
- Advise on tax equalization schemes
- Provide tax compliance services for individual and corporate clients in Hong Kong and China

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