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Hot topics Mergers and transactions: Chinese activities during the first half of 2010 • Effects of the Chinese anti-monopoly law on planned mergers and acquisitions Industries New rules regulating overheating real estate market Investment and financing Forming a joint venture in China – the most important steps Tax and legal Tax incentives for qualified services to foreign customers • Shanghai a future logistics center for Asia: incentives and outlook • New regulations increase tax burden on all foreign companies doing business in China • China's free trade agreements: developments and outlook Economic spotlight on Asia On the road to Chaiwan? – Taiwan and the PR of China redefine their relationship Publications A guide to investing in Taiwan • Tax in Taiwan

Swiss edition

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Editorial

Dear Readers,

2010 has been a turbulent year, with the financial crisis keeping companies and markets on edge worldwide. Nevertheless, the first signs of an upward turn are unmistakable – by the first half of 2010, Chinese transactions activity had regained its pre-crisis level. Reason enough for the editorial team at *pwc:china compass* to take a closer look at these events, making the Chinese market for mergers and acquisitions the centrepiece of our spring 2011 edition. This is reflected in two feature articles which focus on this area of business activity.

In the article “Mergers and transactions: Chinese activities during the first half of 2010” (starting on page 4), we summarise the results of an ongoing study by PwC China, while in our second feature article, “Effects of the Chinese anti-monopoly law on planned mergers and acquisitions” (starting on page 6), our experts analyse the rules that apply to the M&A market. In particular, this article examines the latest amendments to the anti-monopoly law, describing two decisions by the Chinese Ministry of Commerce that have attracted widespread attention.

However, business combinations, acquisitions and mergers are not the only areas of activity of which investors in China should be aware. The real estate expert Florian Hackelberg explains Circular 10 in his latest article, “New rules regulating overheating real estate market” (starting on page 9). The Chinese administration aims to use its new regulations to cool down a market some already see as a bubble about to burst. There is indeed cause for concern: double-figure percentage jumps in real estate prices are not unknown, especially in the apartment sector in the booming coastal metropolises. The author examines the rules introduced by Circular 10, and the effect they are likely to have on the Chinese real estate market.

As China experts know only too well, not every item of news from the Far East is cause for jubilation. Sometimes we have to report on developments that will really bite. An example of this is the increasing difficulty foreign companies are experiencing in obtaining preferential tax treatment in China. But every cloud has a silver lining – and in this case it’s the fact that “TASE” companies do still profit from tax incentives granted to certain services. In the article “Technologically Advanced Service Enterprises” (starting on page 14), we examine this trend more closely. Our tax experts explain what tax advantages can be gained if your company can achieve “TASE” status.

In keeping with editorial tradition, our “Economic Region Asia” section goes beyond the Mainland China border to probe relations between Beijing and Taipei. The process of rapprochement between Taiwan and the PR of China is developing at breath-taking speed – reason enough for a portrait of the Economic Cooperation Framework Agreement signed on July 29th 2010 between Taiwan and China as the most comprehensive and significant agreement for both sides over the last 60 years. In the article “On the road to Chaiwan? – Taiwan and the PR of China redefine their relationship” (starting on page 25), we explain what has been agreed between the Mainland and the island, put the situation in perspective, and assess the consequences for investors.

Another development that has caused many to prick up their ears is China’s announcement that in 2011 it will be promulgating its 12th Five-Year Plan. With “urbanisation rather than industrialisation” as its theme, the Beijing administration is implementing what is essentially a new strategy in its economic policy. According to what is known to date, economic growth will no longer be the main priority, to which everything else must be subordinated. This prospect raises expectations and permits us to feel confident about the coming year. Exactly how China intends to spell out its goals will be explained in future editions of *pwc:china compass*, which will keep you fully informed about the latest developments.

While China and Taiwan’s rapprochement has taken pressure off a long-standing crisis that once dominated the Straits of Taiwan, tensions have continued to rise on the Korean Peninsula during the past few months. China is in a unique position to exert its influence in the region, especially with regard to Pyongyang. Now Beijing’s political leadership must exert all its skills and diplomacy here and in the other crisis-hit regions in Asia such as Afghanistan and Pakistan.

As you are probably aware, not only is 2011 the Chinese Year of the Rabbit, but it is also the International Year of Chemistry. The great Marie Curie, the Polish-born French chemist, physicist and winner of two Nobel Prizes (1903 for physics, 1911 for chemistry), once said, “A scientist working in the laboratory is not just a technician, he also stands before the laws of Nature like a child in Wonderland.”

With these words in mind, may I wish all our readers lots of success in 2011.

Yours

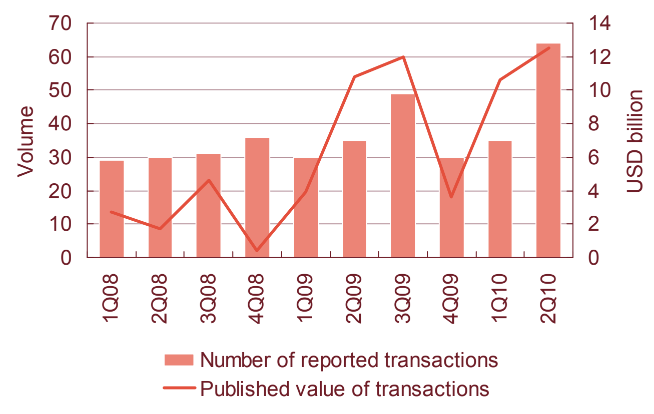
Stefan Schmid
Leader China Business Group

Mergers and transactions: Chinese activities during the first half of 2010

This article explains …
- how investment in and by China has developed as a whole,
- which economic segments and regions the Chinese favour when investing abroad and
- why a current ministerial decree by the Central Government is considered likely to give impetus to the M&A market.

The financial crisis kept markets and companies worldwide in suspense for a long period. The strategic issues centred on reducing costs, managing current assets and securing funding, and the same held true for China. With the return to profitability, stronger growth and better, more lasting, sources of inexpensive funding, companies and investors are once again considering potential targets for investment and takeovers. During the first half of 2010, Chinese activities in these areas were already regaining the levels prevailing before the start of the crisis, and new peaks of investment abroad were reached. A study by PwC China now provides our readers with an overview of the situation, and this article summarises the main facts.

PwC China will be publishing a twice-yearly updated summary of the activities taking place in the M&A (mergers and acquisitions) field in China in the light of the prevailing economic situation for interested parties. The Spring 2010 issue of *pwc:china compass* informed you about the publication in July 2009 (starting on page 35). The publication on which the current article is based on dates from August 16th 2010. PwC China is likely to be presenting the follow-up study for the second half-year 2010 to the press in the following month, and will simultaneously publish it at www.pwccn.com.



Source: ThomsonReuters, PwC analysis

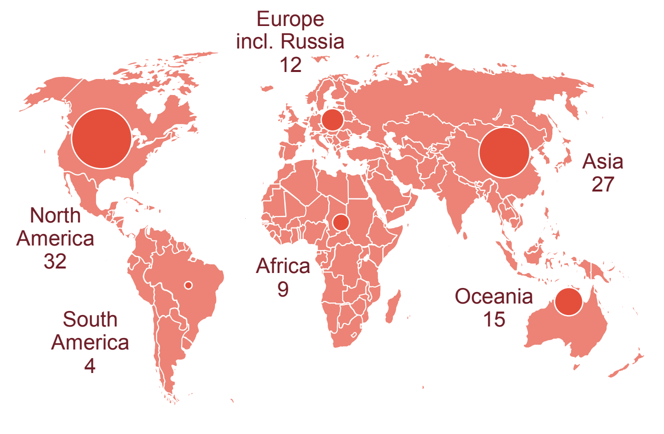
Foreign investment from 2008 up to and including 1st half of 2010

Overview

As the study shows, Chinese M&A activities recovered strongly during the first half of 2010, encouraging expectations that the stable level of activity among such transactions would continue during the rest of 2010 and beyond. This concerns investments made within China and from outside, as well as China's own foreign investments. China's foreign investments experienced their highest growth during the first six months, rising by over 50 per cent compared with the first six months of the previous year and so reaching new record highs. This positive trend is also reflected in transaction volumes. Seven foreign investments exceeded a value of one billion US dollars, for example, compared with only three during the first half of 2009. In total, 99 Chinese investment transactions abroad were reported during the first and second quarters of 2010. This is a trend which has continued since the first quarter of 2008.

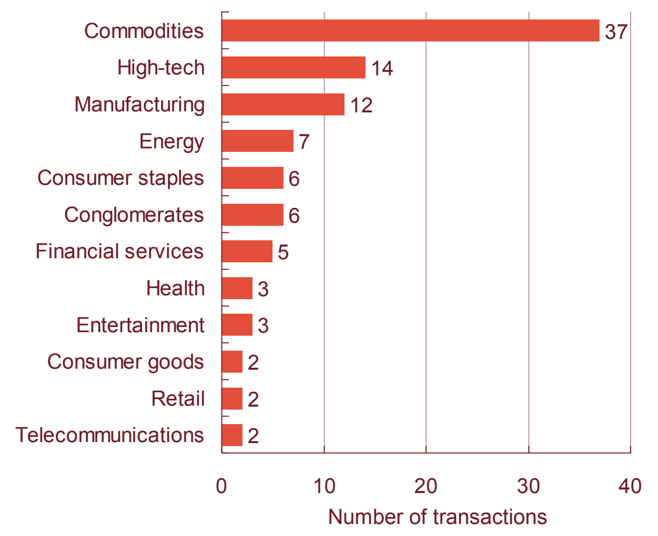
Foreign investment

As ever, one of the prime targets of Chinese investment abroad is the commodities sector. During the first half of 2010 the number of transactions in this sector came to a total of 37. The largest transaction was undertaken by the petroleum and natural gas company Sinopec, which acquired a nine per cent stake in Synacrude (the world's largest producer of synthetic oil from oil sand) from ConocoPhilips at a price of 4.7 billion US dollars. Another noteworthy transaction was a 1.2 billion US dollar investment by China Investment Corporation in PennWest Energy (a company operating gas and oil fields). Geographically, Australia (along with Canada, the location of two of the above acquisitions) is the primary target of Chinese investment abroad. Africa is also becoming a much more frequent target of Chinese investment.



Number of Chinese foreign investment by region

The commodities sector overall remains the primary target for Chinese investment abroad. The Chinese government promotes this sector by granting inexpensive loans in order to provide adequate protection for the supply of commodities, which act as the driver of future economic growth. But Chinese investors are also devoting more attention to other industries, including manufacturing in particular, as well as the high-tech and service sectors. Chinese interest in these branches of industry is spreading out geographically to economic regions such as the USA, Japan and the European Union.



Foreign investment by industry during the first half of 2010

Domestic activities in the M&A field

The generally positive trend is not restricted to foreign investment alone. Both domestic investments and foreign investment in China have recovered very strongly, reaching levels last observed prior to the financial crisis. During the first half of the year the transaction volume rose by 26 per cent compared with the first half of 2009, which was then the lowest level for three years. A total of 1,884 transactions were recorded during the first half of 2010, with 22 exceeding a value of 500 million US dollars – during the same period of 2009, the figure was just 17. As a point of interest, the largest transaction during the first half of 2010 was entered into by China Mobile when it acquired 20 per cent of the shares in Shanghai Pudong Development Bank for the equivalent of 5.8 billion US dollars. As in this case, most of the M&A activities within China involved transactions by Chinese purchasers. Foreign investment in China still remains below pre-crisis levels, but is on the way to reaching its previous high levels.

Financial investors

Activities by financial investors, including private equity and venture capital funds, have stayed at last year's level. Domestic private equity and venture capital funds attracted record amounts of investment capital during the first half of 2010 and, as always, foreign funds remain committed to the Chinese market. However, increased activities by both domestic and foreign private equity funds were observed during the first half of the year, and in all probability this will be reflected in the number of transactions successfully concluded by year-end. Moreover, the number of domestic funds has undergone phenomenal growth, and the number of foreign funds active in China is also now at a record level. In addition, the first successful transactions are being seen in which the two groups are acting as co-investors.

Outlook

The Central Government's recently enacted New Circular 36 foresees the further opening-up to private investors and enterprises of industries to which access was previously restricted. These would include infrastructure and logistics, construction, banking and financial services, as well as social welfare services concerned with health and care of the elderly. The expansion of the relevant industrial sectors, which were formerly reserved exclusively for state-owned enterprises and conglomerates, will also increase the number of strategic M&A transactions.

In addition to this, international investors are expected to return to the Chinese market with transaction volumes that were last observed before the financial crisis. Investments from abroad are expected to feature areas such as the high-tech sector, which should derive above-average benefit from growth in consumer expenditure and domestic demand, as well as new energy and environmental protection standards.

The existing growth trend in Chinese foreign investment is likely to continue in the near future. In addition to the commodities sector, which has long enjoyed preferred status, other industries such as the automobile and components industry and the high-tech sector will become the focus of investment activity.

With the rising level of interest from Chinese companies in the global capital market, their increased competitiveness, the further accumulation of technical expertise, growing production and service competence, as well as solid earnings expectations in the developed markets, Chinese corporate investment in foreign businesses will also show an increasing trend, and will drive up the number of large-scale transactions.

If you have any questions concerning this article or the new study or are interested in further information, just call or e-mail one of the contacts below.

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Effects of the Chinese anti-monopoly law on planned mergers and acquisitions

China's mergers and acquisitions (M&A) market remains highly dynamic. Legislation enacted over the past few years demonstrates the Chinese central government's determination to exert greater control over the economic activity of investors, at the same time creating greater transparency – reason enough to take stock of the anti-monopoly situation in China.

This article explains …
- which Chinese M&A regulations are of relevance, as well as
- the latest changes and additions to the anti-monopoly law and
- two decisions by the Chinese Ministry of Commerce which caused a stir.

China remains an attractive market for mergers and acquisitions (M&A). While the total number of transactions worldwide has declined over the past two years, M&A deals in China and Hong Kong have increased by 6.5 per cent compared with 2008. In 2009, some 749 such deals took place. Driven by the global upturn, the expectations attached to M&A activity soared even higher towards the end of last year, especially in the automotive, mining, energy and steel sectors.

China – no easy touch

The number of M&A deals transacted may be noteworthy, but companies should still be wary of the barriers facing them when they invest in the Chinese market. In order to better regulate M&A transactions overall, China has enacted a host of new laws and amended existing regulations to meet changing market conditions. Three pieces of legislation stand out:
- The "Guidance Catalogue" for foreign investment, issued in 2007
- The "Regulations on combinations or acquisitions of domestic companies by foreign investors", promulgated in June 2009
- The amended version of the Companies Act of 2006

A host of additional regulations apply to foreign invested enterprises in which at least 25 per cent of the Chinese shares are held by a foreign company. Following the Ministry of Commerce (MOFCOM) ruling in 2009 prohibiting Coca-Cola from acquiring the Chinese soft drinks company Huiyuan, foreign companies must now plan their M&A transactions with greater attention to China's new anti-monopoly rules.

Anti-monopoly control in China

The People's Republic of China anti-monopoly law (AML) came into force on 1st August 2008. Adoption of this law was an important precondition for China joining the WTO. The main objective of the AML is to prevent unfair monopolistic behaviour by participants in the market.

The law distinguishes between three areas:
- Agreements, decisions and activity coordinated between independent companies aimed at restricting competition
- Abuse by companies of market-dominating positions
- Mergers designed to obstruct or eliminate competition

The Chinese rules relating to business combinations now impinge markedly on M&A transactions. The AML stipulates an advance notification procedure which companies must apply when threshold values notified by the State Council are exceeded, as well as when the AML exemption rule for majority shareholdings does not apply. In August 2008, the State Council issued a separate regulation defining thresholds calculated on the basis of the sales of the companies involved. In the first phase, the intended transaction must be notified when
- global sales of all companies involved in the combination exceeded ten billion RMB (approx 1.4 billion CHF) in the previous year, and at least two of the companies had sales within China exceeding 400 million RMB (approx 56.5 million CHF);
- total sales of all companies involved in the combination exceeded two billion RMB (approx 283 million CHF) in the previous year, and at least two of the companies had sales within China exceeding 400 million RMB.

A separate regulation issued in August 2009 lays down thresholds for companies in the banking, insurance and securities sectors, as well as for certain other industries and sectors. However, what seems a simple regulatory process is in fact opaque, as MOFCOM takes Article 4 of the regulation to be an enabling clause. According to this interpretation, MOFCOM may examine combinations which are likely to have the effect of eliminating or restricting competition, even when thresholds have not been reached. This type of procedure entails risk for the companies involved, as the regulation does not specify the conditions under which MOFCOM is entitled to exercise its authority. The regulation simply states that MOFCOM must apply proper procedures during the investigative process of obtaining evidence. However, the manner in which such a procedure should be conducted when ascertaining a potential threat to competition is more closely defined in two implementing regulations which came into force on January 1st 2010. These regulations serve as indicators of how to analyse the planned combination, in order to determine whether it needs to be notified or not, as well as outlining the criteria MOFCOM applies when it examines whether or not competition will be restricted. Nevertheless, some aspects remain unclear. For example, the draft version of the implementing regulations had previously defined "control". Defining control is important in all cases of business combination where no majority shareholding is acquired, as the companies involved must then decide whether a business combination exists within the meaning of AML. The same applies with regard to business combinations as they relate to joint ventures. Previously, the draft regulation had confirmed that only an independent joint venture established with a view to long-term operation could be seen as a business combination pursuant to AML. However, this clarification has since been deleted from the regulation, leaving companies alone with the difficult decision as to whether or not they must notify the intended combination as a joint venture.

Landmark decision in the Coca-Cola/Huiyuan case

An idea of the sort of difficulties facing companies is evident from one of the first cases in which the new AML was applied. In its decision of March 18th 2009, MOFCOM vetoed acquisition of the Huiyuan Juice Group Limited by Coca-Cola. Huiyuan is one of China's biggest soft drinks producers, with a market share of around 40 per cent in the juices sector. At the time, Coca-Cola had a market share of just 10 per cent. Had the Ministry of Commerce given the green light, the Coca-Cola deal would have been the biggest foreign acquisition of a Chinese company to date. However, MOFCOM barred the transaction on the grounds that Coca-Cola would have too large a share of the Chinese market following the deal, and would subsequently force small and medium-sized soft drinks companies off the market. MOFCOM further argued that the merger would lead to consumers paying higher prices, while at the same time having less choice. During the six months in which MOFCOM was processing the planned transaction, both sides put forward various proposals for saving it. However, Coca-Cola failed to convince MOFCOM that its proposals would keep any restrictions on competition within bounds. Subsequently, the Coca-Cola/Huiyuan decision was seen by western media as evidence of a trend towards greater protectionism. On the other hand, the case could also be interpreted as no more than rigorous application of the AML as it stands.

Approval of Novartis's acquisition of Alcon failed to produce greater transparency

In its decision of August 13th 2010, MOFCOM approved the acquisition of Alcon Inc. by Novartis AG. However, during the notification procedure, MOFCOM expressed concern that the acquisition could restrict competition on the market for ophthalmic anti-inflammatories/anti-infectives and for care products for contact lenses.

MOFCOM determined that following such an acquisition, Novartis's market share in ophthalmic anti-inflammatories and anti-infectives would increase globally to 55 per cent and would exceed 60 per cent in China. The Ministry of Commerce, fearing that Novartis would put earlier products back on the market once the deal had gone through, decided that Novartis's current market share in China of just one per cent was due to a targeted strategy of disinvestment by the company in the run-up to the transaction. It is generally a very difficult and complex task to prove such an effect, which would restrict competition. However, MOFCOM's briefly worded decision gave no indication of how such a conclusion had been reached.

In addition to this, MOFCOM believed that after the planned takeover, Novartis's market share for contact lens care products would reach around 60 per cent globally, with a 20 per cent share of the Chinese market. This would have made Novartis the second-biggest provider in China. In 2008, a Novartis subsidiary had already concluded an exclusive distribution agreement with Hydron, China's biggest company for contact lens products (with around a 30 per cent market share). MOFCOM feared that the acquisition along with the existing distribution agreement would have a negative effect on competition in terms of prices, quantities and sales areas. Here too, MOFCOM's briefly worded decision shed insufficient light on the rationale behind these fears.

Approval was finally granted subject to far-reaching concessions, whereby Novartis conceded to MOFCOM a five-year halt on sales of ophthalmic anti-inflammatories and anti-infectives and termination of its exclusive distribution agreement within 12 months.

One remarkable feature of all this is worth mentioning: just one day before this agreement was reached, MOFCOM had held a press conference relating to the treatment of foreign enterprises within the framework of the AML. In this connection, the Ministry of Commerce announced that it had subjected only foreign enterprises to such stringent conditions, not domestic companies. In conclusion, it would be very much in the interests of foreign investors were MOFCOM to communicate its decisions more transparently in future, especially in view of the Novartis/Alcon case.

Anti-monopoly legislation in China is still evolving

Anti-monopoly legislation in China has already developed considerably. Some long-awaited implementing regulations came into force on January 1st 2010, clarifying many areas and providing useful information. The anti-monopoly rulings issued by MOFCOM over the past few years have also been of assistance to companies in terms of the decisions it has taken in practice. However, real legal certainty is still a remote prospect. The cases of both Coca-Cola and Novartis make one thing clear – the Ministry of Commerce must qualify its decisions in such a way as to show that they genuinely represent an expression of its desire to control competition, rather than being inspired by seemingly protectionist considerations. Further clarification is also needed in future as to how the new AML will be interpreted.

In China, many roads lead to Beijing

Establishing a company on the Chinese market does not always entail the acquisition of a large enterprise already established on the market. Purchasing of a company below the threshold values can be an attractive alternative. This enables the investor to gain initial experience with the Chinese market while establishing useful connections with the previous owner. Taking this route enables investors to better assess the advantages of the current investment climate. Balancing of the pros and cons of M&A as a means of entering the Chinese market must be a realistic part of any market entry strategy. All too often, planning is based solely on positive assumptions. The acquisition of a large company certainly has the advantage of being able to put an existing infrastructure (established networks of suppliers, buyers and logistics) to use immediately, thereby gaining a speedy foothold in the market. At the same time, the possibility of coming into conflict with the AML must be part of any such consideration. On the other hand, acquiring a small company means that such conflicts will generally be avoided, although an infrastructure must first be created, which calls for considerable financial, human and time resources.

Companies are well advised to obtain information about current developments and to examine planned mergers or acquisitions closely, in order to identify any areas of potential conflict with existing anti-monopoly laws.

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Do you know how long paper money has been in existence in China?

The world's first paper money was issued in China in 1120 during the Song Dynasty.

Source: Hans Hauenschield, *China Takeaway*, Ullstein Verlag

你知道了吗

New rules regulating overheating real estate market

The recent spectacular growth in the Chinese real estate market has created widespread international interest. Double-figure price increases per quarter have not been unusual, especially for private residential property in the booming coastal mega-cities. This has led the Chinese central government to intervene repeatedly over recent years in order to dampen speculation and give the market a chance to cool off. Circular No 10 is a further government regulation introduced to control investment activity in the real estate and property market. Our real estate experts, Dr Florian Hackelberg and Florence Chan, summarise Beijing's latest changes.

This article explains …
- why the Chinese government wants to moderate price increases in the real estate market,
- what new rules have been introduced with Circular No 10 and
- how the new rules will affect the Chinese property market.

A speculative market

Different sectors in the Chinese property market are developing in widely varying ways. While some parts of the market are experiencing sustainable growth, other areas such as private residential property have seen localised price jumps, with prices even doubling on a monthly basis. These price rises have been fuelled by speculative investment, combined with the simple fact that there are no real alternative sources in which Chinese people can invest. The turbulence of the Chinese stock market, together with financial scandals, have scared off many private investors looking for a secure investment. At the same time, investment in fixed-interest-rate money is unattractive, as it fails even to cover inflation losses. Many Chinese, especially among the new middle classes, therefore see a second or third home as the only alternative into which they can plunge their savings profitably. This has stimulated demand, with property prices continuing to rise massively. At the same time, the tremendous increase in the cost of residential property means that many Chinese people on lower incomes have little chance of realising their dream of buying their own home. In many parts of China, the gap between annual income and residential property prices is already less advantageous than in western countries.

In order to prevent the real estate bubble from bursting – which would obliterate the savings of thousands of Chinese – the Chinese central government has decided to slow the market down, while ensuring that affordable residential accommodation remains available. This, then, is the rationale behind the latest regulations, a move that must be seen as part of a long-term policy on the part of the Chinese central government (Circular No 4, enacted in January 2010, has already had some limited success).

Circular No 4, enacted in January 2010, stipulates higher levels of own capital when buyers seek loans to finance property. This has had a short-term effect, with the market cooling down locally as desired by the Chinese government. Nevertheless, the first quarter of 2010 still saw rapid increases in real estate prices, especially in the private residential segment, forcing the government to introduce Circular No 10 in April 2010.

Inefficient provision of affordable housing is a further aspect forcing the Chinese government to intervene. As the chances of higher profits are greatest in the high-price residential property segment, Chinese investors are prioritising projects in this area. With regard to the demand side, there is often no real need to utilize the residential property acquired, resulting in apartments standing empty. This coincides with a lack of residential property in the lower price segment and of state-aided housing. This is because profit margins in these segments are comparatively low and thus less attractive for investors.

In order to counteract this trend, and to guide investment activity in the real estate market, in April 2010 the Chinese central government introduced Circular No 10. This administrative ruling comprises further regulations, in particular with regard to the minimum own capital that an investor must provide as personal equity when seeking a loan in order to finance a property purchase.

The new rules

Real estate investment frequently uses third party capital, as the leverage obtained increases the potential interest gain available from own capital. Nevertheless, there is increased risk when property loses its value heavily, with the result that more than just the investor's own capital may be lost.

These risks are addressed through the rules in Circular No 10, which has increased the minimum amount of own capital an investor must supply. Beijing appears to be making it more difficult for speculators to purchase property, especially when that property will not be lived in by the owner. The hope is that price increases at the high end of the residential property market will ease. At the same time, the previous high level of third-party financing, through which private investors stimulated the market, will also decline.

Circular No 4 stipulated that only 40 per cent of own capital was necessary when purchasing a second property, and that the financing bank was allowed to determine the loan interest rate based on its own risk assessment, but the new rules under Circular No 10 are considerably stricter.

According to the new regulations, the ratio of own capital to third party financing for a second property must comprise at least 50 per cent of the purchase price. Additionally, the financing bank may no longer base its loan interest rate on the risk profile of the investor alone. Lending banks must now apply a minimum interest rate at least 1.1 times the base lending rate of the Chinese central bank, the People's Bank of China (PBoC benchmark). The table below summarises the new regulations.

Status of property	Amount of own capital required	Minimum interest rate
First property	no less than 30 per cent of the loan for property with an accommodation surface area of 90 sq. m or more	–
Second property	no less than 50 per cent of the loan	no less than 1.1 times the base lending rate of the People's Bank of China
Additional property	Own capital must be significantly greater and will be set by the financing bank.	–

Own capital and third-party-lender interest rate requirements under Circular No 10

The central government is applying its new ruling strictly in order to ensure sustainable growth. Central government wants to ensure that ordinary Chinese people can still buy residential property for their own use. In consequence, first-time residential property and property with a surface area of less than 90 square metres are largely unaffected by the new rules.

The new rules are also intended to stimulate the construction of state-aided residential property for people on low incomes. In 2010 alone, a further 2.8 million standard apartments will be completed.

Main effects

The new rules had a direct effect on the housing and real estate market in the second quarter of 2010. The housing transactions market has already cooled down, while the number of apartments purchased has fallen slightly. The new rules are intended to reduce the price of apartments by between 10 and 20 per cent over the next 12 to 18 months.

As a secondary effect, real estate developers are now focusing their activities more strongly on second-tier cities such as Tianjin, Zhongshan, Wuhu and Xian.

Another article on issues raised in the Spring 2010 *pwc:china compass*

- "No place like home ... in Wuhan? Practical advice on purchasing property in China", Winter 2009/2010, from page 21.

In addition, interest in investing in the retail-store property market is growing, as this remains outside the remit of Circular No 10. For example, the Chinese real estate development company China Vanke, well known for its spectacular residential property projects, has recently started three new projects in the retail store segment.

Conclusions and outlook

The Chinese central government wishes to implement the new regulations quickly and apply them in the individual provinces. While the desired effect of falling prices for residential property was seen briefly after the introduction of Circular No 10 in April, residential property prices still remain high, especially in first-tier cities. In the third quarter of 2010, transaction activity regained momentum, with property prices rising again. In view of this, Circular No 10 is unlikely to remain the last regulatory measure from the Chinese central government. In order to counteract further excessive price rises, fiscal regulations have been introduced at the local level.

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Do you know what a leading general and statesman of the Qing Dynasty said about the relationship between China and the West?

When Li Hongzhang (1831 to 1901) visited Bismarck in Berlin in 1896, he wrote to the Chinese Emperor: "Even when we foreigners ask about the latest model, examine it carefully and try to copy it, the Europeans bring out a newer one just a couple of years later. Putting China behind again."

Source: Hans Hauenschield, *China Takeaway*, Ullstein Verlag

你知道了吗

Forming a joint venture in China – the most important steps

What procedures are involved in order to set up a joint venture successfully in China? Under what circumstances can foreign investors expect to profit from a joint venture (JV) with a Chinese company? What needs to be taken into account when looking for the right partner? Marc Wintermantel, our colleague in Shanghai and an expert in transactions, draws on working practice to describe the key elements involved. His suggestions are based on numerous discussions he has held with companies involved in the JV process. While this article cannot replace individual advice and support, it outlines in brief the main areas that apply to any company wishing to set up a successful joint venture in China.

This article explains …
- why it can be difficult to find a suitable Chinese partner,
- what you should bear in mind when applying to set up a joint venture and
- what are the main issues to consider while negotiating a JV contract.

Reasons for setting up a joint venture

Many international companies desirous of investing in China opt for a joint venture (JV) with a local partner. There are many reasons why companies embark on the not always easy search for a suitable local partner, with Chinese regulatory requirements being just one motivating factor. Although China has eliminated many barriers to investment in the export manufacturing and consumer products sectors since its entry to the World Trade Organisation (WTO), many sectors of its economy are still subject to legal restrictions. Partnering with a local company in order to enter the Chinese market may be an attractive alternative to help circumvent legal restrictions, but also when an investor wishes to focus on China's growing domestic market ("In China – for China"), rather than simply using the country as a favourable base for export-oriented manufacturing. Selecting the right partner can ease access to sales channels and smooth relationships in the domestic market, as well as greatly reducing the time needed to develop products that cater for Chinese tastes.

It is becoming increasingly difficult to select a suitable partner

Chinese companies that were previously small enough to acquire in full are now becoming too large for many investors to buy outright. And with China's performance during the financial crisis, its companies have become increasingly self-confident and more demanding at the negotiating table. Today, Chinese companies are no longer looking just for injections of capital, as financing is becoming increasingly available to them on their domestic market. At the same time, Chinese entrepreneurs are becoming ever less inclined to share future profits with a JV partner. The reason for this change lies in the growing confidence of Chinese-run companies in their ability to serve their domestic market with their own product offerings, or to use their own business model. Such strong, expanding Chinese companies do not need partners except to provide technology enabling them to gain a competitive edge in the domestic market, or to provide market access – in other words, to satisfy their desire to "go global".

Bearing this in mind, what are the key stages and factors involved in forming a JV? In what follows we shall provide some answers.

Selecting a JV partner

In general, formation of a JV with a partner with whom the foreign investor already has a working relationship is more likely to lead to a successful joint venture. It is helpful to have known the Chinese partner for some time when assessing whether he shares a common business strategy and is capable of developing and growing the business in line with that strategy. It is equally essential to know with whom you are dealing when it comes to the question of integrity, so that you know that funds have been allocated correctly, not to mention helping to avoid fraudulent behaviour. This is particularly relevant, as it can be difficult to assess the reputation of a company or management team. While national ID numbers can be obtained in order to carry out a proper background search, this can be a sensitive topic.

During the selection process, it is important to understand the JV partner's organisational structure and how any related parties will play a role in the JV. This is useful with regard to the compliance profile of the JV partner, and is a good indicator of the way the JV will be run in future. However, top priority should be given to assessing the JV partner's liquidity, as the risk of fraud increases when a JV partner faces liquidity issues in other areas of his business.

Structure of the joint venture

The most common structure used is relatively simple, with both parties injecting their assets directly into a newly established JV company. In this scenario, the Chinese partner generally contributes an existing business to the JV, including infrastructure, plant, customers or distribution network, suppliers, workforce and relationship with the government. On the other side, the foreign investor will frequently contribute technology and know-how, key management and cash. The success of the whole project depends greatly on having one's own management resources seconded to key positions within the JV, even where this may lead to "dual leadership" in some areas, and thus to higher costs. When considering the extra cost involved, investors should heed the fact that JVs frequently fail when the foreign investor fails to send its own management to China.

One common trend is for both sides to inject cash only into the JV, thus simplifying the valuation process. In parallel with this, an agreement is concluded whereby each party agrees to buy certain assets from the other party at an agreed price once the JV has been given formal approval and been legally established. However, this approach still calls for valuation of the acquired assets when a JV is to be formed with a State-Owned Enterprise (SOE).

Under Chinese company law, at least 30 per cent of the assets contributed must take the form of cash. A foreign investor can make this contribution in a foreign currency. No restrictions are placed on the type of assets that may be contributed, but human resources/management expertise are not deemed to be an asset. On the other hand, local authorities frequently restrict the level of intangibles to approximately 40-50 per cent of total assets contributed. The valuation report is used as a guide for the JV equity ownership of both parties, but in practice the equity split may differ from the actual value of the assets contributed. Once the formal side of the JV formation has been completed, clients often underestimate how much time it will take to import tangible assets (such as machinery) into the country, and one particular point that should be noted is that machinery older than eight years faces a rigorous import evaluation. This may even involve Chinese import officials flying to the current location of the assets to assess them in full operational mode.

Chinese regulations differentiate between two types of joint venture:

- Equity Joint Venture: profits, risks and losses are shared in proportion to each partner's equity stake. Ownership is normally determined by capital contribution. Foreign participation must be at least 25 per cent for the JV to be considered a Foreign Investment Enterprise (FIE).
- Cooperative Joint Venture: similar to an Equity Joint Venture in structure, but with more flexibility as the sharing of profits is governed entirely by the JV contract. The foreign partner has priority over the Chinese partner vis-à-vis the return on investment.

Documents and Regulatory Approval

The following documents are required for submission when setting up a joint venture in China:

- Joint Venture Agreement
- Statutory Valuation
- Feasibility Study Report (business plan)

In the course of preparation of the above-mentioned documents, especially the feasibility report, investors are often forced back to the negotiating table, despite the JV agreement already having been signed. The number of different regulatory bodies required to approve the JV depends on the size of the proposed JV, and whether the Chinese JV partner is an SOE or a listed company. Regulatory approval is a step-by-step process, with the application moving on to the next regulatory body after receiving approval from the preceding one. Larger JVs, such as companies with a total investment in excess of 30 million US dollars (equity + long-term debt), as well as JVs involving SOEs, often require the approval of national regulatory bodies, which invariably adds to the time needed to secure approval.

The box below outlines key components of the feasibility report – a relatively detailed document often requiring several weeks, if not months, of preparation.

Contents of a feasibility study report

1. General information
   - Project background and purpose
   - Details of each partner
   - Details of JV ownership
   - Source of capital contribution
   - Project timeline
   - Number of departments, composition of management and number of employees
   - Summary and conclusion vis-à-vis feasibility of the joint venture
2. Market analysis
   - Market analysis for the relevant sector
   - Competitor analysis
   - Brand and market position
   - Market and financial forecast
3. Production overview
   - Planned product and technology development
   - Scale of production and plant layout
   - Planned processes and equipment
   - Supplier of raw materials and utilities
4. Logistics quality and IT systems
   - Planned logistics system details
   - Quality management system details
   - IT system details
5. Infrastructure overview
   - Building and facility details
   - Power requirements and supplier
   - Water requirements and supplier
   - Heating, ventilation and air conditioning system
6. Health and safety
   - Fire protection system
   - Environmental protection system

In addition to internal valuations, the "statutory valuation" forms a key document and is a regulatory requirement in the approval process. The valuation must be conducted by a licensed Chinese valuation firm. Where an investor enters into a JV with an SOE, a statutory valuation of the assets contributed by both parties must be submitted. Such a valuation is typically much more thorough than a standard valuation, and must be approved by the State-owned Assets Supervision & Administration Commission of State Council (SASAC). As SASAC often questions the methods and assumptions used, the firm performing the valuation must be able to justify the appropriateness of the figures.

Where a JV is to be set up with a private company, valuation by a Chinese firm is still required, but it is typically less detailed and the outcome is often guided by the values attributed by both parties.

The table on the following page provides a summary of the various stages in the approval process, the documents required for submission, the time involved and the focus of the regulatory body.

Stages in regulatory approval	Timeline in days (may vary)	Key documents	Regulatory focus
Approval by State-owned Assets Supervision & Administration Commission of State Council (SOEs only)	120–150	Feasibility study report (business plan), valuation report	–
Notification/Approval by China Securities Regulatory Commission (listed co only)	180–270	Feasibility study report, valuation report, JV agreement	Fairness of transaction, pricing (valuation)
Approval by National Development and Reform Commission (NDRC)	20–40	Feasibility study report, environmental assessment	Feasibility of the project, impact
Approval by Ministry of Commerce (MOC), Anti-Monopoly Bureau (depends on size)	30–180	Anti-monopoly disclaimer	Anti-monopoly risk
Approval by Ministry of Commerce	< 90	JV agreement, feasibility study report, valuation report, articles of association, NDRC approval	–
Approval by State Administration of Foreign Exchange	–	MOC approval	–
Capital injection and verification of injection by a CPA firm	–	Valuation report, bank statements, various asset transfer statements	–
Obtain business licence and other registration (tax authority, industry association etc)	–	MOC approval, capital verification report, valuation report	–

Stages in regulatory approval (documents to be submitted, timelines and regulatory focus)

Potential investors should note that it is important to agree upon a valuation firm that is both independent and competent. When a reputable firm is chosen, the valuation methods will generally be similar to western valuation methods, although the results obtained can vary widely from firm to firm. During the valuation process both parties will supply input in order to agree on appropriate valuation methods and to provide feedback on the draft valuation results prepared by the firm. The foreign investor must understand which areas can be influenced and how best to negotiate the most favourable strategy. It is also important to understand the implications of different assumptions or methods used by the Chinese valuation firm, compared with the investor's internally generated valuation – while the latter is fundamental for any final investment decision.

Role of accounting rules during negotiations

Negotiations often involve a lengthy stop-start process. This makes it all the more important to identify the key decision-makers and what is motivating them. Foreign investors are well advised to hold back on concessions, as negotiations will probably continue for longer than originally expected. Fundamental commercial differences are rarely solved at the letter of intent stage of negotiations.

From an accounting point of view, the question of "control" is a major topic at the negotiating table. The question of control versus "joint" control will affect negotiations, as the ability to consolidate revenue is increasingly becoming a key negotiating factor for Chinese partners and may dictate governance issues. Chinese companies often contribute a significant part of their existing business to the JV. Some Chinese groups even consist of JVs only, which is why it is crucial for them to consolidate revenues. When each investor wants to consolidate the JV (under its respective GAAP), this can significantly affect the rights and obligations of the respective parties. Control determination affects how the JV will be included in the reporting company's financial statements – consolidation, proportionate consolidation or equity method.

Consequently, this affects the size of the balance sheet and top-line revenue, and may indirectly affect various KPIs, covenants or the remuneration of key executives. When determining control, consideration should be given to the relative voting rights of the partners and the veto rights held by either party. Experience has shown this to be very much a question of judgement, and legal rights may sometimes appear to contradict how the JV partners actually intend to operate the venture.

Timing

In general, PwC advises its clients to plan for a 6-12-month period from the start of the application process to obtaining the business licence. Timing depends on two key factors: the time taken to prepare the regulatory and legal documents, and the time required for regulatory approval.

Depending on various factors, such as the size of the JV, whether the partner is an SOE, and the industry within which the JV will operate, this timeline may even extend beyond 12 months.

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Tax incentives for qualified services to foreign customers

A 15-per cent rate of corporate income tax, exemption from business tax and further relief on tax, infrastructure, human resources, foreign exchange and subsidies – do such incentives still exist in China today? Yes, if your company has qualified as a "Technically Advanced Service Enterprise" (TASE) and part of its revenue comes from outside China. In the summer of 2010, the rules for qualification were simplified, enabling a larger number of companies to benefit from the tax incentive. This article explains what conditions have changed and how to qualify.

This article explains …
- what "Technically Advanced Service Enterprise" status means,
- what advantages accrue from it and
- how to apply for recognition as a TASE.

Recent trends in Chinese tax law

Over the past few years, foreign companies have found it increasingly difficult to qualify for preferential tax treatment in China. While China once promoted foreign investment through targeted tax relief, it has now changed its strategy, placing greater emphasis on the equal treatment of foreign and Chinese companies with regard to tax.

One better-known example of this policy change is China's return to a uniform corporate tax rate for foreign and Chinese invested enterprises, part of a major corporate tax reform in 2008. That this reform was only one step towards further moves in the same direction is illustrated by the recent ending of exemptions that applied to foreign companies regarding urban surcharges (further details can be found in the article "New regulations increase tax burden on all foreign companies doing business in China", in this edition of *pwc:china compass*, see page 16).

Many people see these developments as a sign of China's greater confidence in its own economic strength. Apart from that, China seems to be giving greater support to its domestic companies, as it strives to create its own national champions in key sectors. This policy is reflected in China's declared desire to "unify its tax system" and create "equal and fair conditions for competition".

Tax relief reduced for foreign companies

In the wake of these changes, the options available to lower the level of corporate income tax in China have continued to decrease. As a rule, tax incentives are now only available at the local level for new investments, and then only for a limited period of time. Where this is the case, local governments are prepared to forego part of their tax revenue. However, the higher echelons of government look increasingly less favourably on local investment support. As a result, any preferential treatment is now meted out individually – for example, by making land available free of charge, or by granting support for capital goods. Widespread lower tax rates are a thing of the past.

On the other hand, the move away from granting foreign companies preferential treatment has gone hand-in-hand with greater incentives for investment within precisely targeted sectors of industry. High-tech service operations that strengthen China's technology base and increase its value added share in the international division of labour, are one of the few areas now left for tax incentives. If there is any potential to reduce the corporate income tax rate – whether as a domestic or foreign company – then it is almost only here where it can be found.

Probably the best-known aspect of China's tax policy directed at promoting innovation, is its preferential lower rate of corporate income tax of 15 per cent for new and high-technology companies. This reduced rate contrasts with the generally applied corporate income tax rate of 25 per cent. The conditions that must be met in order to qualify for the preferential tax rate are relatively strict, including among others a substantial transfer of largely sensitive technological know-how. As many readers know, China still provides no effective guarantee that intellectual property will be protected, so many companies prefer to forego tax benefits, rather than transfer know-how to China.

Additionally, an increasing number of cases have been reported recently in which tax relief previously granted by the authorities has been rescinded following a later inspection. Apart from the financial burden of a 10 per cent tax back-payment for past years, companies affected are suffering from what, for them, has proved to be a useless transfer of know-how to China.

Incentives for high-value services in China

On the other hand, another less familiar route to preferential tax rates does exist, and can be very attractive, provided the conditions can be met. Specifically, this refers to a company being granted "Technologically Advanced Service Enterprises" (TASE) status. Behind this is a policy introduced by China with the objective of establishing itself as an international location for the service sector. This particularly applies to the outsourcing of services.

Preferential treatment for TASEs was introduced on a major scale in 2009, after a pilot project, started in 2007 in Suzhou Industrial Park, proved successful.

These previous measures were based on the following Circulars:
- Guobanhan [2009] 9 of January 15th 2009
- Caishui [2009] 63 of May 24th 2009
- GuoKeHuoZi [2009] 152 of June 26th 2009

The three Circulars combined what were previously separate incentives and tax opportunities, turning them into a single body of rules. These national Circulars have since been extended by local implementing regulations, for example HuKeHe [2009] 31 of August 21st 2009 for Shanghai, while Caishui [2009] 63 has been replaced by Caishui [2010] 65 as of July 1st 2010.

To some extent, the original regulations were very strict. For example, a company wishing to attain TASE status had to show that at least 70 per cent of its revenue came from the provision of qualified services. Additionally, companies were required to submit international certificates, such as CMM (Capability Maturity Model) or ISO certification.

As a result of such restrictive requirements, only comparably few, large Chinese companies were able to gain recognition and benefit from preferential treatment. The number of officially published TASEs as of July 2010 was (2009 figures in brackets):

- Shanghai: 119 (105)
- Tianjin: 35 (26)
- Shenzhen: 26 (16)

No July figures for Beijing are available. In 2009, only 47 TASE companies were published as having gained recognition.

On the other hand, those companies that have been able to take advantage of the new rules have profited greatly. In an interview with the China Daily on August 12th 2010, Jin Hui, Tax Director of the Chinese software giant Neusoft, stated that tax relief had saved his company over three million RMB (around 332,000 euros) in the first seven months of 2010. Hui also believed that small and medium-sized enterprises could profit from the incentives.

In order to make TASE qualifications easier to apply overall, the rules were eased in the Circulars Guobanhan [2010] 69 and Caishui [2010] 65.

The advantage of TASE status

Once a company has been awarded TASE status, those parts of its profits gained from qualified services are subject to the lower level of corporate income tax of 15 per cent. Additionally, qualified sales with foreign customers are free from business tax (BT). These tax incentives add up to considerable savings in costs and charges for a TASE.

Finally, a TASE is entitled to deduct staff training costs up to 8 per cent of its total wage and salary bill from its taxable income. Generally, Chinese corporate income tax law only allows 2.5 per cent to be deducted as training expenses. Any amounts above the threshold can be carried forward to later years.

Tax relief applies up to December 31st 2013. This means that the total incentive period following introduction of the new rules in 2009 is set to last five years. At present, it is not known whether the incentives will be extended beyond 2013.

Companies which do qualify and obtain TASE status profit from several further advantages:

- Relaxed capital exchange controls (foreign exchange)
- More flexible personnel rules (approval of special working time models)
- State subsidies
- Support with infrastructure

Qualifying for recognition as a TASE

Obtaining these benefits is linked to a series of qualifying conditions, set out below. While describing the conditions involved in order to qualify, we also cast some light on the more critical aspects of the rules.

The obvious constitutive feature of a TASE is the qualifying services it provides and which China considers to be of high technological value. Generally, these are services provided to companies which have moved certain parts of their operations to outside parties (outsourcing). The Chinese rules differentiate between three main types of qualifying service (the English abbreviations are the ones used in the official Circular Caishui [2009] No. 63):

- Information Technology Outsourcing (ITO): this includes software development, information technology and system maintenance of IT resources (system hosting).
- Business Process Outsourcing (BPO): this includes a long list of possible services, from consultancy services (e.g. design of business processes or supply chain management) to back office functions.
- Knowledge Process Outsourcing (KPO): this category mainly refers to diverse services relating to research and development.

A detailed, if not conclusive, catalogue of qualified services can be found in the annex to Circular Caishui [2009] 63.

Describing qualifying services as “high technology” might be somewhat misleading, however. Relatively simple services (for example office services) also qualify if performed within the broader framework of outsourcing activity.

On the other hand, services in some sectors do not qualify, despite their outsourcing service nature. This applies, for example, to the logistics sector, where recognition as a TASE has, to date, been practically unreachable in the authors’ experience. This means that each application must be carefully examined on its merits in close contact with the relevant authorities.

According to Circulars Guobanhan [2010] 69 and Caishui [2010] 65, qualifying services must account for at least 50 per cent of total annual income. That is a considerable reduction compared to the rules first introduced in 2009 – at that time, income from qualifying services had to account for at least 70 per cent of annual income.

A further condition for qualification is the offshore amount that makes up the service. At least 50 per cent of income from the qualifying service must be obtained from foreign customers. In other words, supplying domestic customers is not sufficient. The purpose of this rule is to establish China as an international outsourcing centre, thereby increasing its proportion of income from the service sector as part of the value added process.

Note: only sales to foreign customers are exempt from business tax, whereas the lower corporate income tax rate applies to all income from qualifying services.

Bearing this in mind, regional shared service centres could well prove to be an attractive business model as it allows to centralise relevant functions within China.

In order to take advantage of the tax incentives in China using this model, at least half of all income must originate from foreign companies. That income is exempt from business tax, while all income in the qualifying shared service centre is subject to the lower rate of corporate income tax.

Other criteria that must be met in order to qualify as a TASE:

- At least 50 per cent of the company's staff must hold a university degree or higher qualification.
- The company must be located in one of 21 pilot cities: Beijing, Changsha, Chengdu, Chongqing, Dalian, Daqing, Guangzhou, Harbin, Hangzhou, Hefei, Jinan, Nanjing, Nanchang, Shanghai, Shenzhen, Suzhou, Tianjin, Wuhan, Wuxi, Xiamen or Xian.
- The company must have impeccable status, ie, a legal entity that has not violated any administrative rules over the last two years – that includes regulations relating to import/export, finance, tax, foreign exchange or customs.
- The company must apply highly-developed technology or have strong R&D capabilities.

The previous requirement of international certification (for example, ISO or CMM) has since been lifted through Circulars Guobanhan [2010] 69 and Caishui [2010] 65.

Application procedure

The application procedure involves several stages. First, an application for TASE status is made online. Following this, and within between 20 to 40 days after the necessary documents have been received by the relevant authority, the application is subjected to first assessment by an individual expert. This is followed by assessment by a panel of experts who hold the ultimate decision-making power. Applications that have been approved by the panel of experts are then publicised (on the internet) within ten days. Should an objection be raised on publication, the application is subjected to renewed scrutiny and assessment.

Once a final positive decision has been made, TASE status is granted. If the company in question wishes to profit from the associated advantages, a separate application must be made to the relevant tax authority.

Readers should note that individual aspects of the application procedure are decided locally, and can differ from city to city.

Conclusions

The tax benefits that accompany TASE status are attractive – and have now become accessible to a larger number of companies, following the relaxation of qualifications from mid-2010. The fact that preferential tax treatment for foreign invested enterprises has ended means that the TASE route could be an enticing alternative for companies wishing to reduce their tax levels. Added to this are a series of non-tax-related incentives that go alongside TASE status.

Should you be interested in applying for TASE status, please bear in mind that your company must comply with a large number of administrative requirements, and must follow the application procedures precisely. In other words, a successful application must be based on a realistic self-assessment and good planning. PwC's experts would be pleased to provide support in this process.

If you have any questions or would like further information, just call or e-mail the contacts below.

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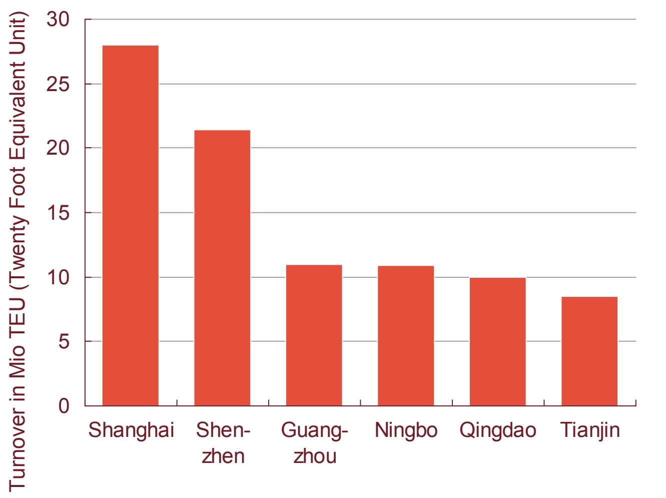
Shanghai a future logistics center for Asia: incentives and outlook

Following guidance given by the Beijing political leadership in 2009, Shanghai has developed into a leading location for financial services and the maritime economy in China. Construction of an international shipping centre and new tax incentives have made the city, on the banks of the Huangpu, even more attractive, as it seeks to entice shipbuilders and logistics companies to settle there. Despite – or perhaps because of – its early developmental phase, Shanghai could well be an alluring alternative hub for the logistics sector. Reflecting on current developments, this article discusses Shanghai as a potential logistics centre, focussing especially on its tax incentives. The authors compare China's "new boy" with the classic entrepôts of Hong Kong and Singapore, as part of the decision process of where to invest.

This article explains …
- the tax incentives in China arising from the expansion of Shanghai as a logistics hub,
- the conditions companies must fulfil in order to profit from the incentives and
- how Shanghai compares to the logistics hubs of Hong Kong and Singapore.

The Shanghai Yangshan bonded port

The Shanghai Yangshan bonded port, also referred to as the Yangshan Free Trade Port Area (Yangshan FTPA), lies around 32km from the Shanghai district of Nanhui. Built to overcome the relatively shallow waters of the natural harbour within the Shanghai metropolis, the new port provides 15-meter deep berths. When the project is finally completed, Yangshan FTPA will stretch some 20km and provide 30 container ship berths. In logistics terms, the port lies just 104km from the major international sea routes. Integrated into the Yangshan FTPA is the 30km long Donghai Bridge, which links Yangshan port with the metropolitan area of Shanghai. A wind power project, providing renewable energy, is integrated into the bridge and a metropolitan train line links the port with the city.



Most important Chinese ports by turnover 2008

The main incentives

As is frequently the case in China, the initiative to turn Shanghai into an international finance and logistics centre found its origins in a circular issued by the State Council of China (Guofa [2009] No. 19) entitled, "Guidance on expediting the development of modern services and advanced manufacturing industries as well as building Shanghai as an international financial and shipping center." The Circular outlines the route that Shanghai should take in order to develop into an international logistics centre by 2020. The stated aims for the International Shipping Center are:
- Major extension of shipping capacity
- Development of an investor-friendly logistics environment
- Development and availability of highly efficient, modern multi-functional services relevant to the logistics sector

In order to achieve these ambitious goals, the Circular provides for numerous tax incentives and preferential customs treatment for investors in the shipping and logistics sector. In particular, this includes:
- Extension of preferential tax treatment until June 30th 2011 for Chinese financed ships sailing under a flag of convenience (方便旗).
- Exemption from business tax (BT) on certain services provided by companies registered in the Yangshan bonded port, as well as on income derived from international carriage, storage, freight-forwarding and warehousing services.
- Permission to open an offshore bank account in order to ease foreign transactions.
- Regulations on the reimbursement of taxes in order to establish the Yangshan FPTA as an international shipping hub.

In order to save costs, some shippers register their vessels in a state flying a flag of convenience.

The Chinese Ministry of Finance and the State Administration of Taxation have promptly implemented these political aims, as formulated in their joint Circular Caishui [2009] No. 91. In addition to exemption from BT for logistics companies registered in the bonded port, transport insurance sold by insurance companies registered in Shanghai is now also exempt from BT.

In order to provide tax incentives to vessels sailing under a flag of convenience, Beijing issued Circular Caiguanshui [2009] No. 28. This exempts ships previously registered abroad and sailing under a foreign flag from customs duty and importation valued added tax until June 30th 2011. However, vessels must be over

50 per cent financed by Chinese investors, and certain age limitations and a minimum level of technical equipment apply to the vessels themselves.

Building on these rules, the local governments of Shanghai and the Pudong New Area have issued circulars with the objective of promoting a logistics-friendly environment locally. Within this framework – and as frequently practiced by China with some success – pilot enterprises are selected to ensure a staged, controlled implementation of provisional measures. This is usually followed, after a certain period of time, by the widespread introduction of the new rules for whole sectors of industry and regions.

Further preferential treatment and incentives expected for Shanghai

As can be seen, using a top-down process initiated in Beijing trickling down to the local government level, China is making an orchestrated effort to establish Shanghai as an emerging logistics hub in Asia, with the intention of competing against existing entrepôts such as Singapore or Hong Kong. The early rules are still in need of further qualification and are probably only the beginning of a whole package of incentives in the logistics area that will apply to the Shanghai area.

Following the issue and promulgation of the Circular "Important planning organisation for the development of the Shanghai International Shipping Center," tax incentives have now reached the testing stage. In the current pilot phase, running from July 1st to December 31st 2010, five to ten well-known logistics companies operating in the international transport sector – and thus freed from BT – will be invited to set up in the Yangshan FPTA.

In order to gain recognition as an internationally active logistics company, applicants must fulfil two conditions. Firstly, the Circular states that logistics companies must pass a state examination to determine their suitability. Secondly, in order to operate in the first place, logistics companies must employ at least five accredited logistics specialists and apply to the municipal administration for recognition as an operator in the international transport sector.

Despite these administrative hurdles, recognition is relevant for tax purposes, as BT (normally 5 per cent) usually cannot be offset against input VAT, unlike the Chinese VAT. As such, BT does represent an additional tax burden. However, the trend towards recognising specific services and their subsequent exemption from BT is definitely a growing trend, as demonstrated by the latest Circular Caishui [2010] No. 8 from April 23rd 2010. This particular directive exempts all transport services rendered to domestic companies and natural persons from BT retrospectively, dating back to January 1st 2010.

In this context, "transport services" are defined as:

- Carriage of persons and goods within China with a foreign destination
- Carriage of persons and goods outside China with a destination within China
- Additional specific transport of persons and goods performed outside China

In practice, this means that BT paid in the period January 1st to April 23rd 2010 can be used to offset future BT liabilities. Alternatively, a tax reimbursement is also possible: your PwC contact would be pleased to make the necessary applications for you.

Glossary of terms

Bare (boat) charter refers to an unmanned vessel chartered for a single trip or a defined period of time.

Time charter is an arrangement by which the ship owner provides the charterer with a ready-to-sail, loadable and manned vessel for a defined period of time.

Voyage charter is an arrangement by which the charterer is provided with a vessel for a specific trip, but not for a specific period of time.

Hong Kong, Singapore and Shanghai as logistics hubs in Asia

By putting together a bundle of incentives for the maritime economy, Shanghai is becoming attractive for logistics companies seeking to set up a hub in East Asia over the medium and long term. In addition, Shanghai is starting to compete directly with the established logistics centres in Asia. In view of this, potential investors may be interested in comparing Shanghai with the classic locations of Singapore and Hong Kong. The table below provides a brief orientation when preparing for an investment decision.

As the table shows, while Shanghai currently provides exemptions to BT, the two classic locations, Hong Kong and Singapore, have clear tax advantages in terms of corporate tax rates.

Hong Kong has long been an attractive location in which to invest. The low level of bureaucracy, its legal certainty and the low level of profits tax, currently at 16.5 per cent, make Hong Kong a prime choice for investors, especially those in the shipping and logistics industries where, under certain conditions, Hong Kong provides tax breaks down to zero per cent. On the other hand, Hong Kong has a small DTA network compared to the other two locations, which could be disadvantageous in some tax scenarios.

Tax	Shanghai Yangshan	Hong Kong	Singapore
International transport sales tax	• Exemption of BT for logistics companies registered in the Yangshan bonded port • Caishui [2010] No. 8: Extension of BT exemption to all logistics companies	No provisions.	No provisions.
Foreign logistics income	• Depends whether foreign tax authority imposes VAT or BT • More favourable rules (exemption) possible where a Double Taxation Agreement exists (DTA) with China; strong expansion of DTA network, with numerous additional DTAs currently under negotiation • Caishui [2010] No. 8: Carriage of persons and goods free from Chinese BT	• Income from foreign carriage services classified as “off-shore”, as thus not subject to Hong Kong profits tax. May be taxed abroad however. • Where DTA exists with Hong Kong, more favourable rules may apply (exemption).	• Income from foreign carriage services not subject to corporate tax in Singapore. May be taxed abroad, however. • Where DTA exists with Singapore, more favourable rules may apply (exemption).
Corporate tax	• Profits from logistics companies subject to the general corporate tax of 25 per cent	• Ship owner is subject to profits tax. Specifically, the ship owner is subject to profits tax when his vessel lies within Hong Kong territorial waters (except for chance moorings). • Profits tax depends on the vessel’s registration and type of freight transported. Vessels not transporting goods in Hong Kong territorial waters are not subject to profits tax. • Tax incentive: vessels loaded in Hong Kong and sailing under Hong Kong flag with international waters as their destination are free from tax on profits from carriage business. • Persons in the shipping business not resident in Hong Kong are exempt from profits tax when the foreign country deals correspondingly with Hong Kong subjects liable to tax.	• Only ships registered in Singapore with international carriage services are exempt from tax on company profits. • Approved International Shipping Enterprise: foreign ships registered in Singapore are exempt from corporation tax, provided they are solely occupied with international carriage. • In all other cases, a corporate tax rate of 17 per cent applies.
Relevant customs duties and importation VAT	• Ships sailing under a flag of convenience are not affected. • Where vessels previously sailing under a flag of convenience are re-registered to a Chinese flag, customs duties and importation VAT will not be levied until 2011.	No provisions.	• The international carriage of goods is not subject to the Goods and Services Tax (GST). • Companies registered for GST can apply for tax rebates.
Tax on chartering and container leasing	• Voyage charter and time charter are treated as regular income from the carriage of goods and persons. Conversely, income from bare charter is treated as income from lease and rent. • Companies registered in the Yangshan bonded port with income from voyage or time charter are exempt from BT. Profits are subject to the normal corporate tax rate (25 per cent). • Income from bare charter is subject to a BT of 5 per cent, as well as a corporate tax rate of 25 per cent. • Companies registered in Yangshan which make use of services such as voyage, time or bare charter are subject to BT and corporate tax.	• Income from charter operations is exempt from the Hong Kong profits tax. Exception: the ship operates exclusively or mainly in Hong Kong waters, or between Hong Kong and the Pearl River estuary. • Whether income from container leasing is taxed or not depends on whether it counts as part of the ship’s operation. When deemed to be income from an independent leasing business, such income is subject to the general profits tax of 16.5 per cent.	• Maritime Finance Incentive: favourable corporate tax rate of between 5 to 10 per cent, depending on the applicant fulfilling specific conditions. • Where the conditions for the incentive are not met, the general corporate tax rate of 17 per cent applies.

Comparison of tax conditions relating to transport business in Shanghai, Hong Kong and Singapore

Thanks to its Maritime Finance Incentive – recently extended by a further five years to March 31st 2016 – Singapore currently offers a series of tax incentives, for both the international carriage and freight-forwarding industries. Singapore also has the backing of a well-functioning network of service industries including management, insurance and shipping finance. Together with its tax incentives, Singapore's overall environment makes it to a very logistics-friendly location.

Conclusion

Disregarding the current tax issues, Shanghai offers several strategic, commercial and non-fiscal competitive advantages as China's future logistics centre.

Shanghai's future as a leading international transport and freight-forwarding centre has just started. But one thing is clear: potential investors can expect some exciting developments and should monitor how the tax incentives, currently in their pilot phase, play out in practice. Your *pwc:china compass* will keep you up-to-date with the events as they unfold.

If you would like more information or wish to seek advice, please call your PwC contact or send us an e-mail.

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New regulations increase tax burden on all foreign companies doing business in China

This article explains …
- what has changed,
- the consequences of the Circular for foreign companies and
- why all affected companies should account immediately for higher surcharges when calculating prices.

On October 18th 2010 the State Council issued Circular 35, in which it stated that "urban construction and maintenance tax" and the "education surcharge" were now to be applied to foreign companies. The effect this will have on foreign and foreign invested companies is the subject of this article.

The new rules affect all foreign companies and foreign invested companies

Circular Guofa [2010] No. 35, which came into force on December 1st 2010, now extends the Chinese Urban Construction and Maintenance Tax (UCMT) and the Educational Surcharge (ES) to:
- All foreign companies
- All foreign invested companies (ie, companies with a foreign investment of at least 25 per cent)
- All foreign individuals living in China

In the past, only Chinese national companies based in China were liable to pay UCMT and ES. Foreign companies, foreign invested companies and foreign individuals living in China were explicitly exempt from these surcharges.

UCMT and ES are national surcharges calculated on value-added and indirect taxes in China, specifically:
- Business Tax (surcharge on the value of specific services)
- Value-Added Tax (surcharge on the value of goods supplied)
- Consumption Tax

Contrary to what their names suggest, UCMT and ES are not levied on urban development or educational services. Rather, they are earmarked as that part of fiscal income with which the Chinese state finances these specific areas of activity. Where entities are liable for UCMT and ES, both surcharges must be paid together with the value-added tax due.

Depending on where the taxable entity is based, UCMT is charged at either 5 per cent or 7 per cent calculated on the amount of VAT due. Where the entity is based in an urban area, a UCMT rate of 7 per cent is charged. Where the entity is located in a regional or country area, the UCMT rate is reduced to 5 per cent, while a UCMT rate of 1 per cent is charged throughout the (rural) rest of the country.

The national ES rate is 3 per cent, calculated on the total amount of VAT due. In some areas, ES of just 1 per cent had been charged in the past. However, information obtained in mid-November shows that the Chinese Ministry of Finance issued a circular on November 7th 2010 instructing all tax authorities to charge a local ES rate of 2 per cent – in addition to the national ES rate of 3 per cent. That means an additional total ES surcharge of 5 per cent must be added to indirect taxes – all the more surprising as only local tax authorities benefit directly from ES.

Higher tax expenses are the result

As a result of the new ruling, companies liable to pay the surcharges must now expect to submit between additional 6 per cent to 12 per cent of the output VAT on top of the output VAT, as at least 1 per cent UCMT and 5 per cent ES, or even as much as 7 per cent UCMT and 5 per cent ES is now due. However, the rules just stated will only apply if the changes, as reported immediately before publication of this article, are realised in their entirety – in other words, the information given here is based on the assumption that national and local ES amounting in total to 5 per cent will be levied. The new measures apply to sales transactions as from December 2010. In consequence, the amount due must be submitted for the first time with the VAT declaration for January 2011.

Businesses in China whose revenue is subject to business tax (BT) are also affected. Normally, business tax is charged at 5 per cent on services, such as technical service fees. Under the new rules, the effective tax rate goes up by a further 0.3 per cent to 0.6 per cent on technical service fees paid by customers, based on one of the following scenarios:

- 5% BT x (1% UCMT + 5% ES), or
- 5% BT x (7% UCMT + 5% ES)

Naturally, revenue from the sale of goods is subject to the same calculation.

In most cases, UCMT is likely to be charged at the higher end of the scale, as foreign invested Chinese firms or China projects are usually based in urban areas. It is unclear what tax rate will apply to a foreign company based in Germany that supplies services to a company in China. According to the present business tax rules, the fee for services rendered is subject to Chinese BT, as Chinese tax law sees China as the place of service provision when either the service providing or receiving party is based in China. In this case, tax would be charged dependent on the rate applicable for the customer based in China.

New surcharges are real expenses

Although these surcharges can be deducted when computing the corporate income tax (CIT) base in China, this will not be recognised by the German tax authorities (for example, within the framework of a double taxation agreement, or if classified as a VAT expense). In other words, the new surcharges represent real expenses which companies must now take into account when calculating their prices. If necessary, the new rules should be taken as a starting point from which to negotiate prices with customers in order to avoid margin loss. Uncertainty surrounding the introduction of the new rules has been exacerbated by the fact that the new regulations were not passed on to local tax authorities immediately. As a result, it is unlikely that the rules will be applied uniformly at first.

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Do you know which year starts on 3rd February 2011 according to the Chinese calendar?

According to the Chinese calendar, 2011 is the year of the “metal rabbit”. This stands for gentleness, harmony and pleasure – so next year we should take a more relaxed approach to life, with plenty of love.

Source: www.chinesisches-horoskop.de

你知道了吗

China's free trade agreements: developments and outlook

China is working hard to expand its network of trade agreements (FTAs). Its short-term objective is to reduce barriers to the international exchange of goods, while the medium-term goal is to eliminate them entirely.

This article explains …
- which states and international organisations have either signed, or are negotiating, FTAs with China,
- which Chinese authorities are responsible for implementing the regulations and
- what rules apply with regard to "preferred origin".

China is energetically seeking to conclude regional and bilateral free trade agreements (FTAs) with its major trading partners. The box below shows which Chinese FTAs exist.

Free Trade Agreements with China

- Association of South East Asian Nations (ASEAN)
- Closer Economic Partnership Arrangement (Hong Kong and Macao)
- Asia-Pacific Trade Agreement
- Chile
- New Zealand
- Pakistan
- Singapore
- Peru
- Costa Rica

China has signed FTAs regulating the trade in goods and services, as well as investment activity. As far as trade in goods is concerned, China has entered into FTAs in order to eliminate customs tariffs and other trade barriers within specified periods of time.

In this process, China has been guided by the framework set up by the World Trade Organisation (WTO). In principle, China's FTAs covers all manner of trade in goods and commodities, applying harmonised rules of origin. With regard to China's trade with third countries, existing customs tariffs remain in place, as do its mutual agreement rules.

China-ASEAN FTA

Probably China's best known foreign trade agreement is the FTA it has concluded with the Association of South East Asian Nations (ASEAN), the substance of which commits the parties to significant reductions in tariffs. The FTA came into effect on July 20th 2005. In a phased reduction of tariffs, the Agreement differentiates between:
- Type of goods (categorised into "normal", "sensitive" and "highly sensitive")
- Country (new members to ASEAN are subject to a longer implementation period)
- Most-favoured-nation tariff (in principle, the most-favoured-nation tariff applies to every WTO member state, and should have come into effect on July 1st 2003)

Most goods fall under the tariff code category "normal", and are thus subject to more favourable tariffs. Sensitive goods account for 400 to 500 tariff items at most, categorised in keeping with the worldwide recognised Harmonised System (HS). Up to a maximum of 100 to 150 goods may be classified under the "highly sensitive" tariff codes. Under the FTA rules, tariffs are to be reduced in phases. ASEAN-6 countries at a higher level of development (Brunei, Indonesia, Malaysia, Philippines, Singapore and Thailand) are subject to zero per cent tariffs from 2010. Zero per cent tariffs will not apply to the lesser developed ASEAN 4 (Cambodia, Laos, Myanmar and Vietnam) until 2015.

Future FTAs

At present, China is negotiating intensively with nine other states and organisations. The following table outlines the negotiations, and indicates what progress has been made.

The Chinese authorities empowered to negotiate and administer

The Ministry of Commerce (MOFCOM) has authority to lead negotiations for all of China's free trade agreements. Other ministries and institutions below State Council level also participate in the negotiations, including the Ministry of Finance, Ministry of Agriculture, General Administration of Customs and the Commodity, Inspection and Quarantine Authority. Their involvement applies especially to areas of classification falling within their competence, as these authorities are involved in customs declarations and processing.

The following Chinese authorities hold main responsibility for implementing FTA rules:
- The Council of Tariff Codes is responsible for approving the application of preferential tariffs.
- The General Administration of Customs verifies certificates of origin and goods origin at the time of import or export.
- The Commodity, Inspection and Quarantine Authority is responsible for issuing certificates of origin for goods and commodities to be exported, originating from China.
- MOFCOM is responsible for implementing FTA rules relating to trade, services, investment and related areas.

Preferred origin

Under customs law, "preferred" refers to preferential tariffs granted to some states or organisations. International trade defines "origin" as the "economic" state or area from which a good or commodity is deemed to originate. Preferential treatment based on origin is granted to some countries or organisations under certain conditions. These countries benefit from preferential treatment in the form of preferred tariffs.

State/ organisation	Progress notes
Australia	On April 18th 2005, a "Memorandum of Understanding" was signed between the Australian Department of Foreign Affairs and Trade and the Chinese Ministry of Commerce, recognising China's status as a full market economy and starting the negotiation of an FTA between Australia and China. In the period from December 2008 to February 2010, a total of 14 rounds of negotiations had taken place.
Costa Rica	Negotiation of an FTA between China and Costa Rica began in November 2009. The negotiations have been completed, but the agreement has yet to be ratified.
Island	Negotiation of an FTA between China and Island began in December 2006. By April 2008, four rounds of negotiations had been held.
Gulf Cooperation Council (GCC)	The members of the GCC are Saudi Arabia, United Arab Emirates, Oman, Kuwait, Qatar and Bahrain. In July 2004, a Framework Agreement on Economic Cooperation, Trade, Investment and Technical Cooperation was signed. Following this, negotiation of an FTA between China and the GCC commenced. Four rounds of negotiations had been held at the time of writing.
Norway	In September 2008, China and Norway started the negotiation of an FTA in Oslo. In September 2009, the fifth round of negotiations took place in China. By March 2010, a total of seven rounds of negotiations had been held.
Southern Africa Customs Union (SACU)	SACU was formed in 1969 when South Africa, Botswana, Lesotho, Namibia and Swaziland agreed to form the Southern Africa Customs Union. In June 2004, negotiations on an FTA originally initiated between China and South Africa were extended to include SACU, but no major breakthrough has been reached to date.
India	In January 2010, the "Economy and Trade Investment Cooperation Forum" was held in Beijing. The P.R.C. Ministry of Commerce put forward several proposals to initiate the negotiation of a bilateral FTA between China and India. This led to the signing of the "Memorandum of Understanding on Strengthening the Trade and Economy Cooperation between the P.R.C. Ministry of Commerce and the Indian Ministry of Commerce and Industry".
South Korea	In October 2009, the "Mid and Long Term Development and Plan Report on Trade and Economy Cooperation between China and Korea" was concluded in Beijing. A total of six rounds of negotiations led to the signing of a Memorandum of Understanding between China and South Korea in May 2010.
Switzerland	According to recent reports, negotiations are due to start at the beginning of 2011.

States and organisations currently negotiating FTAs with China

Rules of origin

1. Value content

As noted, China's FTAs follow rules formulated by the WTO. This also applies to the principle of origin of a good or commodity.

Accordingly, Chinese FTAs apply the following general classifications when defining origin:

- Goods wholly obtained or produced in a contracting state
- Substantial transformation of the goods (change in tariff classification; specified manufacturing processes; value addition)
- Cumulation (for example, accumulation in value of pre-production materials from contracting states can result in preferred origin status)
- Minimal processing not leading to preferred origin status

As most goods are not wholly obtained or produced in terms of tariff classification, companies tend to choose substantial transformation as a means of gaining preferred origin status for their goods. "Value addition" is the rule most used (addition in value of goods over production costs). The value added criterion varies depending on the FTA that applies. When calculating value addition to non-origin goods, China normally permits local production costs, locally sourced materials, local labour, additional charges and profit to be factored in. There is no official cap on the amount of profit that can be treated as value addition, so that companies producing in China can easily achieve the 40 per cent value addition in practice. Companies resident in China usually obtain preferred origin status for their goods without having to invoke value addition.

This contrasts with non-qualifying operations (minimal processing) which are not a suitable method for obtaining preferred origin status. Minimal processing is defined as:

- Measures undertaken to preserve goods for transport or storage
- Measures to facilitate shipment or transport
- Packaging of goods or presentation for sale

2. Direct transport

Usually, China's FTAs stipulate that goods be transported directly between the contracting parties (for example, direct passage from China to Thailand). Transport via third parties – such as Hong Kong, when goods from China are destined for an ASEAN state – may also be permissible, with or without handling or interim storage. However, care must be taken to ensure that the goods do not enter into free circulation, or are subject to any processing beyond the need to handle and preserve them. Where transport to an ASEAN state takes place via Hong Kong, a "certificate of no further processing" may be required. This is issued by the China Inspection Company Ltd.

3. Third party invoicing
The production chain used by most international companies often involves the use of a subsidiary to sell the product. The latter may be a regional headquarters, with registered offices in a country not party to the FTA. This applies to goods being sold from Hong Kong which fall under the China-ASEAN FTA. A new Measure on the Administration of Origin for Imported and Exported Goods under ASEAN-China FTA was issued by the General Administration of Customs and took effect on January 1st 2011. The third party invoicing issue is now included in this new Measure. Therefore, third party invoicing can be accepted by China Customs provided relevant documents can be submitted to Customs.

Documentary requirements

1. Export
Where products are produced and exported from China, a two-stage documentation procedure must be followed. The Commodity, Inspection and Quarantine Authority (CIQ) has responsibility at both stages:

- Stage 1 – Registration of operations: This one-off requirement must be renewed annually. If the manufacturer is already registered for other production purposes, it may be exempt from registration. Failing this, the producer must prepare an application, including supporting documents, and submit the production process to inspection.
- Stage 2 – Certificate of origin: A certificate of origin is issued individually for each batch of goods to be exported. In the case of goods transacted between ASEAN and China, Form E is the certificate of origin (paper document, in triplicate). Standardised procedures have been set with regard to the application and issue of Form E. At present, the procedure is not supported electronically.

2. Import
Apart from the usual shipping documents, the following documentation is required:

- Freight documentation (through bill of lading), issued by the exporting country
- Copy of the original commercial invoice for the goods
- Certificate of origin issued by the relevant authority in the exporting state

Under certain circumstances, a certificate of origin may not be necessary. This applies when the value (free on board) of the goods to be imported originating in an ASEAN state is less than 200 US dollars. In this case, Form E can be waived.

3. Verification and dispute settlement
In China, the CIQ is responsible for verifying certificates of origin. This can take place either at CIQ's own initiative, or following a request from an overseas country. The rules on origin and the procedures for certification may stipulate arbitration to settle disputes. That includes consultation procedures with the states involved, time limits and other details. However, the FTAs concluded by China are still in their infancy, and no fixed practice of arbitration has been established so far.

Clearly, China is playing an active role in the culture of setting up free trade agreements. Anyone considering a commercial involvement with China should bear this in mind beforehand – reason enough to take stock of the current FTA situation from time to time.

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On the road to Chaiwan? – Taiwan and the PR of China redefine their relationship

On June 29th 2010, the People's Republic of China and Taiwan signed the Economic Cooperation Framework Agreement (ECFA) in Chongqing (China). The ECFA is the most comprehensive and important bilateral agreement reached so far between the two sides of the Taiwan Straits. It is a defining moment following their 60 years of disparate history, and a landmark event in the process of normalisation between Taiwan and China. But while the ECFA permanently strengthens economic ties between the two signatories, their combined potential has engendered concern elsewhere, with some other countries fearful that their own companies will now face intensifying competitive pressure. This fear was exemplified recently by the South Korean press when it coined the term "Chaiwan" (China plus Taiwan), a neologism that shows how many Asian countries, including South Korea, are redefining Taiwan's role. This article sets out to discuss the economic areas covered by the ECFA and its implications for foreign investors.

This article explains …
- what Beijing and Taipeh have agreed to in concrete terms,
- how states cooperating closely with Taiwan assess the new situation and
- what consequences this may have for German investors.

Economic Cooperation Framework Agreement

The Economic Cooperation Framework Agreement (ECFA) extends well beyond the Free Trade Agreement (FTA) between Beijing and Taipei. Its three main aims are

- cross-strait cooperation to promote the economy, trade and investment,
- facilitation of free trade in goods and services in both directions, and
- creation of a fair and transparent environment for investment to safeguard the flow of capital on both sides.

A major component of the ECFA is the "Early Harvest List", which beginning on January 1st 2011, reduces import tariffs over the next three years for 539 Taiwan-made products and 279 products from Mainland China. The list covers a wide spectrum of products ranging from petrochemicals to textiles (see Table 1). Trade and investment restrictions are also to be lifted over the medium to long term, giving both sides free access to certain service sectors (Table 2).

Following ratification by Taiwan's parliament (the Legislative Yuan) in mid-August, the ECFA formally took effect on September 12th 2010. The opening of 11 Chinese service sectors to Taiwanese companies, including IT and R&D, has had an immediate effect. In return, Taiwan has since opened up nine of its own service sectors. The agreement should result in a win-win situation for both sides over the medium term, although in the early stages Taiwan will likely benefit more.

Import duties to China in 2009	3-year tariff reduction period			Sectors/products
	1st year (from 1.1.2011)	2nd year (from 1.1.2012)	3rd year (from 1.1.2013)	
≤ 5%	0%	0%	0%	Petrochemicals, metal products, textiles, elevators/conveyors for goods
5–15%	5%	0%	0%	Car parts, bicycles and accessories, textiles, electronics, household appliances, tools and machinery, fishery products
>15%	10%	5%	0%	Rubber tyres, suitcases, textiles, household appliances
Source: www.ecfa.org.tw				

Tab. 1 Tariff reductions on imports of Taiwan products to Mainland China – "Early Harvest List"

Import duties to Taiwan in 2009	3-year tariff reduction period			Sectors/products
	1st year (from 1.1.2011)	2nd year (from 1.1.2012)	3rd year (from 1.1.2013)	
≤2.5%	0%	0%	0%	Petrochemicals, electronics, sewing machines
2.5–7.5%	2.5%	0%	0%	Car parts, bicycles and accessories, textiles, electronics, tools and machinery
>7.5%	5%	2.5%	0%	Textiles, bearings, rubber tyres
Source: www.ecfa.org.tw				

Tab. 2 Tariff reduction on imports of Chinese products to Taiwan – "Early Harvest List"

Consummation of the ECFA is a significant milestone in the relations of the two sides. In this context, rapprochement is a major step towards ending the long-standing tension between Taiwan and Mainland China that has persisted for the last 60 years.

List from Mainland China	List from Taiwan
Non-Finance Sectors	
1st Phase	
from 28.10.2010	from 1.11.2010
• Accounting, auditing and bookkeeping • Extension of temporary audit licences • IT services • Research and development on natural science and engineering • Convention services • Reduction of limits on number of films produced in Taiwan	• Research and development • Conference services • 10 films per year, either made in China or produced jointly by China and Taiwan • Commission agent's services • Computer reservation system in air transport
Sectors to be opened in further phases	
• Hospital services • Professional designing • Aircraft maintenance	• Jointly held B2B exibitions • Sporting and other recreational services • Specially design services
Finance Sectors	
Sectors to be opened in further phases	
• Banking • Insurance and insurance-related services • Securities, futures and other related services	• Banking
Source: www.ecfa.org.tw	

Tab. 3 Opening up service sectors

Divided by the Taiwan Straits

Taiwan, an island the size of Baden-Wurttemberg in Germany, is separated from Mainland China by the Taiwan Straits in the Western Pacific. The island's legal status (which has been in dispute since 1949) lies at the heart of the cross-strait conflict. The former Japanese colony became the refuge of the Kuomintang under the leadership of Chiang Kai-shek following the latter's defeat by Mao Zedong's Liberation Army during the Chinese Civil War 61 years ago. The designation "Republic of China" was first used by Sun Yat-sen as its first President in 1912, following the overthrow of China's last emperor Pu Yi, and continues to be used by Taiwan's government. However, since the founding of the People's Republic of China (PRC) in Mainland China in 1949, the two sides have vied for international recognition, each claiming to be the sole legitimate government of China.

Following the Soviet example, the People's Republic of China introduced a centrally controlled economy. A nation of enormous proportions, the People's Republic struggled hardly on its road to recovery after the Second World War. Taiwan's economy on the other hand picked up rapidly and stabilised with backing from the USA. By the end of the 1950s, agriculture on the island had developed rapidly, while the textiles industry took on an increasingly important role due to support of the Taiwan government.

At the end of the 1950s, Taiwan started a process of industrialisation, which later turned into an "economic miracle", with high rates of economic growth. Taiwan's economic development led the USA and Japan to outsource labour-intensive production to the island, where light industry grew especially rapidly due to its low wages and cheap production processes. By the 1980s, Taiwan had evolved into one of Asia's four "Tiger States", together with South Korea, Singapore and Hong Kong.

On the other side of the Taiwan Straits the situation was completely different. Politically motivated movements, in particular the Cultural Revolution (1966 to 1976), set Mainland China back many years, paralysing its economy.

Not only did the two economic systems divided by the Taiwan Straits develop differently, the political and social systems also drifted apart. Mainland China isolated itself from the rest of the world for many years, remaining unpopular on the international political stage. Taiwan, on the other hand, integrated actively into the international political community, with this phase of its development reaching a zenith by the end of the 1960s. At the time, Taiwan enjoyed diplomatic relations with over 60 nations and was the sole representative for all of China at the United Nations (UN). Things changed in 1971 when Taiwan lost its UN membership and was replaced by the People's Republic of China. After it started to open up in the 1980s, Mainland China returned to being a full member of the international community.

Two factors have always played a central role in the tension that existed between the two countries: the efforts of the People's Republic of China to reunite with Taiwan and the determination of the Taiwan government to retain independence. For many years the threat of war hung over the Taiwan Straits like the sword of Damocles.

Rapprochement

Although Taiwan and China did not officially communicate with one another for nearly 60 years, there is no doubt about the common heritage that spans the Taiwan Straits. In both sides the majority of the population is comprised of Han Chinese, while Mandarin is the official language in both Taiwan and Mainland China. Today, Mainland China uses a simplified Chinese script, while Taiwan retains traditional Chinese characters.

After what had been a long period of stand-off, common economic interests were finally rekindled. In Mainland China, the economy grew quickly after 1978 following Deng Xiaoping's open door policy. On the other hand, Taiwan's companies were looking for alternative locations in an effort to stem rising production costs.

The cross-strait economic relations began to take on a more relaxed tone towards the end of the 1980s. The process was further expedited after the Taiwan government eased restrictions on economic ties with Mainland China at the beginning of the 1990s. Many Taiwan companies subsequently moved their labour-intensive production processes to Mainland China. Taiwan suppliers started to invest in China, especially in the Fujian province directly opposite Taiwan on the other side of the Taiwan Straits – numerous original equipment manufacturers (OEMs) established production facilities on the mainland. Subsequently, Taiwanese companies started to settle around Shenzhen in the Pearl River Delta and around Shanghai in the Yangtze Delta.

Taiwan is one of the world's largest producers of semiconductors, electronic equipment, liquid crystal display (LCD) products and bicycles. Its companies now profit from the vast market for technological products in Mainland China. The cross-strait economic ties have strengthened with China becoming Taiwan's biggest trading partner. Driven by these common economic interests, both, China and Taiwan, started to look beyond their own backyards politically in 2001. This can be seen by the mutual support they gave each other when applying to join the World Trade Organisation (WTO). Shortly after China acceded to the WTO, Taiwan became the 144th member under the heading of "The Separate Customs Territory of Taiwan, Penghu, Kinmen and Matsu".

Action taken by the two sides to draw closer met with considerable success after President Ma Ying-jeon took office in 2008. Economic interests were defined as the main priority on both sides of the Taiwan Straits. Only later would political issues be discussed. Adhering to this principle, Taiwan and China continued to improve their relations and ratified a series of agreements. Restrictions on travel to and from China were lifted, and direct postal, transport and trade links were established via the Taiwan Straits. This progress created a clear basis for the negotiations which followed, concluding in the signing of the ECFA.

ECFA opens up a new chapter

According to the "Global Investment Report" published by US-based Business Environment Risk Intelligence S.A. (BERI), Taiwan ranks fourth worldwide in terms of its investment climate, directly behind Switzerland, Singapore and Norway. The ECFA has been a significant factor in this remarkable result, as lower levels of tension have greatly reduced political risk in the Taiwan Straits – one of the three main indices used by BERI to determine the investment climate.

The fact that the ECFA has had a positive effect is confirmed in many areas. According to the International Monetary Fund, Taiwan's economy will grow by 9.3 per cent in the course of 2010. Statistics show that Taiwanese companies invested over 8.65 billion US dollars in Mainland China during the first nine months of 2010. The Taiwan Ministry of Economics forecasts that over ten billion US dollars will flow from Taiwan into the People's Republic of China in 2010.

Up to 370 passenger aircraft a week fly directly from Taiwan to six Chinese cities, including Beijing and Shanghai. This year around five million Taiwanese citizens will travel to China.

At present, Taiwan is taking major efforts to realign its economy towards the manufacture of technologically intensive products and to become a centre for research and development, which it sees as a key factor in gaining new competitive advantages and ensuring that its economic development is sustainable. As part of ongoing tax reforms since 2008, corporate income tax has been cut twice within 12 months, and now stands at 17 per cent. This has made Taiwan attractive again to foreign investors, as well as to Taiwanese companies considering a return to Taiwan from Mainland China.

Lower profit margins due to increased labour costs are another reason why Taiwanese companies are beginning to rethink their strategy. In this context, there was widespread shock at the news of several suicides among employees at Foxconn in Shenzhen, a subsidiary of Hon Hai, which supplies the western electronics giants Apple and Dell.

Such acts of desperation have been widely interpreted as a cry for better working conditions among migrant workers in Mainland China. These events, together with increasing wage costs and an improved investment climate following the ECFA, induced Hon Hai to plan new high-end production lines for the island. Based on sales revenue alone, Hon Hai is the world's largest subcontractor in the electronics sector. Many other Taiwanese enterprises could follow suit and move back – at least, that is the hope of Taiwan's Ministry of Economics.

By signing and implementing the ECFA, China has demonstrated its good intentions to Taiwan in setting aside conflicts and cooperating economically. China can certainly profit from Taiwan's leading position in terms of knowledge bases and the experience Taiwan has gained in international markets over the last decades. Now, by cooperating closely, China and Taiwan can combine their regional and global economic strengths.

Effects of the ECFA on the region and the global economy

In concluding the ECFA, Taiwan and China have gained access to an even bigger market, while the Agreement has especially strengthened the competitive ability of Taiwanese companies. However, this has also placed pressure on countries within the region, such as South Korea and Japan, to enter free trade agreements with China and Taiwan as soon as possible. South Korea already perceives a threat from "Chaiwan" in the wake of the ECFA, as it competes strongly with Taiwan (especially in electronics and chemicals). Many Japanese companies are facing similar problems. On the other hand, Japan also sees fresh opportunities emerging from the ECFA due to Taiwan's long years of economic dependence on Japan, and the fact that Taiwan imports many components from Japan for onward processing.

As far as Switzerland is concerned, both Taiwan and the People's Republic of China are important trading partners. In terms of prices alone, Swiss companies cannot beat their Taiwanese competitors. Switzerland's only chance is to convince buyers of the outstanding quality of its products, "Made in Switzerland". As a result, Swiss companies have no choice but to innovate. At the same time, Swiss companies based in China can profit from the ECFA. Now they can access new markets in Taiwan or benefit from a wider choice of good and more flexible Taiwanese suppliers. Taiwan aims currently to promote international investment in such areas as biotechnology, green energy and health care. Swiss companies able to provide such products and services now have greater opportunities in China and Taiwan as a result of the ECFA.

Executing the ECFA has also created an environment for Taiwan to enter into free trade agreements with the USA, Japan, the European Union, the Association of South-East Asian Nations (ASEAN) and other countries. In a globalised world, a national economy can only create a long-term perspective for its growth by integrating both regionally and within the global economy.

In the words of one Japanese economist describing the effects of the ECFA on Taiwan, "This is a vitamin shot for Taiwan's economy, but not a panacea." Taiwan continues to face many challenges, including structural change and resistance from the opposition Democratic Progress Party to further cooperation with China. But Taiwan's government headed by President Ma is optimistic and sees the ECFA as creating a solid foundation for stable development heading into a potentially golden decade.

If you would like more information, just call or e-mail the contact shown below.

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你知道了吗

Do you know which work by the German poet Goethe was subject to intense debate among Chinese youth?

The epistolary novel "Die Leiden des jungen Werther" (The Sorrows of Young Werther), published in 1774, triggered lively debate among young intellectuals involved in the 4th of May Movement in 1919. They came to the conclusion that their fate was the same as that of Charlotte – repression by a feudal system.

Source: Hans Hauenschield, *China Takeaway*, Ullstein Verlag

A guide to investing in Taiwan

Separated from Mainland China by the narrow Straits of Taiwan, Taipei has been making efforts for several years to attract more foreign investment. In view of this, PwC Taiwan regularly publishes investment guides which provide potentially interested companies with an introduction into investing in Taiwan.

"Doing Business in Taiwan" is directed at companies making their first tentative steps towards Taiwan, as well as investors wanting to expand their presence there. The handbook provides an insight into all the main aspects of investing in Taiwan, ranging from company formation to the management of human resources. Foreign investors will find answers to many of the issues they face when setting up in Taiwan. For example, the Guide covers such areas as regulatory environment, labour law, audit requirements, accounting rules and all the main tax aspects relating to investing in Taiwan. The revised September 2010 issue of this useful reference work includes all major changes to relevant laws and regulations enacted since the end of 2009. Also included are articles about the lowering of corporate tax to 17 per cent, which took effect in May 2010, as well as the new reduced tax levels following the *New Statue for Industrial Innovation*, enacted in April 2010.

Doing Business in Taiwan
Published by PricewaterhouseCoopers Taiwan

For more information and to order
www.pwc.com/tw/en/forms/download-doing-business-in-taiwan.jhtml?processed=true

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Tax in Taiwan

This brochure gives foreign investors a quick but precise overview of the tax system and current tax rules in Taiwan, as they apply from March 2010.

Amongst others, the Guide: "Taiwan Pocket Tax Book 2010", covers the following areas:

- Company income tax
- Income tax
- Transaction tax
- Stamp duty
- Customs duty

Taiwan Pocket Tax Book 2010
Published by PricewaterhouseCoopers Taiwan

For more information and to order
www.pwc.com/tw/en/publications/taiwan-pocket-tax-book-2010.jhtml

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