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BDO International

CHINA INSIDER

INTERNATIONAL

2007 - No. 1

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I. ECONOMIC POLICY AND FOREIGN INVESTMENT IN CHINA

Minimisation of country-specific, partner and project risks

If a foreign company decides – beyond the regular trade relations – to invest in a manufacturing location in China, special attention should be paid to **risk management**. On the one hand, an investment in China bears country-specific risks. In addition, the Chinese environment also has an impact on the general entrepreneurial risk.

If a foreign company holds assets either via a joint venture together with a Chinese partner or in a subsidiary, the transfer of profits (dividends, sales profits, liquidation profits or similar) and the conversion to the desired currency may, where applicable, be subject to reservations concerning approval and/or participation of the local authorities. Aside from this, other possible unlawful public-authority interference with private property must be considered among the political risks as particular country-specific risks. The general China-specific risks are defined by both positive and negative factors. Positive factors are, for example, the comparably stable political situation, the growing Chinese domestic market, a favourable labour market, and the existence of special tax privileges in certain development areas. By contrast, the increasing social tensions caused by insufficient social welfare systems or infrastructure problems, e.g. in the power-supply sector or the traffic system, pass for negative country-specific factors.

The following country-specific risks are classified as **particularly noticeable** when doing business in China:

- Because of linguistic obstacles, there are great communication barriers. Intellectual property and transferred know-how are inadequately protected by law while the entire judicature system is said to be ineffective. In many cases, know-how transfer or even a simple share disposal may be subject to governmental control including approval procedures.
- Intergovernmental investment-protection treaties or investment-promotion agreements may reduce but never rule out the country-specific risks. Additional safeguarding, e.g. through investment guarantees in the Federal Republic of Germany or certain international investment banks, should be taken into consideration as the case arises.

Moreover, there exist **entrepreneurial risks** directly arising from the project. When investing together with a Chinese partner, it is usually rather difficult to receive reliable information on that partner's economic capabilities, because only local companies and not individuals are admitted as cooperation partners. It is a lot harder to receive information on the individuals behind the scenes. Local law offices, audit companies or economic institutions assist in both choice and evaluation of potential partners by, for example, performing due-diligence investigations or providing economic information.

There may well be **conflicts of interest** from the very beginning when cooperating with a Chinese partner. The foreign investor, for instance, expects to find a way into the Chinese market and assistance in matters such as communication with the authorities; the Chinese partner, on the other hand, is interested in access to capital, know-how or modern machinery. The so-called 'partner risk' may be concealed here: the Chinese partner's goal may be to maximise its own interests at all times and, later on, crowd out the foreign partner. For this reason alone, many foreign investors currently prefer to establish their own subsidiary without cooperating with a Chinese partner.

An investor will also **consider** the common entrepreneurial risks. The choice of location plays a special part in this respect. Often, an investor faces legal and other problems, some of which include the procurement of official approvals and, again, the infrastructural prerequisites of the possible location. Therefore, when it comes to finding a location, it seems rather beneficial to fall back on a China-experienced service provider or look around for already existing locations, e.g. in special industrial zones or investment-promotion areas.

Simple **practical details** can be of help. Sometimes, for instance, the supply of raw materials and power slows down because of infrastructural shortcomings. In order to avoid production grinding to a halt, stock capacities must be provided should the situation arise. In some areas, quota fixings for power can lead to power failure. These cases can be handled by providing a diesel-emergency power generator or by discussing and planning interruptions in the supply with the power provider beforehand. Supply and transportation problems because of the local traffic situation and official regulations can often be avoided by assigning China-experienced international logistic experts to the job.

The inadequate protection of know-how and intellectual property as well as the misuse of

(electronic) data still present problems in China. This calls for **practical arrangements**. Process descriptions or formulae can be held back while key components could be supplied directly from the parent company. There are particular risks posed by disloyal employees and partners. It appears that preventive measures can reduce this partner risk. Amongst others, these measures include the set-up of efficient control systems and visits from the parent company at regular intervals.

Financing risks need to be considered as well. To avoid the risk that a potential failure of the investment in China may affect the parent company, the investment should be financed independently. Therefore, for example, borrowed funds should be secured in relation to the respective project only, if possible. Special interest and currency exchange risks play a decisive role, too. To provide against these risks, financing instruments such as hedging deals can be considered.

II. CORPORATE LAW

New Enterprise Income Tax Adopted

On 16 March 2007, the National People's Congress of the People's Republic of China (PRC) adopted a new Enterprise Income Tax Law which is intended to unify the current Income Tax Law on Enterprises with Foreign Investment as well as Foreign Enterprises (FIE) and the Provisional Regulations applied to domestic companies. When the new legislation takes effect on 1 January 2008 the differentiation between foreign and domestic investments and enterprises will be abolished. This way the PRC continues on its path of liberalizing the Chinese market.

The **tax rate** will be lowered from 33 % flat to 25 % flat. In return the system of tax holidays for manufacturing as well as export oriented FIEs will be completely abolished. The same apples to the lower 15/24 % tax rates currently still applicable to FIEs in specifically designated economic zones. The lower 15 % tariff for high-tech enterprises - today only applicable in "High-Tech Zones" - will be expanded countrywide in order to incite further growth in this market sector. Additionally, for small and thin-profit enterprises, the rate is reduced to 20 %.

Other preferential tax rates existing under current law will be abolished. Enterprises approved to be established prior to the promulgation of the new tax law that are enjoying such preferential rates are given a period of 5 years to progressively move up to the 25 % tax rate under the new law. This way, adaptation is supposed to be made easier for them. Enterprises entitled to tax holidays under existing law are permitted, pursuant to regulations of the State Council, to continue their tax holiday after the new law will have come into effect. For enterprises that have not commenced their tax holiday on account of losses, the tax holiday period will be deemed to commence upon the effective date of the new law.

It is unclear, on the other hand, whether, for example, dividend withholding tax might still be exempted from enterprise income taxation or whether the current general reduction of the withholding tax rate to 10 % will be retained under the new law. The authorities are expected to issue further details and clarifications on this matter in the near future.

The **new law applies** to enterprises and organizations deriving income within the PRC. The law differentiates between resident and non-resident enterprises. Resident enterprises are enterprises established in the PRC and foreign enterprises which are not established in the PRC but whose effective management lies in the PRC. Resident enterprises are taxed on their worldwide income. Non-resident enterprises are, however, enterprises established outside of the PRC whose effective management is not within the PRC. They are taxed on China sourced income and effectively connected income. This new "effective management" test replaces the current "place of incorporation" test.

Besides the reduced tax rate for high technology companies, the new Enterprise Income Tax Law provides for a number technology and industry focused **tax incentives**. This way the PRC intends to strengthen modern industry sectors in the whole country.

Venture capital enterprises making "encouraged" investments, i.e start-up investments, for once, will be eligible to reduce taxable income by an amount equal to a percentage of the investment. A percentage of the investment spent by an enterprise for the purpose of environmental protection, production safety or energy and/or water savings can also be set off against payable tax.

Tax incentives for investments in infrastructure, agriculture, forestry, livestock farming and fishing has been preserved whereas it is speculated that the refund on dividend reinvestment will no longer be available as the new law does not mention it. It is also assumed, even though not expressly mentioned, that tax incentives for investments in Central and Western regions will be retained.

With the new Enterprise Income Tax Law Chinese

tax authorities are entitled to adjust transfer prices which are not at arm's length. Companies with subsidiaries are now required to provide documentation on transactions with related parties and to submit reports on such transactions including financial reports. It is noteworthy, that this is the first time that China has ever enacted **CFC-rules** and included a **general anti-avoidance provision** in its income tax law to counter perceived tax-avoidance transactions.

Under certain conditions, resident enterprises need to include a portion of the income of a controlled overseas enterprise in its taxable income. This regulation applies only if the controlled company is resident of a tax haven.

Although lacking clarification on this point, the law explains that if the debt and equity ratio exceeds a prescribed standard, the interest on the excess debt may not be deductible in computing taxes.

These rules will be accompanied by a general anti-abuse regulation which empowers Chinese tax authorities to make adjustments to arrangements leading to a reduction of payable tax, if lacking any justified business reason.

Domestic enterprises that have set up offshore companies to hold their group in China will **need to consider** whether these offshore companies will be considered to have their place of effective management in China and therefore fall within the China tax net under the new plan.

The new law states that the grandfathering treatment will apply only to those foreign entities that have been allowed to set up in China before the promulgation of the new law. The cut off date is, however, unclear. It is to be seen, if the exact cut-off date will be the date of approval of the set-up by the Ministry of Commerce, the date of issuance of the business licence by the State Administration of Industry and Commerce, or the date of capital contribution by the foreign investor.

Since many tax incentives, currently in place for overseas investors, will be abolished with the adoption of the new law in 2008, it can only be recommended for foreign investors to accelerate their action plans. If the contemplated business is behind schedule, it is advisable to first establish flexible investment/acquisition vehicles and to expand the business with these vehicles at a later stage. However, investors need to act quickly as dates for application may have already expired.

Considering that reinvestment refunds and withholding tax exemptions for dividends will be abolished, foreign investors should review their Chinese subsidiaries and take prompt action to enjoy the current benefits.

For the tax year 2008, it is advisable to invest predominantly in high technology and environment-friendly equipment. Since the lower tax rate for the high technology sector will be expanded nationwide foreign investors should consider moving their subsidiaries to Central or Western China in order to enjoy further tax benefits. This, on the other hand, is only sensible if tax incentives for these reasons will be retained.

With new, more stringent anti-abuse provisions in place, it will be even more important in the future for investors to provide comprehensive and comprehensible transfer pricing agreements and documentation. It may arguably be advisable to make use of advance pricing agreements in order to ensure clarity for the coming tax year.

A New Insolvency Act for China

China has developed into one of the leading investment locations on a worldwide basis. In spite of China's increasing attractiveness, the protection of investor interests still falls far short of international standards. To make the conditions for investment yet more attractive, the National Congress passed the **Enterprise Insolvency Act** on 27 August 2006, which, in the event of insolvency, puts the investor's interests first, in priority to those of the employees.

The regulations of the new Insolvency Act will **come into effect on 1 June 2007**. They apply to both domestic and foreign, as well as private and state-owned companies. To solve the conflict between creditors and debtors, three instruments are principally available: an arrangement out of bankruptcy, winding-up due to insolvency and restructuring of the company.

As a basic rule, the insolvency needs to be declared by order of the court. If a third party can provide sufficient security or if the debtor is absolved from its liabilities prior to the necessary court ruling, , the state of insolvency does not arise. If this is not the case, the debtor is permitted to apply for an **arrangement out of bankruptcy**. This application requires both judicial authorisation and a simple majority of creditors, who must jointly hold at least two-thirds of the claims.

If no out-of-court compromise can be found, the liquidator named by the court must prepare a plan for the **winding-up process**. This plan needs to name the assets that are to be sold and the way in which the sale is to be carried out, and requires the acceptance of a creditor committee.

Any party that has receivable claims against the insolvent company may be part of this committee. Priority in distribution of the sale proceeds is given to satisfying the creditors' claims, followed by the wages and social benefits of the employees as well as social security contributions and other obligations.

In addition, debtors and creditors who account for at least 10 % of the receivables may apply in court for a **restructuring** of the company. Should the application be approved by the court, the interim administrator needs to prepare a detailed and comprehensive plan for restructuring within six months. The restructuring plan requires a simple majority in the creditor committee and the authorisation of the respective judicial authority.

According to the new regulations, the company management will be held **liable subject to private law** if it pays insufficient regard to the creditors' interests during the proceedings. Furthermore, members of the management of an insolvent company are not permitted to accept another management job in a Chinese company for a minimum period of three years after the declaration of insolvency. These kinds of specific penalties for entrepreneurial misconduct are new to the Chinese legal system and constitute an important step towards establishing a modern corporate governance system.

For the first time, the new regulations include some that concern **international insolvency proceedings**. The new Insolvency Act brings business assets located abroad within the scope of the insolvency process. It will also be possible from 1 June 2007 to assert claims deriving from foreign insolvency proceedings with regard to assets located in China. However, these innovations are greatly limited by the fact that they are only applicable if the insolvency proceedings are bilaterally accepted, do not contradict China's public policy and are not prejudicial to the legally guaranteed interests of Chinese creditors.

The new regulations have particular influence on **Chinese state-owned enterprises** (SOEs). If the Central Committee of the Communist Party has already resolved to privatise an SOE, the Insolvency Act does not apply to that particular enterprise. From 1994 to 2005, the Chinese government dissolved no less than 3658 SOEs and – in the last year alone – has released USD 4200 million (EUR 3110 million) in wage payments for redundant employees.

In conclusion, it remains to be stated that, for China, the new Insolvency Act constitutes an important step towards international investment standards and a sustainable appreciation with regard to investment terms, especially for foreign companies. However, it remains to be seen how these regulations are going to be implemented at the local level. The lack of commercial expertise among the judiciary and the continuing need to train experts in good time can be expected to cause obstacles for some time to come.

III. BANKING AND FINANCE

Financing Direct Investment in Asia

Today, investments are executed in a fast and efficient manner on a world scale as governmental regulations and restraints are being everywhere reduced. There are, however, deviations from this trend when it comes to financing such investments, because financing possibilities are dependent on country-specific characteristics derived from different cultural and political factors. In this respect, it is particularly striking in China that the involvement of a local bank remains indispensable even though the state-owned banks cannot compete with their internationally renowned rivals as far as entrepreneurial understanding and service are concerned. In India, by contrast, the investor finds a fully developed banking system in which both domestic and foreign financial institutions offer comprehensive banking services. There is, however, one common factor linking an investment decision in either country: the current state of the respective currency (RMB or rupees).

Even once a direct investment in Asia has been successfully financed, the risk still remains high. This applies to both economic and political risk . Therefore, it is imperative to take preventive measures.

In Asia as in Europe, the preparation of a comprehensive and solid **business plan** is the first step for the financing of each and every investment. For this purpose, it is imperative to evaluate the situation of the market, the competition, supply and prices. The investor's financing decisions will concern the debt-equity ratio, the source of funds (home country or host country), risk management and the choice of financing instruments.

When it comes to shifting locations or financing joint ventures, an exact and professionally established **valuation of contributions-in-kind** is necessary. In the possible event of an import of contributions in kind, attention must be paid to customs duties and other import regulations. An improper valuation can result in disastrous consequences for the whole financing package. If the valuation of contributions-in-kind is regarded as

improper, i.e. too high, by the foreign capital contributors, a financing gap that cannot be bridged may well result.

Internationally renown banks have active operations in almost all Asian countries while, in general, investors still resort to domestic banks because of currency convertibility and banking regulations. Especially in markets that are, in part, still **heavily controlled and regulated by the government**, the involvement of a **local bank** facilitates both contact and interaction with problematic authorities. Chinese investment laws are among those that require a minimum equity capital in relation to the investment amount. The fact that the instrument of foreign-currency loans (with subsequent conversion into RMB) is regularly cut off by the currency control authority (SAFE) is just another example of governmental intervention. However, the involvement of a Chinese bank also includes some disadvantages. These banks often request considerable guarantees. In addition, financing decisions may be held up because of a course of action that cannot be considered very business-friendly by Western standards.

Within the complex Indian banking system, with financial service providers on a western level, borrowing abroad – which is usually cheaper than a rupee-denominated loan – is controlled and approved by the Reserve Bank of India. Especially in direct comparison with China, one can find a much better understanding of business needs by the Indian credit institutions and policy makers. As already mentioned, convertibility and stability of the individual currency is as crucial a factor for loan decisions in China as it is in India. Though, at this point, the Indian rupee is not yet fully convertible, it has shown an impressively stable development during the last few years.

If investing abroad, **safeguards** available to investors cannot cover the entrepreneurial risk but only the political risk. The investment guarantee against sovereign interventions offered by the German government and the World Bank subsidiary MIGA present possibilities.

As regards Germany, it is necessary to have either an investment support and promotion agreement with the country of destination or protection of the investment through a national legal system. It is also possible to insure exports to a subsidiary or other affiliated companies via export credit guarantees

In China and India, there are a number of **peculiarities** that need to be considered. Professional advice and preparation is recommended for information on these options and for adjusting to the country-specific credit situation.

IV. DOUBLE TAX TREATIES

The New Hong Kong / People's Republic of China treaty

Since 1 July 1997, Hong Kong has been a Special Administrative Region (SAR) of the People's Republic of China. Though, from a political point of view, Hong Kong is part of the People's Republic, its economic, legal and tax system will, for the time being, remain independent for another 50 years. According to article 108 of the Basic Law of the Hong Kong SAR, Hong Kong has the right to pass its own laws in areas where it has autonomy. This autonomy essentially extends to all spheres except those of foreign affairs and defence policy.

On 21 August 2006, Hong Kong and the Chinese central government signed a new agreement concerning the avoidance of double taxation (Arrangement between the Mainland of China and the Hong Kong Special Administrative Region for the Avoidance of Double Taxation – hereinafter referred to as the DTT). The DTT came into force in the People's Republic on 1 January 2007 and in Hong Kong on 1 April 2007.

Compared to the previous DTT, the new one covers a wider area. The taxation of dividends, interest and royalties as well as the taxation of capital gains is now regulated for the first time. The new DTT is supposed to continue the avoidance of double taxation between China and Hong Kong while it is especially intended to attract investors by granting tax incentives. According to an official statement, Hong Kong expects to win even more foreign investment this way, in particular through investors who want to invest in mainland China via Hong Kong.

1. Changes in connection with withholding taxes

According to the old DTT, when it came to dividends from a subsidiary, loan interest and royalties it was the treaty partner in which the intellectual property was used or the loan was granted or from which the dividends were distributed that had the taxing rights, subject to to a maximum amount (withholding tax). This basically corresponds with the OECD Model Convention and is retained in the new DTT (Articles 10, 11 and 12). However, the withholding tax rates are now reduced.

a) Dividends

Instead of the previously applicable 20 %, dividends are now subject to a 10 % withholding tax (Article 10(2)(2)). The withholding tax rate is

reduced to a maximum rate of 5 % if so-called intercorporate dividends to a company with a minimum participation of 25 % are concerned. Although, at present, China does not levy withholding tax on dividends, investors enjoy a greater planning reliability with regard to possible tax reforms because of the DTT.

b) Interest

The withholding tax rate for interest payments (previously 10 %) is now limited to a maximum of 7 % (Article 11(2).

c) Royalties

From now on, royalties paid from the mainland to Hong Kong are subject to a 7 % tax rate as opposed to 10 % previously (Article 12(2)). If the royalties are paid between related parties and the agreed fee exceeds the amount appropriate for the service, the beneficial treaty rate is only applicable to the 'appropriate' (arm's length) amount (Article 12(6). By contrast, the excess proportion of the royalty is subject to the domestic withholding rate of 10 %.

d) Capital gains

Article 13 governs the taxation of capital gains. Gains from the sale of real property, a permanent establishment or the assets of a permanent establishment are subject to taxation in the territory of the treaty partner where the real property or permanent establishment is located. The same is true for the sale of shares in a company whose assets mainly consist of real property as well as for the sale of material participations (of at least 25 %) in other companies. If a participation of less than 25 % is sold, the sale proceeds are now exempt from withholding tax on the mainland if the sale is made by a Hong Kong based company. While a literal interpretation of these provisions appears to suggest that the exemption applies where the interest disposed of is less than 25 %, the interpretation by the Chinese tax authorities seems to require the aggregate participation of the investor to beless than 25 % at all times for the exemption to apply.

2. Exchange of information

For the first time, the possibility of information exchange between the Hong Kong Inland Revenue Department and the highest Chinese tax authority in Beijing has been agreed (in article 24). The reason for this might well be the Chinese tax authority's interest in improving the possibilities of inspection and in creating a more effective exchange of information.

To avoid an abuse of the information rights, the exchange is limited to data that is necessary for the application of the taxes covered by the DTT.

3. Perspectives for tax planning

Because of its independent legal system and the investor-friendly tax system, Hong Kong has always been a popular location for foreign investors in Asia, particularly for those investing in China. By using an intermediary holding company in Hong Kong, for instance, it is possible to enjoy the special benefits granted to resident companies by the Closer Economic Partnership Agreement between Hong Kong and the Chinese central government in the event of investments in mainland China. The DTT between the Beijing government and Hong Kong now also creates benefits in tax matters and reduces existing uncertainties. When looked upon in international comparison, the agreed withholding tax rates are among the lowest anywhere.

V. CORPORATE INCOME TAX

Transfer Pricing Adjustments can Result in a Deemed Dividend

In September 2006, a notice was issued by the Chinese State Administration of Taxation (SAT) that clarifies the treatment of **transfer pricing adjustments**. According to the notice the inappropriate portion of a transfer price in favour of a foreign related party (other than interest, rent and royalties) constitutes a deemed distribution of dividends where the enterprise does not adjust its accounting records after a transfer pricing tax adjustment took place. The deemed dividends are subject to Chinese **withholding tax. That is, the withholding tax exemption provided by domestic law on dividends paid by foreign investment enterprises to their foreign investors does not apply to such deemed dividends**. Any downward transfer-pricing adjustments of interest, rental income, royalties etc. will not reduce withholding tax that has already been paid.

VI. TURNOVER TAXES AND CUSTOMS DUTY

Customs-Value Implications of Screening Export Goods before Shipment from China

With its extremely low wages, China is providing stiff competition for manufacturing industries in Europe, the USA, Japan and Taiwan. To survive, some companies have resorted to importing pro-

ducts with high labour cost from China, thus transforming themselves from manufacturers to importers and distributors.

Due to quality problems Chinese companies are tempted to fill containers with defective products, especially where the purchaser is located somewhere abroad and has already paid for the goods. If the consignee of the shipment raises a complaint against this practice, his Chinese business partner will probably offer to compensate the defective part of a shipment by way of additional supply next time. As long as there are no sufficient controls, this course of dealing will continue and cause even higher expenses for the purchaser, who has to get rid of the defective parts. Actually, there are only two options to avoid this vicious circle. Under the first option, the foreign buyer will at least administer final controls before shipping the goods himself. Of course, if the purchaser has already paid for the shipment before the start of production even this is too late. Under a second option, the foreign purchaser will rely on a professional buying agent for quality control. These agents will take over the whole purchase in China including choice of suppliers, pricing negotiations and quality controls until shipment.

This scenario leads to several questions regarding customs value.

- The manufacturer or exporter (seller) is controlling the export goods himself, eliminating defective pieces and adjusting price and invoice accordingly. If the purchaser finds further defective goods or missing quantities before presentation at customs, there will be a difference between the purchase price and the customs value. Customs is obligated to consider this difference if appropriate evidence is presented. It is irrelevant at which point in time (before or after passing of the risk) according to the terms of trade the defects occurred.
- If the seller (manufacturer or exporter) orders a third person to check the goods before shipment, the seller will bear the cost and take those costs into account when calculating price and invoicing. If the seller is adding these expenses to the price, they will belong to the transaction value (customs value) in the same way as sales commissions. The further explanations at supra apply accordingly.

By contrast, if the purchaser (importer) makes use of a third party as service provider for quality control before shipment (or at the place of import before presentation to customs), then he bears the costs. These costs do not belong to the customs value, in the same way that the commission of a buying agent does not.

If the purchaser (importer) orders a third person to review the quality of goods on his behalf, and appears as a formally independent purchaser vis à vis the manufacturer or exporter, then the first sale price paid by the intermediate purchaser in the EU could under article 147 of the Community Customs Code Implementing Regulation provide a basis for the customs value declaration of the second purchaser (importer). If the first sale is a sale for export to the import country, e.g. under CIF clauses, the difference between the prices in both transactions can be irrelevant. However, there could be evidential problems.

If the intermediate purchaser acts in his own name but on account of the importer, that intermediate purchaser would actually only be a buying agent. If shown separately on the invoice, his commission is deductible from the customs value (cf. article 8.1(a)(i) WTO/GATT customs value convention = article32(1)(a)(i) Community Customs Code). A prerequisite is an appropriate commission contract instead of a sales contract between the intermediate purchaser and the importing purchaser.

VII. EXPATRIATES

Expatriate Individual Income Tax in China

China's tax bureaux are rigorous in seeking out workers who **abuse tourist visas** for working and ambitious to find foreigners in China who underdeclare their taxable income. Penalties are severe, up to five times the amount due plus the original tax liability. Businesses can have their **licences withdrawn** and worker's residence permits can be revoked very quickly.

With the growing computerisation of local tax offices and the facility this offers for inter-office networking, the volume of data available to the Chinese tax authorities increases accordingly. Visa types, length of stay, entry and exit forms, as well as the number of entries can be seen at one glance. Thus, every movement of **foreign workers** can be **traced** throughout the country.

Expatriates who are sent by a foreign company and who spend more than 183 days in China during one calendar year become subject to Chinese individual income tax. Even if the number of days spent in China is less than 183, but the expatriate works as a Chief Representative or Representative of a representative office of a foreign company in China or the expatriate's salary is borne by a Chinese entity or establishment,

that individual's income is subject to Chinese tax from the first day of work.

When the liability to tax exists, expatriates have to declare their **full salary** for the assigned position. It is against the law to declare an 'arranged' fixed salary and to lower the tax liability consequently. This practice is illegal and – as a result of computerisation – risky and the chances of being caught are growing fast.

Where the tax bureaux suspects someone of evading taxes, the authorities are allowed to substitute a higher salary than that declared. Since income tax is high in China (up to 45 % for salaries exceeding EUR 10,000 (USD 13,500 per month), it is advantageous to take a significant proportion of remuneration in the form of benefits, which are, in some cases, not taxable on the expatriate but are on the other hand deductible for the company, e.g. employer-provided housing or reimbursement of actual rental costs of accommodation.

Taxes have to be paid at the end of each month. The tax bureaux will **certificate** the tax paid since these can be credited against the taxes due in the home country. Foreign workers become fiscal residents in China, if they have stayed in China for more than five consecutive full years. As a result, the basis for taxation is the worldwide income in a subsequent year in which they stay in China for a full year. Exceptions are made if the taxpayer resides outside China for more than 90 days cumulatively or more than 30 days consecutively in a calendar year (as such a year would not be considered a full year of residence). In cases in which the taxpayer stays outside China for the above mentioned time period, the five-year residence clock starts anew after the return to China.

VIII. ACCOUNTING AND AUDITING

Chinese Accounting Standards converging with IFRS

As from 1 January 2007, companies listed in China have been obliged to prepare their accounts in accordance with the Accounting Standards for Business Enterprises (ASBE) that were adopted by the Chinese Ministry of Finance in February 2006. The voluntary application of these accounting standards is strongly recommended to unlisted companies. Thus, the Chinese Ministry of Finance has taken another step to decrease the differences between the Chinese accounting standards and International Financial Reporting Standards (IFRS). It is important to understand, however, that Chinese accounting standards are designed for Chinese accounting practice and are not supposed to be a mere copy of IFRS .

In this article, we shall be examining selected regulations of the ASBE with their IRFS equivalents, to highlight the similarities and differences.

The alignment of Chinese accounting standards with IFRS is an important step for the further opening of the Chinese market. As an indicator for company success, the new accounting standards facilitate the access to foreign capital markets for Chinese companies. The harmonisation of accounting systems results in a smaller number of adjustments and, with it, the time and effort needed for adjustments when preparing the accounts and making the IFRS transitions of Chinese financial statements. Chinese annual accounts will become more comparable and comprehensible for foreign investors. By way of the measures taken, the Chinese government hopes further to strengthen foreign investors' confidence in the Chinese market.

The differences between the new Chinese accounting standards and IFRS particularly concern related-party transactions , the write-up of extraordinary write-downs made in the past as well as the accounting methods and presentation of grants from public authorities.

IFRS qualify all transactions concluded by state authorities as transactions of related parties and companies and, therefore, as subject to mandatory disclosure. By contrast, Chinese accounting standards do not qualify Chinese state-owned enterprises as related. Thus, if Chinese state-owned enterprises conduct business with each other, there is no need for disclosure at all.

IFRS permits write-ups from extraordinary past write-downs (for impairment etc). Chinese accounting standards do not allow for this kind of write-up.

When it comes to grants from public authorities, which are already subject to special accounting regulations put into effect by the government, the grants need to be accounted for and depicted in compliance with those regulations and not according to Chinese accounting standards.

The following table gives further selected examples of the differences between Chinese accounting standards and IFRS:

Issue	ASBE	IFRS
Framework	In general, the historical acquisition and production costs must be capitalised. Current value, sales value, cash value and fair value are only admissible if they can be assessed in a reliable way.	Historical acquisition and productions costs as far as valuation of additions is concerned. Differentiated secondary valuation: • Continuous acquisition and production costs in compliance with lower-of-cost-or-market principle (acquisition cost model) • Current value accounting (revaluation model)
Inventories	LIFO-valuation is not allowed. Acquisition costs of inventories that are borne by an investor must be accounted for in compliance with the values set by the investment contract unless these are inappropriate.	LIFO-valuation is admissible upon allowing for and meeting certain reporting requirements.
Long-term assets held for disposal and abandoned business divisions	Not regulated.	Capitalisation, valuation and reporting regulated in IFRS.
Real estate held as financial investment	• Usufruct of immovable property held for leasing or appreciation in value and buildings held for renting. • The acquisition and production cost method is supposed to be used for evaluation of additions. The continued acquisition and production costs generally need to be assessed for the secondary evaluation. The revaluation method including the assessment of the current value can only be applied if the value can be determined reliably.	• Concerns real property listed as financial investments are those that are held for renting, finance leasing and operating leasing while complying with certain requirements and for appreciation in value. • Usufruct of immovable property held for renting may be qualified as property finance investment if the requirement of valuation according to the revaluation method is met. • The profit or loss resulting from the revaluation must be released to income when it comes to the periodic results.
Fixed assets	Capitalisation of acquisition or production costs. Secondary valuation: continued acquisition costs.	Capitalisation of acquisition or production costs. Secondary valuation: continued acquisition costs or according to the revaluation method.

Issue	ASBE	IFRS
Agriculture	• Three categories of agricultural assets: biological assets for consumption, biological assets for production and biological assets for environmental protection. • Capitalisation of assets in compliance with acquisition and production costs. • In general, the continued acquisition costs need to be the basis for the valuation of biological assets for production. • Extraordinary write-offs must be undertaken for biological assets for consumption and production if the attributed value ranks below the book value. • A write-up is intended for biological assets for consumption, however prohibited when it comes to assets for production. • No extraordinary write-off for biological assets for environmental protection.	• In principle, the need to capitalise the current value minus the estimated sales expenses applies to both the valuation of additions and the secondary valuation. • The acquisition and production costs are only a means to revert to if the attributed current value cannot be reliably determined. • Profit and loss resulting from the valuation must be released to income.
Debt expenses	• Contrary to regulations hitherto existing, the new regulations concerning capitalisation of debt expenses do not only apply to tangible fixed assets but also to intangible assets and inventories that take a long time to acquire or produce. • Debt expenses that can be directly allocated to debts taken up for acquisition or production of the asset minus the interest income from unused loans and income deriving from investing these loans in the meantime may be capitalised. • The weighted average costs for general borrowed funds that were not especially taken up for the asset are also capitalizable. • The interest component of leasing payments is not affected by the debt expense regulations.	• The special regulations for debt expenses concern intangible assets, tangible assets and production orders that take a long time to acquire or produce. • There is a one-off capitalisation option that needs to be utilised uniformly. • The directly allocable debt expenses are a) those especially taken up for the purpose of acquisition or production of the qualified asset whereas profits from interim investments need to be subtracted and b) those weighted average costs for general borrowed funds that were taken up for no special purpose whereas these may be assessed either for the entire group or on the basis of the individual group company's financing. • The debt expense regulations include the interest component of leasing payments.

Issue	ASBE	IFRS
Consolidated accounts	• As a matter of principle, all annual financial statements must be prepared as at the same balance-sheet date and included in the group financial statements. • If the balance-sheet dates of subsidiaries differ from that of the group as a whole, it is necessary to either conduct a rollover or prepare separate accounts. • For companies that are under common control, business combinations must be shown using the pooling-of-interest method.	• The financial statements of subsidiaries with balance-sheet dates different from that of the parent company may be included in the group financial statements if the period of the deviation does not exceed three months and the preparation of interim accounts is impracticable. • Adjustments need to be made for significant events that occur in the period between the balance-sheet date for the group and the differing subsidiary balance-sheet dates. • The pooling-of-interest method is not applicable for amalgamations of companies that took place after 31 March 2004.
Segmental reporting	• Mandatory for all companies that have more than one business unit or operate in geographically different markets. • Reporting according to a two-step concept: a) business units and b) geographical markets.	• Mandatory only for listed companies. From 2009 on, segmental reporting will take place only on the basis of the internal reporting that the company's management uses for its decisions (management approach). Up to and including 2008, segmental reporting must be prepared according to the two-step concept of a) business units and b) geographical markets.

There are no substantial differences between the new Chinese accounting standards and IFRS with respect to the following issues:

- Exchange of non-monetary assets
- Debt restructuring
- Carrying amounts, valuation and presen tation of financial instruments
- Taxes on income
- Transfer of money-equivalent assets
- Covering transactions
- Accounting and valuation methods, adjustments of estimations and errors
- Results subsequent to the balance-sheet date
- Cash flow statements
- Interim reporting
- Statements concerning relations to related companies and parties with the exception of state-owned enterprises
- Earnings per share

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