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I. CHINESE TAX LAW

China's New Tax Regulations

Guidelines on Withholding Tax

On 9 January 2009, China's State Administration of Taxation (SAT) issued a circular (*Guo Shui Fa* [2009] No 3) providing guidance for the application of withholding tax on payments to non-resident enterprises. Income derived by a non-resident enterprise from a Chinese source, including dividends, interest, rent, royalties, capital gains, and other income, is taxed based on the source principle, and the person who is responsible for making the payment to the non-resident enterprise acts as a withholding-tax agent.

On the first occasion on which a person enters into an agreement with a non-resident enterprise that will require tax to be withheld, he is required to register as a withholding-tax agent within 30 days of signing the agreement.

A withholding-tax agent must withhold income tax on the earlier of the date on which the payments are due and the date on which the agent actually makes the payment. The tax withheld must be paid over to the tax authorities within seven days after it is withheld. If a non-resident enterprise applies for a tax exemption or tax reduction under Chinese tax law, it must complete the required procedures regarding the tax exemption or reduction before it is able to enjoy the benefits. If a tax treaty provides a preferential rate of withholding tax to a non-resident enterprise, it may apply for the treaty rate to have effect. However, if it fails to make such an application based on the provisions of the tax treaty, China's domestic tax law will be applied.

If a non-resident enterprise refuses to have tax withheld, the withholding-tax agent must stop paying the enterprise money to the extent of the withholding tax amount. The agent must also report this matter to the tax authorities within one day.

If both parties to an equity-transfer agreement are non-resident enterprises and the equity transaction takes place outside China, the domestic enterprise whose equity is transferred is required by the Circular to submit the agreement to the tax authorities when registering the change of equity and has the obligation to assist the tax authorities in taxing capital gains derived by the transferor from the transfer of the equity. In such a case, the vendor himself is required to file tax returns with the local Chinese tax office or appoint an agent to do so.

Taxation Procedures on Construction Projects and Services

On 20 January 2009, the SAT issued the Provisional Measures on the Administration of Tax on the Undertaking of Construction Projects and the Provision of Services by Non-Resident Enterprises (Decree [2009] No 19).

This decree provides a more effective taxation procedure for the purpose of controlling business tax, VAT and EIT in connection with construction projects and service businesses. For this purpose, 'construction projects' include construction, installation, assembly, repair, decoration, exploration, and other contracting business.

A non-resident enterprise engaged in a construction project or the provision of services is required to implement tax registration procedures within 30 days after the relevant agreement is signed. It will also be required to submit a copy of the project completion and acceptance certificates and other necessary documents to the tax authorities and implement tax deregistration procedures within 15 days of the completion of the project.

When filing income tax returns, a non-resident enterprise must provide the tax authorities with a series of supporting documents, such as construction project or service settlement reports, financial statements and statements on foreigners who work on construction projects or provide services. If a non-resident enterprise believes that its operations, whether on the construction project or in the provision of services, do not thereby constitute a permanent establishment in China, it must submit an application form together with supporting documents when claiming tax-treaty preferential treatment. If it fails to do so, it will not be entitled to enjoy the benefits of the treaty.

In addition to EIT returns, a non-resident enterprise will also be required to file business tax or VAT returns if it has a business establishment in China through which business tax or VAT activities are performed. If it does not have a business establishment in China, its agent will act as a withholding-tax agent for such taxes. If it does not have such an agent, the other contractor of the construction project or the buyer of the services will be required to act as the withholding-tax agent.

Annual EIT Filing Procedures for Non-Resident Enterprises

On 22 January 2009, the SAT released a circular (*Guo Shui Fa* [2009] No 6) containing guidelines for annual EIT filing procedures for non-resident enterprises. Under the guidelines, a non-resident enterprise established under the laws of another country (or Special Administrative Region) which has no effective management but a permanent establishment in China will be required to submit annual EIT returns to the tax authorities and settle EIT within five months of the end of the financial year, regardless of whether it earns a profit or incurs an operating loss. The EIT settlement procedures may not be required for a non-resident enterprise if it temporarily carries out construction projects or renders services in China for less than one year, has already terminated these business operations and paid the relevant tax, or if it has completed deregistration within the first five months of a calendar year.

If special circumstances exist that prevent a non-resident enterprise from completing annual EIT settlement procedures within the required period, it may apply to the tax authorities within the first five months following the end of the financial year to postpone annual EIT settlement procedures.

Salary Tax Deductions

'Reasonable' salaries and wages paid by an enterprise are tax-deductible. On 4 January 2009, the SAT published a circular (*Guo Shui Han* [2009] No 3) clarifying that reasonable salaries and wages are those already paid by an enterprise to its employees according to the enterprise's salary and wage system formulated by the shareholders' meeting, board of directors, salary and wage committee or relevant management organisation. In determining whether salaries and wages are reasonable, the tax authorities will normally take into account the following factors:

- whether the enterprise has formulated a standardised salary and wage system;
- whether the enterprise has withheld and paid relevant individual income tax for salaries and wages;
- whether the salary and wage arrangements have the purpose of reducing or avoiding tax;
- whether the salaries and wages paid by the enterprise are relatively stable and the adjustment of salaries and wages follows a regular process in a given period; and
- whether the salary and wage level of the enterprise is in line with that of the same industry or area.

In accordance with this circular, salaries and wages are exclusive of employee welfare, educational expenses for employees, trade-union expenses, pension premiums, medical-insurance premiums, unemployment-insurance premiums, industrial-accident insurance premiums, maternity-insurance premiums and housing funds.

Change in Business Tax

China's business-tax regulations have been changed. Effective from 1 January 2009, new business-tax regulations may have a significant impact on foreign enterprises and individuals providing China-related services. Under the old regulations, services performed outside China were not subject to business tax, while the new regulations provide that the provision of services will become subject to business tax if either the provider or the recipient of the services is situated in China. This means that under the new regulations, a foreign provider of services will be liable for business tax when rendering services to an enterprise or individual situated in China, regardless of whether the services themselves are performed within or outside China. For example, would a foreign enterprise have the obligation

to pay business tax to the Chinese government if it rendered taxable services (e.g. accounting and tax consulting or construction-design services) to a Chinese enterprise or individual and the services were completed solely outside China? The answer would be 'No' if the old rule applied. However, it will be 'Yes' if the new rule is applied. In this regard, the business tax will be imposed by withholding, similarly to income tax. Concretely, the Chinese recipient of the services will act as a withholding-tax agent to withhold the business tax when consideration for the services becomes payable. Under China's foreign-exchange controls, the consideration cannot be remitted to the foreign enterprise unless the tax is accounted for.

Services subject to business tax include services related to transportation, telecommunications, cultural activities and athletics, construction, finance and insurance, entertainment, advertising, agency, catering, consulting, designing, hotel services, leasing, tourism and warehousing.

Similarly, the assignment of intangible assets will be subject to business tax under the new regulations if either the vendor or the purchaser of the intangible assets is located in China. Assignment of intangible assets is the transfer of ownership or the right to use intangible assets, including the transfer of land-use rights, trademarks, patents, know-how, copyrights or goodwill and the leasing of cinematography films.

As a type of turnover tax, business tax is charged on the total revenue and other additional fees received from the other contractual party. In the transportation, tourism and construction industries, if an enterprise subcontracts work to a third party, costs paid by the enterprise to the third party can be deducted from the enterprise's total revenue when computing business tax. The new regulations emphasise that these deductions will not be allowed if the receipts provided to the enterprise by the third party do not comply with China's laws, regulations, and other requirements of the State Council's department in charge of taxation. Concretely, if the third party is located in China, statutory invoices are required and will be issued by it; if the third party is situated outside China, receipts issued by it are considered acceptable vouchers for such purposes. When reviewing the receipts, the tax authorities may require that confirmation documents issued by an overseas notary be submitted.

Individual Income Tax on Stock Options

On 7 January 2009, the Ministry of Finance and SAT released a circular (*Cai Shui* [2009] No 5) establishing a right to tax income from stock-appreciation rights (SARs) or restricted stock. The circular states that income from SARs or a restricted stock derived by an individual from a domestic or foreign public company is subject to individual income tax (IIT) and refers to the guidance provided in circulars *Cai Shui* [2005] No 35 and *Guo Shui Han* [2006] No 902. A SAR is an

award granted by a public company to its employees under which the holders would benefit from the appreciation in value of a set number of shares of company stock over a set period of time. If a holder exercises SARs under the prescribed conditions, he or she will receive cash from the public company, which amounts to the number of shares granted multiplied by the difference of second-market prices between the issue and exercise dates. Restricted stock means stock of a public company that is granted by the public company to its employees according to the conditions stipulated in a stock-incentive plan.

In accordance with circulars No 35 and No 902, an employee is generally not immediately liable for IIT when granted stock options and will be subject to IIT on net income when exercising stock options. Once an employee transfers stock options before the exercise date, net income from the transfer is treated as employment income and is subject to IIT. If an employee receives dividends from the shares arising from exercising stock options, the dividends are classified as income from interest and dividends. If an employee transfers the shares, gains from the disposal of the stocks are regarded as income from assignment of property.

Change in Property Tax for Foreign-Owned Enterprises

On 31 December 2008, the State Council issued Decree No 546 to abolish the Provisional Rule of Urban Property Tax promulgated on 8 August 1951. With effect from 1 January 2009, foreign investment enterprises, foreign enterprises and foreign individuals became subject to the Provisional Rule of Property Tax of the People's Republic of China issued on 15 September 1986.

Property tax is quite similar to but independent from urban property tax. Before 2008, property tax applied to domestic entities and individuals, whereas urban property tax applied to foreign investment enterprises, foreign enterprises and foreign individuals. With the abolition of urban property tax, all such entities and individuals are subject to uniform property tax regulations. Property tax is usually imposed on the owner of immovable property located in city, county, town or mineral zone. It is normally charged at 1.2% of the value of the immovable property. This in turn amounts to the original value of the immovable property multiplied by a ratio ranging from 10% to 30%. If the immovable property is let, the property tax is generally charged at 12% of the annual rents.

Stamp Duty on a Group's Internal Vouchers

Some enterprises use all kinds of vouchers when transferring goods or materials from one group company to another. Some of the vouchers are only used for internal accounting purposes without having the character of a contract, while others are used for settlement purposes and have the nature of a contract. Therefore, on 5 January 2009, the SAT published a circular (*Guo Shui Han* [2009] No 9) explaining the application of stamp duty to such vouchers. Vouchers are subject to stamp duty if they are signed by two parties and have the nature of a contract and are used for supplying goods and serving settlement purposes; vouchers used for internal purposes without the character of a contract are not subject to stamp duty.

Amendment to the Criminal Law on Tax Evasion

On 28 February 2009, the Seventh Meeting of the Standing Committee of the Eleventh National People's Congress passed the seventh Amendment to the Criminal Law of the People's Republic of China (the 'Amendment'), in which the criminal provisions on tax evasion were revised. The most important changes in the tax provisions are the cancellation of a purely quantitative standard for the commission of a criminal offence of tax evasion and the introduction of a policy of exemption from criminal sanctions under certain conditions.

In the past, a criminal offence was generally deemed as committed by a taxpayer who evaded CNY 10 000 in taxes. Under the Amendment, a taxpayer is deemed to have committed a criminal offence if he evades a 'relatively large' amount of taxes. The Amendment does not define what is meant by 'relatively large'. Explanations to the Amendment state that the reason for this is that tax evasion is considered as quite complex and the same amount of taxes evaded makes for different degrees of damage to society at different stages. Thus, the actual amount of the term 'relatively large' will be determined by the judicial authority based on practice and adjusted at the appropriate time.

According to the Amendment, a taxpayer will be exempt from criminal sanctions for tax evasion if, after receipt of a demand for the tax evaded from the tax authorities, he or she pays the taxes due as well as any late-payment penalties, and has already been subject to an administrative sanction. This will not apply if the taxpayer has already been subject to criminal sanctions at least once or to administrative sanctions at least twice on account of tax evasion within the preceding five years. This serves the purpose of providing a first offender with an opportunity to correct his or her default. Below, we have reproduced a translation of the new article 201 of the Criminal Code containing the new tax-evasion provisions.

New Article 201

A taxpayer who files false tax returns or fails to file tax returns by fraudulent or covert means shall be sentenced to imprisonment:

- for three years or less or criminal detention, together with a fine, if the taxpayer has evaded a relatively large amount of tax and the amount represents 10% or more of the total amount of taxes payable; or
- for three to seven years, together with a fine, if the taxpayer has evaded a significantly large amount of tax and the amount represents 30% or more of the total amount of taxes payable.

A withholding agent who fails to pay or underpays a relatively large amount of tax already withheld or collected by the means referred to in the preceding paragraph shall be sanctioned in accordance with the provisions of that paragraph.

If a taxpayer has committed the acts mentioned in the preceding two paragraphs two or more times and the legal consequence of the defaults is not yet final, the amount of tax evaded shall be aggregated on each occasion.

If a taxpayer has committed the acts mentioned in the preceding first paragraph, and after receipt of a demand for the evaded tax from the tax authorities, has subsequently reimbursed all tax payable and late-payment penalties and has already been subject to administrative sanction, the taxpayer shall be exempt from criminal sanction, unless the taxpayer has already once been subject to criminal sanction or subject to administrative sanction at least twice by reason of tax evasion within the preceding five years.

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CFC and Thin Capitalisation Rules under the New Enterprise Income Tax Law

The New PRC Enterprise Income Tax Law ("New EIT Law") and its Implementation Rules came into effect on 1 January 2008 and provide a new tax framework and introduce new anti-avoidance provisions. Under the New EIT Law, there is a Chapter of Special Tax Adjustments, which makes only general provision for combating avoidance provisions. Accordingly, the SAT has issued detailed Administrative Regulations concerning Special Tax Adjustments (the 'Regulations') under a tax circular *Guo Shui Fa* [2009] No 2, which also have effect from 1 January 2008.

We provide below a brief insight on the CFC (controlled foreign company) and the thin capitalisation rules under the New EIT Law and the Regulations.

CFC Rules

CFCs are non-Chinese companies ('foreign companies') controlled by persons resident in China for tax purposes ('Chinese residents'), whether corporate or individual, each of which directly or indirectly holds 10% or more and jointly hold 50% or more of the foreign company. If a Chinese resident has an indirect holding in a foreign company, the effective holding in the foreign company for CFC purposes is calculated by multiplying the ownership percentages in the intermediate holding layers.

If any of the intermediate holdings is more than 50%, such a holding is treated as 100% for calculation purposes in this regard. Notwithstanding this share ownership test, if a Chinese resident exercises 'effective control' over a foreign company by virtue of shares, capital, business operations, purchases and sales, etc., that foreign company is also regarded as a CFC for Chinese tax purposes. However, at present, there is no official guideline to define 'effective control' in this regard.

The New EIT Law introduces the CFC rules, which are intended to compel Chinese-resident shareholders to bring into tax in the current tax period their proportional interest in the undistributed profits (i.e. deemed dividend) of CFCs established in comparatively low-tax jurisdictions (i.e. jurisdictions in which the effective rate of corporate tax is lower than 50% of the standard EIT rate of 25% in China) where there is no legitimate business reason for the low or non-distribution of the profits of the CFC.

According to the Regulations, the deemed dividend to be included in the taxable income of a Chinese-resident shareholder is the share of dividend (calculated based on the Chinese-resident shareholder's share ownership ratio in the CFC) for the part of the year in which the shareholder was part of the controlling group. In this regard, shareholders can claim foreign tax credits (if foreign tax is paid on the dividend) to the extent otherwise allowable. When actual dividends are paid later, they will be exempt from tax to prevent double taxation.

The Regulations also provide that there will be no deemed dividend if any one of the following conditions is met:

- the CFC is situated in territories that are designated by the PRC State Council as zero or low-tax jurisdictions; or
- the CFC has income derived mainly from active business operations; or
- the annual profits of the CFC do not exceed CNY 5 million.

On 21 January 2009, SAT issued *Guo Shui Han* [2009] No 37, stating that Australia, Canada, France, Germany, India, Italy, Japan, New Zealand, Norway, South Africa, the United Kingdom and the United States are considered to have effective tax rates higher than the threshold referred in the CFC rules of the New EIT Law. As a result, the undistributed or under-distributed profits arising from CFCs in these countries do not need to be included in the taxable income of the Chinese-resident shareholder provided that a resident shareholder can produce the evidence of his residence status.

As regards statutory filing, the Regulations require a Chinese-resident shareholder of a CFC to submit foreign-investment information forms when filing its annual Enterprise Income Tax return with the PRC tax authorities.

The Regulations appear also to require individual Chinese shareholders to recognise their share of deemed dividends from CFCs and it is anticipated that the Individual Income Tax Law will be revised accordingly.

Thin-Capitalisation Rule

The New EIT Law contains a specific thin-capitalisation rule, which disallows interest deductions on borrowings from related companies if the interest-bearing loans of the enterprise exceed certain prescribed 'safe-harbour' debt-equity ratios. The Implementation Rules of the New EIT Law provide definitions for 'debt investment' and 'equity investment' for this purpose. 'Debt investment' refers to financing directly or indirectly obtained by an enterprise from its related parties and requiring repayment of principal and interest. 'Equity investment' is investment obtained by an enterprise without the need to repay principal and interest, and which confers on the investors the entitlement to the net assets of the enterprise.

The Regulations clarify that interest expense includes interest, guarantee fees, pledge fees, and other fees of a nature similar to interest, incurred directly or indirectly from related-party borrowings. In addition, the Regulation also stipulates that any disallowed interest cannot be carried forward for tax-deduction purposes in subsequent years.

On 19 September 2008, the Ministry of Finance and the State Administration of Taxation issued *Cai Shui* [2008] No 121 which, inter alia, defines permitted debt-equity ratios. The Notice provides for a related-party debt-equity ratio of 5:1 for financial enterprises and 2:1 for other enterprises.

Calculation of Debt-Equity Ratio

While the prescribed debt-equity ratio was determined by the tax authorities, the Regulations provide guidelines on the calculation formula of a company's debt-equity ratio using a weighted average calculation as follows:

$$\frac{\sum \text{monthly average related-party debt}}{\sum \text{monthly average equity}}$$

Whereas the monthly average related-party debt is the sum of the beginning and ending balances of related-party debt divided by 2, and the monthly average equity is the sum of the beginning and ending balances of total equity (includes paid-up capital and capital reserves) divided by 2. In this regard, the equity of the enterprise as per its balance sheet is used rather than a fair market value of equity.

Disallowed Interest

The Regulations contain the formula to calculate the disallowed interest as follows:

$$\text{Total related-party interest} \times \frac{(\text{Actual debt-equity ratio} - \text{prescribed debt-equity ratio})}{\text{Actual debt-equity ratio}}$$

For interest payable to a foreign related party, the disallowed interest is calculated as follows:

$$\text{Total foreign related-party interest} \times \frac{(\text{Actual debt-equity ratio} - \text{prescribed debt-equity ratio})}{\text{Actual debt-equity ratio}}$$

Disallowed interest to a foreign related party is treated as dividend and subject to dividend withholding tax when paid to the foreign recipient. In this regard, if any interest withholding tax has been withheld which is in excess of the applicable dividend withholding tax, no refund will be available.

According to the Regulations, the above treatment of disallowed interest as dividend is only applicable to interest paid to a foreign related party. For any interest on local related-party borrowings, the lender's taxable treatment of the interest would not change.

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Taxation of Permanent Establishments in China

In accordance with the New Chinese Enterprise Income Tax Law, foreign companies that have a permanent establishment on Chinese soil are now subject to Chinese corporation tax.

Chinese understanding of the term ‘permanent establishment’

The Executive Order relating to the New Enterprise Income Tax Law defines the term ‘permanent establishment’. In accordance with Article 5 of the Order, any manufacturing and economic operation is a permanent establishment. Although Article 5 names plants and offices as examples of a permanent establishment, the provision does not require a fixed place of business. In contrast, any place or location from which a service is rendered is sufficient. Moreover, the Order does not include a minimum time limit, i.e. even a non-permanent activity in China may lead to taxation of a permanent establishment.

The China-Germany tax treaty & limitation of the term ‘permanent establishment in China’

However, the China-Germany tax treaty restricts the broad Chinese understanding of the term. In accordance with the treaty, the term basically requires a fixed base, exactly corresponding to the German understanding of the term. With regard to construction projects or service projects that generally do not have a fixed base, the tax treaty requires a presence in China of at least six months. Projects that are completed within a shorter period of time do not constitute a permanent establishment in terms of the treaty. Thus, a permanent establishment resulting from the provision of services in China can only be constituted if the service project takes longer than six months within any 12-month period. Therefore, the broad Chinese understanding of the term ‘permanent establishment’ needs to be construed more narrowly under the China-Germany treaty.

Calculation of profits in accordance with Chinese tax law

Depending on the nature of the permanent establishment, the profit is either determined in accordance with the so-called deemed-profit-method or the cost-premium-method. The deemed-profit-method is applicable to project-related permanent establishments; profits are estimated. The tax base for this estimation is the gross remuneration paid for the services rendered. The estimated profit amounts to 10% to 40% of the gross remuneration paid. The tax authorities assess the exact percentage rate. The cost-premium-method is applicable to the representative offices of foreign companies; profits are estimated on the basis of the expenses actually incurred.

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VAT Reform

The old VAT system in China was a ‘production-based’ system, which generally disallowed the recovery of input VAT incurred on the purchases of fixed assets and required it to be capitalised as part of the cost of fixed assets. Since 2004, VAT reform programmes have been launched by the Chinese authorities to enable deduction of input VAT incurred on fixed-asset purchases (i.e. a ‘consumption-based’ system) by certain industries in certain trial regions of the country (e.g. North-eastern Region, Central Region and Eastern Inner Mongolia). Starting from 1 January 2009, the following new policies have been implemented.

Nation-wide and industry-wide applications

There are no geographical and industry restrictions on deduction of input VAT incurred on fixed-asset purchases.

Full input VAT recovery

The input VAT incurred on the purchases of fixed assets such as machinery and equipment are fully creditable. The previous restrictions on input VAT recovery that are applicable to the trial regions were withdrawn.

Carry-forward of excess input VAT

If the amount of input VAT recoverable is greater than the amount of output VAT charged on sales within a VAT reporting period, the excess input VAT may be used to offset future output VAT.

Cancellation of Import VAT exemption treatment for imported equipment

There has been a preferential VAT treatment for foreign-investment enterprises (FIEs) in certain encouraged industries or under certain modes of business operation in China (e.g. processing trade) on importation of equipment from overseas, consisting of exemption from import VAT. However, such preferential VAT treatment has been abolished on 1 January 2009. Instead, the taxpayer may recover the import VAT as input tax.

In this regard, the new policy may create cash-flow pressure and potentially hit the import costs of some businesses that are not registered as VAT general taxpayers, since only VAT general taxpayers can recover input tax.

Cancellation of VAT refund on domestically manufactured equipment purchased by FIEs

This preferential VAT treatment was also abolished on 1 January 2009, as the input VAT incurred on the purchase of domestically made equipment should in future be creditable in the normal way under the forthcoming consumption-based VAT system. This new policy may also create cash flow pressure for FIEs, since the input VAT incurred on the purchase of the domestically manufactured equipment would no longer be refundable but only creditable, and it may take a long time for these FIEs to offset the excess input VAT.

Reduction of VAT rate for small-scale taxable persons

The VAT rates applicable to so-called 'small-scale' taxable persons (4% for commercial enterprises and 6% for manufacturing and other enterprises) have been reduced to 3%, with effect from 1 January 2009. This measure is viewed as an alleviation of the VAT burden of these small enterprises. In addition, the minimum-income thresholds for VAT registration have been raised to help the development of these small businesses.

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II. DOUBLE TAX TREATIES

Hong Kong – Luxembourg Treaty in Effect

The Hong Kong – Luxembourg double tax treaty came into effect on 20 January 2009. The agreement has retroactive effect in Hong Kong and Luxembourg from 1 April 2008 and 1 January 2008, respectively.

The new treaty is especially interesting because – if certain requirements are fulfilled – dividends originating from an EU Member State may be distributed to Hong Kong without being subject to withholding tax.

On the one hand, this can be attributed to the fact that, in accordance with the EC Parent-Subsidiary Directive, dividend distributions between Member States of the European Union are not subject to withholding tax if the investor ('parent') company holds at least 15% in the investee ('subsidiary') company and has continuously done so for a period of at least 24 months. Thus, a dividend distribution from an EU Member State to Luxembourg is free of withholding tax, provided that the requirements of the Directive are met. In this connection, attention needs to be paid to the fact that, to some extent, the manner in which the EC Parent-Subsidiary Directive has been implemented into national law in different Member States provides for lower standards as regards the requirements. In Luxembourg, for example, the dividend income is tax-exempt if the Luxembourg-based company continuously holds at least 10% of the shares in the investee company for a period of at least 12 months. With respect to relief from German withholding tax, it needs to be noted that, in accordance with the 'anti-treaty-shopping' regulation embodied in German tax law, care must be taken to ensure that the interposed Luxembourg company is not disqualified under that regulation from entitlement to treaty benefits (e.g. withholding tax-exemption).

In addition, the treaty provides that no withholding tax will be levied in the event of dividend distributions from Luxembourg to Hong Kong if the Hong Kong 'parent' company holds at least 10% in the Luxembourg 'subsidiary'

or if the acquisition cost of the participation amounted to at least EUR 1.2 m. With respect to the Luxembourg 'subsidiary', the following requirements need to be met:

- Its share capital must be no less than EUR 12 500
- Its management must be located in Luxembourg and
- all strategic decisions concerning the company are made in Luxembourg.

As dividend income is already tax-exempt in Hong Kong due to national statutory regulations, dividend income originating from an EU Member State and distributed to Hong Kong via Luxembourg can be collected free of tax.

As far as exit strategy, i.e. the disposal of the shares in the European company, is concerned, it is possible to collect the respective capital gains tax-exempt in Hong Kong as long as certain requirements are met.

One reason for this is that, in the case of bilateral treaties between EU Member States, the right to taxation of gains on disposal is usually granted to the country of residence of the disponent (here: Luxembourg), Luxembourg, however, chooses not to exercise its taxing powers in this respect. Thus, the gains on disposal are tax-exempt in Luxembourg. On the other hand, no withholding tax will be levied in Luxembourg regarding the dividend distribution from the Luxembourg-based 'subsidiary' to the Hong Kong 'parent' company if the latter held at least 10% of the shares in the company that has been disposed of while it meets the further requirements mentioned above from a German point of view.

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III. ACCOUNTING AND AUDITING

Corporate Governance – How newcomers on the stock exchange in China approach this challenge

Corporate governance represents a full range of mechanisms that are able to create a balance between shareholders' rights and the needs of the executive board or the management. Solving the conflicts of interest between those two groups requires both internal and external mechanisms. Providing information sufficiently regarding the operative business, the financial situation and the external environment of the company, precisely and in a timely manner is indispensable and enables the shareholders to monitor and supervise the company.

This requirement applies to all countries and in this respect China is no exception. And yet the corporate governance practices in China used to look quite different when compared with the United States, the United Kingdom or

Germany, for example. This was mainly due to the fact that in China, the government acted as the main shareholder. Accordingly the corporate governance practices could best be described as a control-based model, in which the main shareholders kept the listed companies under tight control by using the corporate-governance mechanisms.

The immense capital needs of Chinese companies in recent years required a further development of corporate governance, geared more to transparency aspects, in particular for protecting minority stakes. In this context we must emphasise that Chinese companies meet their capital requirements on the domestic but also on international capital markets. Accordingly the development of corporate governance in China is characterised not only by regulations in China but also by the requirements of international capital markets.

Requirements of Chinese corporate governance

While in the 1990s the development of corporate governance was characterised by the requirements regarding the privatisation of state-owned companies into private-sector, commercial companies, in the new millennium, efforts that should lead to a higher transparency and thus attractiveness of the Chinese capital markets can be identified. Furthermore, the development of corporate governance regulations was stepped up by the fact that at the beginning of the millennium the Chinese stock exchanges, like their American counterparts, were jolted by the scandals in listed companies. In order to counteract the shareholders' loss of trust and confidence, the Chinese authorities issued several regulations to improve market transparency and to strengthen shareholders' rights.

As a result, important reforms for the further development of corporate governance in China have been initiated since 2002: The admission of foreign investment in companies listed on Chinese capital markets since 2002 as well as the conversion of previously government-owned and non-tradable shares into tradable shares in 2005 were aimed at an increase of market-induced corporate governance due to increased shareholders' rights. Market transparency was considerably strengthened by the introduction of formalised quarterly reporting in 2007. In addition, with the 2007 introduction of the Accounting Standards for Business Enterprises (ASBE), IFRS, with few exceptions, was effectively introduced for companies listed on the Chinese stock exchanges.

An additional milestone in the development of corporate governance was completed in January 2002 when the China Securities Regulatory Commission (CSRC) issued the Corporate Governance Code for companies listed in China. The Code follows the corresponding US regulations and establishes regulations, for example, regarding financial-reporting processes, information publishing and management-information systems. It is the goal of the Code

to expand shareholders' rights, to increase the importance of institutional investors in decision-making processes and to strengthen the rôle of the executive board and the supervisory board. By instituting numerous corporate governance measures, the CSRC has, in recent years, strengthened the rights of private investors.

Within the framework of efforts to introduce reliable corporate governance regulations, however, it must be added that there has been an amount of over-regulation. A related example can be seen in the organisation of supervisory regulations in the company statutes of Chinese companies. As a matter of principle, Chinese legislators made the decision in favour of a two-tier system similar to the German system, in which the supervisory board is to supervise the executive board. At the same time Chinese public companies are also acquainted with the rôle of independent (non-executive) directors, who are also responsible for the appointment of the independent auditors. Chinese companies adopted the idea of independent directors from the Anglo-American single-tier system. In daily practice this duality has led to difficulties when defining the responsibilities between supervisory board and independent directors.

All corporate-governance regulations turn out to be ineffective if their implementation into practice does not take place. For this reason, the Chinese authorities are increasing their efforts to improve the training of the accounting and controlling staff as well as of the independent auditors. As a result the introduction of ASBE was substantially supported by the simultaneous implementation of the Chinese auditing standards which to a large extent were adapted from International Auditing Standards (IAS).

International corporate-governance requirements

Regulations such as the Chinese Corporate Governance Code as well as the ASBE apply only to companies that are listed on Chinese stock exchanges. Yet many Chinese companies are flocking to international capital markets. Those companies have to observe the regulations of each market. The ASBE, for example, are not recognised as the equivalent of the IFRS. For an initial public offering in Europe, financial data from the past in accordance with IFRS is still required. In the United States, year-end accounts in accordance with US GAAP are expected.

Which corporate governance regulations apply to internationally listed Chinese companies depends on two criteria. On the one hand, the regulations of the corresponding stock exchange and the current stock-exchange supervision legislation apply. On the other hand, the regulations of the country in which the listed company is established have to be complied with. This applies to China only in very few cases since a direct listing of a Chinese company is only authorised in exceptional cases, such as those of large former state-owned companies. It is for this reason that many Chinese companies have established

holding companies outside China, which are listed on their respective stock exchanges. (so-called ListCos). Thus one can arrive at the situation where a listing in the United States or Europe has to comply with the corporate governance regulations of Singapore or Hong Kong, because the ListCo is established there. If in the case of a US listing the regulations of the country of establishment necessitate a deviation from US corporate-governance rules, the company has to describe those deviations and the reasoning behind them in a separate report. In Europe such a description of deviations related to the corporate governance of the respective countries is not necessary.

German corporate-governance requirements

The German corporate governance statutes are regulated by both the transparency guidelines of the German Stock Exchange (*Deutsche Börse*) and the statutory regulations for public limited companies. More extensive statutory regulations apply only to companies incorporated in Germany.

Fourteen Chinese companies are currently listed on the German Stock Exchange. Six companies – all of them listed in the Prime Standard – utilise a ListCo in the form of an AG (public joint-stock company) and therefore have to comply with the regulations of the German Securities Trading Act. The remaining companies are mainly domiciled in Singapore or the Netherlands and are thus subject to the statutory corporate-governance regulations of those countries.

During the post-IPO phase, companies listed in the Prime Standard have to comply with the transparency guidelines of the German stock exchanges and publish annual and quarterly financial statements and ad-hoc announcements as well as carry out an annual analyst conference.

Since those companies have chosen the German AG form and are listed domestically, they have to comply with more extensive transparency regulations than a non-European company: As a German AG they also have to publish a situational report as well as an interim situational report for the half-year. These publication obligations necessitate that companies be able to rely on top-quality and functional management-information systems. Important statutes for companies incorporated in Germany additionally include the obligation to submit a balance-sheet affidavit as well as a binding declaration certifying that the statutes of the German Corporate Governance Code have been complied with.

The fact that Chinese companies are able to meet the demanding German requirements was shown by ZhongDe Waste Technologie AG, with its 2007 Annual Report: In the Manager Magazine's competition for the best annual reports, ZhongDe was placed in the top half of the 10 largest stock exchange newcomers in 2007.

It appears to be quite useful that German AGs have to adopt corporate statutes in accordance with the German Securities Act. The German two-tier system with a supervisory board appears to be tailor-made especially for companies from the Chinese cultural environment, organised within a strict hierarchy. This also corrects the somewhat ambiguous allocation of responsibilities under Chinese law and leads to clearly defined responsibilities between supervisory board and executive board. In addition, the appointment of German and Chinese members to the supervisory board, which can be observed in daily practice, leads to a mutual understanding of intercultural differences and combines in the best possible way the knowledge of German members regarding the German capital-market requirements with the knowledge of the Chinese members regarding the Chinese market.

Furthermore, in contrast to corporate statutes in other countries, the statutes of a German AG confer on shareholders more extensive control rights. This protects minority shareholders in particular.

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IV. FOREIGN EXCHANGE ADMINISTRATION

New Foreign-Currency Regulations in Effect

On 2 July 2008, the Chinese State Administration of Foreign Exchange (SAFE) issued several regulations for inspecting foreign currency in the scope of export trade. This basically concerns the set-up of a new online system for examining foreign currency in export trade and registration of advance and delayed payments in the scope of export and import trade.

The economic background to these measures is the massive increase in Chinese foreign-currency reserves over the course of the past few years. China is trying to control the inflow of funds more efficiently and strictly by way of the new regulation.

The legal framework consists of a total of three SAFE circulars dated 2 July 2008 (source: www.safe.gov.cn). These Circulars are entitled:

- 'Issues Related to the Implementation of the Measures for the Online Inspection of Foreign Exchange Collection and Settlement of Export Proceeds'
- 'Issues Concerning Management of the Registration of the External Debt under the Item of Corporate Trade in Goods'
- 'Measures for Online Inspection of Foreign Exchange Collection and Settlement of Export Proceeds'

In accordance with the new regulations, foreign-currency inflows from abroad will in future be inspected via SAFE's new electronic online system. The transferred amounts will be cross-checked with the corresponding declarations in the relevant trade agreements.

In line with the objective of the circulars, this basically concerns all companies that receive payments from abroad or transfer money to a foreign country.

Control account and preliminary foreign-currency volume

Under the new system, foreign-currency payments are first credited to the so-called 'Subject-to-control account (STC account). Companies need to open such an account as an additional account at their main bank. The account is an interim account. The foreign currency transferred to this STC account is frozen for as long as SAFE's inspection is under way. This means that the company may neither withdraw money nor transfer money to a different STC or regular account. In accordance with the circulars, the STC-account balances are supposed to be interest-bearing. However, the amount of interest is not stated in the circulars. Thus, the amount of interest will probably depend on the respective bank. Companies are advised to contact their main bank and inquire to this end.

It should be noted that SAFE determines a preliminary foreign-currency volume for companies on the basis of the prior year's business volume and other factors (for instance the size of the company). Within the limitations of this prescribed volume, payments from abroad may be transferred from the STC account to the regular account without problems. Any transfer as well as inspection of whether the incoming payments range within the admissible foreign-currency volume is carried out by the bank. Each payment within the respective volume reduces the preliminary annual foreign-currency volume.

Should payments from abroad exceed the preliminary foreign-currency volume, the company needs to prove that these payments originate from export trade. This may, for instance, be done by presenting recently concluded trade agreements and completed customs forms. To this extent it is possible to increase the preliminary foreign-currency volume on an ongoing basis. Accordingly, computation of the foreign-currency volume is based on current operations.

Registration of credit debts

From now on, the new regulations require those companies to which they are applicable to register credit debts that are to be divided into the following categories: prepayments and delayed payments.

The old regulations required only those companies to register prepayments that were on the SAFE inspection list due to violation of the foreign-currency regulations.

Registration of delayed payments was mandatory only for amounts exceeding USD 200 000 and terms of payment of 180 days.

Prepayments

In accordance with the aforementioned circulars, prepayments are payments for trading transactions that are made and received prior to the export supply date agreed in the trade agreement or that were received prior to the official export declaration of the goods.

Prepayments with a contractually agreed term of payment need to be declared within 15 business days of receipt of the payment. Registration is carried out via the SAFE Trade Credit Registration System.

Delayed payments

Delayed payments are payments for trading transactions which are due in compliance with the trade agreement and made after the agreed import date or are made at least 90 days after the time of import of the goods.

If delayed payments occur on the basis of contractual agreements, they must be registered within 15 days of the conclusion of the contract, otherwise after the expiration of 90 days from the day of import/declaration of the goods. This mandatory registration of delayed payments came into effect on 1 October 2008.

With regard to delayed payments, SAFE will determine a quota that may – as a basic rule – not exceed 10% of the prior year's total foreign-currency income. Exemptions are admissible for large-scale enterprises and long-term import agreements.

Summary and conclusion

The implementation of an electronic online system will make foreign-currency inspection both swifter and more efficient. Especially the time aspect of inspection might bring benefits for the companies concerned.

The stricter registration obligations regarding prepayments and delayed payments, however, might well bear a disadvantage. Many companies finance their Chinese subsidiaries via prepayments and delayed payments. These funding options will only be possible within a very limited scope, especially in consideration of the admissible 10% quota for delayed payments.

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