

Jesa Consulting Ltd.

NEWSLETTER

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What is Jesa?

Jesa is a service company headquartered in Shanghai specializing in facilitating start-up of new industrial productions while providing reliable management and control solutions. We operate 4 main branches in China and a foreign office in Ulaan Baatar (Mongolia). Since 1998, Jesa has built a team of 70 specialized employees in addition to 25 engineers following "in loco" projects. Commercial relationships are exclusive and strictly confidential, ensuring the highest expertise on each single commercial and technical issue. Jesa is a leader in managing manufacturing processes and eliminating any industrial and regulatory problems while helping our clients save financial resources and time.

Jesa is currently expanding its services providing support to those companies seeking to develop distribution network and retail system in China as well as in Mongolia. We also perform HR audit and investment analysis (trouble-shot analysis) to verify performances in support to enterprises already established in China.

The Chinese Tax Law Reform: Implications for Foreign Investors

The new Chinese Enterprise Income Tax concludes almost thirty years of preferential tax treatment for foreign invested enterprises compared to domestic companies applying the same fiscal treatment to both foreign and domestic enterprises.

In December 2007, the Decree of Enterprise Income Tax, containing the first implementation rules for the new law, was issued. As it often happens in China, after the issuance of a law which contains general guidelines, a series of decrees and implementation rules are issued in order to adapt the law's underlying concept to

the market's reactions. The following description of the new and most updated changes introduced by the government regarding fiscal policies will be further modified and/or completed in future.

Modification in tax rates

The new law introduced a unique tax rate of 25% both for foreign and domestic enterprises with the aim to equalize the tax treatment. Reduced tax rates of 15% and 20% could be applied only to high-tech enterprises and selected small enterprises respectively. As regards high-tech enterprises, the new law stresses the concept of property of "core proprietary intellectual property". The rules to determine the eligibility of high-tech enterprises for the reduced tax rate have not been yet promulgated.

A withholding tax rate of 20% is adopted on the passive incomes (dividends, royalties, interests, etc.) sourced in China and transferred to enterprises non fiscally resident in China.

New fiscal incentives policies

While under the previous law, fiscal incentives were based on geographical drivers, with the new law incentives are determined mainly on an industrial base. The aim is to promote high-tech businesses, environmental protection and energy-saving industries, as companies belonging in the public sectors.

Transitory regime

For foreign invested enterprises established before the introduction of the new law (16 March 2007) the following transitory rules are introduced:

- Foreign invested enterprises enjoying preferred tax treatment under the previous law with 15% and 24% tax rates, can be eligible for a five years transitory period during which the tax rate will gradually increase until reaching 25%;
- Foreign invested enterprises that still not profited by the five years tax-free period will be allowed to enjoy the tax-holiday during the transitory period.

Fiscal residence

Following international practices, the new law introduces the concept of "management or control" for determining the fiscal residence. A company fiscally resident in China is defined as a company under Chinese law or which effective management is located in China. If a non Chinese company is managed and controlled in China (the elements to be considered are the location of operations, personnel, treasury, financial functions and properties), it is considered fiscally resident in China and subject to the Chinese tax law on its worldwide incomes.

Mergers and acquisitions

The implementation rules of the new law are not comprehensive: many rules are missing, such as those concerning corporate reorganizations, among which mergers and acquisitions. The fiscal treatment of corporate reorganizations, indeed, refers to regulations that will be emanated separately. It is expected, however, that the tax holidays for intra-group reorganizations will be limited to share transfers when the transferee is a Chinese company.

Therefore, more clarifications are required to determine whether reorganizations involving external transferees and commenced before the end of 2007 are eligible for tax exemption according to the new law.

The impact of the new law on foreign investors varies according to the industry typology and its geographic location, but, generally speaking, it surely have a major impact on privileges and competitive advantages of foreign investors in China during the last thirty years. The foreign invested enterprises that under the previous law received fiscal incentives will see an increase in the tax burden. It is indeed necessary that they revise their fiscal profile and the tax planning system in order that the effective tax rate will be evenly managed in China. On the other hand, foreign enterprise contemplating an investment in China must take into account the tax burden increase and the consequent reduction in profits

in the moment they take their investment decisions.

Because the new law abolished the probability of a tax exemption, the acquisition of an existing foreign enterprise on the Chinese market could be more attractive for those foreign investors than the establishment from zero of a foreign invested enterprise. During the transition period, the foreign investor could inherit the favorable fiscal treatment through the acquisition of an existing foreign invested enterprise by the mean of shares.

Individual Income Tax for Foreign Employees

The president of the People's Republic of China signed order to issue Law of the People's Republic of China on Individual Income Tax (Revised in 2005) on October 27, 2005. This article's aim is to inform the reader about the latest changes of in the law and its implementation rules.

The law is aimed at all employees (including Chinese and foreign) who work within the territory of China, especially at those earning high income.

Employees should consider the following issues:

1. Do you have proper education on what income to report and how to calculate tax?
2. How much time will it take to complete the application and file it?
3. What documentation must be provided for substantiation (how to obtain /deliver it)?
4. Where and when to file?
5. What implications will this have for home country filing?

Personal income tax rate

Schedule 1. Individual income tax rate:

| Grade | Monthly Taxable Income | Tax Rate(%) |
|-------|---|-------------|
| 1 | Income of 500 Yuan or less | 5 |
| 2 | that part of income > of 500 to 2,000 Yuan | 10 |
| 3 | that part of income > of 2,000 to 5,000 Yuan | 15 |
| 4 | that part of income > of 5,000 to 20,000 Yuan | 20 |
| 5 | that part of income > of 20,000 to 40,000 Yuan | 25 |
| 6 | that part of income > of 40,000 to 60,000 Yuan | 30 |
| 7 | that part of income > of 60,000 to 80,000 Yuan | 35 |
| 8 | that part of income > of 80,000 to 100,000 Yuan | 40 |
| 9 | that part of income > of 100,000 Yuan | 45 |

(Applicable to income of wages and salaries)

Schedule 2. Individual income tax rule:

| Grade | Monthly Taxable Income | Tax Rate(%) |
|-------|--|-------------|
| 1 | Income of 5000 Yuan or less | 5 |
| 2 | that part of income > of 5,000 to 10,000 Yuan | 10 |
| 3 | that part of income > of 10,000 to 30,000 Yuan | 20 |
| 4 | that part of income > of 30,000 to 50,000 Yuan | 30 |
| 5 | that part of income > of 50,000 Yuan | 35 |

(Applicable to income gained by self-employed industrial and commercial households from their production or business operations, and income gained by enterprises and institutions from contracting or leasing operations)

Categories

The below chart (Shanghai Daily) describes when a foreigner is generally subject to individual income tax on earnings.

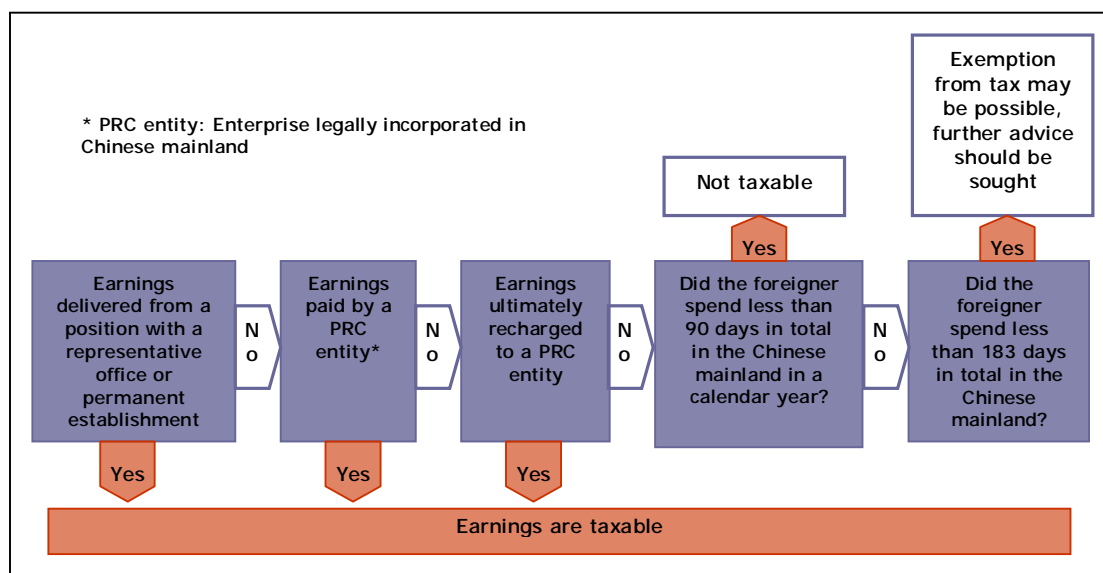
Domiciled Individuals

There are expatriates who usually or habitually reside in China due to family or business relationships or those who are registered householders with a personal residence record. Most people in this category are PRC nationals but one can be considered Domiciled if he/she has a Chinese national spouse. If a foreigner is in possession of a Chinese equivalent of a "Green Cards" (i.e. naturalization working permit) then he/she will be also be susceptible to classification as Domiciled.

Where income is equal to or above 120,000 RMB a year, these individuals are required to report their worldwide income and gains. This means any of personal gain, in whichever form, in China and in their home country combined.

Long-Term Expatriates

This category applies to foreigners who have spent more than 5 full consecutive years in the PRC. It is important to point out that a "full year" is a calendar year where absences from the PRC do not exceed: 1) 90 days in total or 2) 30



consecutive days (the departure and arrival dates do not count as being abroad).

The tax situation for these people is same as above: where income is equal to or above 120,000 RMB a year, these individuals are required to report their worldwide income and gains. This means any of personal gain, in whichever form, in China and in their home country combined.

Short-Term Expatriates

The category applies to a foreign-national residing in China for 5 years or less. Same as above, a "full year" means that the individual must not have spent more than 90 days total or 30 days outside the PRC (excluding departure or arrival dates).

Where income is equal to or above 120,000 RMB a year, these individuals must report all sources of income and personal gain obtained within the PRC. This implies that any sources of income external to the PRC (i.e. from the home country) do not to be filed.

Filing Period

For individuals who receive income from outside the PRC: 30 January of next year.

For all others: 31 March of next year.

Penalties

For late filing: RMB 2,000 to RMB 10,000.

For late payment: surcharge of 1.5% per month.

For incorrect tax return: up to RMB 50,000.

For tax evasion: up to 5 times the amount evaded and consequently potential penal sentencing and/or deportation depending on the gravity of the situation.

Flash: China's New Employee Paid Annual Leave Measure

Even if in the past other regulations (the 1994 Labour Law and the 2005 Civil Servant Law) stipulated general guidelines on the possibility for employees to take leave, for the first time

starting from January 1, 2008, employee paid annual leave will be mandated by China's central government and will, thus, become mandatory. The Employee Paid Annual Leave Measure, issued by the State Council, requires that employees with one year's service or more are entitled to paid annual leave according to the following schedule: 1) service between 1 and 10 years, 5 days of paid annual leave; 2) service between 10 and 20 years, 10 days of paid annual leave; 3) service exceeding 20 years, 15 days of paid annual leave.

According to Hewitt's 2007 Index study, 98.5% of all employers provide annual leave to employees. Annual leave days typically range from 10 to 20 days by employee service year and position level. However, there are employers who currently provide no or less-than-statutory paid annual leave to lower level employees or at the manufacturing level. For such companies, the new Employee Paid Annual Leave Measure imposes compliance risk and actions need to be taken to adjust the current annual leave policy.

According to Hewitt's study, employers usually put in place company-specific policies with regard to unused annual leave. 29.2% of the plans forfeit unused leave, 67.1% of the plans allow carry-over of unused leave to a certain point of time in the following year. Only 6% of the plans allow employees to trade unused leave for cash and the compensation is usually 100% of the normal daily pay.

Under the new regulations, mandatory annual leave shall be taken within the calendar year in general. For those employees who cannot take annual leave due to work (and the employer shall have employee's consent in advance), they are entitled to compensation equal to 300% of the normal daily pay.

If a company foresees that compensation for unused leave is significant and predictable, they may need to recognize liability under the new regulations using the 300% pay standard.

Under the new regulations, mandatory annual leave is not applicable for those who take summer and winter holidays, paid personal leave (>=20 days), and sick leave (length of leave

links to service). However, home leave (if applicable) is considered as having a special purpose and therefore is not offset by annual leave.

Although uncertainty still remains on, for example, how "service" is defined (whether calculated across company, or based on specific company hire service), as well as on how unused leave is defined, the new regulations clearly signal the government's desire to improve employee leave benefits. A detailed implementation rule is expected soon.

The top priority for company HR is to review their current annual leave policies to ensure compliance with the new regulations. HR should also be aware that many employees may have questions on how this new law impacts them. Additionally, HR may want to take this opportunity to communicate annual leave benefits to improve employee awareness and perceived value.

For inquiries regarding this newsletter or for any other concerns; please contact us anytime at:

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