



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. Jesa is currently expanding its services to provide support to those companies seeking to develop environmental projects in China, such as alternative energies and environmental management.

Impact of the Unified Corporate Income Tax Law on Foreign Direct Investment

In a move to modernize their tax system and bring about equal treatment amongst enterprises in China, the PRC drafted the new Unified Corporate Income Tax Law. Despite the obvious benefits it will bring to local Chinese companies, many have been discussing whether this new statute will have significantly negative impacts on the influx of foreign direct investment (FDI) into the PRC. With India and Vietnam quickly on the rise and offering foreign companies their respective alluring advantages, will the increased tax rates for foreign enterprises dissuade them from entering into China?

In reality, China's preferential "Dual Tax" policy is still just one of a myriad of reasons why

foreign enterprises chose to operate in the country. Therefore, before jumping ship it would be important to consider the following:

1) Fair Play

The new enterprise law simply reduces certain preferential policies previously granted to foreign investors, in turn placing local and foreign enterprises on a similar playing field. While it might affect foreign investment in the short-run, it will lead to a healthier and productive competitive environment in the long-run.

2) Neighbour Performance

The average corporate tax level in neighbouring countries is between 25% - 30%; therefore the new tax rates will not be comparatively higher.

3) Additional Incentives

From an investor's point of view, the tax level is not the only deciding factor which is taken into consideration. They will also be focusing on the political and economic stability of the country, the future development of the market, the present labor resources, the infrastructure integrity, and other support services available.

4) Transition Period

In order to ease the negative impact a sudden tax increase would have on foreign enterprises, the PRC has decreed that it will provide a transition period of 5 years during which affected companies will have the tax gradually phased in.

It is clear that overall the tax will not have any unalterable impacts on the level of foreign investment in China. It will, on the other hand, change the structure of investment within the country by focusing investment to certain industries rather than basing it geographically (note: preferential policies for Western and North-eastern China will be maintained).

Vietnam and India, China's closest competitors, also offer advantages to foreign investors wanting to outsource or de-localize. In order to understand comparatively their investment environment it is essential to analyze various attractive factors:

	Vietnam	China	India
Minimum wage for unskilled workers	50US\$ (average)/Month	70US\$ (average)/Month	30US\$ (Average)/Month
Qualified workers	At least 7% more than unskilled workers. Difficult to define for qualified managers	About the same cost as Vietnam for the middle level, lower for the top level	Average entry level direct labor costs are 12% lower than China but after 4th year of operation costs are very similar
Land Cost	35US\$/sqm (average)	30US\$/sqm (average)	N/A**
Land ownership	Land lease	50 Yrs land lease	Private ownership
Utilities	Vietnam More expensive than China		Power costs are significantly (20-25%) cheaper in China
Company Income tax (general rate)	28% for FIE's and local companies; Special reductions can be applied	25% with the Unified Tax; reductions applied to special industries	30%
VAT	0-10%	17%	4-12.5%
Domestic market	82 million population	1.3 billion population	1.03 billion population
	207 US\$ pro capita private consumption	310 US\$ pro capita private consumption	451 US\$ pro capita private consumption
Supporting industries	Vietnam doesn't possess a wide range of supporting industries to provide raw material or sub assemblies. Import of raw material and pre-cursor is required	China has a wide source of supporting industries in major areas along the coast and major cities.	Industries can provide coal (4th largest reserve in the world), iron ore, titanium, etc.
Transportation	Road system still not completely developed. Railway too obsolete.	Mostly based on railways is improving very quickly. The number of express ways is booming.	Good railway system yet still heavily underdeveloped road system
Cost of shipping a 40 foot container	Slightly over 2,500US\$	About under 2,000US\$	Significantly cheaper in China
Company set-up	REPO's, Joint Ventures and WOFE. REPO's discouraged in Vietnam		Branch office, 100% subsidiary, JV (most popular), Acquiring existing Indian company
Capital requirements	30% of invested capital	From 25% till 70% of the investment (less the investment higher the proportion)	Varies according to area
Duration of the company	50 years (extendible to 70 years)	50 yrs - productive co.; 30 yrs - commercial co.	Varies according to area
Timing for the license and registration	10-20 days	1-6 months	Varies according to area
	No more than 45 days		
	Problems with corruption		
Protection of intellectual property	Weak but improving	Weak	Very good: protection of IP has been an established system since the Anglo-Saxon rule
Rule of law	Weak but improving	Strengthening but still some areas to be improved	Strong but still improving
Predictability of law and government policy	Can be unpredictable	Predictable	Stable political climate; predictable

**NOTE: Since land is privatized the land cost will vary depending on the situation of the specific area.

Each country offers its distinct advantages and it is therefore important to view foreign direct investment in Asia not as an either/or decision but as a comparative approach that examines which country best fits your investment plans. Vietnam has considerable advantages in terms of taxes and cost of human labor; not to mention the higher quality of the labor. Unfortunately, the government structure is relatively unstable and much of the country is plagued by corruption. India excels within the IT industry and there are less overall language barriers, but the infrastructure is in poor condition and it is lacking FDI growth. One clear advantage which China holds over its rivals is the sheer size of its accessible consumer market. Especially with regards to luxury goods and other high-income products, the number of consumers who can afford such items is steadily on the rise. Comparatively, China's middle-high class is, and will remain, larger than its rivals still for quite some time. This offers a distinct advantage for investors looking to capitalize on a steadily growing luxury market with tremendous future potential.

Each country has the ability to offer foreign enterprises attractive opportunities for investment. It is clear that investors must look at emerging Asian nations as compliments rather than substitutes within the wide spectrum of investment opportunities in the continent. Therefore, in relation to this, China's modernizing tax system will not be placing any unsurpassable blockades to FDI, it will instead offer the investment climate a future of stability which will allow China to take its place amongst the developed nations of the world.

Explanation of China's VAT Tax System

1. The current VAT system of China

The VAT is essentially a tax imposed on the increased value which commodities acquire as they move through the various stages of production or circulation, or on the value added of certain commodities. Generally, companies engaged in trading, manufacturing and servicing industries are subject to VAT and/or Business Tax (which is a 5% tax levied on intangible goods such as the transfer of intellectual property). Some service companies are required to pay business tax, such as: transportation, construction, finance and insurance, posts and telecommunications, culture, sports, and recreation. Enterprises involved in such activities will *not* need to pay VAT. Furthermore, any company engaged in the importing and manufacturing of the eleven goods specified in the Consumption Tax regulations (tobacco, alcohol, cosmetics, skin and hair care products, jewellery, fireworks, gasoline, diesel oil, tyres, motor-bikes and automobiles) are also subject to Consumption Tax in addition to VAT. VAT is the major source of fiscal revenue for the Government of China. The income is shared between the Central Government (75%) and Local Governments (25%).

Tax base

The tax base is referred to as taxable sales volume. Sale volume means all the money paid directly by the buyers. This also includes fees outside the price such as charged commission, subsidy, packaging, rent for packages, etc., but not output tax paid by the buyers, consumption tax charged on behalf of tax bureaus, and transportation fees paid by the customers. If the ordinary taxpayers sell goods or taxable services for a price that combines the sales amount and output tax, the formula for computing the sales amount is:

$$\text{Sales amount} = \text{Total sales amount (including VAT)} / (1 + \text{Tax rate})$$

Taxpayers

There are two kinds of VAT taxpayers in China: General Taxpayers and Small-Scale Taxpayers. There are primarily two requirements which judge the status of a taxpayer. For example, small taxpayers are those who: 1) are engaged in the production of goods or the provision of taxable services as their sole or principal business and their annual turnover is less than RMB ¥1,000,000 (in the wholesale or retail sectors the annual turnover must be less than RMB ¥ 1,800,000); and 2) if a taxpayer maintains a sound accounting system and is able to provide accurate accounting records for taxation purposes, they may be registered as a general taxpayer. Small taxpayers are taxed on the basis of the revenue derived from sales of goods or provision of taxable services by applying proper rates (4% for commercial sector and 6% for other sectors):

Tax payable = Sales amount x Applicable rate.

For general taxpayers the process to calculate the tax payable it is explained as:

VAT payable = Output tax - Input tax.

Output Tax Versus Input Tax

Output tax is the amount collected by the seller in the moment of the sale on the basis of the sales amount at an applicable VAT rate for the goods or taxable services sold. The sales amount is defined as the selling price in addition to related fees; but not the VAT itself. The formula is:

Output tax = Sales amount x VAT rate.

If the buyer returns back the sale, it should reduce the output tax at the same time. Similarly, input tax is the amount paid by the buyer in the moment of the purchase on the basis of the purchase amount at an applicable VAT rate for the goods or taxable services purchased. Purchase amount is defined as the

purchasing price plus related fees; but not the VAT itself. The formula is:

Input tax = Purchase amount x VAT rate.

Tax Computation

General taxpayers have to pay to the government tax bureau the balance between the output tax and the input tax levied at the same point. The formula is:

VAT payable = Output tax - Input tax

The standard VAT rate is 17%; with the exception of certain goods which are subject to VAT at 13% or at 0%; refer to the table below of taxable items and rates for more information:

Table of VAT Taxable Items and Rates

Coverage of collection	Rate
Exportation of goods (except otherwise stipulated)	0
Agriculture, forestry, products of animal husbandry, aquatic products; Edible vegetable and grain duplicates; Tap water, heating, cooling, hot air supplying, hot water, gas, liquefied petroleum gas, natural gas, coal/charcoal products for household use; Book, newspapers, magazines(excluding the newspapers and magazines distributed by the post department)	13%
Feeds, chemical fertilizers, agricultural chemicals, agricultural machinery and plastic converting film for farming; Selected metal mineral products, Selected non-metal mineral products, coal.	
Crude oil, mine salt ; goods other than those listed above; Taxable services.	17%

Importation goods

Importation goods are taxed on the basis of the composite assessable price by applying the applicable tax rate. Where the taxpayers import the taxable goods under the Consumption Tax, the Consumption Tax payable shall be included in the composite assessable price.

***Tax payable = Composite assessable price ×
Applicable VAT rate***

***Composite assessable price = Customs
completion price** + Custom Duty +
Consumption tax***

**Note: Customs completion price is equivalent to C.I.F.

Exported goods

In case of a 0% rate applicable to exported goods, the exporters may apply to the tax authorities for the input tax refund on those goods exported. At present, the refund rates consist of 3%, 5%, 8%, 13%, and 17%.

Exemptions

Goods are also exempted from VAT if 1) they are imported by scientific research institutes or schools, 2) they are directly for scientific research or education, or 3) they cannot be produced in China.

Registration

Joint Ventures, Wholly Owned Foreign Enterprises, Representative Offices and other similar organisations in China are required to register with the tax authorities within the time limit prescribed in the relevant regulations. In general, this has to be completed within 30 days after the business licence is issued. Registrations have to be filed with both the State Tax Bureau and the Local Tax Bureau. The two bureaus have their own tax jurisdictions. To qualify as an ordinary VAT payer and be able to issue VAT invoices, a taxpayer has to undertake VAT registration as well. Upon completion of the tax registrations, the tax authorities will issue a tax registration certificate which must be renewed every year. During the registration process, one should discuss with the tax officers and confirm the basis for tax calculation and filing. Furthermore, VAT payments are usually on a monthly basis and tax authorities will not send tax returns. Instead, one should collect blank tax returns from tax offices, complete them, and file them accordingly.

2. Problems with the VAT

China currently practises a system of basing VAT on production. Under this system, fixed assets are classified as consumer goods and are subject to VAT. As a result, enterprises may not claim tax deduction for the purchase of fixed assets such as equipment and machinery. This increases the tax burden of capital (and technology) intensive enterprises and is not conducive to economic restructuring. Thus, the switch from production-based VAT to consumption-based VAT has become necessary. Why did the Chinese government choose the production type of VAT? There are two main reasons that led to the choice. First, it can ensure to provide the Chinese central government with sufficient tax revenue at a lower rate. If the government had chosen another kind of system, the tax rate would have been very high for the sake of collecting a certain amount of tax revenue. Second, the higher tax rate would have a delusive effect on both the national economy and the goals of collecting and administering the VAT.

However, the economic situation has since changed. The government recognized that certain regions in China had a disproportioned level of investment which drove down their local economy. In order to improve the situation the government wanted to expand investment in these areas. Therefore, the production type of VAT would no longer be suitable. In consequence, since 2004 the government has been experimenting with consumption-side VAT in the industrial areas in North-eastern and Central China which are in need of development. In these regions industries are able to have a full refund on their VAT in order to stimulate overall investment.

Highlights from Around China

- Jobs scarce for China's graduates

China's graduates have faced many difficulties finding a job. It is estimated that more than one million of the 4.95 million new graduates this year will end up without a fixed job. Some employers and economists say the problem is one of rising expectation; others say the students' skills don't match what is required in the job market. Employers say students are often not qualified for the available job openings and blame the university system for failing to adapt to the nation's new economy.

- M&A's to rise in retail sector

PricewaterhouseCoopers has studied China's retail and consumer sector. The results show growing merger and acquisition activity. As stated by the company's retail and consumer manager: "Many more foreign retailers will resort to the practice of mergers and acquisitions as a way to gain efficient and effective market entry, while domestic players will buy out smaller regional retailers as a strategy to extend their presence." Furthermore, it seems strategic alliances and voluntary chains will be another trend among retailers, especially smaller ones, in the coming years.

- WTO: China outpaces US in exports

China surpassed the United States as the world's second-largest exporter in the middle of last year, according to figures released Thursday by the World Trade Organization. In total exports for the full year, China is behind Germany and the United States; it overtook the United States in the last six months of 2006. Export growth from China boomed 27 percent last year, outpacing all other major trading nations. "China's merchandise trade expansion remained outstandingly strong," the WTO said. "Office and telecom equipment continued to be the mainstay of Chinese export growth, but significant gains in world market shares in 2006 could be observed

in 'traditional' exports such as clothing and 'new' products such as iron and steel."

- BMW woos hydrogen support

BMW AG is trying to have Chinese support to promote hydrogen as a mainstream new energy solution. The Munich-based car maker has chosen China to launch its BMW Hydrogen 7 sedan in China, with an internal combustion engine capable of running on either liquid hydrogen or gasoline. With a 74-liter petrol tank and a fuel tank containing eight kilograms of liquid hydrogen, the BMW Hydrogen 7 can run 700 kilometres on one tank, including at least 200 kilometres powered by hydrogen. Top speed could reach 230 kilometres per hour. UK industrial gas maker BOC Group Plc partnered with Tongji University and Shell to build Shanghai's first hydrogen refuelling station in 2005 other has been put under construction in Beijing.

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