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Peeling the Onion Part 3 - Out Now

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Peeling the Onion Part 3 - Out Now

With the current viruses globally over the World Wide Web (NOT our server!) slowing down internet delivery and causing problems for mail delivery, many of you may not have received the latest copy of our "**Peeling the Onion**" newsletter.

The topic of this latest article is **Business Fraud** and investigates the problems for Foreign Invested Enterprises (FIEs) in initially discovering and then resolving Business Fraud issues in China. Below is a snippet from the article:

"Whether it is a result of, as Xunzi argued, "All men being inherently evil", or the more contemporary social pressures associated with the "to get rich is glorious" mentality, however fraud has become a widespread problem for many foreign firms doing business in China.

Many western economies adhere to business operations and corporate governance built upon stringent audit/accounting requirements and certain legal disclosures. However, Chinese business has, for centuries, been built upon connections (Guanxi) and verbal confirmations. It is due to these differences and lack of corporate transparency that "Business Fraud" is one layer of the "Doing Business in China" onion that is not so easy for foreign firms to peel, but often the most costly!"

We invite you to read the rest of the article online at: www.lehambrown.com/LB3.html. We hope you find it both useful and interesting!

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MOFTEC's Direction - Put Clear and Simply

The Ministry of Foreign Trade and Economic Cooperation ("MOFTEC") recently issued its new Industry Catalogue for Foreign Investment ("Catalogue"). Effective as of 1 April 2002, the Catalogue acts as a guide for MOFTEC's attitudes and policy direction concerning foreign investment. It also provides certain industry segments with taxation benefits, such as reduction in custom's duties and other preferential tax treatments.

Encouraged:

In line with China's 'opening up' to meet WTO requirements, it was no surprise to see the number of "encouraged" investment industries expand and the scope of prohibited areas reduced. Service industries were the big winners out of the Catalogue shake-up, with higher education, IT software and programming, logistics, property development, and commodity wholesalers and retailers all being promoted to the list of "encouraged" industries.

Restrictions:

A number of Infrastructure and Utility industry sectors such as water supply, telecoms, and city heat and gas suppliers were also promoted from the "Prohibited" category to a "Restricted" category. Whilst this is certainly a move in the right direction, there are still many restrictions which still apply. Such restrictions include investment and shareholding caps, although these will gradually diminish in line with WTO requirements.

Another interesting development in the Catalogue is the move to an open "Restricted" category, compared with the previous "Restricted A" and "Restricted B" categories. This has created a number of issues however, as the previous duty exemptions on plant and machinery for "Restricted B" companies are now not applicable to the new 'cross the board' "Restricted" category. For example, companies who were previously entitled to such duty exemptions before 1 April 2002 are now unclear as to their entitlements. This is particularly important for companies who have imported a portion of their plant and equipment before the 1 April deadline, and intend to import the other portion after this date.

In such cases MOFTEC has not yet issued its ruling or clarification on whether the tax treatment will be 'grand-fathered' or whether no such exemptions will be extended at all. It is suggested that firms in such situations seek professional advice to understand their tax obligations and also to assist in negotiations with the taxation departments.

Mergers and Acquisitions - Business Tax regulations

In light of the current expansion in China-related Mergers and Acquisition activity, we thought it may be useful to quickly review some of the main tax implications - in this case Business Tax.

Under Article 1 of the Provisional Regulations of Business Tax of the People's Republic of China, any transfer of real properties or intangible assets in China is subject to business tax at the rate of five percent

This legislation is therefore applicable in Merger and Acquisition activity whereby the transferor of the assets should pay business tax on the transfer of real properties, such as office buildings, and intangibles, such as patent, copyright, trademark, know-how, trade name, goodwill, etc.

However, according to the latest regulations issued by SAT in 2001 under Circular 165, Guoshuifa, in acquisitions and reorganizations where the acquiring company acquires all the shares, or equity interest in the target company, the business tax consequences will depend upon the shareholding structure of the target company.

If the target company is a subsidiary or wholly foreign owned enterprise of its parent, the takeover will not be treated as a taxable event because the transfer price is not determined simply by the asset value, but by a combination of the target company's assets, debts and labour force.

If, however, the target is a joint venture or has several shareholders or investors, it is unclear whether business tax should be levied on the transfer of shares from the original shareholders, including the value of real and intangible property.

Taxation Terms

增值税

"Zeng Zhi Shui"

(Value Added Tax)

营业税

"Ying Ye Shui"

(Business Tax)

消费税

"Xiao Fei Shui"

(Consumption Tax)

所得税

"Suo De Shui"

Although the doctrine of step transactions is not well known or adopted in China, tax authorities will not allow taxpayers to avoid their tax obligations through simply setting up a company and then transferring their shares. Therefore, in a corporate reorganization where some equity interest of the target company is based on real property or intangible assets, taxpayers are advised to consult professional advice to ascertain the business tax consequences of such a transaction.

New Car Loan Regulations Expected by June

Officials in Beijing are close to announcing new rules that will allow foreign companies to offer car loans in China, an announcement many analysts expect to create heated competition in the domestic market.

Industry sources said that the People's Bank of China will announce the long-awaited stipulations governing the establishment and operations of jointly-owned auto financing companies on China's mainland by June, a move that will eventually open the huge market to overseas financiers. "We are still in the process of drafting the rules," said a central bank official, who wouldn't say when the new regulations will be made public.

Several overseas companies, mainly automakers, are already talking to Chinese financial institutions about possible partnerships. The Agricultural Bank of China, the nation's largest auto loan lender, is in talks with General Motors, Toyota and DaimlerChrysler simultaneously and it will choose one partner from the three, said Cui Yiping, a consumer lending official with the bank.

"Overseas automakers can take advantages of our vast banking network in the nation through the partnership to market their products," said Cui, adding that the bank can benefit from its partner's experience. China Minsheng Banking Corp. is also reportedly to be in talks with potential overseas partners to set up an auto financing company on the Chinese mainland. If everything goes smooth, the first Sino-foreign auto financing institution may appear on China's mainland in early 2003, said analysts.

Aware that foreign competition threatens their dominant role in the car-loan market, many domestic banks are working to improve their loan services before the foreign companies are allowed to set up business in China. The Shanghai branch of China Construction Bank relaxed regulations governing auto loans recently, a move that enables expatriates and people from other provinces of the nation but living in the city to apply for car loans, raises the upper age limit for borrowers from 60 to 65 and offers lower interest rates.

The CCB branch said that it will offer floating interest rates to car-loan borrowers, which should lead to interest rates that are 5 to 10 percent lower than current rates. Currently, the guiding interest rate on one-year car loans stands at 5.31 percent, with loans lasting no more than five years.

In China, only 12 percent of private vehicle sales nationwide have benefited from bank financing, compared to about 80 percent in Western countries. Analysts said that the involvement of world auto giants, such as General Motors and Volkswagen AG, in the Chinese auto financing industry will likely to boost vehicle sales by up to 50 percent. With no detailed rules announced yet, it is premature to discuss the move's benefits for both domestic and overseas companies, but the potential is obviously in place.

ChinaBiz news, 27 May 2002

"Providing an alternative in China"

insights@lehmanbrown provides updates of the latest taxation and accounting regulations in the People's Republic of China. It is designed to provide you with interesting and informative information to assist in your dealings with China or any China-related issues that you may encounter.

If you do not wish to receive this newsletter, we have provided an unsubscribe facility below.

LehmanBrown also provides a monthly newsletter *Peeling the Onion* which investigates certain topical issues affecting businesses in China, particularly for those companies and individuals with operations in the PRC, or looking to establish a presence in-country.



Recent editions include:

- ▶ Due Diligence in China
- ▶ Transfer Pricing Strategies in China
- ▶ Business Fraud in China
- ▶ Corporate Valuations in China
- ▶ Crisis Management in China
- ▶ China's Changing Tax Environment
- ▶ Internal Controls in China
- ▶ Establishing an SME in China
- ▶ Managing Your China Business Under SARS
- ▶ Treasury Management in China
- ▶ Banking in China
- ▶ Mergers and Acquisitions in China
- ▶ Bridging the Accounting Standards Gap in China
- ▶ The Changing Role of CFOs and Accountants in China
- ▶ Transfer Pricing Investigations...When not if!

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