

Peeling the Onion



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Peeling the Onion provides an in-depth analysis of the major issues facing multinationals doing business in China in today's environment. It features a regular update of regulations, taxation, business environment and accounting legislation affecting foreign invested enterprises in China.

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feature article

Start for 2007 – Various tax changes taken effect

China tax reform is processing in a steady and cautious manner. A host of taxes, including corporate income tax, value-added tax (VAT), the resources tax and land use taxes will be covered by the reforms. From the beginning of year 2007, several taxes step into new stage.

Stricter Individual Income Tax (IIT) Reporting Obligations

The Chinese tax authority has issued a series of new regulations strengthening on the IIT collections. Some new measures concerning IIT reporting requirements are introduced. Highlighted below are the two major movements:

All people all income principl

Starting from January 1, 2006, employers, which served as the IIT withholding agency, are required to report and withhold for all types of incomes paid out to all relevant individuals; irrespective how much the payment amount is and whether the individuals are employees or not.

Along with the income filing, personal data of the individual income earners are also requested. In particular, where the individuals are non-Chinese nationals (including people from Hong Kong, Macau and Taiwan), more detailed information shall be provided. For instance, the foreigner's working permit number, passport number, the position held inside and outside China, the contact information of that individual's employer inside and outside China, estimated duration of stay in China, place of the payment for the payroll.

Dual reporting by self-filing and withholding

Starting from 2006, in addition to the IIT reporting from withholding agent, the following types of taxpayers are also obliged to furnish tax authorities with details of their income by the end of March of the following year.

- Ø Chinese nationals having income derived from more than one source;
- Ø Chinese nationals having income derived from overseas source; and
- Ø Chinese nationals having income derived in China without any withholding agent.

- Ø Taxpayers (including both Chinese nationals and foreign expatriates) derived income more than RMB120, 000 per annum

These new measures are aimed at full disclosures and embracing the concept of managing the total income of all taxpayers. With the comprehensive and detailed information system, the tax authorities will be more effective at curbing tax dodging and ensuring the collection of the tax amount due. The ultimate target is to shift the management focus from high-income earners to all individual income tax payers. This reflects the increasing attention and determination of the Chinese government to enhance the administration of individual income tax.

Higher Vehicle and Vessel Tax

The previous Vehicle and Vessel Usage License Tax for foreigners has been replaced by Vehicle and Vessel Tax, which applied to both native and foreigners. According to the regulation, within the territory of the People's Republic of China, the owners or managers of vehicles, shops and boats shall be the taxpayers of vehicle and vessel tax. The upper limit for vehicle tax is doubled, bringing the annual tax on passenger-carrying vehicles to between 60 and 660 yuan, and freight vehicles to between 16 and 120 yuan per ton.

At the moment, local tax bureau of each area is busy setting the new levy standard for vehicle and vessel tax. It is said that, many big cities intend to increase the previous standards. Take example for Beijing, the levy standard of passenger-carrying vehicles is capable to be raised above 360 yuan, while the previous standard is 200 yuan for native and 120 yuan for foreigners.

The tax collection on vessels will continue based on each vessel's capacity. By raising both the lower and upper limits, it will come to between three and six yuan per ton.

Urban Land Use Tax – Also Applied to Foreigners

The newly revised Tentative Regulations of Urban Land Use Tax have been issued. The new regulation has changed in the provisions of taxpayer and tax amount.

- A new section is added to the regulation, “The units as stated in the aforementioned section shall include state-owned enterprises, collective enterprises, private enterprises, joint-stock enterprises, *foreign-invested enterprises*, *foreign enterprises* and the other enterprises··· ···” This section includes foreign individuals and enterprises, which were only subject to low Site Use Fees and Land Transfer Fees, into levy target.
- The amounts of land use tax per square meter have been raised to the following standards:
 1. RMB1.5 to RMB 30 in large cities;
 2. RMB 1.2 to RMB 24 for medium sized cities;
 3. RMB 0.9 to RMB 18 for small cities;
 4. RMB 0.6 to RMB 12 for cities under the county level, towns, and industrial and mining zones. ”

The new regulation will control the forestalling and promote the proper usage of urban land. But it will have negative effects on foreign enterprises to some extent, at least in the current period. “Most foreign invested enterprises like to arrange whole year’ s financial budget at the beginning of the year. The new land use tax will bring additional expenditure to the

enterprises and increase the difficulties to capital turnover” , said the financial manager of a foreign invested enterprise.

Other Taxes

The most important aspect of China tax reform – Corporate Income Tax – is still in process. The Corporate Income Tax Law was passed by the Standing Committee of the National People's Congress ([NPC](#)), the national legislature, in December 2006, and will be endorsed at the NPC's annual plenum in March. The new law is expected to be issued in 2008.

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Labor Contract Law

A source of considerable controversy, China’ s first proposed Labor Contract Law in more than ten years, while not expected to pass into law this month during the annual National People’ s Congress, is, according to experts, assured of passage before the end of the year. The proposed law aims to expand worker protections by giving increased leverage to unions as well as attempting to outline some basic reciprocal employer-employee responsibilities. Among them, the law attempts to delineate the terms of probationary periods of employment, employment termination and severance compensation more favorably with respect worker interests. The proposal has been greeted by labor rights activists around the world as a much needed piece of legislation and a reassuring sign of Beijing’ s sincerity in confronting pressing labor issues and growing polarization between privileged, urban-dwelling Chinese their less fortunate peers in rural areas.

Late last year the proposed law attracted a bevy of media attention after revelations and accusations of a fierce advocacy campaign against the legislation by western business interests. While advocacy from all sides has certainly occurred and has in fact been solicited by the PRC government, most everyone agrees that the initiative’ s intention is admirable, namely to improve labor conditions and create a more harmonious dynamic between employers and employees.

Where is the Problem?

China is often beset by a lack of a formalized enforcement infrastructure, and it is the contention of various business groups that many of the countries most persistent problems are the result not of faulty public policy but rather an enforcement vacuum. Nevertheless, increased authority lent to trade unions to act as employee representatives, secure worker rights and function, more generally, as a workplace watchdog is a prominent feature of the legislation. Unions will be empowered to negotiate and consent to employer policies, regulations and mass labor terminations. Individual employees also stand to receive severance compensation should their “fix-term” contract expire without renewal.

The Consequences

These, and additional requirements of a similar ilk are, perhaps reasonably, viewed by western businesses as overly burdensome, ineffective and ultimately a counterproductive policy solution. Dr. Keyong Wu, an expert with the British Chamber of Commerce, says, “Business is attracted to China not only because of its labor costs but also because of its efficiency. If regulation starts to affect that and flexibility, than companies could turn to India, Pakistan and South-East Asia.” And it is in this sense that worker interests are very intimately linked with their corporate employers.

IP Efforts

The scope of the proposed law extends to employee responsibilities as well. In an effort to improve the Chinese intellectual property (IP) environment, it provides employers avenues by which to use and enforce “non-compete clauses” in their labor contracts. Such laws charge current and former employees privileged with knowledge of trade secrets or IP with a set of fiduciary responsibilities aimed to protect confidential material of the company from which it came. These are encouraging efforts that should serve to promote an innovative and competitive Chinese business environment for both foreign and

domestic enterprises.

Trends?

The loud international debate that has accompanied the labor law's proposal gives us pause to reflect on some macroeconomic forces perhaps at play. Labor rights activists around the world have lamented the global marketplace's tendency to cultivate "a race to the bottom" which rewards those economies with the fewest labor protections, lowest costs and least cumbersome regulations, which may "bring global wages and conditions down to the level of the least protected." So why has there been such sustained downward pressure on wages and costs? The selling of services certainly need not dictate it be so.

Harvard economist Richard Freeman interestingly posits that over the past twenty-five years or so, with the liberalizing of the Indian, Chinese and former Communist bloc economies, the global workforce has effectively doubled—China alone accounts for 50% of the increase. This workforce expansion, however, was not accompanied by a commensurate increase in capitol—these were then relatively undeveloped nations without tremendous inherent value—which had the effect of dramatically altering the global capitol/labor ratio. Workers around the world have then found themselves competing for essentially the same amount of capitol as before the market was labor saturated and thus capitol has emerged as an exceedingly valuable commodity.

Conclusion

Thus, given what may be a comparative disadvantage, labor legislation of the kind proposed is imperative to ensure that the most basic worker rights are guaranteed and that the Chinese economy and its constituent workforce enjoy a legal and stable work environment. Foreign enterprises operating in China generally do use more advanced labor relations standards than locally owned businesses and, while the ultimate version of the law is sure to impact them both, it will likely demand more thorough operational modifications from domestically owned entities. As with so many meaningful policy reforms, however, practice and implementation will present the most significant hurdles and largely dictate both the scope of influence and success.

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“TO DO OR NOT TO DO -- Whether to migrate operations to China”

If you work for a manufacturing company or retail company and have not yet moved operations beyond domestic borders, someone in your company has likely asked in the past year, Should we source from China?

The big question for the uninitiated is of course is: Should we go into China? The answer depends in part on your company's products. Most analysts note that China excels at sourcing components or goods made on templates, such as furniture, toys, and consumer electronics and appliances.

The answer also depends on the level of PRC exposure your company seeks. For companies entering China only for procurement, cost advantage is still China's primary draw, but companies considering permanent stakes may find better product quality and manufacturing flexibility, as well as growing domestic demand, to be more important. Depending on these factors, here's what sourcing from China can offer your company.

Lower labour costs

According to a Boston Consulting Group (BCG) report the average hourly pay (including benefits) of production workers in China is approximately 20 times less than other developed western countries. As a result, countries such as the United States need to be 25 times more productive than their Chinese counterparts to remain competitive.

Long-term flexibility in production

Companies often overlook the fact that, once Chinese workers have been well trained, substituting human hands for expensive, specialized machines can actually improve the flexibility of production lines.

Proximity to downstream manufacturers

Moving operations to China can also mean lower transport especially shipping. The main reason for this is that when high-tech or heavy industry type companies (eg. auto companies, chemical companies, etc) move into a particular area they will often find similar companies operating there. Sub-contracting and sourcing for products and materials becomes much more easier. And with customers also located nearby shipping costs is further reduced.

Familiarity with the PRC operating environment

Companies with long-term plans to supply the Chinese market can start with a sourcing operation, which enables them to explore their options and lay the groundwork for a move towards local production.

Lower capital costs

For companies that plan to set up manufacturing operations in China, land and set up costs can be a fraction of the cost of most western developed countries. Furthermore, companies that use and source for local components and materials obtain further cost reductions.

Favourable tax structures

Foreign-invested companies enjoy a more favourable tax rate as compared to their domestic counterparts. On top of that Government rebates of value-added-taxes on exports are also favourable. Though government has plans to unify the business tax structure and phase out some of these incentives, localities are likely to continue to offer incentives to lure investors.

Despite the numerous advantages and favourable conditions, setting up operations in China does have its difficulties. Namely, China is well known to have a tough environment for logistics and intellectual property rights (IPR) protection and as a lackluster enforcer of legal contracts. The following are some of the difficulties which any company setting up operations can experience:

Initial start up time

Getting a sourcing operation up and running may take longer than you anticipate, depending on the complexity of your product and your supplier's abilities. Finding a new supplier almost always requires new molds or new lines and plenty of quality control.

A weak intellectual property regime

Foreign companies will find IPR protection a major concern for the foreseeable future, despite reassurances made from the Chinese authorities.

Increased management complexity

Adding an overseas branch or supply relationship requires stronger communication, stringent quality control monitoring, and a redesign of operations to adjust to different comparative advantages. The sheer geographical distance and cultural differences causes some companies to hesitate.

Longer and more complex supply chains

Delayed delivery if consumer goods to US and European consumers is a risk unless companies manage their supply chains properly.

Energy shortages, environmental disasters and other operational hiccups

China is prone to power shortages which can cripple operations. PRC producers have borne the brunt of the power outages; some have been forced to operate only on the graveyard shift. Natural disasters such as the recent Taiwan earthquake, which affected Internet lines and cables had an adverse effect on the communications links between companies in China and their respective overseas head offices.

Decommissioning of local assets

Companies may find that closing factories in the US and Europe and laying off workers necessary and normal if sourcing adds excess capacity and returns to local assets are low. Such actions in China are treated differently and penalties are unique to individual companies but usually entail financial, social and sometimes political costs.

Other trends have added to the appeal of China as an operating and sourcing destination. First, as more foreign companies move to China, their high-quality production values becomes a challenge to the local companies. They are able to compete not only on price but on quality and service. Second, as the Chinese consumer market grows enough to support major industries, companies are establishing their presence in hitherto unexplored product lines and supply chains. For example, retailers and product assemblers are joining component makers in China making diversification an advantageous option to grow and expand. Lastly, the PRC government seems to have convinced the business community that it is serious about building an investment-friendly framework for foreign companies to enter into. Transparent licensing and registration laws, China's strenuous efforts to be recognized as a market economy and the Chinese government's embrace of private entrepreneurs offer some comfort to those who are thinking about taking the plunge.

Before taking the plunge two major factors would need to be considered.

Assessing the costs:

Each company must make its own decision to move to China, and a careful cost analysis is a critical part of this decision. Total cost analysis will incorporate cost savings (the largest portion of which is usually cheap labour and components) and additional cost incurred, such as the initial set up costs and higher freight costs and duty payments.

Choosing the right path:

Perhaps the easiest way for a company to source in China is to link up with an existing supplier's operations there or to encourage an existing supplier to also make the move. This allows for Chinese production prices at a familiar level of quality control and delivery. Another way to find potential partners is through contacts and referrals from officials in the relevant industry and ministry. But whoever you choose to go into business with, proper due diligence of your intended partner's financial health is a prerequisite.

Finally, companies already in China cannot and should not afford to be complacent. China is evolving and changing day-to-day. With this change, the demand for goods and services increases for greater choice. Manufacturing companies especially need to be ready to respond to these changes quickly and meet demand. Companies need to diversify and should plan annual reviews of their product lines to see if sourcing, production, or logistic operations need to be modified. Staying fresh and ahead of the game is key to surviving in China.

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