Crossing international boundaries

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TAX FLASH
JANUARY 2012

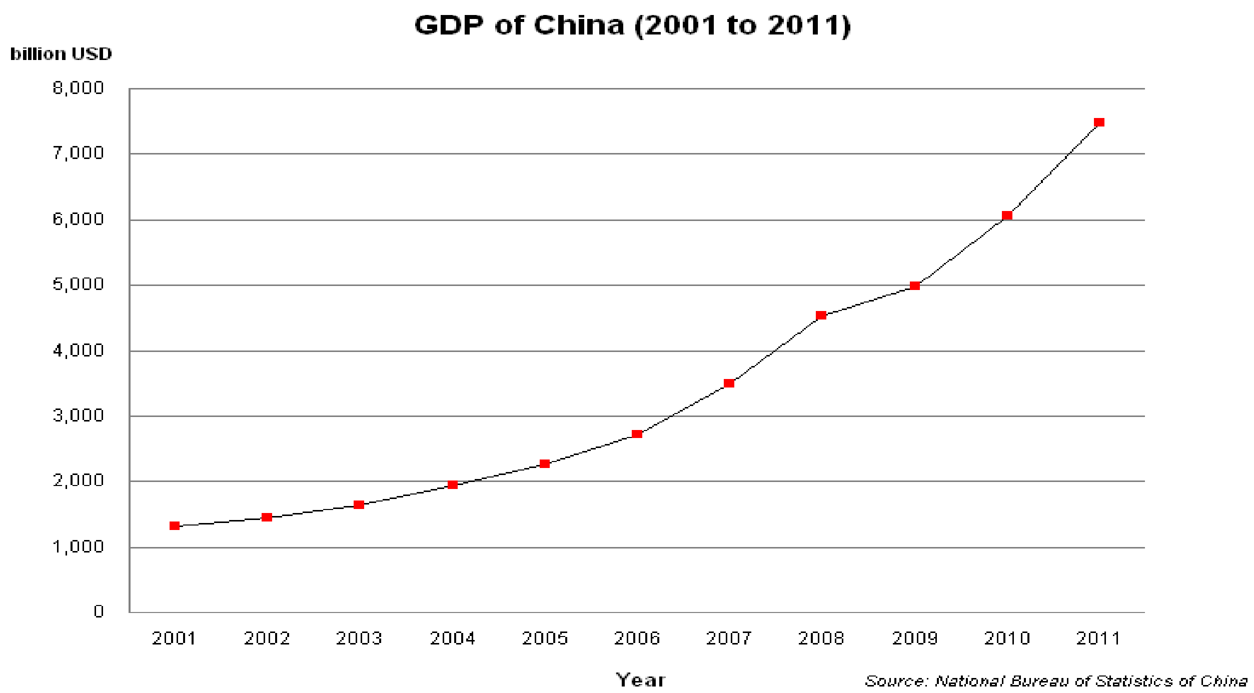
ECONOMIC OUTLOOK OF CHINA - 2012

The International Monetary Fund cut its forecast for global economic growth in 2012 and 2013, citing growing financial strains and rising downside risks as Europe's debt crisis entered a "perilous new phase." China is now expected to see growth slow from 9.2 percent in 2011 to 8.2 percent in 2012, re-accelerating to 8.8 percent in 2013.

Establishing a well-off society and developing China's economy would still be the major objectives for the 12th Five-Year Plan. Key performance indicators would still be GDP, inflation rate, import & export amounts, foreign direct investment and outbound investment amounts, as well as foreign exchange reserve balance. Changes in the taxation policies as well as policies for foreign direct investments, outbound investment and internationalisation of Renminbi ("RMB") are anticipated. In this Tax Flash, we highlight the development in these areas.

I. Macroeconomics

As mentioned in our Tax Flash January 2011, the theme of the 12th Five-Year Plan is to balance wealth distribution; transform the economic development strategically; improve social infrastructure; and enhance environmental protection. GDP is the key performance indicator.



Consumption

In light of the sluggish economic development in the U.S. and Europe, domestic consumption shall become a key driver in China's economic growth. Many provinces/cities have increased the minimum wage in 2011.

We anticipate the Chinese government will increase the wages and salaries of the civil servants significantly within the coming few years, as well as increasing the minimum wages on a countrywide basis.

The changes of Individual Income Tax Law made in 2011 are not adequate. Reduction of tax rates and introduction of further allowances could help to strengthen the overall compliance as well as narrow the income inequality issue. We anticipate further changes along this line will be introduced by 2015.

Investment

According to the National Bureau of Statistics of China, the total fixed asset investment for the year 2011 is RMB 30,193 billion, a grow rate of 23.8% compared with 2010. The investments in primary, secondary and tertiary industries are RMB 679 billion, RMB 13,226 billion and RMB 16,288 billion, respectively.

Intellectual property and related research & development activities are encouraged by the Chinese government. We anticipate additional financial subsidies and tax preferential treatments will be granted to further promote these activities.

Government Spending

Significant increases of civil servants' salaries are anticipated. In addition, capital expenditure on infrastructure projects, especially in the central and western part as well as North-eastern provinces, would be increased to increase the competitiveness of these regions.

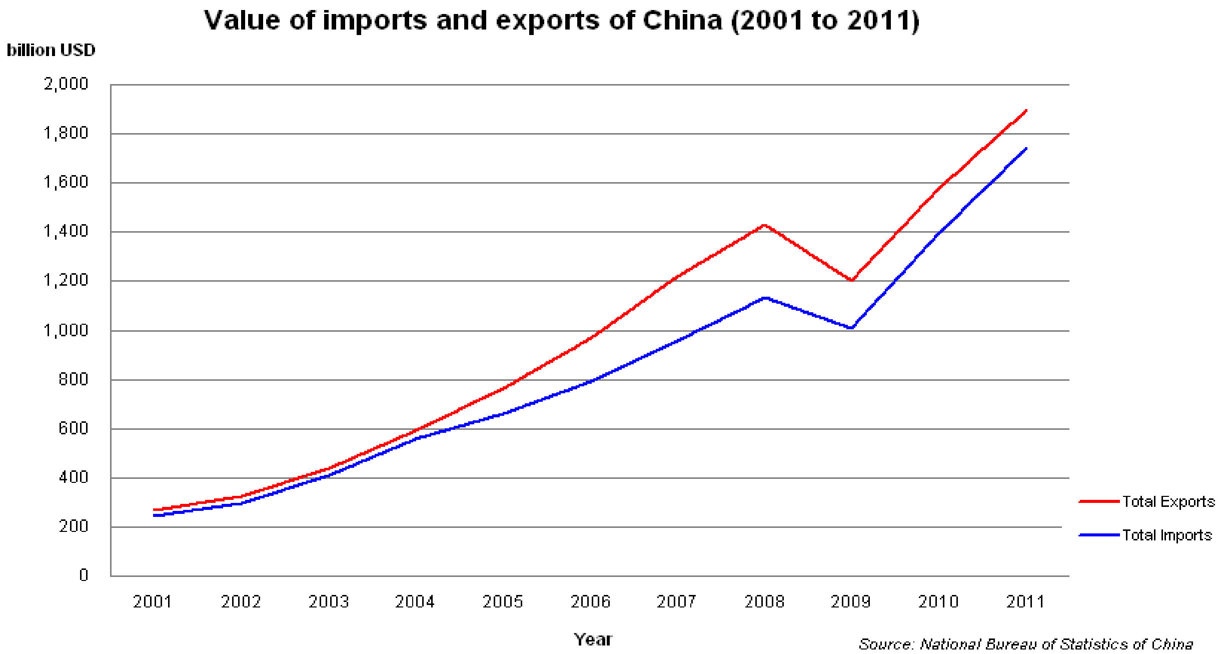
It is anticipated that the new government will continue upgrading the living standards of the rural areas and fostering the urbanization process of the central and western part as well as North-eastern provinces. Making Shanghai the global financial centre may not be the top priority in light of these other priorities.

Imports & Exports

China is already the global "factory". However, the poor prospective growth in the Western market and the rising wages/costs in China could pose a challenge for further export growth.

Imports for domestic production and consumption will be promoted. More relaxation in technology import, such as the approval and registration formalities is anticipated. Customs duty rate on advanced machinery and equipment will be further reduced. Currently, tax policy on importation of software is confusing. Customs duty is generally zero rated but import Value Added Tax ("VAT") at 17% may not be eligible for credit/refund for enterprises in the service industry. Moreover, business tax and surtaxes would be imposed on royalty payments. A clear and consistent tax policy shall be introduced in order to promotion adoption of software available in the global market.

Duty-free shopping in Hainan may be extended to other major cities in China, in light of the growing purchasing power of the citizens. Consumption tax ("CT") shall be reviewed and revised in light of this shift in objectives.



II. Foreign Direct Investment

National treatment becomes the main theme. Preferential tax treatments would no longer be available to foreign investment enterprises. Additionally, foreign investors are still restricted or prohibited to invest in certain industries. For example, exploration and distribution of natural resources would still be dominated/monopolized by state-owned enterprises.

With over 1.3 billion people and the increasing purchasing power of the population, more and more retailers and luxury brands are casting their eyes on China. According to preliminary data released from China's National Bureau of Statistics, retail sales of consumer goods totaled RMB18.12 trillion nationwide last year, up 17.1 percent year-on-year. We anticipate more foreign investors will invest in China to further develop their markets (see our Tax Flash October 2011 for details).

The Catalogue of the Guidance of Foreign Investment Industries was amended in December 2011 and became effective from 30 January 2012. More industries are now opened to foreign investors. Foreign investors are encouraged to invest in high-end manufacturing, high & new technology, modern service, new energy and energy saving and environmental-friendly industries. Multinational companies are encouraged to establish regional headquarters, research and development centres, procurement centres, finance management centres and accounting centres in China.

The major amendments of the Catalogue are highlighted as follows:

1. increase in the number of strategic industries in particular the development of new energy vehicles
2. inclusion of the development and manufacture of aviation, aerospace, automotive and environmental friendly materials in the fabricated metal products industry
3. inclusion of the design and manufacture of production equipment for automotive batteries in the special equipment manufacturing industry
4. inclusion of key components of new energy vehicles in the transport equipment manufacturing industry, and
5. inclusion of leasing and business services, venture capital companies and intellectual property service in the modern service sector.

As mentioned in our Tax Flash January 2011, foreign investors entering the Chinese market via mergers & acquisitions will be subject to more stringent approval and review procedures.

III. Outbound Investment

"Go global policy" is a major measure in the 12th Five-Year plan. Fiscal policies and regulations e.g. Chinese Oversea Direct Investment Environment Protection Guidelines are anticipated to be proposed and issued. Chinese entities are allowed to use RMB directly to invest overseas through mergers and acquisition, establishment and direct equity investment (of course subject to the currency regulations of the countries where the investees are located). However, there has been virtually no growth in outbound investment for the year 2011 compared with 2010.

The Chinese government has been stepping up its measures to promote professional firms such as accounting firms, legal firms and appraisal firms to expand overseas so as to assist Chinese enterprises' aggressive expansion plans globally. However, it seems the various departments involved (National Development & Reform Commission, Ministry of Finance, Ministry of Commerce, etc.) are not working in concert. Medium and smaller enterprises in China would still face a lot of challenges and difficulties in formulating and implementing their go global policy. A higher level authority may be required to be set up in order to formulate a comprehensive series of policies to assist this goal.

IV. Taxation

Taxation is an effective fiscal tool which affects economic growth and development. The following taxation policies are proposed to be reformed in the near future in order to strengthen the taxation system.

- Individual Income Tax

  As mentioned above, we anticipate the tax rates (currently the highest marginal rate is 45%) are to be lowered and more allowances (e.g. married person allowance, child allowance, parent/grandparent allowance) will be introduced.

- VAT and Business Tax ("BT")

In order to reduce the double taxation issues on trading of goods and provision of services and to support the development of modern services industry, starting from 1 January 2012, a deepened reform on the VAT system in some regions and industries was launched. The details are highlighted as follows:-

- The pilot program of VAT reform has been launched in the transportation industry and certain modern services industries ("Pilot Industries") in Shanghai effective 1 January 2012. Under the pilot program, VAT instead of BT will be levied on Shanghai enterprises engaged in Pilot Industries. If all conditions are ready, the reform will be launched on the selected industries throughout the whole country.
- Other than the current VAT rates of 17% and 13%, two new VAT rates of 11% and 6% are introduced under the pilot program of VAT reform.

Taxpayers in the original Pilot Industries can continue to enjoy the BT incentives based on the adjustment of the VAT system.

We understand that Beijing has also applied to the Central government to implement the pilot scheme in May 2012. It is anticipated VAT will replace most of the BT by 2015.

Please refer to our Tax Flash December 2011 for details of the VAT reform pilot program.

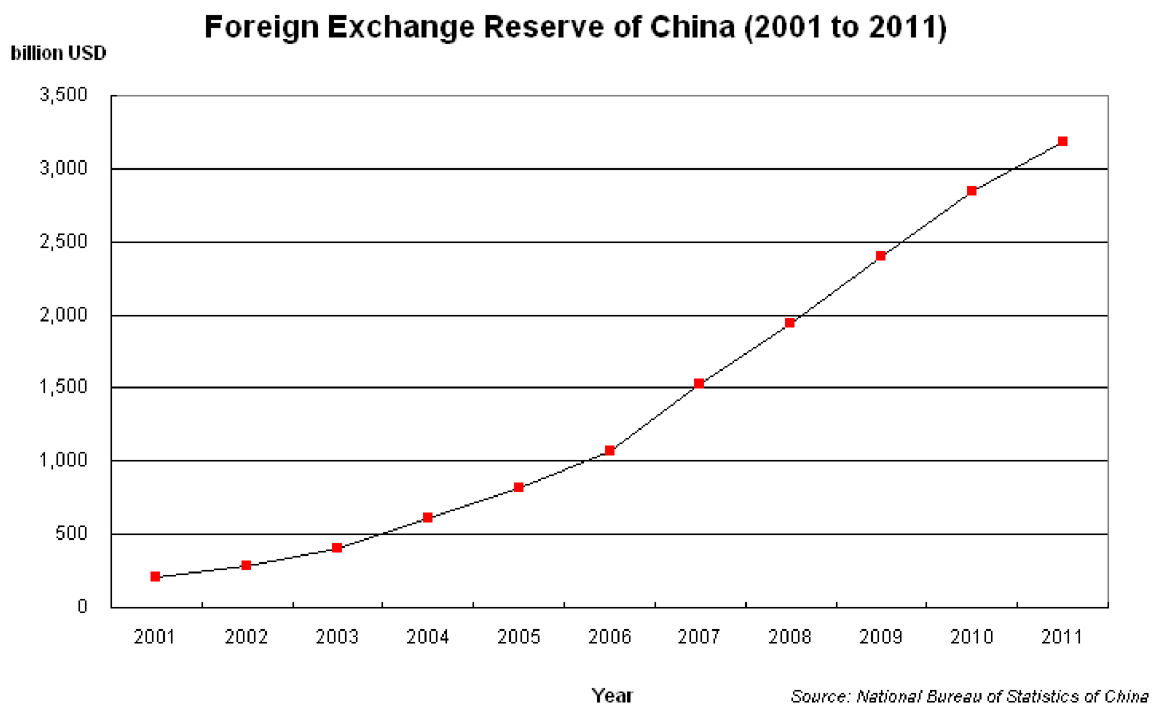
- CT and Resources Tax ("RT")

  The Chinese government has proposed to adjust the scope of CT in line with its industry development policy. The respective tax revenue would be used to promote energy conservation as well as guide rational consumption.

  In order to promote resources conservation and environmental protection, reform of RT also been introduced.

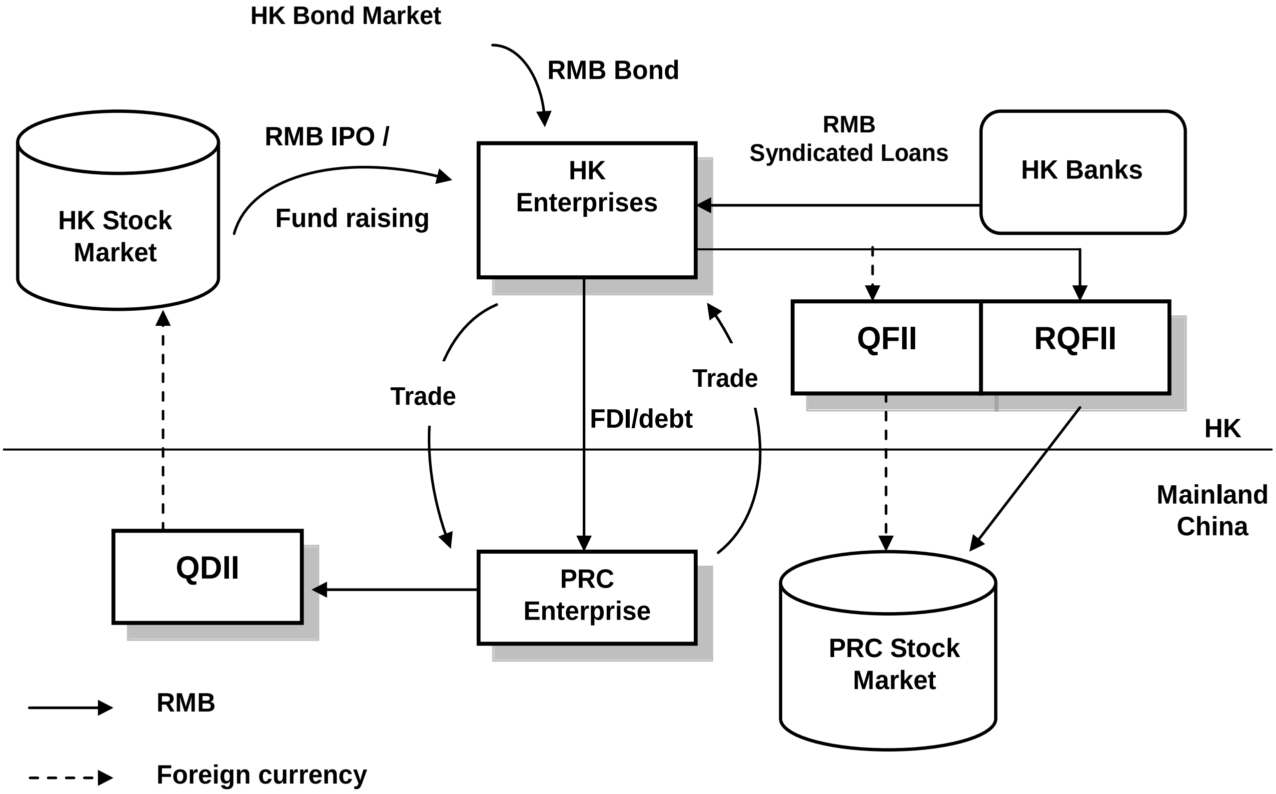
V. Internationalisation of RMB

The Chinese government is still being attacked by the Western world on its manipulation of the exchange rate of RMB. Although most of the comments are totally illogical, the exchange rate of RMB, the exchange rate system as well as the accumulation of foreign exchange reserve are all interrelated and form one of the major concerns of the Chinese government.



The overall objective of the Chinese government is to have RMB be used as a dominate trade settlement currency and investment currency for Chinese enterprises by 2015. RMB as a reserve currency would be a longer term goal. If this can be achieved, China will no longer need to worry about the continued accumulation of foreign exchange reserve. In addition, the noises on RMB exchange rate manipulation will disappear as well.

To achieve this goal, a sophisticated offshore RMB centre as well as a healthy mechanism would be required. Shanghai has announced that it shall be the main RMB offshore centre. Additionally, the development in Hong Kong seems to be promising.



Apart from using RMB as trade settlement currency, enterprises in Hong Kong can now raise funds in RMB through initial public offerings, issue RMB denominated bonds in Hong Kong and obtain RMB loans from banks. On the other hand, Hong Kong enterprises are also allowed to invest into China in RMB through capital injection and loans into foreign investment enterprises, as well as through settlement of purchase consideration for acquisition transactions. In addition, RMB qualified foreign institutional investors ("RQFII") program has been introduced. The Hong Kong Securities & Future Commission approval came shortly after the China Securities Regulatory Commission granted RQFII licences to 21 companies on 22 December 2011. Nine of those licences are for fund management companies and 12 for securities firms. The State Administration of Foreign Exchange in China announced on 30 December 2011 that it has granted RMB 10.7 billion in total RQFII quotas, so far, to five fund companies and five securities firms. The program's initial total investment quota is set at around RMB 20 billion.

Conclusion

The prospect of economic growth in China is promising. The US economy is picking up as well. As long as the US economy as a whole is creating value, "money printing" is a natural phenomenon instead of a problem. The uncertainty about the Euro could be a concern though. As part of the 12th Five-Year plan, the Chinese government shall pay more attention to "development" (progressive changes in the socio-economic structure) on top of "growth" (increase in GDP or increase in per capita income) in order to make China a well-off society.

RSM NELSON WHEELER TAX ADVISORY LIMITED

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- Advise on tax efficient holding and operational structures for new cross-border investment, including the formation of Hong Kong and Chinese business entities
- Review existing cross-border investment structures, advise on identified deficiencies, quantify any potential exposure from such deficiencies, and further advise on restructuring approach and procedures
- Assist clients to discuss and clarify matters with tax officials, including transfer pricing and advance rulings
- Act as client representative in tax audits and tax investigations
- Provide transaction support services on mergers and acquisitions, including tax due diligence, deal structure advice, tax health checks, related human resources arrangements and other tax compliance and consultation services
- Advise on human resources and structuring employment arrangements in a tax-efficient manner
- Advise on tax equalization schemes
- Provide tax compliance services for individual and corporate clients in Hong Kong and China

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