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Taxation and Fiscal Strategies in China (in an Business and International Perspective) and Business Culture

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Agenda

1. An overview of China domestic taxes for consideration, including corporate income taxes, turnover taxes, other tax concepts, and tax administration.
2. Some discussions from international tax perspectives:
   - what are typical investment vehicles in China;
   - what are typical options of operations in China; and
   - how to structure the operation and activities in China for a Canadian corporation.
3. Some discussions from business strategy perspectives:
   - new leadership, new agenda for growth, new political environment and landscaping in China;
   - free Trade Zone/ Free Trade Area in Tianjin, Shanghai, and Other Provinces;
   - coming up with the strategies for the market entry and growth in China;
   - observation and recommendations - government relations regulatory compliance;
   - observation and recommendations - managing risks;
4. Quick Tips re: Chinese business culture

An Overview of Taxes for Consideration

The People's Republic of China levies a wide range of taxes as follows:

Income Taxes

- corporate income tax (CIT) including withholding income tax(WHT); and
- individual income tax(IIT).

Turnover Taxes

- value added tax (VAT);
- business tax (BT);
- consumption tax (CT); and
- custom duty (CD).

Property and Behavior Taxes

- real estates tax (RET);
- land appreciation tax (LAT);
- arable land occupation tax (A LOT);
- urban and township land-use tax(UTLUT);
- deed tax(DT);
- stamp duty (SD);
- custom duties(CD); and
- Other type of taxes including motor vehicle acquisition tax, vehicle and vessel tax, resource tax, urban construction and maintenance tax, vessel tonnage tax and tobacco tax.

Corporation Income Taxes (CIT)

- A tax resident enterprises (TRE) is subject to corporation income tax on their world wide income.
- A non-TRE that has no establishment or place in China is taxed only on its China-source income. A non-TRE with establishment or place in China shall pay CIT on income derived by such establishment or place from sources in China as well as income from outside China which is effectively connected with such establishment and place.
- Standard corporate tax rate in China is 25%, and there is no income tax at provincial and local level.
- A lower income tax rate is available for the certain sectors/industries as follows:
  - Qualified new/high tech industries that meet the prescribed criteria and be subject to an assessment - 15%.
  - Integrated Circuit (IC) production enterprise with a total investment exceeding RMB 8 billion, or which produce integrated circuit with a line-width of less than 0.25 micrometer - 15%.
  - Key software production enterprises that meet prescribed criteria and be subject to an assessment - 10%.
  - Qualified technologies-advanced service enterprises in 20 cities such as Beijing, Shanghai, Tianjin, Guangzhou, and Shenzhen, etc.) - 15%. This incentive is only available certain technology-advanced service section members and meet prescribed criteria and be subject to an assessment.
  - Qualified small and thin-profit enterprises that fulfil certain conditions - 20%.

Turnover Taxes

Value-added tax (VAT)

- Sales and imported goods as well as repair, replacement, and processing services are subject to VAT.
- Standard tax rate: 17% ; Small-scale taxpayer: 3%.
- The sales of necessity goods may be subject to a reduced tax rate of 13%.
- Effectively starting from Jan 1, 2009, the VAT system is a consumption-based VAT system, which means that input VAT on fixed assets is fully recoverable except for situation specified in VAT regulations.
- Exported goods from China may be eligible for a refund that ranges from 0 -17% for the VAT incurred on materials purchase domestically. There is a prescribed formula for determine the amount of refund.

Business Tax (BT)

- Imposed on services, transfer of intangible assets and immovable property taken place within China. Starting from 2009, services taken place in China refer to either service providers or service recipients in China; thus, a business rendered outside of China may be subject to business tax in China.
- Business tax rate ranges from 3-5% except for the entertainment industry may be up to 20%.
- Business tax is not recoverable but it is deductible for income tax purposes.

Consumption Tax (CT)

- Imposed on 14 categories such as cigarette, alcoholic beverage and certain luxurious and unfriendly items.
- Computed on sales amounts or sale s volumes.

Other Tax Concepts For Consideration

- Branch Income
  - ✓ A branch of a non-TRE in China is taxed at branch level. If more than one branch, can elect to file their taxes at the main office in China on a consolidated basis. No further tax upon remittance of branch profits.
- Group taxation
  - ✓ Not permitted under CIT law unless otherwise prescribed by the State Council.
- Transfer price regime
- Thin-capitalization rules
  - ✓ Interest arising from excessive related party loans could be disallowed. The safe harbor debt to equity ratio for enterprises in the financial industries (5:1) and other type of industries (2:1). If sufficient evidence to show that the financing arrangement is at arm's length, these interests may be deductible.
- Controlled foreign corporation (CFC) rules
  - ✓ Undistributed profits of CFCs located in low-tax jurisdictions with an effective tax rate of less than 12% may be taxed as a deemed distribution.
- Tax incentives, investment tax credit, and other incentives
  - ✓ Predominant-industry oriented, limited geography-based tax policy. Exemption or reduction for agriculture, forestry, animal-husbandry, and fishery products. Tax holidays for specified basic infrastructure projects, environmental protection/energy water conservative projects, qualified new/high tech enterprises, newly established software production enterprises, integrated circuits design enterprises, and qualified energy-saving enterprises.
- Withholding taxes

Tax Administration

- Annual return
- Payments of taxes
- Audit Circle
- Statute of limitation
- Recent focus of Chinese tax authorities

Typical Investment Vehicles

- Foreign companies, enterprises or individuals may subject to the approval from Ministry of Commerce or other relevant ministries in order to establish business in China by using the following investment vehicles:
  - representative offices;
  - wholly foreign owned enterprises (WFOE);
  - foreign invested commercial enterprises (FICE); and
  - Joint Ventures (JV).
- Certain bank, institutions, and insurance companies may subject to approval to set up branch in China. Starting from March 1, 2010, foreign investor are allowed to establish foreign invested partnership in China.

How to structure the operation and activities in China for a Canadian corporation

General rules:

A Canadian corporation that expects to operate a business in a foreign country should determine if its activities should be carried on through a foreign branch operation (“Foreign Branch”) or by incorporating a foreign subsidiary corporation (“Foreign Corporation”) in the foreign country:

Advantage and disadvantage to carries on in a foreign country through a Foreign Branch or through a Foreign Corporation should be identified in order to take the best business decision.

Advantages of a Foreign Corporation

- Desirable to operate a profitable operation in a low tax jurisdiction through a Foreign Corporation;
- Repatriation of profit should be exempt of tax in Canada if certain conditions are respected;
- The sale of shares of a Foreign Corporation may be exempt from foreign tax pursuant to a tax treaty with Canada if the value of the shares is not principally derived from real property in the foreign country;
- Foreign Corporation can provide limited liability to the Canadian corporate shareholder;
- May be viewed as the more acceptable business vehicle in some countries; and
- The financial information to provide to the foreign jurisdiction would be limited to the Foreign Corporation.

Disadvantages of a Foreign Corporation

- Not possible to use the operating losses of the Foreign Corporation against Canadian domestic income of the parent corporation; and
- Might be subject to foreign withholding tax on payments of dividend. Withholding tax rate might be reduced pursuant a tax treaty with Canada.

Advantages of a Foreign Branch:

- If losses are anticipated in a start-up period, operating losses can be used against Canadian domestic income of the parent corporation;
- Branch remittances are not applicable to payments of dividend and hence would not be subject to withholding tax by the foreign jurisdiction. However, some foreign jurisdictions will impose a branch tax on profits not reinvested in the business of the branch in the foreign jurisdiction; and
- If a foreign jurisdiction does not impose branch tax, it may be advantageous to operate through a branch rather than a foreign subsidiary as the overall foreign tax burden will be lower.

Disadvantages of a Foreign Branch:

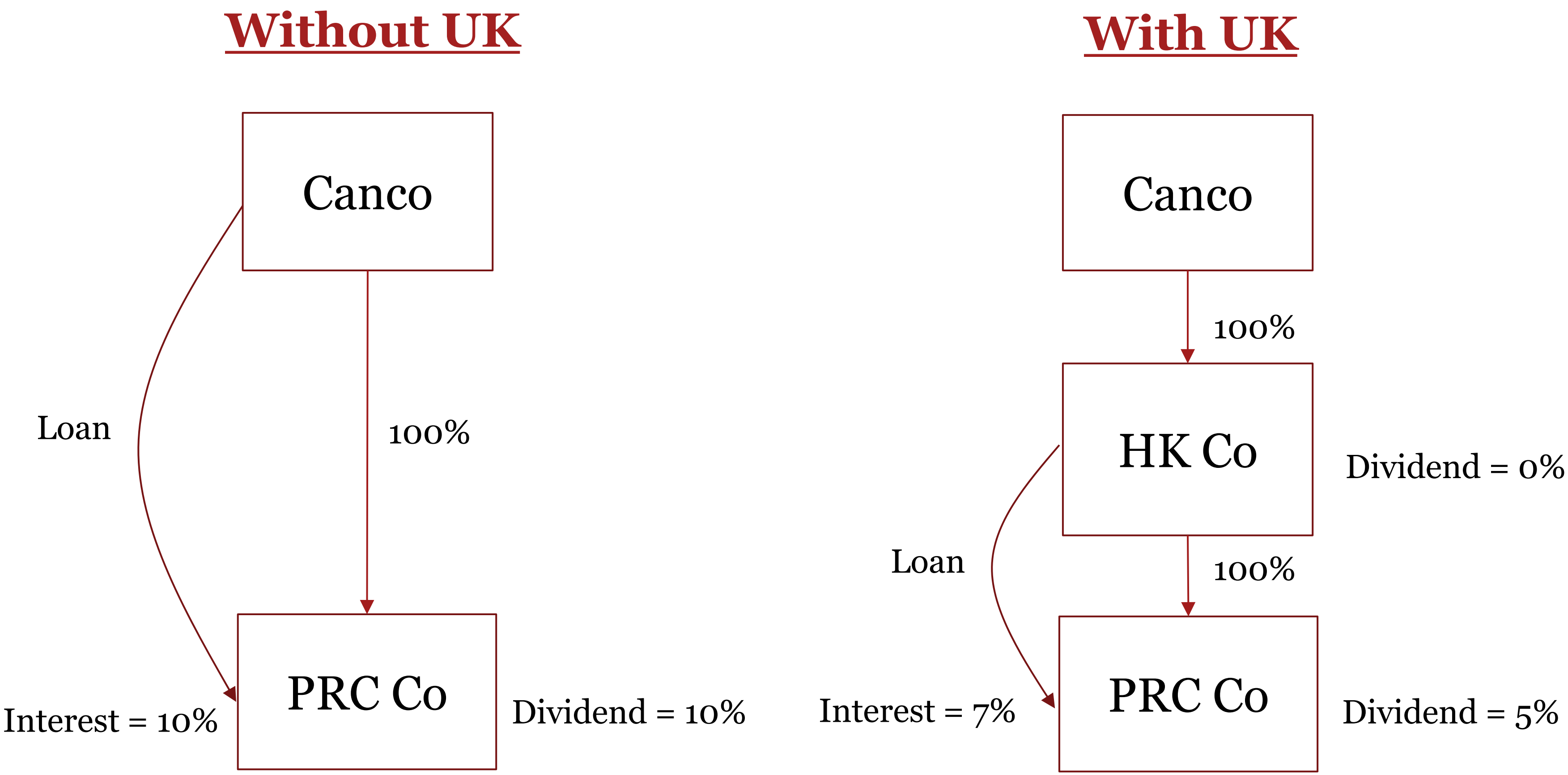
- Foreign business income earned by a Canadian corporation through a Foreign Branch is subject to Canadian income tax at normal business tax. A foreign tax credit is provided for the purpose of minimizing double taxation of the branch tax. Hence, if the foreign tax rate is lower than the Canadian tax rate, the favourable tax advantage is lost;
- If the foreign operation becomes profitable, there is no possibility to subsequently incorporate the Foreign Branch on a tax-free rollover basis from a Canadian perspective;
- It is undesirable to operate a profitable Foreign Branch operation in a low tax jurisdiction as business profits will be subject to the higher Canadian tax rate regardless of whether such profits are distributed to Canada (i.e., no possibility to defer Canadian taxation on income until repatriation);
- The ultimate sale of the Foreign Branch's assets will be subject to the foreign country's tax. In contrast, a sale of the shares of a Foreign Corporation may be exempt from foreign tax pursuant to tax treaty provisions; and
- Foreign Branch should file an income tax return with the foreign jurisdiction, which includes information about the parent corporation, such as accounts' and directors' names. Usually this information is requested by the foreign jurisdiction to determine the business profit reasonably allocated to the Foreign Branch.

Investment in China through HK

Key objectives of a tax-efficient financing structure:

- Facilitate efficient funding to China, and repatriation of profits back to Canada;
- Reduce taxable income in China otherwise subject to Chinese income tax;
- Reduce global effective tax rate; and
- Minimize withholding taxes on cross-border payments.

Investment in China through HK (cont'd)



Update on Canada-China Tax Treaty

	China-Canada (Current Treaty)	Hong Kong-Canada (New Treaty)
Limitation of benefits	None	Yes – on interest, dividends and royalties
Dividends: lowest rate of withholding	10%	5%
Access to low rate of dividend withholding	Beneficial owner must own >=10% of votes of the dividend payer	Beneficial owner must control directly/indirectly >=10% of votes of the dividend payer
Interest on arm's length debt	Not subject to withholding tax	Not subject to withholding tax
Branch Tax	10%	5%
Branch Tax Exemption	On first $500,000 of branch profits	None

New Leadership, New Agenda for Growth, New Political Environment and Landscaping

- New elected "fifth generations" leadership by 18th National Congress of Community Country of China:
  - Mr. Xi, Dr. degree of Law; and
  - Mr. Li, Dr. degree of Economics.
- Three key themes stands out:
  - Restructuring the economy;
  - Boosting the domestic demand; and
  - Spurring green growth.
- Investor should focus on growing domestic market and rising income as well as the green projects and move the labor-intensive industries toward central and west part of the Country.
- In term of China future investment priorities, the government will provide greater direction, more clarity on investment, and more incentives to invest in key industries: advance manufacturing, high-and new-technologies industries; energy-saving and environmental protections, modern services and inland province.

Free Trade Zone/ Free Trade Area in Tianjin, Shanghai, and Other Provinces

- Shanghai free-trade zone was launched in Shanghai, China on September 29, 2013. The zone covers an area of 29 km2, integrating four existing bonded zones — Waigaoqiao Free Trade Zone, Waigaoqiao Free Trade Logistics Park, Yangshan Free Trade Port Area and Pudong Airport Comprehensive Free Trade Zone. It is seen as a testing ground for a number of economic new reforms.
- Tianjin Dongjiang Free Trade Port Zone was established on August 31st, 2006 by approval of the State Council.
- 10+ Free Trade Zones/Free Trade Area have been approved by State of Council in China.

Purposes of Free Trade Zone/Free Trade Area

- Explore new trade and investment model.
- Boost and open up service industry.
- Facilitate currency exchange liberalization for investment and trade.
- Form an efficient and investor-friendly regulatory environments for business operation in China.
- Upgrade and streamline the custom supervision framework , improve the operational efficiency for the logistics companies operating in the FTZ, and therefore reduce the warehousing and logistic costs and enable the company to offer their customers optimized logistic solutions.

Market Entry and Growth

Coming up with the best-fit strategy

- Work with the local partners to leverage resources such as sales channels, customer bases, and low production costs.
- Identify the right local partner, align with their interests and fulfilling their strategy intention, with assistance with external advisers, is often critical for market entry.
- Understand the difference in culture, customs and tradition and adopt a flexible market entry strategy that can accommodate these differences, will go a long way in China.
- Identify the open and closed industries for foreign investors: encouraged, permitted, restricted, and prohibited.
- Be nimble enough to response to changes in the fluctuating environmental and innovative enough to approach China differently.
- Quote from Lazaro Compos, CEO of Swift:

  "On business development, we would traditionally start with the standard product set and adapt to the local needs. But in India and China, you need to forget the products that you got and start from scratch. Start from what it is they need and build from there."

Recommendation - Market Entry and Growth

- Make sure that a merge or acquisition is the best growth strategy and evaluate all the options before proceeding.
- Perform adequate due diligence as earlier as possible in the deal process to uncover deal and target risks.
- Identify the potential risk, putting them into the right context.
- Work with the experienced local adviser to leverage their experience and manage key deal execution challenges, perform due diligence, assist with negotiation and resolve the issues identified.
- Be flexible, patient, and persistent throughout the negotiation process to be successful at doing deals.
- Post-merger integration need to be considered early on and carefully planning with full management buy-in from both sides.

Observation and Recommendations - Government Relations and Regulatory Compliance

Observation

- Foreign business cites a lack of access to government as one of significant risks.
- Secure the right connections in China necessitates a considerable commitment of time and resources.

Recommendation

- Work collaboratively with government regulations and look for common ground with government officials.
- Work with officials you are comfortable with and strive to maintain these relationships; be consistent and persistent.
- Cultivate a wide network of local contacts.
- Trust partners or advisers with the right knowledge and local connections and ensure your interests can be heard by the appropriate governments when they need to be.

Observation and Recommendations - Managing Risks

Observation:

- Company without insights into local business practices and culture finds themselves wholly unprepared for the underlying risks.
- Global compliance policies, training and procedures have proven largely inadequate in identifying red flags and assessing risk in China.

Recommendation:

- Adopt a holistic and China-specific risk management framework.
- Address both strategic drivers (i.e. growth and cost rationalization) and sustainability drivers (i.e., business infrastructure and compliance) in risk management.
- Appoint China-based senior management to lead compliance programs to ensure they are proactive and effective.

Quick Tips - Business Culture

- Since Chinese culture has its richness and heritage, before approaching the business in China, please be mindful for the following qualities and values:
  - Saving and giving face
  - Respect for elders and rankings (note that the latter is particularly important when dealing with government officials)
  - Patience
  - Politeness
  - Modesty
- Pay attention to when people say “yes” but actually “no”.
- Identify who are intermediate persons and who are the decision makers.
- Find out the underlying and real purposes from interaction with Chinese business people.
- Use “Guanxi” (i.e., network), a double-edged sword to secure favor in personal relation.
- Useful link in the website of The Canada Trade Commissioner Service:

  http://www.tradecommissioner.gc.ca/eng/document.jsp?did=107932

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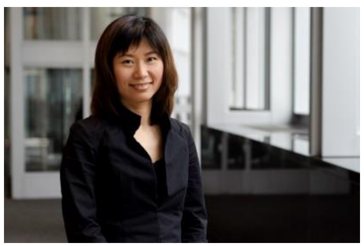

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Questions and Comments?

* Please note that some of materials are extract from *PwC Worldwide Taxation Summary* and PwC Publication of *Doing Business and Investing in China*.