

## China Becomes World's Fourth Largest Economy

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China's gross domestic product ("GDP") reached 18.2 trillion RMB (about \$2.3 trillion) in 2005, an increase of 9.9% from prior year, the National Bureau of Statistics reported on January 25, 2006. With this increase in their GDP, China has surpassed France and Britain to become the world's fourth largest economy.

Last December, the bureau revised China's 2004 GDP to almost \$2 trillion, approximately 16.8% more than originally announced. The bureau also revised GDP numbers for years prior to 2004. The revised numbers showed that China averaged 9.9% growth between 1993 and 2004.

In 2005, China's total retail sales reached \$840 billion, an increase of 12% over 2004. According to the bureau, consumption in urban areas increased by 13.6%; while the wholesale and retail sectors grew 12.6% and the catering industry grew 17.7% in 2005.

China Outlook is a newsletter designed to provide you with insights into the China marketplace and how that can impact your business. We hope that this newsletter will be informative for you and would appreciate any feedback you would care to offer. If you have any comments, please contact our editors: Alex Pan, Debbie Chan, Peter Kao, and Daphne Su.

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### PwC Observations:

Based on governmental releases, China has maintained average annual growth of 9.9% over the past 13 years. But, tensions between China and its major trading partners, the anticipated appreciation of China's currency, and a shortage of natural resources makes maintaining such high GDP growth very difficult.

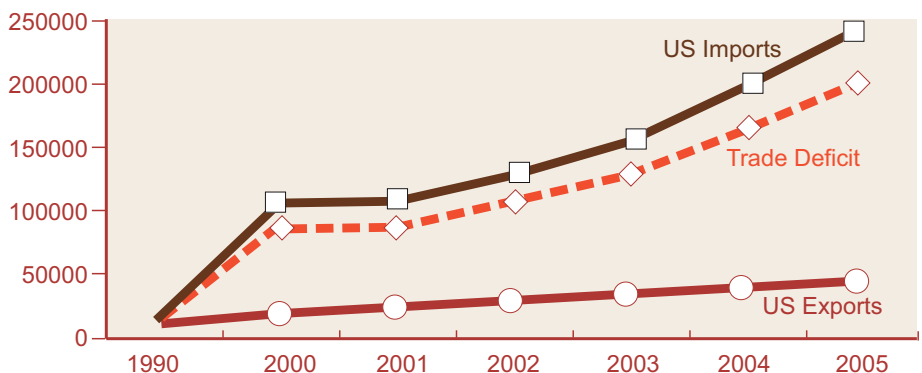
USD Million

Year	US Exports	US Imports	US Trade Deficit
2005	41,800	243,500	201,700
2004	34,721	196,699	161,978
2003	28,368	152,436	124,068
2002	22,128	125,193	103,064
2001	19,182	102,278	82,096
2000	16,185	100,018	83,833
1990	4,806	15,237	10,431

### US - China Trade

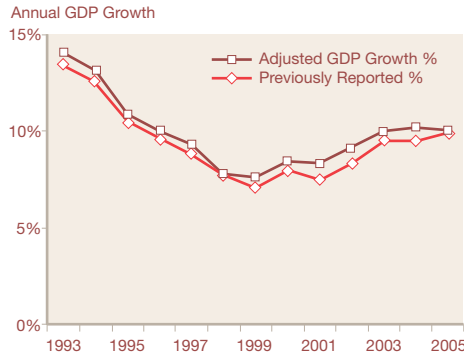
SOURCE: US Census Bureau  
(www.census.gov)

Million USD



# China's Becomes World's Fourth Largest Economy (cont'd)

## China GDP Growth Rate



Percent Revised CN GDP Growth

Year	Adjusted GDP Growth %	Previously Reported %
1993	14%	13.1%
1994	13.1%	10.9%
1995	10.9%	10.0%
1996	10.0%	8.3%
1997	8.3%	7.8%
1998	7.8%	7.6%
1999	7.6%	8.4%
2000	8.4%	8.3%
2001	8.3%	9.1%
2002	9.1%	10.0%
2003	10.0%	10.1%
2004	10.1%	9.9%
2005	9.9%	

SOURCE: National Bureau of Statistics of China, New Releases, January 25, 2005 Beijing China, reported by World Journal. See [www.worldjournal.com](http://www.worldjournal.com) (also will be posted on [www.stats.gov.cn](http://www.stats.gov.cn))

With a population of 1.3 billion, China is also emerging as an important consumption market for foreign investors. Based on a recent PwC survey of CEOs from 45 countries, 55% of the respondents are planning to do business in China during the next three years. Of this group, 75% are primarily attracted by China's domestic market opportunities while 48% are also influenced by opportunities due to the lower manufacturing costs in China. China also recognizes that at least 33% of its GDP growth in 2005 was attributable to domestic consumption.

Foreign enterprises also recognize China's domestic market opportunities. Based on China Ministry of Commerce ("MOFCOM") statistics, they have approved over 1,000 foreign investment retail companies after December 11, 2004 when the China wholesale and retail sectors were fully opened to foreign investors.

On April 19, 2005, MOFCOM issued a notice (MOFCOM Notice 9, 2005) which enables existing foreign invested manufacturing companies ("Manufacturing FIE") or investment holding companies to expand their Chinese business scope to include retail and/or wholesale operations. Before the release of MOFCOM Notice 9, a Manufacturing FIE could only sell self-made products to Chinese domestic customers. With this notice and government approval, Manufacturing FIEs can import or purchase products from other Chinese or foreign suppliers and bundle the purchased goods with its self-made products to provide a full line of products to its Chinese customers.

During the initial stages, the application for establishing a foreign invested commercial enterprise ("FICE") required the central government's ap-

proval. The approval process could be time consuming and detailed operational and business plans were closely scrutinized. On December 9, 2005, MOFCOM issued Notice No. 94 which delegated approval authority to local government. With this change, it is expected that the government approval period for obtaining a FICE license can be reduced substantially.

With deregulation and an expedited approval process, FIEs now have alternative means to support their China domestic distribution operations. These options include the following:

1. Establishing a China Service WFOE to support their China customers with technical or after sale services for goods exported into China;
2. Establishing a China Service WFOE to provide certain back-office functions to support other China manufacturing or distribution affiliates;
3. Establishing a R&D center (or Service WFOE) to conduct research and development of application intangibles to support other China production needs;
4. Establishing a FICE to purchase products from related/unrelated manufacturers for China domestic distribution.

Implementing some of these structures can be fairly complicated. Common issues include China income tax rates on distribution/service profit, business tax, VAT reporting, customs duties and other local government regulatory and filing requirements. Foreign companies should consider professional advice before implementing any of the restructuring plans.

## The Chinese Business Network

### Who We Are

CBN is a US based group within International Tax Services at PricewaterhouseCoopers LLP. We work with our foreign offices to provide tax compliance and consulting services to multinational corporations with current or future operations in the greater China region.

### China Outbound

Specializing in both US and China tax laws, we can provide a wide range of services for companies with interest in operating in China. Whether a company needs assistance with expanding their current China operations or with their first ever venture into the country, we have the expertise and knowledge to provide a comprehensive approach to their China operations. We are well versed in China's income tax laws, value added tax and customs issues, as well as foreign exchange regulations.

# China Tightens Anti-Tax Evasion Measures

China's tax authorities have intensified investigations of tax evasion by both foreign and domestic enterprises. The State Administration of Taxation ("SAT") has been conducting an average of 230 anti-tax evasion investigations annually resulting in additional tax collected of US\$ 375 million, the Xinhua News Agency reported on January 12, 2006.

Based on the report, China loses at least US\$ 3.75 billion in tax revenue each year and foreign invested enterprises are mainly blamed for the shortfall. Many foreign enterprises report losses to avoid paying income taxes. Some local tax officials have estimated that the tax revenue loss could be as high as US\$ 2.1 billion.

To curb massive tax evasion, it is expected that the SAT will amend the country's anti-tax evasion regulations. Key measures currently being considered by SAT include:

1. Amending existing regulations concerning related party transactions
2. Adding provisions to curb tax evasion activities with tax haven entities
3. Adding provisions on foreign controlled corporations
4. Adding provisions on thin capitalization restrictions

According to Su Xiaolu, an anti-tax evasion expert from the SAT, the tax authorities will monitor closely the following types of enterprises:

1. Loss enterprises
2. Enterprises that have frequent transactions with tax haven affiliates

3. Enterprises that have increasing revenues, but report profits and losses alternatively
4. Stable growth enterprises whose net profits have always been at a minimum level

In 2006, the SAT will (1) expand the number of transfer pricing audits; (2) initiate additional bilateral advanced pricing arrangements ("APA"); and (3) provide its audit examiners with comprehensive anti-tax evasion training.

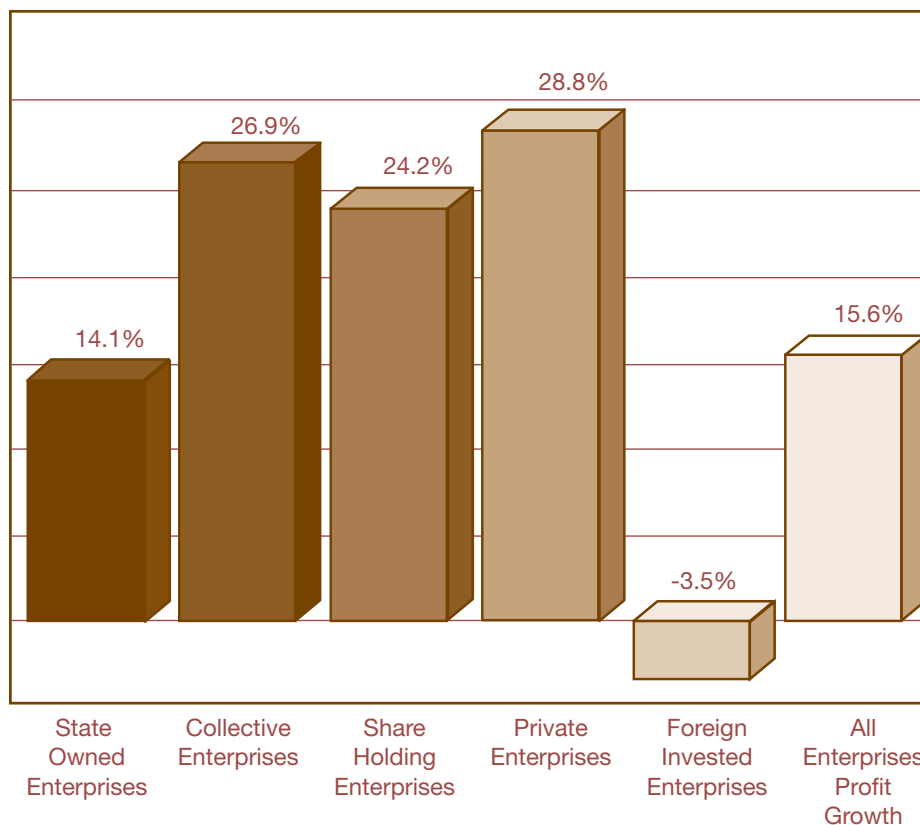
Meanwhile, Chinese Premier Wen Jiabao recently instructed Chinese customs authorities to continue enforcing customs duties, the Xinhua News Agency reported on November 30, 2005. Nationwide, collection of customs duties and import taxes reached US\$ 60 billion during the first 11 months of 2005, an increase of 10.6% over the prior year.

**"...China loses at least US \$3.75 billion in tax revenue each year and foreign invested enterprises are mainly blamed for the shortfall."**

## Profit Growth By Enterprise Types

Percentage Growth over Last Period (January 2004 - April 2005)

SOURCE: State Administration of Taxation - China



# China Tightens Anti-Tax Evasion Measures (cont'd)

## PwC Observations:

Based on a survey conducted by PwC in November 2004, China ranks highest in Asia on a list of countries that provide the greatest tax challenge. The results of the survey reflect the respondents' concerns over the complexity of Chinese domestic laws and practices. Most see transfer pricing as high risk, with 66% of respondents identifying it as such.

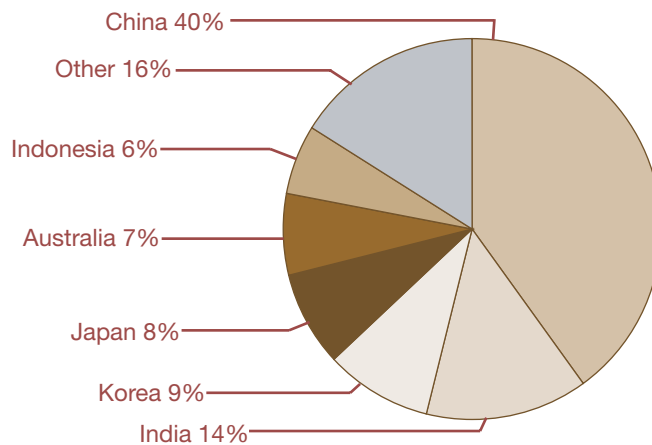
According to SAT's statistics, over 50% of the FIEs in China are in a loss position. From January to April 2005, profit growth of FIEs decreased by 3.5%, while the profit growth rate of all types of entities is about 15.6%. FIEs have therefore been accused of not paying their fair share of tax in China. Based on our observations, the Chinese tax authorities will further

strengthen its tax audit practice on FIEs in the following manner:

1. Increase national/provincial joint audits of FIEs with multiple locations in China;
2. Emphasize the business and technical aspects of tax audits by leveraging specialized units with intensive experience in various major industry sectors;
3. Expand audits to cover turnover taxes and the related transactions, including VAT and business tax;
4. Assist taxpayers with the double taxation impact resulting from tax audit adjustments by accepting/approving more APAs..

### PwC Survey Question Which Country Presents the Most Difficult Tax Challenge?

SOURCE: PricewaterhouseCoopers, 2004 Survey (Tax Creating Value or Managing Risk?)



It should be noted that transfer pricing adjustments can have an impact not only on income tax, but also on VAT, business tax, consumption tax and customs duties. And the statute of limitation may extend to 10 years according to the Chinese transfer pricing regulations.

Since China is playing a more and more important role in many US companies' global strategy, now it is time for US management to review its China business operations and to reassess its China tax exposure.

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