



December 31, 2006

Issue No. 009

China's Draft Bill Unifies Corporate Tax Rates at 25%

In this issue:

1. China's Draft Bill Unifies Corporate Tax Rates at 25%
2. New Administrative Regulations for Foreign Banks in China

Based on a recent news report, the Standing Committee of the National People's Congress ("NPC") began to deliberate the country's first ever tax law that will unify differing corporate income tax rates for foreign and domestic funded companies at 25%. The new income tax rate is expected to take effect in 2008 if the bill is adopted by the NPC in March 2007. (*Xinhua News, December 24, 2006*).

At the news conference announcing the new rate, Jin Renqing, China's Finance Minister and a major promoter of this bill, declared that under the new bill, domestic and foreign funded enterprises will be treated equally but that China will still provide certain tax incentives designed to support the country's goals of innovation and investment in under-developed regions. Minister Jin also asserted that certain qualified small enterprises which currently enjoy reduced tax rates of 18% or 27% will continue to enjoy a reduced income tax rate of 20% under the proposed tax bill. (*finance.sina.com.cn. December 24, 2006*).

Based on the above reports, some of the more salient provisions of the proposed tax bill include:

- The five-year tax holiday currently available to many foreign owned manufacturers will be rescinded. In addition, the 50% tax rate reduction subsequent to the five-year holiday available to export-oriented foreign businesses will no longer be offered.
- A grace period will be provided to phase out the manufacturer tax holiday for no longer than five years.
- A preferential income tax rate of 15% will be granted to all qualified hi-tech companies and/or environmentally-friendly enterprises regardless of the origin of their investors or the location of their operations. Currently only qualified hi-tech companies located within certain designated hi-technology zones can enjoy the reduced rate.
- All qualified enterprises with investment in equipment for environmental protection, water conservation or operational safety, may be eligible for income tax credits on certain qualified expenditures.

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 and Peter Kao.

350 South Grand
Los Angeles, CA 90071
(213) 356-6000

China's Draft Bill Unifies Corporate Tax Rates at 25% (continued)

- Investments in China's Western region that qualify as an "encouraged industry sector" may continue to benefit from the reduced incentive rates provided under the current tax system.
- Special economic zone tax incentives are expected to be phased out within the next five years.

PwC Observations

Currently, Chinese domestic-owned companies are subject to income tax at a rate of 33%, while their foreign-owned counterparts benefit from tax waivers and incentives and pay an average of 15%. These tax incentives provided to foreign-owned enterprises were established to attract foreign investment to China and resulted in China becoming one of the world's top destinations for foreign direct investment ("FDI"). Based on Chinese government statistics, China FDI reached \$60.3 billion in 2006.

Under the current China income tax system, income tax regulations applicable to Chinese domestic funded enterprises are issued through the Premier's Office by the State Council, whereas tax laws for foreign funded enterprises are pronounced by the legislative branch of the National People's Congress

("NPC"). In addition to the difference in governing bodies and the tax rate disparity, the current methods of computing taxable income were different as they applied to Chinese domestic funded and foreign funded enterprises. With the proposed unification of tax law, the Chinese government levels the playing field and provides the same tax treatment to both domestic and foreign funded enterprises.

Leveling the playing field became critical in recent years due to China's commitment to the World Trade Organization ("WTO") to open up its domestic market sectors to foreign funded enterprises. Prior to China's accession to the WTO in 2001, foreign funded Chinese enterprises were focused on making products for overseas market needs with very limited interaction or competition with Chinese domestic funded enterprises. Since China joined the WTO, China has gradually opened up its domestic market to foreign owned enterprises and an increasing numbers of foreign owned enterprises are now competing directly with Chinese domestic funded enterprises. Under the current system, the disparity in tax rates has put Chinese domestic owned enterprises at a disadvantageous competitive position with their foreign counterparts.

While the proposed bill removes many of the incentives enjoyed by foreign investment enterprises ("FIE's"), the bill benefits FIE's that currently conduct service or distribution operations within China which were not eligible for the many manufacturer incentives and are currently subject to income tax at 33%. This 8% reduction of the applicable income tax rate should also benefit non-manufacturer foreign funded enterprises such as foreign investment commercial enterprises ("FICE's").

To take advantage of hi-technology tax incentives, FIE's should evaluate the possibility of upgrading their existing China operations by enhancing or maintaining the level of advanced technology or environmentally-friendly processing to continue to qualify for tax incentives provided under the new tax law. Alternatively, for low profit-margin or labor intensive operations, foreign investors may take advantage of regional incentives by relocating their operations to China's Western or Central regions.

These observations are based upon information currently available as reported by various news agencies and government press releases, as we have not yet had the opportunity to directly review the bill itself.

New Administrative Regulations for Foreign Banks in China

On November 16, 2006, the deputy director of the Legislative Affairs Office of China's State Council announced to the public that new administrative regulations for foreign-invested banks will be forthcoming. The new regulations will allow foreign banks to own Chinese incorporated banking subsidiaries to provide a full scope of banking services to Chinese individual customers and foreign investment enterprises ("FIE's"). This new regulation complies with China's commitment to the World Trade Organization to fully open its domestic financial service industry before December 12, 2006.

Under the new banking regulations, full scope banking services are only available to banks that are incorporated in China. Therefore, foreign banks that intend to offer full scope banking services to Chinese individual customers are required to convert their existing branches into a bank incorporated in China. A foreign bank that continues to run its Chinese operations as a branch will still be limited in the range of services that it can offer to its Chinese domestic customers. For example, the Chinese branch of a foreign bank would be banned from engaging in foreign currency services with Chinese



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.

New Administrative Regulations for Foreign Banks in China (continued)

citizens unless that individual obtains the approval of the banking regulatory body and makes a fixed deposit of no less than one million yuan (approximately \$128,000 USD).

This new administrative requirement is intended to limit the risk to Chinese customers as the government believes that linking the range of services to the corporate status of a foreign bank would safeguard the interests and assets of its Chinese customers.

As of December 11, 2006, China would accept applications from foreign banks that wish to convert their branches into a locally incorporated bank.

As of September of 2006, total assets of foreign-funded banks in China exceeded \$100 billion USD, the China Banking Regulatory Commission ("CBRC") announced on November 16, 2006. In addition, CBRC figures show that by the end of September, 14 foreign-funded or joint venture banks were registered in China, with 17 subsidiary banks or other affiliated institutions. Moreover, 73 banks from 22 countries and regions had set up 191 branches and 61 sub-branches in 24 cities, and 183 banks from 41 countries and regions had set up 242 agencies in 24 cities, reported by Chinaview on November 16, 2006.

PwC Observations

Under the new administrative regulations for foreign-invested banks, FIE's and individual customers may anticipate higher quality customer support and a broader scope of services offered by the locally incorporated subsidiaries of foreign banks. With the new banking regulations, FIE's may also find more flexibility in terms of arranging future China investments and financial planning.

Chinese Business Network Contacts

Partners

Alex Pan	Los Angeles	(213) 356-6394	Franklin Lopane	Charlotte	(704) 347-1684
Jim Tapper	Boston	(617) 530-6490	Michael Feder	Washington, D.C.	(202) 414-4555
Michael Ho	New York	(646) 471-0400	Mike Cannon	Houston	(713) 356-5238
Todd Landau	New York	(646) 471-5312			

Directors and Managers

Cecilia Lee	Boston	(617) 530-6218	Debbie Chan	Los Angeles	(213) 356-6391
Diana Boggess	Philadelphia	(267) 330-2379	Erik Rosenfeld	Cleveland	(216) 875-3023
Jane Liu	San Francisco	(415) 498-5658	Jenny Chong	Atlanta	(678) 419-2325

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