

Penetrating the Chinese Market

– Advanced Tax and Structuring Aspects

14 December 2005

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1. PwC Doing Business in China Survey Results
2. Current “Hot Topics”
 - Appreciation of RMB
 - Forthcoming Tax Reform
 - Transfer Pricing
 - Distribution Solution in China - FICE
 - Bonded Logistics Parks
 - Foreign Exchange and Repatriation
3. Advanced Tax Planning



PwC's Doing Business in China Survey

Our questions to foreign investors in China:

- What are their challenges in doing business in China?
- Is it easy for a foreign investor to exit China?
- What will the trend be for foreign investment in China over the next three years?

PwC's Doing Business in China Survey

The key findings of the survey are as follows:

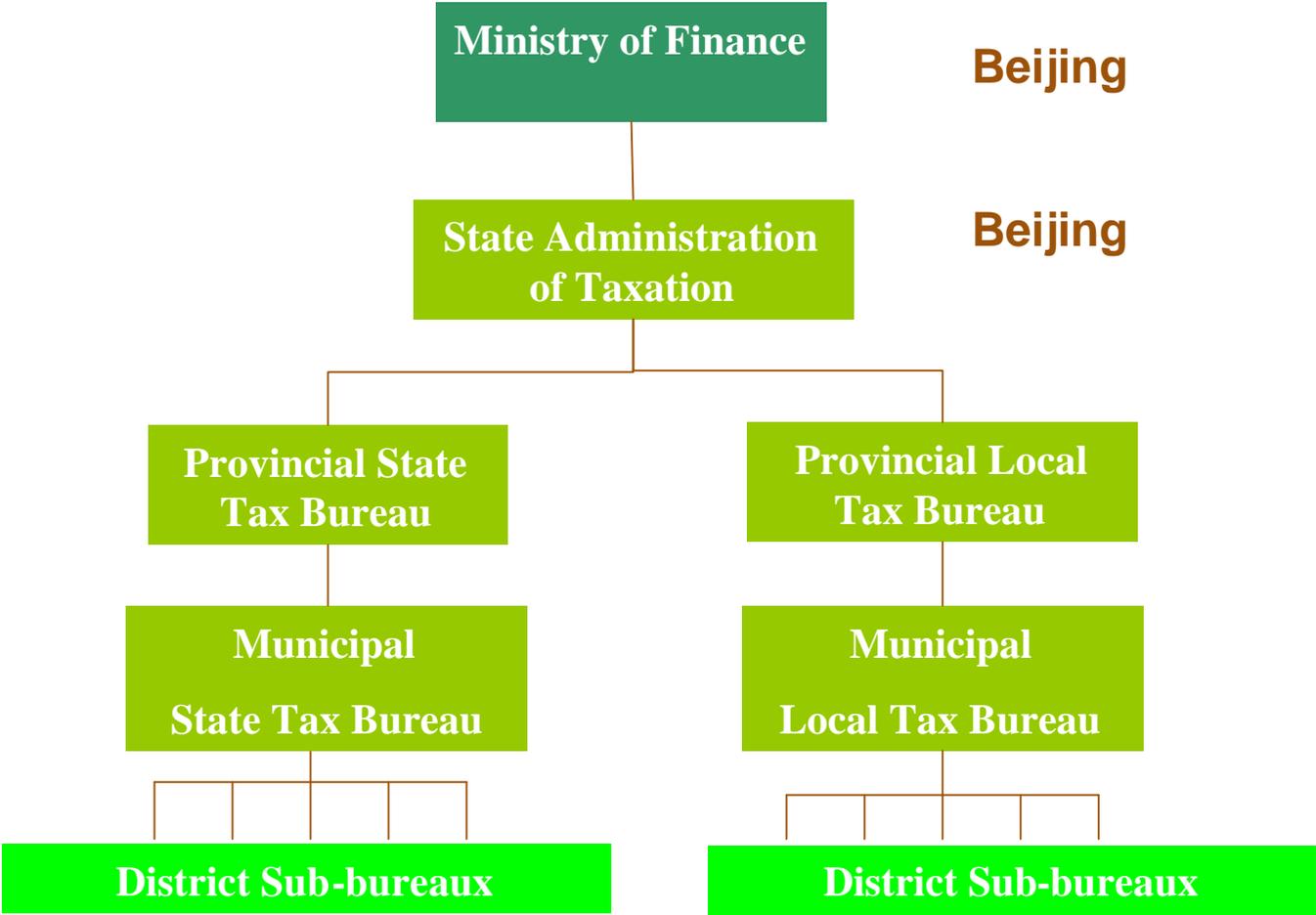
- More competition in doing business.
- 95% of the foreign companies believe that foreign investment in China will continue to increase over the next three years.
- Only 26% of the respondents' investments in China are currently profitable and 72% of them expect profits within the next five years.
- The top three challenges faced by foreign companies doing business or investing in China were the complex and developing legal and political environment, foreign exchange controls and lack of knowledge of the local business environment.
- 82% of the foreign companies think that it would not be easy to exit their investments in China.
- Most of the survey respondents needed advice on legal framework and statutory compliance requirements (74%), tax compliance and tax planning advice (57%).

Difficulties in Doing Business in China

Source of China Issues

- Business scope limitations
- Form vs. substance
- Rules & regulations lag behind business practice
- Inconsistent interpretation & application of law
- Sea of greys
- Complex tax administrative system

PRC Taxation Administrative System



Overview of PwC China

- ✓ **Extensive China knowledge since first office opened in 1980**
- ✓ **Over 6,000 professionals in China and Hong Kong today and has the largest market share**
- ✓ **Biggest variety of client base, including many European MNCs from different industry sectors**
- ✓ **Specialist teams for Transfer Pricing, Customs, M&A, Tax consulting and compliance, Human Resource consulting, etc.**
- ✓ **Access to senior officials of State and Local tax bureaus at all levels, as well as various government authorities in China.**



PwC: also the largest professional services firm in the world

How can we help?

- ✓ Structure your PRC business operation in connection with the global and regional commercial and tax objectives;
- ✓ Assist with M&A due diligence, structure implementation, etc.
- ✓ Design, evaluate and implement various transaction models;
- ✓ Assist with Regional and intra-China Transfer Pricing planning, Customs planning;
- ✓ Assist in general tax planning, tax compliance, audit defense, negotiation, etc.

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Appreciation of RMB

- RMB appreciated about 2% from 21 July 2005
- RMB will no longer be pegged to the dollar, but will float against a basket of currencies.
- The market is expecting further appreciation of RMB down the road but time frame is uncertain.
- Higher costs for exports from China
- Lower costs for imports into China
- RMB not expected to be fully convertible in the next 5 years according to one official

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What's in the crystal ball for China Tax Reform?

- Postponed from 2006 to 2007
- Speculated income tax rate once unified to be 24% - 28%
- Likely 5 year grandfathering period for existing tax holidays
- No clear indication on
 - **Exemption of withholding tax on outbound dividend payment**
 - **Group consolidation regime**
 - **Other tax incentives (e.g., industry specific, etc.)**

The following are expected to happen in the future:

- A unification of domestic income tax regulation and FIE income tax law.
- A combination of VAT regime and Business Tax ("BT") regime.
- Introduction of new taxes such as social security tax.
- Clearing up more than 4000 zones across China and local subsidies and rebates.
- Gradual reduction of Customs Duty rates

What can companies do now to prepare?

- Set up FIEs in China to catch the grandfathering treatment if you have a business plan in China.
- Re-evaluate the nature of preferential tax treatments enjoyed by your PRC operations and plan ahead to get prepared for the tax reform.
- Consider China and regional restructuring to increase flexibility
- Review transfer pricing and cash repatriation needs and adjust strategy if necessary.

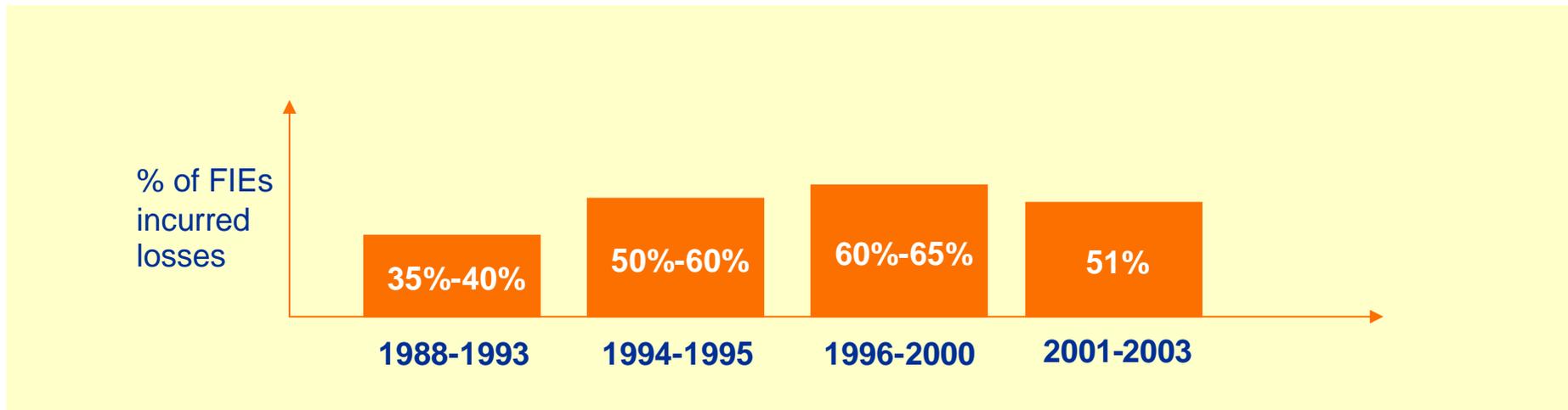
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Overall China Tax Environment

- A total of 494,025 Foreign Invested Enterprises (“FIEs”) have been approved to set up in mainland China by the end of August 2004; however, over 50% of the FIEs are incurring losses;



- It is estimated that China has been losing revenue worth RMB 30 billion per year due to tax avoidance activities of multinational corporations through transfer pricing;
- For Chinese tax authorities, transfer pricing is a low hanging fruit to increase tax revenue.

Current Status of Transfer Pricing Audits

- Aggressive transfer pricing audits conducted including “national audit” and “industry audit”. The SAT provides technical training to officers from various location.
- The local tax authorities have discretionary power and the practice of transfer pricing enforcement varies across the country
- Statute of limitation for transfer pricing: 10 years!
- “Secret comparables” used frequently by the tax authorities
- More complicated types of transactions are under scrutiny, including royalties, service fees, inter-company loans, etc.

What Can You Do? - Transfer Pricing Documentation

- In China, the burden of proof for the reasonableness of its transfer pricing rests with the taxpayer;
- TP documentation is your story on whether your transfer pricing policy conforms to the PRC regulations;
 - ☑ Can be an effective tool to defend or support the reasonableness of your TP policy in the event of a TP audit;
 - ☑ Can be used as supporting documents for an Advanced Pricing Agreement;
 - ☑ Can help evaluate your TP policies and ensure their consistency and reasonableness.

What Can You Do? - Advance Pricing Arrangement (“APA”)

- A circular on detailed APA guidelines was issued in 2004
- Approximately 150 APAs have been concluded so far
- The first bilateral APA was concluded in April 2005 with Japan.
The treatments are in line with OECD guidelines and international practice
- Many more APAs (unilateral and bilateral) are in the making

Take-away Points

- As multinational corporations beefing up their Chinese business operations post WTO, transfer pricing planning is essential for tax / customs duty efficiency and risk management
- Transfer pricing documentation is an essential risk management tool, and contemporaneous documentation may soon be required
- When handling TP audits, “preparation, patience and persistence” are the key success factors
- APA can be a potential tool to reduce TP risks, BUT one size does not fit all – a thorough evaluation is necessary before going for an APA

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Foreign Invested Commercial Enterprise (“FICE”) in China

- Removed major hurdles for expanding into China’s trading and distribution sector. Wholly owned FICE permitted after December 2004.
- FICE can obtain its own distribution rights and import/export rights. Minimum capital requirement is RMB500K for wholesales and RMB300K for retails.
- Existing manufacturing companies, China Holding Companies, Free Trade Zone trading companies are allowed to expand their business licenses to include these rights.



Business scope of “commercial enterprises”



“Foreign-invested Commercial enterprises” (“FICE”) refer to enterprises that are engaged in any one or all of the following activities

- **Commission agent services**
- **Wholesaling**
- **Retailing**
- **Franchising**

Common Issues in FICE Projects

- Timeframe
- Transition with existing business models
- General VAT payer status
- RHQ qualification
- Branching out
- Future tax positions
- Special industries

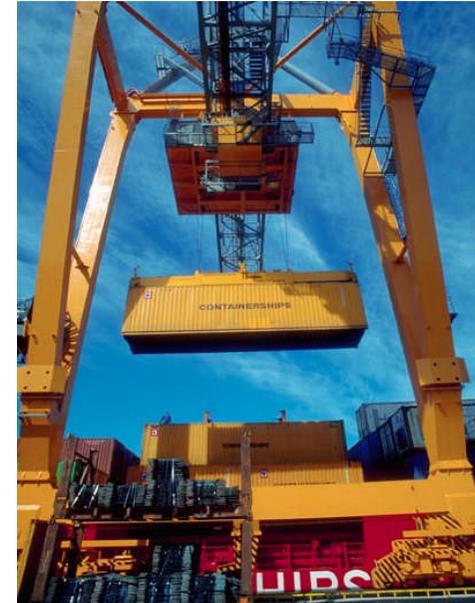
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What's New? - Bonded Logistics Parks (“BLP”)

- Build on the original Free Trade Zone concept
- Subject to Customs Supervision
- No manufacturing, only “simple processing” allowed within BLP
- “Deemed import and export” concept
- Immediate export VAT refund



Bonded Logistics Parks – Comparison of FTZ and BLP

Scenarios	FTZ	BLP
Import from overseas	Bonded	Bonded
Purchase from PRC domestic market	No VAT refund until final shipment to overseas	Immediate VAT Refund
Sell into PRC market	CD + VAT	CD + VAT
Bonded Transfer	Feasible	Feasible
Manufacturing Activities	Allowed	Not allowed
Forex Control	Strict control for non-trade items.	Flexible
VAT within the zone	Exempt	Exempt
Corporate Income Tax	15% in Pudong New Area and special economic zones	15% in Pudong New Area and special economic zones

Possible Use of BLP in Your Operation

- To replace “HK round trip” model
- To be used as a logistics hub for regional distributions
- To provide tax and cash flow planning opportunities for selling products manufactured in China to Chinese customers (i.e., using “deemed export and re-import” concept)
- To facilitate processing arrangements in China



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Foreign Exchange & Repatriation

- Foreign exchange regulatory authorities
 - State Administration of Foreign Exchange (“SAFE”) and its local branches
- Four major categories of overseas remittance:
 - Profit repatriation
 - Tangible goods importation
 - Intangible goods importation
 - Service Agreement

Profit Repatriation - Dividend

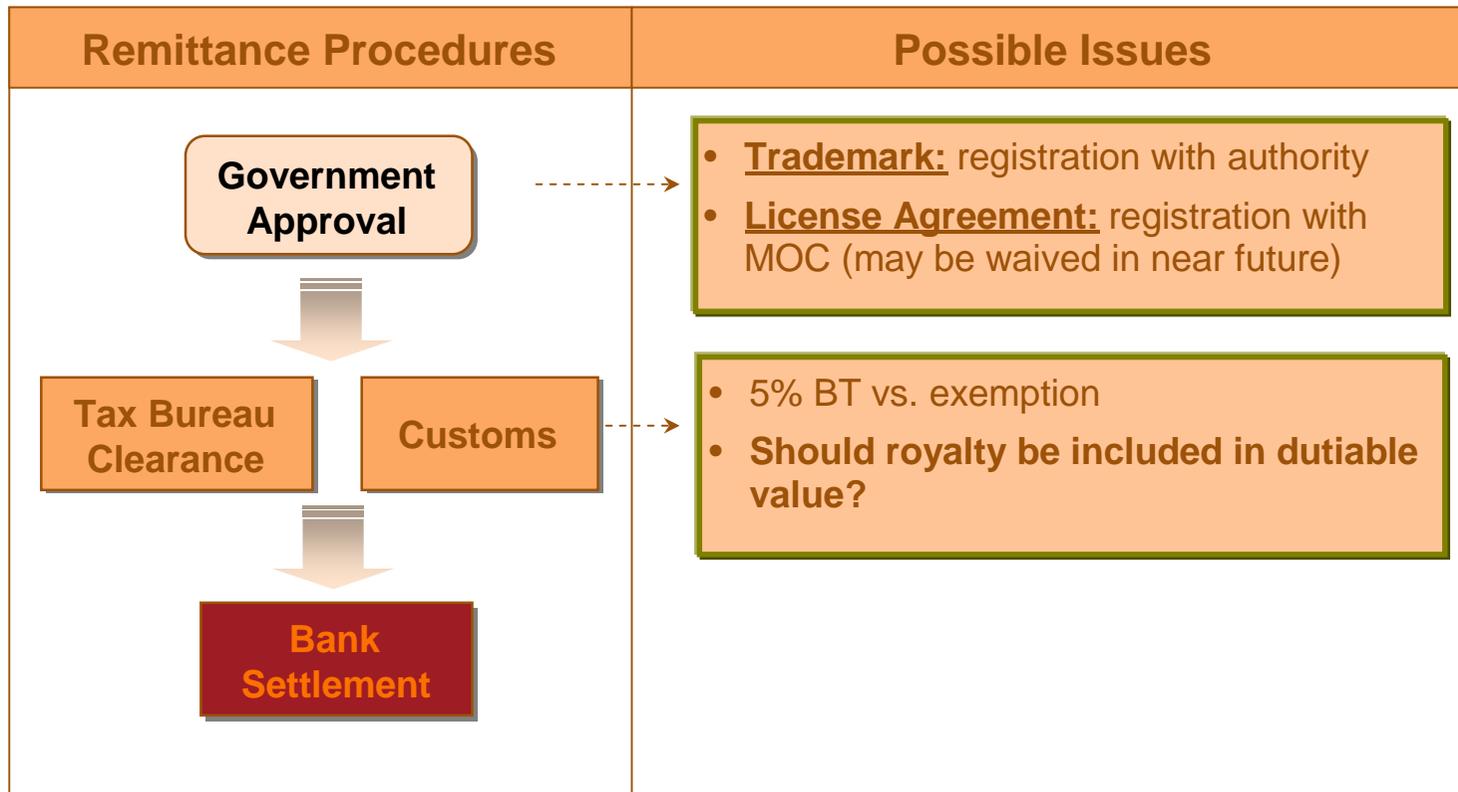
- Only after tax profit are allowed to repatriate
- 0% withholding income tax
- Prerequisite: contribution of all committed capital (including the increased portion) and Dividends pool



Ways of Dividends Repatriation	Difficulty
Year-end repatriation	easy
Retroactive repatriation	medium
Interim repatriation	most difficult

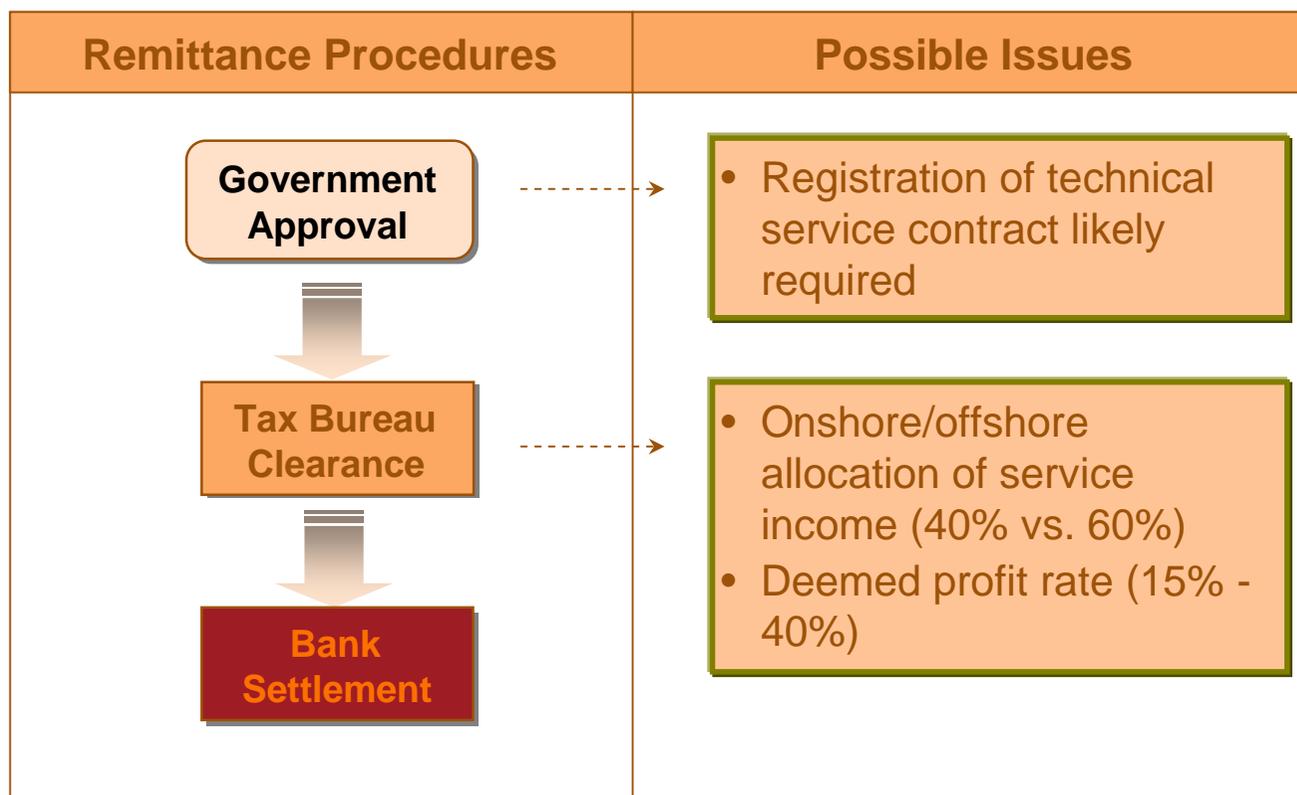
Intangible Goods Importation – Trademark/Royalty Payment

- 5% business tax
- 10% withholding income tax



Service Agreement

- 5% business tax for onshore services
- 33% income tax for onshore services



Repatriation Tax Implications

		Original Amount	Corporate Income Tax	Withholding Tax	Business Tax	Total China Remittance Tax
A	Trademark Royalty	100	0	$(100-5) \times 10\% = 9.5$	$100 \times 5\% = 5$	14.5
B	Hi-Tech Royalty	100	0	$100 \times 10\% = 10$	0	10
C	Service Fee (100% Offshore)	100	0	0	0	0
D	Service Fee (40% Offshore / With PE)*	100	$100 \times 60\% \times 20\% \times 33\% = 3.96$	0	$100 \times 60\% \times 5\% = 3$	6.96
E	Service Fee (100% Onshore With PE)*	100	$100 \times 20\% \times 33\% = 6.6$	0	$100 \times 5\% = 5$	11.6
F	Technology Cost Sharing Arrangement	100	0	0	0	0

*Assuming the deemed profit rate is 20%

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Main Tax Structuring Considerations

- Investment Structures
- Local Tax Reduction Strategies
- Investing in China – M&A Considerations

Direct Investment - *Repatriation of Business Income*



Dividend repatriated from China to Israel would be subject to 0% withholding tax in China under current Chinese domestic law.

Dividends received in Israel are subject to a 25% tax. Alternatively, and at the election of the Israeli company, such dividend will be subject to a 31% (in 2006) tax on the grossed-up income amount against which the Chinese enterprise income tax and w/h tax can be credited.

	<u>2-years</u>	<u>Years 3-6</u>	<u>Regular</u>	<u>Reform**</u>
Income	100	100	100	100
Corp. Tax	0	(18)	(33)	(28)
Withholding: (0)	(0)	(0)	(0)	(7.2)
Israeli Tax: <u>(25)</u>	<u>(13)</u>	<u>(0)</u>	<u>(0)</u>	<u>(0)</u>
Net:	75	69	67	64.8
Total Tax:	25	31*	33*	35.2*

Effective overall Tax rate:

Two years of exemption: 25%

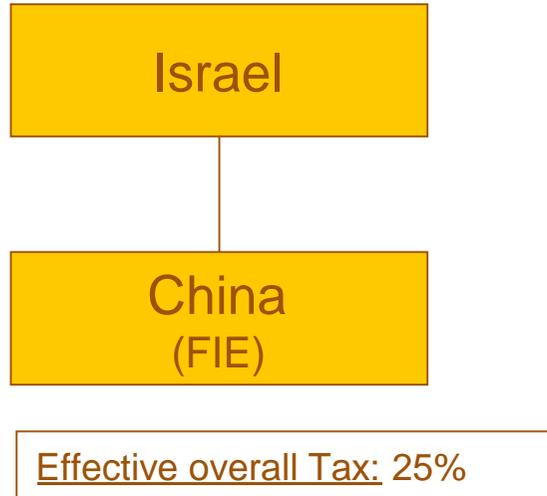
Years 3-6: 31%*

Upon expiration of benefits: 31%*

* *As of 2006, profits distributed as dividends after 2004 should be subject to a minimal overall effective tax equal to the applicable Israeli corporate tax rate for that year. As of 2005 the corporate tax rate is reduced each year and is expected to reach 25% by 2010.*

** *Assuming the expected Chinese tax reform shall enter into force and the tax rates for domestic companies and FIEs will be unified and stated at 28%, and withholding tax for FIEs will be set at 10%.*

Direct Investment - *Capital gain from sale of the Chinese entity*



Capital Gain:	100
Israeli Tax:	<u>25</u>
Net:	75
Total Tax:	25

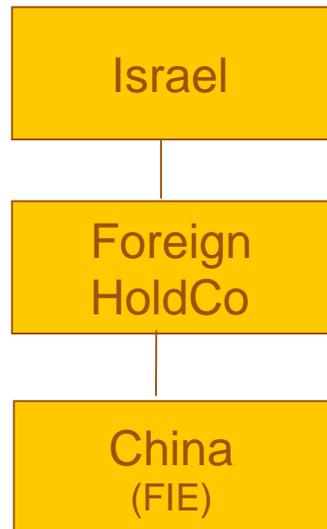
In general, China taxes gains on dispositions by non-residents of their interest in FIEs.

The China-Israel income tax treaty provides for capital gains exemption in China but for gains derived from alienation of immovable property and of an Israeli permanent establishment in China.

The capital gain treaty exemption contrast with the majority of China's other treaties that ensure China's taxing prerogative of capital gains derived by non-residents (e.g., the treaties with the US, UK, Singapore etc.).

Capital Gain generated by the Israeli company will be subject to a 25% tax.

Interposing a foreign holding Company



Key Benefits

Facilitate reinvestment of Chinese earnings which were subjected to Chinese effective tax of more than 20% into non-China projects. Note exposure to Israeli CFC provisions.

Facilitate internal restructurings without obtaining JV partners' approval.

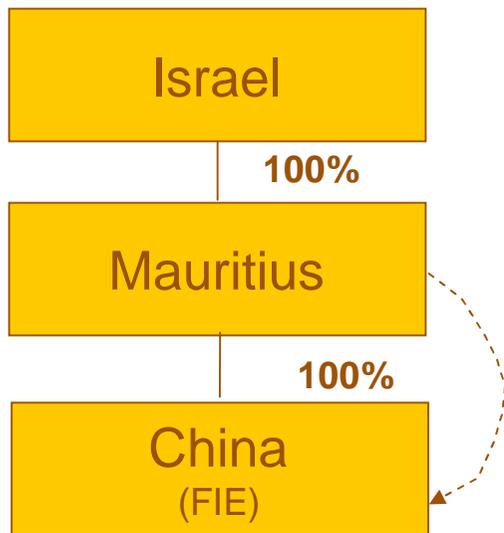
Key Considerations

In terms of the location of the foreign Holdco, there are no "one size fits all" solutions.

Future investment plans.

Israeli CFC considerations.

Provision of Project Services using a Mauritius Company



A Mauritius company can be used as a vehicle to provide services in respect of a China investment to reduce the effective overall tax once the two-year exemption has elapsed.

The treaty between Mauritius and the PRC exempts income derived from the provision of such services, including consulting, provided such services are performed in a period not to exceed 12 months in any 24 month period.

No Mauritius tax would apply on the Chinese source income.

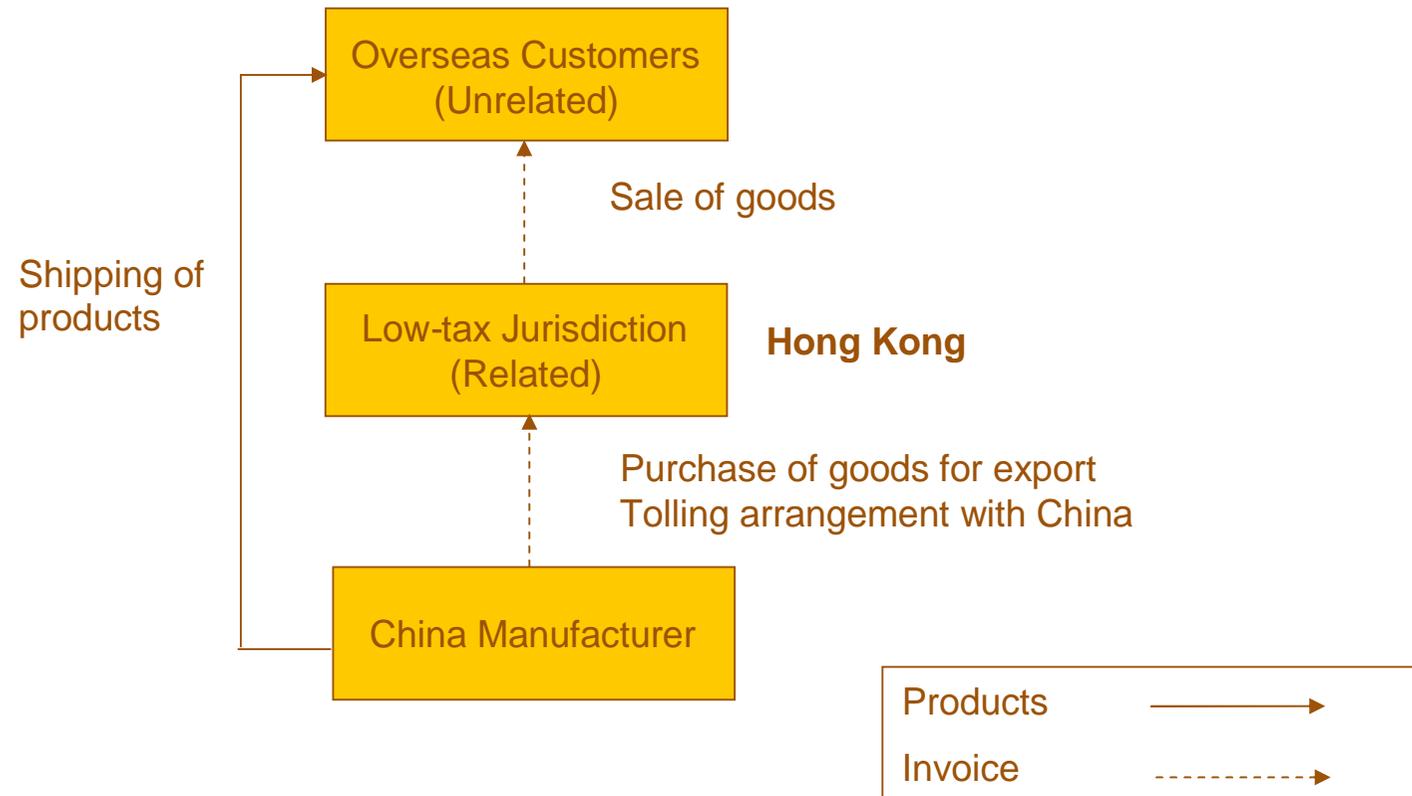
Dividends distributed to foreign residents are exempt from tax in Mauritius.

Income:	100
Mauritius Corp. Tax:	0
Mauritius Withholding:	0
Israeli Tax on Dividend:	<u>(25)</u>
Net:	75
Total Tax:	25

Dividend distributed to Israel will be subject to a 25% tax in Israel.

Effective overall Tax: 25%

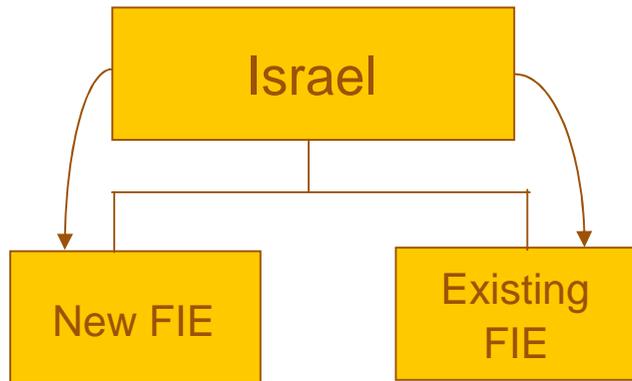
Regional Profit Realignment



Local Tax Reduction Strategies – *Utilization of the Current Tax Regime Incentives*

Strategy # 1: Accelerate New Investments

Obtaining a new FIE tax privilege status before the proposed reform enters into force.



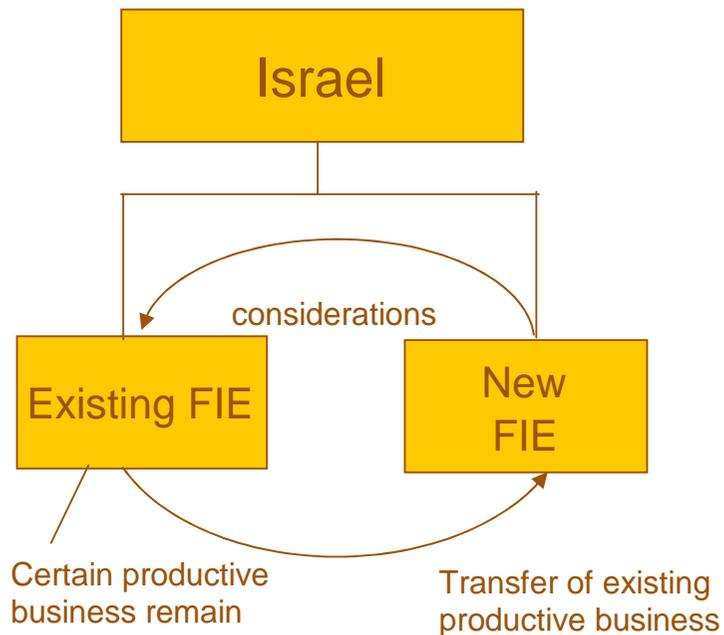
1. FIE tax privilege regime is granted for each company separately.
2. Added conditions:
 - Post expansion Registered Capital is at least USD 60m, or
 - at least USD 15 m new capital, which is also at least 50% of original capital, and
 - For Encouraged projects only

Local Tax Reduction Strategies – *Utilization of the Current Tax Regime Incentives*

Strategy # 2: Tax Holiday Refresher

Transfer of existing productive business from the old FIE to a new FIE or a FIE at an early stage of its tax holiday.

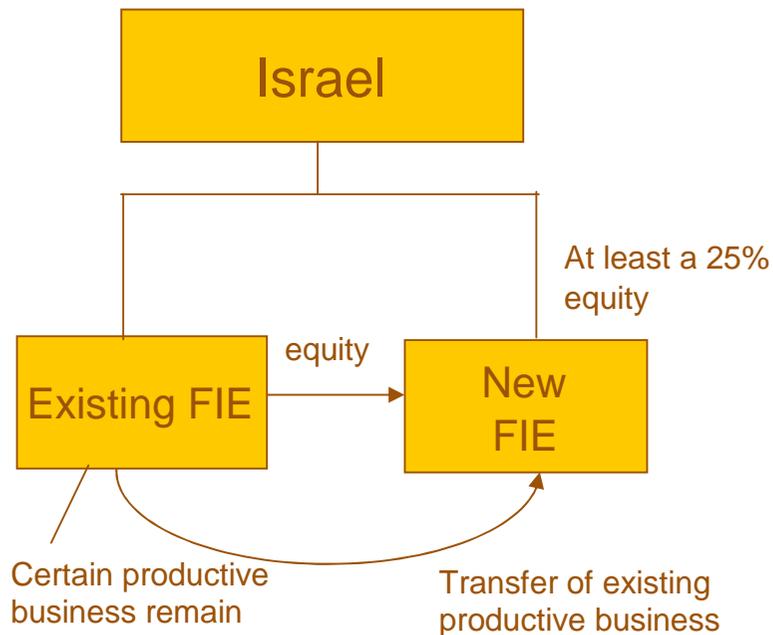
Capital gain would be taxed at the applicable corporate rate of the FIE.



Local Tax Reduction Strategies – Utilization of the Current Tax Regime Incentives

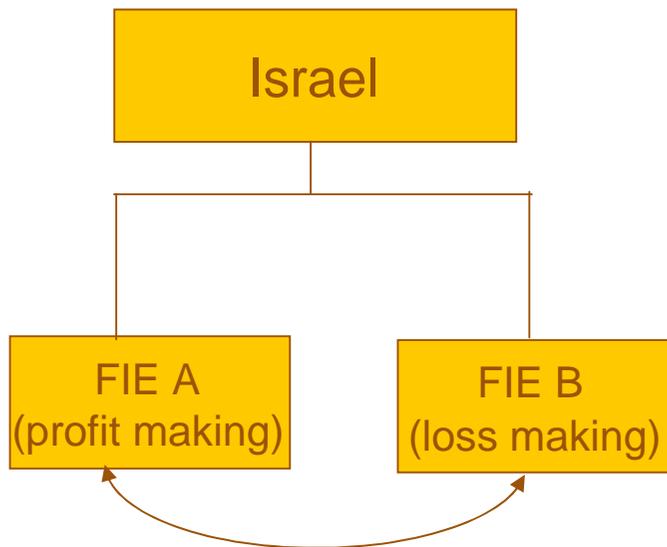
Strategy # 3: Tax Holiday Refresher + Possible Rollover Relief

Transfer of existing productive business from the old FIE to a new FIE or a FIE at an early stage of its tax holiday in exchange for equity.



Local Tax Reduction Strategies – *Utilization of the Current Tax Regime Incentives*

Strategy # 4: Intra-China Profit Realignment



1. Intercompany transactions,
2. Business transfer,
3. Legal Merger

Local Tax Reduction Strategies – *Chinese Debt Planning*

Why Consider Introducing Inter-Company Debt into China?

1. Inability to easily repatriate and redeploy Chinese earnings due to the tight monetary controls and approval process.
2. Payment of principal and interest may be easier than distributing a dividend which is limited to distributive reserves.
3. Leverage would provide tax benefits once Chinese subsidiaries' tax holidays or reduced rate policies expire.
 - Chinese tax holidays typically expire after a certain period.
 - Anticipated Chinese tax reform will likely phase out the traditional tax holiday regime and reduced rate policies and introduce a uniform tax rate system.

Local Tax Reduction Strategies – *Chinese Debt Planning*

Key Considerations

Regulatory Perspective

- Statutory debt-to-equity thin cap restriction in China needs to be considered. (see next slide)
- Loan terms typically need to be evidenced with third party documentation.
- Loans extended to Chinese entities need to be registered with the State Administration for Foreign Exchange. Otherwise, interest payments and principal repayments cannot be made out of China.

Local Tax Reduction Strategies – *Chinese Debt Planning*

Thin Cap Rule – Debt Equity Ratio

Chinese Holding Company

- 4 to 1 – if paid-up capital is less than \$100M or
- 6 to 1 – if paid-up capital is at least \$100M

Local Tax Reduction Strategies – *Chinese Debt Planning*

Thin Cap Rule – Debt Equity Ratio (cont.)

Companies Other Than Chinese Holding Company

Total investment (in USD)*	Minimum Registered Capital (in USD)**
Less than 3 million	70% of the total investment
Between 3 million – 10 million	Higher of 2.1M or 50% of the total investment
Between 10 million – 30 million	Higher of 5M or 40% of the total investment
More than 30 million	Higher of 12M or 33.3% of the total investment

*Total Investment: represents the total amount of funds required to establish the enterprise, namely, the sum total of capital construction funds and the amount of production liquid capital required in accordance with the enterprise's production scale.

**Registered Capital: represents the total amount of capital registered with the administrative authority for industry and commerce for the establishment of the enterprise, namely, the total amount of investment subscribed by the foreign investor. The difference between the total investment amount and the registered capital constitutes debt, which can be financed by the investors or by a third party.

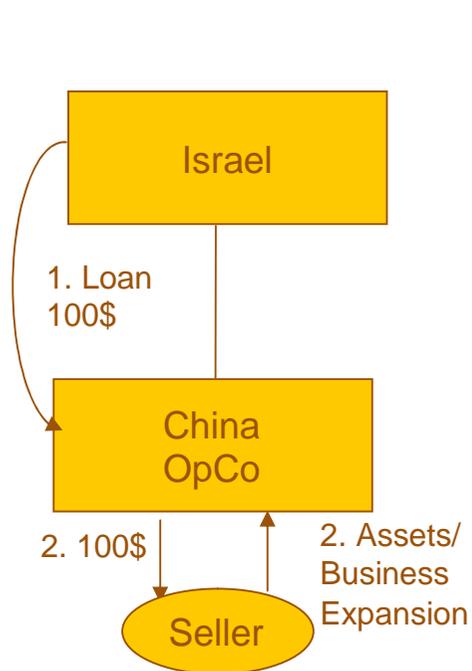
Local Tax Reduction Strategies – *Chinese Debt Planning*

Key Considerations (cont.)

Tax Perspective

- 10% withholding tax on interest accrued by a Chinese entity for cross-border loans to most major jurisdictions, including countries with which China has treaties (e.g., Israel). However, interest paid to Banks and Financial Institutions may be subject to a lower withholding tax (a 7% withholding tax under the Israel/China tax treaty).
- May be able to implement a “low-high” interest rate term, whereby the interest rate is low for the initial few years and subsequently higher in the later years. Useful for taxpayers enjoying tax holidays.
 - However, the “high” interest cannot be excessive (with argument to compensate the previous “low” interest).
 - Transfer pricing and SAFE acceptance/registration issues should be addressed before the implementation of the arrangement.
 - PRC accounting treatment of low-high interest arrangement must be considered.
- The following structures are most effective when dealing with Wholly Foreign Owned Enterprises (“WFOEs”).

Local Tax Reduction Strategies – *Chinese Debt Planning: Expansion/Asset Acquisition*



* Loan can be extended also by an international finance company

Steps

- Israel Lends \$100 to China OpCo
- China OpCo uses \$100 to finance expansion/asset acquisition in China.

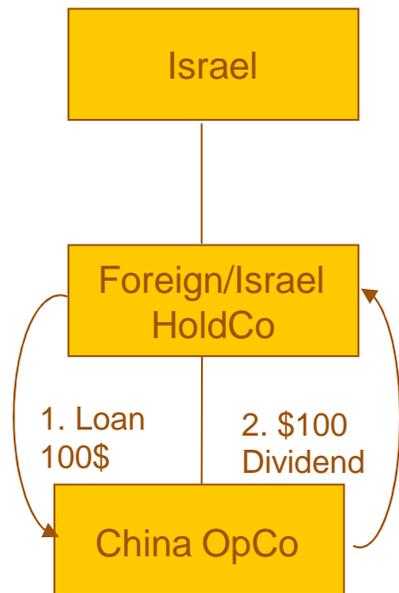
Key Considerations

- Statutory thin-cap rules
- Registration process for the loan
- Foreign currency risk and economic risk

Key Benefits

- Facilitates future cash distributions from China.
- Provides opportunity to enhance exit strategy.
- Introduction of internal debt into China.

Local Tax Reduction Strategies – *Chinese Debt Planning: Borrow to Pay Dividend*



* Loan can be extended also by an international finance company

Steps

1. China OpCo has distributive reserves and can benefit from additional leverage.
2. Foreign HoldCo lends \$100 to China OpCo.
3. China OpCo distribute a \$100 dividend to Foreign HoldCo.

Key Considerations

Statutory thin-cap rules.

Registration process for the loan

Build in necessary features to help the argument that the interest incurred is not capital in nature.

Foreign currency risk and economic risk

In many instances, a China OpCo may not have distributive reserves, therefore, this idea may have limited applicability.

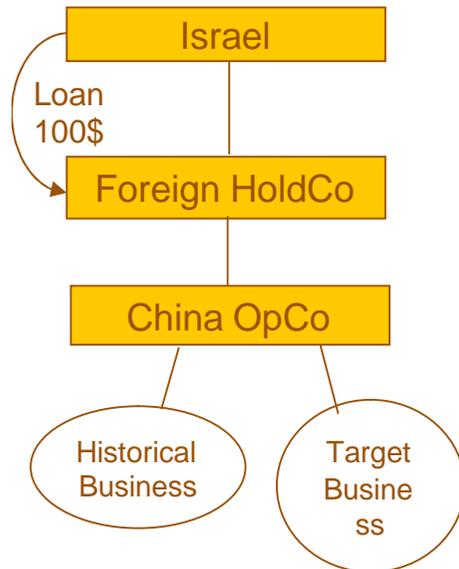
Key Benefits

Facilitates future cash distributions from China.

Provides opportunity to enhance exit strategy.

Introduction of internal debt into China.

Local Tax Reduction Strategies – *Chinese Debt Planning: Stock Acquisition in China*



* Loan can be extended also by an international finance company

Steps

Foreign HoldCo is funded with \$100 of equity.

Foreign HoldCo lends \$100 to China.

China OpCo purchases shares of China Target from Seller for \$100.

China Target merges upstream into China OpCo, with the latter surviving.

Key Considerations

Consider timeframe, regulatory formalities and government approvals for merger. Need a well-developed plan to proceed.

Merger accounting treatment is not well-defined, especially for an upstream merger.

Tax treatment of goodwill isn't well-defined, but a deduction may be possible.

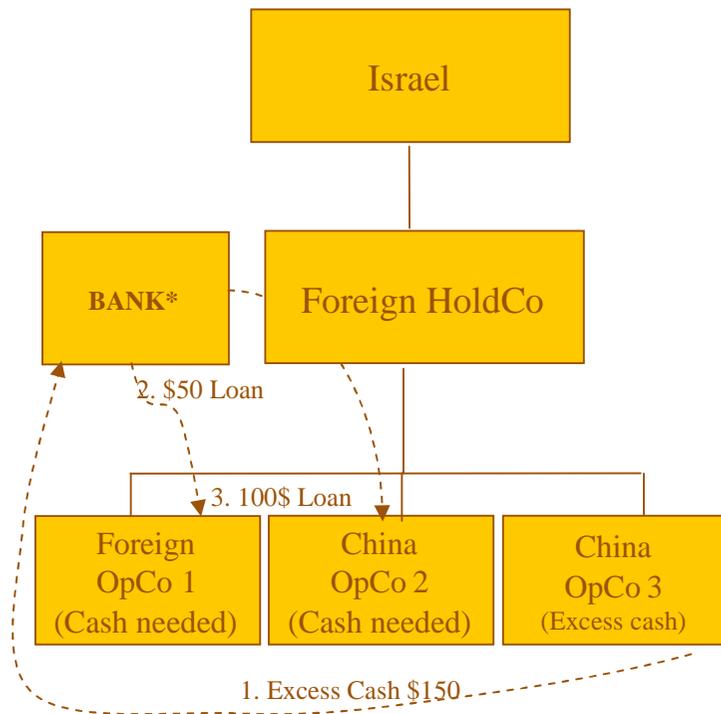
Key Benefits

Tax efficient use of internal debt to facilitate Chinese acquisition. Post merger, the interest expense should be deductible.

Allows tax-efficient redeployment of future Chinese cash via repayment of loan.

Local Tax Reduction Strategies – China Cash Redeployment

Techniques- Entrusted Loan Agreement



- * This bank can be a China bank or a western bank with a branch in China.
- ** Cross border entrusted loan agreements are subject to government approval.

Current State

A Chinese subsidiary with trapped cash enters into a trusted deposit/loan arrangement via a Chinese bank to channel the cash to the other Chinese or foreign affiliate requiring cash.

An intra-China entrusted loan is very common, while a cross-border arrangement is rare and subject to approval. (There are only around 10 precedent cases for cross-border loans).

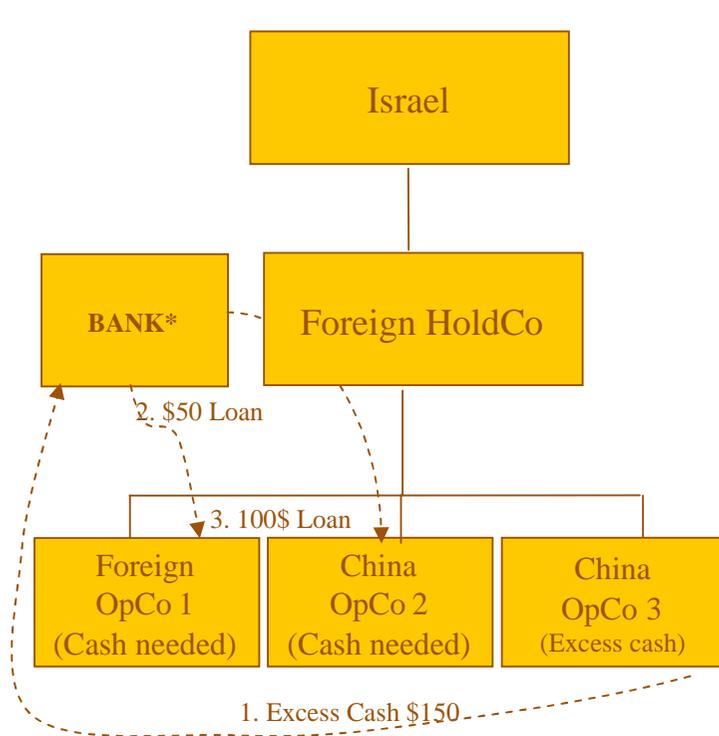
Steps

China OpCo 3 deposits its excess cash with a China bank or a Western bank's branch in China.

In exchange for a nominal fee (10-70bps), the bank makes the money available to China OpCo 2 or Foreign OpCo 1, a member of the same affiliated group as China OpCo 3.

- For a foreign affiliate needing the cash, the arrangement may require a western bank.

Local Tax Reduction Strategies – China Cash Redeployment Techniques- Entrusted Loan Agreement (cont'd)



- * This bank can be a China bank or a western bank with a branch in China.
- ** Cross border entrusted loan agreements are subject to government approval.

Key Considerations

Operational issues: include the right bank

Cross-border entrusted loan currently is only available to profitable companies and is limited to dividend potential.

China OpCo 3 is subject to business tax on the interest income.

Transfer pricing considerations exist.

Key Benefits

Allows tax efficient redeployment of Chinese cash.

May mitigate Israel's exposure to Israeli CFC for routing profits to China OpCo 2 and/or Foreign OpCo 1, via Foreign HoldCo.

M&A Considerations – Tax Considerations

- Complicated and sometimes confusing regulatory environment and tax rules
- Limited exit options and various restrictions
- Common tax due diligence findings
 - **Complicated or unofficial group structure**
 - **Aggressive tax planning schemes**
 - **Special deals with local authorities and unofficial local tax concessions**
 - **Delinquent customs duty and VAT of imported capital equipment**
 - **Statutory and management books and records**
 - **Income Tax & VAT compliance weaknesses**
 - **Unsupportable transfer pricing policy**
 - **Personal tax compliance weaknesses**
 - **Heavy penalty exposure and late payment surcharge on tax non-compliance**

M&A Transactions – Tax Considerations

- Transactional tax costs can be substantial
 - **Carefully structured in Sale & Purchase Agreement**
- Inherent PRC tax issues can erode value of the deal
 - **Tax Indemnity?**
 - **Escrow account?**
- Withholding obligation on capital gain by seller
 - **Tax Bureau may go after the target**

⇒ *Consider Tax Implications at an Early Stage*

Thank you

