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PRICEWATERHOUSECOOPERS 

# pwc: china compass

News for experts

**Hot topic** China and the financial crisis

**Taxes** Accelerated reform of turnover taxes

**Reporting and controlling** Legislation against money laundering

**Investment and financing** Renewable energy

**Publications** Emerging markets increasingly investing in Europe

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Dear reader,

In Hamburg people greet each other with 'Moin Moin', but also more and more with 'Nin Hao'. Hamburg's much-travelled (and far-travelling) business community has had close economic ties with the China for over 200 years. It is hardly surprising, then, that Hamburg, Germany's 'Gateway to the World', has become one of the most popular investment locations for Chinese enterprises. Hamburg has the longest and deepest tradition of economic relations with China in all of Europe.

For this reason and others, I am delighted to bring you the spring edition of your *pwc:china compass* from the Free and Hanseatic City of Hamburg. I have the honour of succeeding Harald Kayser as head of the China Business Group, and I would like to take this opportunity to thank him for his long years of dedicated work on China. Katja Banik and Ling Chen will be supporting me as Operations Managers in my new duties. To get an idea of who we are, just look under *PwC China Business Group* on page 46.

As attentive readers of *pwc:china compass*, you will notice other new faces there, too. As of now, our colleagues in Hong Kong and Singapore are part of the PwC China Business Group. The country offices in China, Hong Kong and Singapore have been operating on a combined basis since the end of 2008, reflecting the increasing importance and integration of this economic region. So with a total of 12,460 staff in 15 offices, PwC China is now more than ever your powerful local partner. To help you get to know us, we will be presenting a short profile of each member of the German Desk in China in this and upcoming editions. We begin with Claus Schürmann, Shanghai, on page 42. We look forward to hearing from you and offering our expertise through direct, personal contact with our specialist staff.

On 26 January, China celebrated the New Year of the Ox. Two of the many characteristics attributed to the ox are power and endurance. According to the Chinese view, this year is marked by traditional, down-to-earth values, or, in other words, 'doing your homework' and 'consolidating'. – China has also been hit by the economic crisis, but its opportunity for recovery may come sooner than for other nations. Here, you will want to read the insights of our Shanghai colleague Jens-Peter Otto in *China's economy in the Year of the Ox: no market for bulls* (p. 4) and the piece from Roland Spahr in Beijing entitled, *Financial risks of globalisation: China as example?* (p. 7).

Shortly after the Spring Festival on 29 January 2009, Chinese Prime Minister Wen Jiabao and German Chancellor Angela Merkel signed a series of bilateral agreements on economic and technological cooperation at the Sino-German economic summit in Berlin. I was impressed by the quality and relevancy of discussions in the individual working groups. The Chinese delegation included a number of high-ranking economic officials from our partner country. In her speech, the chancellor

underscored how welcome Chinese enterprises and sovereign wealth funds are as investors in Germany.

German firms are in demand, for example, for the Action Blue Sky initiative. What to Western ears might sound like the title of a Hong Kong kung-fu film is in China the slogan of a major campaign to highlight the importance and urgency of environmental protection. The Chinese government is providing far-reaching support for the development and efficient use of renewable energies. This is a sector which offers excellent opportunities to German enterprises in particular, enjoying, as they do, a worldwide reputation for cutting-edge technologies. Find out more about the framework for renewable energies in China and the attractive tax benefits and incentives for German companies in two articles by Jürgen Springer (p. 39) and Claus Schürmann (p. 17).

As you can see in the *Tax and legal* section, legislators have further fleshed out the tax reforms which came into force at the beginning of the year. The Jan. 2009 regulations define requirements for documenting transfer pricing that must be met for the first time by the end of the year, and also contain provisions to prevent abuse (e.g. by shareholder debt financing).

As the old Chinese proverb says, life should be handled with a smile or not at all. – On that note, we hope you enjoy reading and wish you every success in your business dealings. May fortune smile upon your activities worldwide!

Franz Nienborg

Member of the Executive Board  
PricewaterhouseCoopers AG  
Wirtschaftsprüfungsgesellschaft

### China's economy in the Year of the Ox: no market for bulls

The hot topic in this issue of *pwc:china compass* is the impact of the crisis in China's financial markets. While Roland Spahr's article *Financial risks of globalisation: China as example?* on page 7 analyses the financial crisis as a global phenomenon and sketches out a way forward, Jens-Peter Otto offers the perspective of a German living in China, with emphasis on the impact on day-to-day business.

Up until autumn 2008 many market commentators believed China would escape the consequences of the global economic crisis. Chinese banks had taken few risks with structured financial products and had far less exposure to write-downs than Western banks. A frequent remark was that Chinese growth in gross domestic product, which had consistently been in double figures for the past five years and stood at 11.4 percent in 2007, had become self-sustaining and was largely independent of other countries' economies. Since then it has become clear to everyone just how deceptive these hopes were.

#### Export sales collapse

The first sector to be hit was the labour-intensive and highly export-dependent toy and clothing industry, which is traditionally located in southern China. There were reports in the press of 3,600 factories in the toy industry closing in the first three quarters of 2008 alone. In total more than 60,000 small and medium-sized enterprises in the province of Guangdong had to close their gates, although the region also saw 100,000 start-ups. Then at the start of December the figures for the automobile industry were published, showing a decline of over 10 percent in November 2008 compared with the same month the previous year. Whereas the slight falls in previous months had resulted from the Olympic Games in August, the devastating earthquake in May and the snow storm in February, the significant drop in car sales since November 2008 is the clearest evidence yet that the global economic crisis has now hit China.

#### Economic forecasts lowered

Far from being decoupled from the rest of the global economy, China is in fact considerably more dependent on exports than many other countries. Exports account for around 40 percent of gross domestic product, roughly the same percentage as German exports, although 58 percent of these exports admittedly involved companies backed by foreign capital. In November 2008 Chinese exports fell against the previous year for the first time in seven years (down 2.2 percent), and this trend accelerated in the months December 2008 and January 2009. Imports slowed even further. For 2009 the Chinese government's target is 10.8 percent growth in the gross domestic product, and the World Bank's forecast is currently just 6.7 percent. Only the next twelve months will show whether these forecasts are still too optimistic.

#### In this article you will discover ...

- what impact the global financial crisis is currently having on day-to-day business in China;
- what action the Chinese government has taken to mitigate the consequences of the financial crisis;
- how the current crisis will impact the economic prospects of German companies in China.

As a result of the growth in the population and the migration of workers to the eastern industrial regions, all estimates agree that 7 percent growth is needed simply to keep unemployment from rising. In past months back-migration to the rural western provinces has already been observed following mass lay-offs particularly in southeastern China. The flood of migrant workers returning to their home provinces after losing their jobs in the coastal region is estimated at 9 million. According to state sources the financial crisis could cost China's export industry a total of around 25 million jobs in 2008 and 2009.

#### Comprehensive spending package decided

China's interconnection with the global economy is forcing the government to respond to the changes in global economic growth forecasts. Reducing the Chinese economy's dependence on exports in future is certainly a serious challenge. In order to secure its growth targets, the Chinese government decided on 9 November 2008 on a 10-point bundle of measures backed by a comprehensive spending package. The government's priority is to improve infrastructure, which should also ensure that the spending package will have a beneficial impact on the Chinese population. The government has already approved a total of 4 trillion renminbi, equivalent to 450 billion euros) up to 2010 for investment in the following projects, amongst others:

- 1.8 billion on road construction and energy supply
- 1 billion on infrastructure renewal in the earthquake region
- 370 billion on improving infrastructure in rural areas
- 350 billion on environmental protection
- 280 billion on improving housing
- 160 billion on research and development
- 40 billion on the healthcare system and education

The total amount is equivalent to around 15 percent of China's gross national product. Beijing is giving priority to ecologically-oriented projects to improve the infrastructure. These include biogas projects in rural areas, projects to improve water quality, new waste-water treatment plants, waste disposal and recovery measures and much more.

#### Fiscal and monetary stimuli

These measures are accompanied by fiscal and other economic stimuli. For example VAT payable on fixed assets from 2009 can now in most cases be deducted from input tax. Previously this part of VAT could only be capitalised and claimed for tax purposes when written off. The export tax refund rate has also been increased for just under 3,500 products. As you may know,

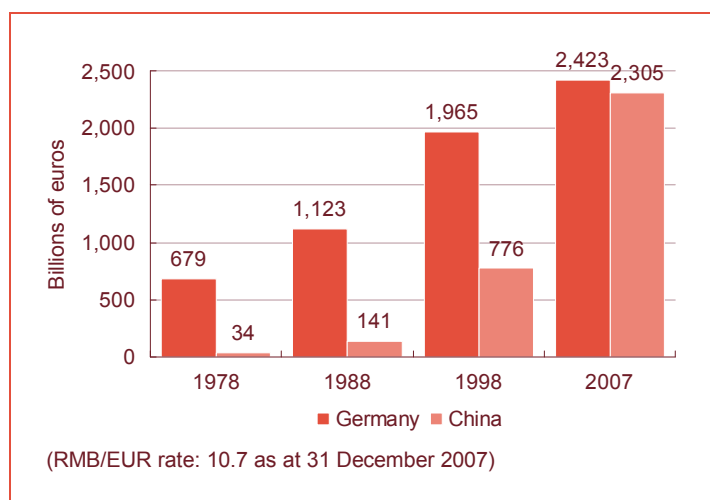
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it is a peculiarity of Chinese VAT that the Chinese VAT export refund system generally disallows full recovery of input VAT. Before the financial crisis the government had been lowering the refund rate in an attempt to stem the balance of trade surplus resulting from high exports.

In 2008 the Central Bank reduced the key interest rate from 7.47 to 5.58 percent in a number of stages. At the last stage, a reduction of 108 basis points in November 2008, China participated for the first time in a globally coordinated financial policy action, which is further evidence that China now sees itself as a player in the interconnected global economy. These interest rate reductions are not currently in danger of increasing inflation. Although the increase in prices was still 8.7 percent in February 2008, driven particularly by the rise in food prices but also the oil price, it fell again in November 2008 to just 2.4 percent and it stood at -1.6 percent in February 2009. This figure is also proof of the economic downturn. However inflation was still a sound 6.3 percent for the whole of 2008.

### Exchange rate losses affect consumer confidence

In the last 30 years China's importance as an economic power has increased by leaps and bounds since the start of Deng Xiaoping's economic reforms in 1978. In 2008 China was set to become the country with the third largest economy after the United States and Japan, displacing Germany from third to fourth place. In terms of economic power per capita of population, China's economy may still be much smaller than Germany's, but taken as a whole the economy's absolute significance is so great that it has a positive or negative effect on economic trends in larger national economies. Whereas China's contribution to world economic growth was a modest 8 percent just 20 years ago, in 2007 it was 26 percent.



### Comparative gross domestic product

The Chinese population's prosperity has also been dampened somewhat in recent months since the stock market collapsed. The Shanghai Composite Stock Index rose by 16 October 2007 to its

highest ever level of 6,092, tripling in value over twelve months, only to hover around 2,000 since mid-September. The ups and downs in the stock index clearly have an impact on the population's consumer behaviour, particularly because it has since emerged that a significant number of Chinese people had invested their savings in stocks to profit from the boom. Profits from companies registered in China with sales of over 5 million renminbi increased by 4.9 percent compared with the same period the previous year in the first eleven months of 2008. Joint-stock companies turned in a relatively successful performance with an increase of 11.4 percent whilst state enterprises saw a fall in profits of 14.5 percent. Average rises were still 36.7 percent last year. As a result of the poor market environment there are almost no initial public offerings taking place, although the agency responsible for oversight of the major state enterprises had in fact intended to make significant reductions in the number of companies it oversees. This development is certainly one more major reason for the cooling of euphoria in the stock market.

### Property price rises slow down

Property price rises have also slowed down in recent months. Despite this, however, any talk of the property bubble bursting is premature. In recent year prices shot up steeply in the large cities, although the price per square metre for an average apartment in Shanghai is still cheap in comparison with other global cities (though the quality of construction may not match that of those cities). It was perfectly possible to resell an apartment bought five years ago at twice the price. This is now a thing of the past. In order to prevent a collapse of the apartment market the Chinese Central Bank has decided to reduce the equity-to-assets ratio required when taking out a loan from 30 to 20 percent. The empty property rate for prime office space in Shanghai rose in December 2008 to over 15 percent, particularly as a result of the recently completed buildings in the Pudong district. Just over 40 percent of the new prime office space has so far been absorbed by the market.

### China's course over the next few years

The bad news over the last months is putting a severe strain on China's credibility as an economic power. To overcome the challenge it will be important for the government not to lose sight of the long-term goal of opening up China, but instead to pursue that goal unerringly even in difficult times. The government will certainly keep on track with the transformation to a market economy. But further deregulation and the roll-back of the state in the business sector is essential if the private economy is to become a strong driver of social and economic development. Routes the government is likely to take are to dissolve existing state monopolies and shift further state enterprises to the private sector to give the Chinese middle-market businesses a fair chance of entering the competition. This development may ultimately reduce the export dependency mentioned earlier because it will stimulate private consumption. Increased production of better quality goods is also a promising route. The

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other states will need to adjust to the fact that China will use the currently low price of commodities – and companies – to go on a global shopping spree. With around 2 trillion US dollars in foreign currency reserves at the end of 2008, there are plenty of funds for this. – If the Chinese government takes a decisive approach to these middle- to long-term goals, China may even emerge permanently strengthened from this crisis. However at the moment the priority must be just to get out of the current situation in one piece.

### Prospects for German companies cautiously optimistic

The start of the Year of the Ox on 26 January 2009 was therefore anything but promising. The impact of the global economic crisis on German companies in China has been very varied. Many of those which have only in the last few years established their business, are still expecting growth driven by the expansion of their market share, albeit with considerably dampened prospects. Providers of infrastructure equipment and their suppliers may be pinning their hopes on the measures decided by the Chinese government and referred to above. It remains to be seen whether providers of high-end products will be able to continue increasing their market shares in China. So far the high-quality segment has been the area in which foreign companies have differentiated themselves from their Chinese competitors. But price is also a significant differential between high-end products from foreign providers and products from the Chinese competition. China's economy is responding in two ways. On the one hand, the administration is trying to increase domestic production of higher-value goods to avoid being squeezed out by countries with even cheaper workforces, such as India or Vietnam, following recent significant increases in domestic wages. On the other hand, in times of crisis consumers are generally very wary of buying expensive alternatives. Over the long term, however, prospects for German companies remain good and the current situation may even offer opportunities for strategic acquisitions at moderate price levels.

### Cautious approach advised

In the short term, a cautious approach is advisable, and a close eye should be kept on the viability of local business partners. This is easier said than done since reliable financial information about suppliers, clients or independent dealer networks is not always readily available. A very proactive approach to monitoring liquidity bottlenecks in Chinese subsidiaries is also required since the strict management of foreign currency rates in China places very tight restrictions on the use of short-term company loans for interim financing.

### Cost control and corporate governance in demand

Chinese companies' performance will show whether the restructuring and privatisation of former state enterprises have been successful. In recent years Chinese companies, with their strong focus on the domestic market, have been lulled into a false sense of security by strong domestic growth with year-on-year increases in sales. In these times of economic crisis with falling sales, strict cost controls are required. Chinese companies have tended to neglect cost control, the reliable internal financial controls it required and corporate governance. If traditional Chinese companies want to survive long-term in the market, the economic crisis should therefore be a welcome incentive to make significant improvements in this area. There will be plenty of opportunities for this from July 2009 when the new rules on internal control systems (comparable to the US Sarbanes-Oxley Act) kick in, at least for publicly listed companies. However, as in all sectors in China, here too there is a healthy amount of scepticism about implementing these regulations. It remains to be seen whether the intended impact can in fact be achieved. – But who knows, perhaps the financial crisis will be sufficient incentive to ensure that these rules are implemented more consistently than in the past. – You can also find out more in the second article by Jens-Peter Otto, *China introduces legislation on internal controls*, on page 12.

In any case your *pwc:china compass* will continue to update you on the success of the measures and hopefully the positive impact of the Chinese recovery package.

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### Financial risks of globalisation: China as example?

A comparison over the last eleven years reveals stock markets in globally networked countries are less volatile in periods of economic security than those in less globalised countries. Stock markets in countries wanting to make huge strides in opening up to the globalised countries pay for this with significantly higher levels of stock market volatility. China is a good example of this. However, in periods of global financial insecurity, such as during the 1998 Asian crisis, after the attacks of 11 September 2001 and the 2002 Enron scandal or in the current crisis, globalised countries no longer have the advantage of financial security. Despite previous efforts to deregulate national markets, standards which can provide adequate levels of security not just in the good times but also in bad times are now overdue for all countries. It is clear from the current financial crisis that China has effective rules from which other countries can learn. – This article develops constructive proposals based on three core arguments which are analysed in detail.

Over recent years the view has become established that globalisation is a key driver in the transfer of knowledge, regulations and standards within the financial world from more developed Western countries to the rest of the world, creating greater transparency, confidence and reliability in global financial markets and ultimately leading to lower volatility of financial products. A group of economists in the International Monetary Fund headed by Ceyla Pazarbaşıoğlu found in their study *The Changing Face of Investors* (2007) that globalisation has had a positive impact on stability reflected in decreasing bond spreads in emerging countries, and lower levels of capital flow volatility and decreasing volatilities of bonds, shares and foreign exchange rates. As early as 2004 Ben Bernanke, who is now, as you know, Chairman of the US Federal Reserve, was already referring to this increasing stability of financial markets as ‘the Great Moderation’ which was probably made possible by the many positive effects of globalisation such as greater openness, deregulation and transparency of global markets.

#### The arguments

Stability is a cornerstone of a strong and well-functioning economic system both from a local and a global perspective. Stability allows all those involved to plan and invest and opens up opportunities for all parties to be assisted to achieve greater prosperity. In this view deregulation of the markets is seen as the means by which stability can be achieved. The recent past has however shown that increased self-regulation in global markets involves not just opportunities but also enormous risks, which means that standards must be improved for all financial markets. At the meeting of the 20 largest economies (G20) in November 2008 in Washington the nations began to develop more rigorous rules and standards which will be binding on all.

#### This article explains ...

- why financial markets in highly globalised countries have low levels of volatility in periods of economic normality and high volatility at times of exceptional economic conditions;
- the correlations between globalisation and risks;
- what lessons can be drawn from the financial crisis and how China can be an example for the West.

In support of the case for improving standards for market participants and financial products, this article compares countries’ efforts to become more open and more deregulated with the financial risks faced by their stock markets. Generally, globalised economies tend to have more open and deregulated markets. This suggests that their financial markets are therefore perceived by market participants as more liquid and more secure. This results in less volatile markets. So argument A states that economies that are more strongly integrated globally will have less volatile stock markets.

As a country’s level of globalisation continues to rise – so the argument goes – this poses considerable risks for the country, particularly since liberation from old rules in favour of less market regulation means users are faced with challenges which may lead to poor investments and unpredictable reactions. Their lack of experience may well create a situation where there is excessive speculation, uncertainties and risks which are expressed in higher levels of volatility. Argument B sums this up concisely: The degree of volatility of a country’s stock market is in direct proportion to the speed with which the globalisation process is driven forward.

Globalised economies are likely to be superior to others in terms of their standards and rules in global crises. These countries ought therefore to be havens of safety and confidence when global crises increase market volatility. This gives rise to Argument C: Economies that are more strongly integrated globally will have lower levels of stock market volatility in periods of global crisis.

The analysis below investigates these three arguments. Based on the findings of this analysis, the article then goes on to make recommendations for improving financial systems.

#### Data sample and preparation

To determine the level of globalisation we have used the KOF Index of Globalisation of the Swiss Federal Institute of Technology, Zurich, which measures several dimensions on a yearly basis for 122 countries for the period between 1970 and 2005. The overall Globalisation Index is derived as a weighted average from three main dimensions, namely economic, social and political, further divided into sub-indices.

Risk is measured by the volatility of a representative stock market index of a country. We initially calculate averages and standard deviations based on the daily closing prices from one year. We then derive values-at-risk on a 99.9 percent confidence level,

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assuming a standard normal distribution of the closing prices, from the mean and standard deviation. The value-at-risk for each country in each year is compared with the annual average of the Index. This eliminates the effect of specific dimensions so that the final Risk Indicator is standardised and can thus provide a more accurate comparison with other countries.

The final set of data includes the KOF Index of Globalisation from 1994 to 2005, and the yearly Risk Indicator from 1998 to 2008 for 27 countries. The box below shows which countries are listed in the KOF Index and which country index has been used for the KOF Index in each case.

### KOF Index countries and country index used

Argentina (Merval), Australia (All Ordinaries), Austria (ATX), Belgium (BEL-20), Brazil (Bovespa), Canada (S&P/TSX Composite Index), China (Shanghai Composite), Denmark (OMX Copenhagen 20), Egypt (CMA Gen.), France (CAC 40), Germany (DAX), India (BSE 30), Indonesia (Jakarta Composite), Israel (TA-100), Italy (MIBTEL), Japan (Nikkei 225), Malaysia (KLSE Composite), Mexico (IPC), Netherlands (AEX), Norway (Total Share), Portugal (PSI 20), Russia (RTS All), Singapore (Strait Times), South Korea (Seoul Composite), Sweden (OMX Stockholm 30), United Kingdom (FTSE 100), and United States (S&P 500).

### General global trends

Figure 1 shows the historical development of the Globalisation Index and Risk Indicator as an average across all 27 countries. Average globalisation has increased throughout the decade but with a slowing-down in recent years. This trend suggests that the world is stabilising around a certain level of globalisation.

The development of the average Risk Indicator is however more volatile. Global volatility peaks can be rationalised by the Asian crisis (1998), declines in the global business economy (2002 and 2003) and the global financial crisis (2008). The low point in 2004 was celebrated at the time by champions of deregulated financial markets as the 'Great Moderation'.

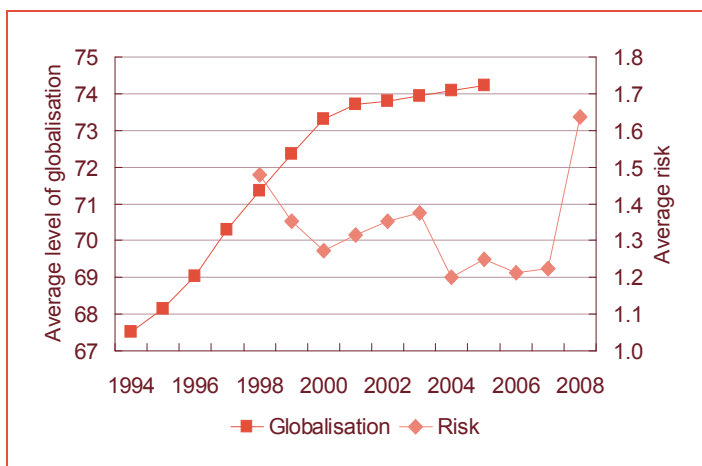


Fig. 1 Average globalisation and risk across all countries

### Country-specific globalisation and risk

In order to provide a robust indication of the relationship between Globalisation and Risk within the time frame in as universally relevant a way as possible, we have applied a weighted average of Globalisation Index and Risk Indicator for each country for twelve (GI) or eleven (RI) years (please see the box). Their relationship is shown in Figure 2.

### Weightings in the Globalisation Index and in the Risk Indicator

The Globalisation Index (GI) was available for each country in the sample for all twelve years observed. A weighted average was obtained for the Index. The GI for 1994 was weighted by 1 and the GI for 2005 was weighted by a factor of 12. The Risk Indicator (RI) was available for 11 years for every country. The RI from 1998 was weighted by 1 and the RI for 2008 was weighted by a factor of 11. The Globalisation Index was found to be highly intra-correlated: Even with a time lag of five years, the average intra-correlation of GI is still +0.975. We concluded that the weighted average Globalisation Index from 1994 to 2005 available from the sample can equally well reflect the current status of globalisation with only minor deviations.

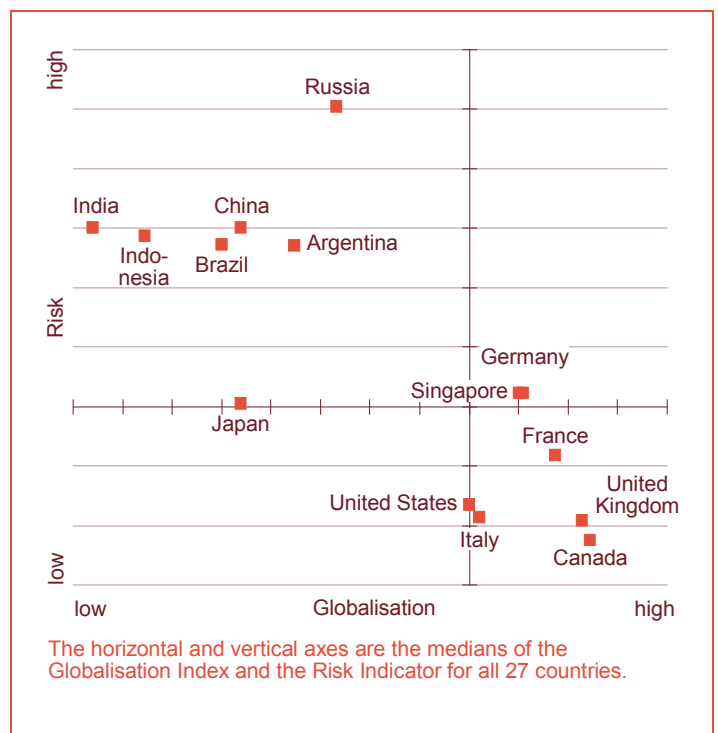


Fig. 2 Globalisation and financial risk

Figure 2 clearly shows that there is a negative correlation between the level of globalisation and the level of volatility in stock markets. This finding supports the above assumption that countries with higher levels of global integration tend to have more mature, sophisticated and highly developed economic systems and open, liquid financial markets. This ultimately creates confidence and can reduce volatilities in local stock markets. Argument A is validated thus far.



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The group of countries with a low level of globalisation, which tend to be more risky, includes countries from Asia and South America plus Egypt. The group of highly globalised and less risky countries includes Western countries from Europe and North America plus Australia. Kose et al. (2007) argue in their study *Financial Globalisation: Beyond the Blame Game* that more developed countries have more stable financial markets because of their greater size and experience, whereas less developed countries often suffer from sudden economic changes, for example in the direction of capital flows, which tend to induce or exacerbate boom-bust cycles in the local economy.

The analysis revealed that China and Germany are countries with relatively volatile stock markets compared to other group members from Asia and Europe respectively. Overall, Germany ranks towards the middle of the table. In Asia, only Russia has a higher risk indicator than China. India is ranked level with China although China's level of globalisation is higher. Figure 3 and Figure 4 draw a comparison between Germany and China.

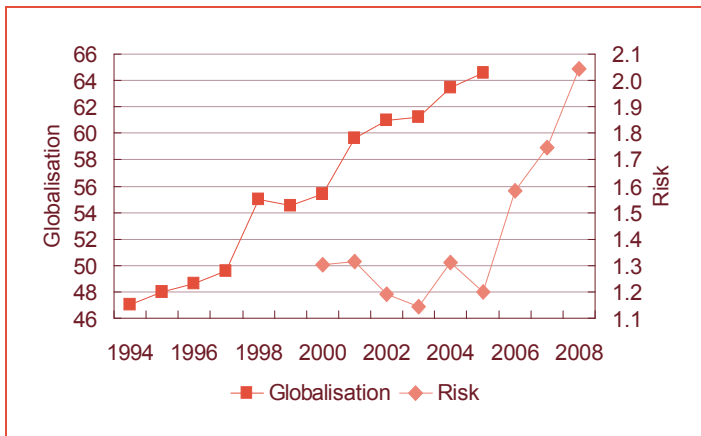


Fig. 3 Globalisation and financial risk in China

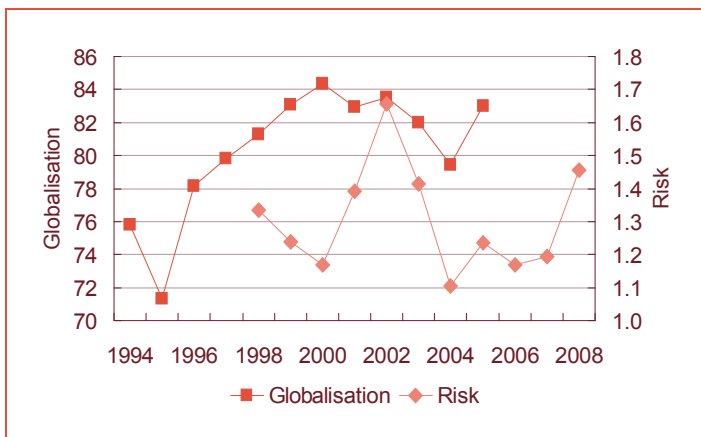


Fig. 4 Globalisation and financial risk in Germany

In China, globalisation has increased dramatically over almost all the twelve years. However in Germany there are signs that globalisation has reached saturation point at a high level. Risk in

China has increased particularly sharply since 2006. Risk peaked in Germany in 2002. Since then it has fallen sharply. Even in the current financial crisis the Risk Indicator has not risen to a new peak as can be seen from Figure 3.

The Chinese stock market is a relative newcomer, is relatively small and includes a large number of inexperienced market participants. The steep rises in share prices since 2006 were also caused by the lack of experience of those involved which led to further assumptions that the Chinese government would buy up shares to stop prices falling or even enact legislation to prohibit this. The dramatic rise in performance on the Shanghai Stock Exchange can be understood as a rush to catch up with global developments on the stock market but also as an expression of excessively high expectations for the future. Excessive levels of confidence in the Chinese stock market were then dashed too quickly. It remains uncertain whether further capitalisation and deregulation could have mitigated this trend. The potential impact of even more deregulation in even shorter time is open to debate. – Does the level of the globalisation process impact on risk? The following section deals with this question.

### Process of globalisation and risk

In order to investigate the effects on risk of a change from one level of globalisation to another, we examined the slopes of linear regression curves for the Globalisation Index and the Risk Indicator over the period.

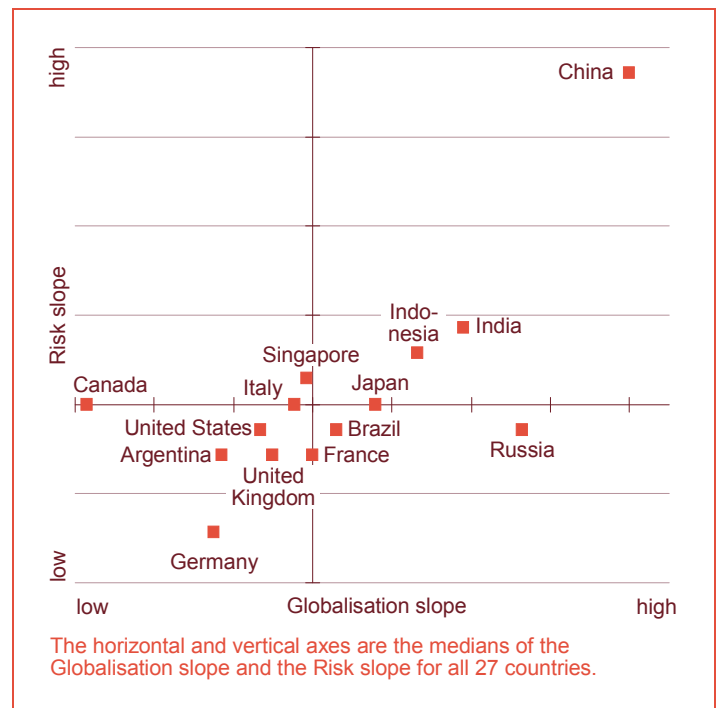


Fig. 5 Slopes for globalisation and risk

Figure 5 shows the relationship between the slope for the globalisation process in the countries investigated and the

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corresponding slopes for the Risk Index. The Globalisation Index is again strongly correlated with the Risk Indicator, but in this case the correlation is positive: the more efforts a country made to open up to world markets and cultures, the greater the increase in volatility in its domestic stock markets. It follows from this that the globalisation process can also involve additional financial risks. From this perspective China has by far the highest increase in risk. This positive correlation raises the question of whether a more rapid opening up of the Chinese market might have reduced the risk or whether it might instead have plunged the stock exchanges into an even greater disaster.

Only the small country of Malaysia just outstrips China in its progress towards globalisation. With the exception of Singapore, Portugal and Israel, the Asian countries show large increases in their level of globalisation and a slight increase in risk. Germany is in the pool of saturated countries and no significant increases or changes in risk can be detected. – As you can see, Argument B is also validated thus far.

These results are trends that are derived from the entire eleven and twelve year periods. Against the background of the current global financial and economic crisis the broader question arises of whether these relationships also apply in periods of crisis. The next section will answer this question.

### Globalisation and risk in times of crisis

The table shows the average correlation between the Globalisation Index for the twelve year period with the Risk Indicator for a specific year. For the six years 1999, 2000, 2003, 2004, 2006 and 2007 the results support Argument A. However this correlation is missing in the four years 1998, 2001, 2005 and 2008; and 2002 even shows a reverse (the only year in which this occurs): In 2002 the stock markets were considerably more volatile in globalised countries. – Argument C is therefore false. 1998 was the second year of the Asian crisis. 2001 and 2002 were years of instabilities and consolidation in global economies; 2001 was the year of the terrorist attack on the World Trade Center, effectively a symbol for an attack on the entire American system, and 2002 saw accounting scandals and company collapses which led mainly in American companies to increased concern over corporate governance which caused stock market volatility to increase. And finally 2008 will go down in history as the year of the financial crisis that introduced a huge crisis in the global economy.

A glance at these crisis years reveals how fragile the superiority of the strategy of free and open, i.e. globalised, markets has been in the past eleven years and how little protection it has offered

market participants globally. In the short term it even led to an inferiority compared to countries with a lower level of globalisation, as can be seen in 2002. Since the vaunted advantages of open, free and unregulated markets provide no visible protection in times of crisis, consideration should be given to improvements to systems which, far from leading to protectionism, can create more security, cushion crises or even prevent them altogether, and thus better promote the wellbeing of all concerned. Until huge improvements are made in this area all market participants must make better and more comprehensive provision for times of crisis than ever. The concluding section provides proposals on how to increase financial market security over the long term and describes measures companies can deploy even today to improve their crisis planning and overcome crises by arranging their financial transactions to promote more sustainable planning.

### Proposals for creating more stable financial environments

One feasible option could be to establish state-financed Risk Funds throughout the world which would focus on payments of credits and all investment types using countercyclical taxation to reduce the financial economy's vulnerability to risk. These funds would be used in a similar way to the economic policies currently being implemented by nations globally to mitigate the consequences of the global economic crisis. China is one of the few countries that have a state fund financed from trade surpluses. Despite other potential structural weaknesses, this is a particular strength of China's. Western countries, in particular the United States, finance their economic policies through increased borrowing, thus deferring the problem of repayment and burdening future generations with increased taxes and the competitive disadvantages this will entail. In this respect China should be taken as an example to emulate. The key characteristic of the Governmental Risk Fund proposed is that it would be financed by a tax on all loans or investment transactions and cover the systemic risk that is revealed when the entire economy is going in the wrong direction. Taxation is designed to be countercyclical so that in the event of excessive increases in market rates the associated risks of equally excessive market consolidation can already be offset in the growth phase by higher tax rates, and the volatilities of the financial market counteracted.

Consideration should also be given by regulators to the creation of comprehensive global quality standards for financial innovations. Self-regulation has shown in the past that standards have mainly been used to increase efficiency in trading. However, analysis from crisis periods was often excluded from this analysis. If the transparency of financial institutions in relation to liquidity and capital is to be ensured in the long term it must be possible to value financial

Year	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Correlation	-0.252	-0.649	-0.747	-0.231	+0.465	-0.598	-0.524	-0.393	-0.616	-0.707	-0.312
N = 27, significance level of one-sided t test < 0.1%/1% for absolute value of correlation >= 0.568/0.445											

Tab. 1 Average correlation of the Risk Indicator for each year

## Hot topics

products even in times of crisis. This requires the imposition of appropriate standards on financial institutions. The China Banking Regulatory Commission was criticised for many years for its restrictive policy on financial innovations. Today this has become a blessing for the Chinese banking community since the problem of structured financial derivatives which are now impossible to value has largely passed it by. The crisis has shown that it is not desirable at a global level for institutions to bring a succession of new financial products to market without controls. After all, we do not build houses until we are sure that their construction can withstand all conceivable vagaries of the weather. The same should apply to financial products. Over the coming months international and national organisations will develop new standards which will then apply in the financial world.

Analysis has shown that enterprises cannot count on stable financial systems even in highly globalised countries and should not expect that the experience of this crisis will make it possible to avoid future ones. Rather, enterprises themselves must operate comprehensive risk provision schemes if they want to withstand this and successive financial crises.

Good risk provision is rooted in the consistent application of appropriate risk management methods developed by the financial sector over the past few decades. Priority should be given to stress test methods, particularly since globalisation creates systemic risks which increase financial market volatility. Financial institutions must be in a position to visualise and mitigate a worst case scenario, such as the current global recession, through its capital and liquidity reserves. Robust stress tests capable of making reliable predictions require the most comprehensive cash-flow data basis possible and an underlying cash management system as well as realistic assumptions for the scenario.

In addition, a forward-looking crisis management system that covers all potential aspects of a crisis and their prevention or overcoming and is in constant dialogue with the Board will prevent company and financial management systems that are too risk prone and will ensure that the company survives the crisis.

It remains to be hoped that the rules and standards currently in development will at least prevent the mistakes of the past being repeated and thus ensure the sustainability and stability of both individual companies and the global network of financial systems, to the benefit of all involved.

Do you have any questions or are you interested in the details of the study? If so, please call us or simply send us an e-mail.

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## China introduces legislation on internal controls

Five Chinese industry regulators have issued joint instructions on internal controls, representing a new initiative to put Chinese business practices on a sound footing. The Chinese Ministry of Finance, the National Audit Office, the China Securities Regulatory Commission, the China Banking Regulatory Commission and the China Insurance Regulatory Commission have launched a Standard requiring listed companies from 1 July to comply with certain principles when setting up internal control systems. This article presents the Standard, which will be supplemented by further implementation guidelines.

Even before the recent publication of the new Standard, guidelines were already in place on establishing an internal control system (ICS) in China. They failed, however, to prevent a series of cases of fraud and corruption – some of alarming proportions – which brought the entire stock market in China into disrepute. Only recently was Huang Guangyu arrested; reportedly China's richest man with an estate estimated at roughly five billion euros, and the founder of Gome, the largest listed chain of electronics stores in China. He was charged with share manipulation and bribery. A number of other businessmen are suspected of embezzling significant assets.

In China corruption and bribery of the regulatory authorities are not uncommon. For example, the former head of the Chinese Food and Drug Administration was sentenced to death in 2007 on corruption charges. He was found guilty by a People's Court of granting approval to medicines which had not been fully investigated in exchange for gifts and bribes. The China Securities Regulatory Commission (CSRC) reported in its China Capital Market Development Report published in 2008 on significant problems relating to corruption and embezzlement on the stock market and announced its intention to raise corporate governance standards for joint stock companies as well as the corporate ethics of all involved in trading on the financial markets.

Since 2006, the ICS of a company seeking approval of an initial public offering must first be audited by an external auditor. However, this is limited to a one-off audit prior to listing. The 2001 Code of Corporate Governance sets out high ethical principles that are not just binding for management and the Boards of listed companies, but also for affiliated persons and shareholders.

The internal control framework under the new Standard consists of standards which are broadly consistent with the principles laid down by the Committee of Sponsoring Organisations of the Treadway Commission (COSO) in 1992 (Internal Control – Integrated Framework ) and 2004 (Enterprise Risk Management Framework ): these relate to the company's control environment, assessment of business risks, control activities, information and communication and supervision of the control system. It is also

### This article explains ...

- why a regulatory framework for internal control systems that is comparable with international standards is urgently needed in China;
- what the guidelines require from listed companies;
- for whom the standards are binding and how they might affect German companies, too.

the declared aim of the new ICS Standard to safeguard company assets. There is an explicit requirement for the establishment of anti-fraud controls, a fraud reporting mechanism and means to protect whistleblowers. The Chinese Standard is thus more extensive than even US and Japanese guidelines on internal controls.

The new Standard emphasises that responsibility for the internal control system lies with the Board of Directors. It must undertake an annual self-assessment of the effectiveness of its ICS and disclose its findings in an annual report. The Standard requires an audit committee to be established and to be responsible for monitoring the effective operation of the ICS.

Currently the external auditor is not required to audit compliance with these new regulations. However, any public accounting firm that is commissioned by a company to conduct an audit of the ICS and issue an opinion is required to include in that opinion a statement on whether the regulations contained in the new ICS standards have been complied with. Such audits may only be commissioned from public accounting firms that have received accreditation from the Chinese Stock Exchange Regulator, such as PricewaterhouseCoopers China.

An effective ICS cannot be set up overnight. The CSRC document therefore sets a deadline of 2020, by which time it would like to see the Chinese capital market achieve global market levels with Chinese companies becoming 'world class players' as a result of the new Standard.

The new regulations currently apply to 1,700 listed companies, which represent only a small proportion of the Chinese economy. The desired expansion to the private economy and state enterprises will only be achieved in the very long term, even if the regulatory bodies encourage unlisted companies to adopt the Standard. Since the financial year for Chinese companies is aligned with the calendar year, the 2009 financial year will be the first to see the regulations enforced.

Many German companies have entered into joint ventures with Chinese partners. Where the Chinese party is listed on the stock exchange it may well be that the joint venture also has to meet the ICS Standard. Even where affiliates of foreign companies are not bound by this ICS Standard, the companies affected would be well advised to subject their own internal control systems to close scrutiny. This is because even for German companies in China,

there is a high risk of assets being damaged as a result of fraud, embezzlement or corruption, as the PwC study *Economic crime: people, culture and controls – The 4th biannual Global Economic Crime Survey* made clear in 2007.

If you have any questions or would like us to advise you, please call us or simply send us an e-mail.

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Do you know who founded the renowned Tongji University in Shanghai?

It was founded in 1907 by the German doctor Erich Paulun as the Tongji German Medical School, and renamed National Tongji University in 1927. Our colleague and long-time author for *pwc:china compass* Jens-Peter Otto gives lectures to Chinese students there today.

(<http://de.wikipedia.org/wiki/Tongji-Universität>; Hans Hauenschild, China Takeaway, *Econ* 2007)

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## Anti-money laundering: still a long way to go for China

According to expert estimates, up to 10 percent of money in worldwide circulation has its origins in crime, and two to five percent of world GDP can be attributed to this kind of illegal activity, making money laundering the world's 3rd largest business after oil and foreign exchange. China is currently particularly vulnerable due to her rapid expansion, as the development of robust systems of risk management and control lags behind the effervescent and rapidly expanding economy. This article by Forensic Services experts Jean Roux and Lars-Heiko Kruse reports on what companies invested in China ought to know.

### This article explains ...

- what China has already done in order to effectively monitor the flow of capital;
- which weaknesses in the prevention of money laundering in China were found according to the FATF report;
- what companies in China should look out for in the fight against money laundering.

As China's market opens up and trade becomes ever more globalised, the flow of funds between organisations has become increasingly complex and difficult to monitor. This presents significant opportunities to money launderers, those organisations and individuals that manage the flow of funds from illegitimate sources through to the legitimate economy.

### Harmonisation with international standards

China has proved that its legislation meets the required standards to warrant admission to membership of the Financial Action Task Force (FATF) in June last year. The FATF is an inter-governmental body whose purpose is the development and promotion of policies to combat money laundering and terrorist financing. In 1990 the FATF published 40 Recommendations which constitute global best practice for combating money laundering.

However, developing appropriate legislation is only the first step in controlling the expanding money laundering industry. The Chinese government needs to enforce compliance with the requirements, as well as develop appropriate systems for monitoring and preventative penalties for violation. Meanwhile, it is the responsibility of the institutions concerned to make sure that they fully understand the requirements of the law, and have implemented appropriate systems to comply. Furthermore, the FATF made a number of key recommendations to the Chinese legislators in its 2007 report, which are likely to eventually be enshrined in law.



# Reporting and controlling

Forward looking organisations should also develop their AML processes in order to comply not only with the current law, but with global best practice and likely future regulations.

In order to make it clear just how great a challenge the global phenomenon of money laundering is for all traders, this article focuses on two key areas where significant problems were identified by the FATF, characterises their weak areas and sets out other important requirements, without which an effective combating of money laundering is impossible.

## Customer due diligence

Customer due diligence is a key part of developing a robust anti money laundering system. This involves the concept of 'knowing your customer', ensuring that the customer is appropriately identified with original documentation and that the institution has an understanding of the nature of business and the source of the money of their customers. Nearly 50 percent of violations of the money laundering law documented in the FATF report were in relation to failure to meet customer due diligence requirements. Although the seriousness of each of these violations was not disclosed, these figures reveal that financial institutions have significant failings in this area.

The FATF also recommended some specific areas of best practice, in order to fully comply with their requirements, for example:

- appropriate identification of legal representatives of companies
- a continuous, risk-based and enhanced legitimisation of politically exposed persons
- solid rules for additional customer assessment during occasional or one-off transactions

Furthermore, a specific recommendation was made that any failure to meet CDD requirements should be reported as a suspicious transaction to the appropriate authorities.

## Reporting of suspicious transactions

Another area which is fundamental to the overall anti money laundering strategy is reporting and investigation of suspicious and unusual transactions. Although financial institutions are required to do this by law in China, the FATF have highlighted some basic barriers to the effectiveness of this reporting. Over 8 million suspicious transaction reports were made between 2004 and 2007 in Germany. In comparison, there were only 35,434 reports of suspicious transactions in Germany over the same period, with 28,504 of these falling on banks.

The lack of discretion in reporting highlights a key problem in the effectiveness of suspicious transaction reporting in China. It is so prescriptive that it is seen as process rather than judgement. This can thus mask real failures in the internal control system or inadequate training in AML techniques, and can waste vital resources that could be spent identifying more pressing issues.

Further to these specific areas, over 25 percent of failures of the law identified in the report relate to inappropriate keeping of records, and 12 percent of violations related to failure to meet appropriate standards of internal control, mainly in relation to inadequate experience of obligations and poor training. Additionally, the law has not yet been expanded to include specific requirements for non financial institutions.

## Own initiative required

Whilst China clearly recognises the importance of implementing a strategy against money laundering, and has taken the first steps in putting this in place, it is evident that the long haul has only just begun, and there is still a long way to go. As the law develops and the regulatory system becomes clearer, better resourced and more effective, it is essential that the relevant institutions maintain a watchful eye over their compliance requirements, learn from experience elsewhere, and continuously reassess their money laundering prevention strategy.

In the meantime, Germany has been able to implement a riskorientated money laundering prevention system, based on an anti money laundering threat analyses. Because only by identifying company-specific risks over the course of a groupwide integrated analysis, companies are able to develop effective and tailor-made prevention measures.

If you would like to seek advice or are interested in further information, please feel free to contact us by phone or e-mail.

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## Insight into company chops (seals) in China

To many Western companies entering the East Asian market, the use of chops is often an alien concept. In China, chops have been instrumental in commercial and governmental transactions since imperial times. While in the West, the trend has moved towards the use of signatures as a means of validating a document, or binding a contractual relationship, in China the chop remains the primary tool for these purposes. A chop serves as a signature stamp representing a legal entity or a natural person, and performs similar functions as the signature in Western organisations. – This article will show what companies should look out for when dealing with chops.

Once a company is successfully registered with the local Administration of Industry and Commerce, it can apply for its Company Official Chop from the local Public Security Bureau (PSB). All Company Official Chops must be approved by the PSB with a specimen of the stamp registered with the PSB. The specimen stamp can be used by the PSB to determine the authenticity of a Company Official Chop stamp in the event of a dispute arising.

There are also specific regulations in place regarding engraving and use of chops, issued directly by the State Council. These regulations strictly specify the shape, size and design of chops for legal entities and organisations.

### Types of chop

A legally registered company in China is required by law to have at least a Company Official Chop in order to conduct its business activities. It is also general business practice to create various chops to serve different business requirements. These chops have several restrictions on use, depending on their type. Listed below are some chops commonly used by companies in China:

#### 1. Company Official Chop

The Company Official Chop is the most significant chop in the company, providing the bearer the authority to conduct business activities on behalf of the company. Technically, anyone who has possession of the Company Official Chop can legally bind the company. The Company Official Chop is required on all official business documents such as contracts, internal/external memorandums, bank account applications and documents filed with government before they are deemed valid.

### This article explains ...

- the different types of company chops;
- which criminal activities companies should protect themselves against;
- which internal controls have proved effective protection.

#### 2. Legal Representative Chop

The Legal Representative Chop represents the signature (i.e. the authority) of the company's designated legal representative, which is filed with the Administration of Industry and Commerce, the government body responsible for the administration of the industrial and commercial sectors. In most cases the legal representative of a company is the Chairman of the Board or the CEO/General Manager. The Legal Representative Chop, usually in combination with the Company Official Chop, is required for numerous legal and official documents, for example, applications for business licenses and tax certificates.

#### 3. Finance Chop

The Finance Chop is used predominantly for a company's financial transactions. It is generally required for banking transactions such as cash withdrawals, wire transfers or changes to account information. The Finance Chop is usually delegated to and controlled by the Finance Officer of a company for conducting daily financial transactions. The company's banks also keep a specimen stamp of the Finance Chop to verify the company's documents presented to the banks, for example bank cheques.

#### 4. Contract Chop

The Contract Chop can be used in place of the Company Official Chop to execute contracts, but is limited to this purpose alone. A company can also have various contract chops which are only valid for specific types of contract.

#### 5. Human Resource Chop

The Human Resource Chop can be used for all Human Resource activities including signing labour contracts with employees, authenticating employment verification letters, registering employees with government bodies and issuing internal memos.

#### 6. Tax Invoice Chop

Some companies (especially in retailing and catering industries) have a Tax Invoice Chop, specifically for the purpose of validating their Tax Invoices.

### Fraud risks

Although some people perceive that chops can be easily fabricated and are thus susceptible to fraud, in reality the risk of this is similar to that of signature fraud, in that forgery of chops can expose both the company and the individual to legal ramifications. Article 32 of the Contract Law of the PRC states that "where the parties conclude a contract in written form, the contract is established when it is signed or sealed by both parties." Though the law allows for a signature to establish a

# Reporting and controlling

contract, common practice requires both a signature and a Company Official Chop. The Company Official Chop can be replaced with a Contract Chop and the authorised signature can be replaced by the Legal Representative Chop.

Anyone who fraudulently obtains property or goods by any of the following means can be subject to a three-year prison sentence and a fine:

- executing a contract using a fictitious name or the name of others without their prior permission
- using forged, altered, or invalid negotiable instruments or other false certificates of property rights as guarantees on a contract
- performing a portion of the contractual obligation, with no intention of fulfilling the entire contract, as a means to deceive the opposite party
- going into hiding after receiving goods, payment, advance payment, or property as a guarantee from the opposite party
- defrauding the opposite party's property through other means

As is common in Chinese laws relating to financial crime, there is also a clause which encourages a stricter sentence "if the amount of money is considered significant", from ten years, up to life imprisonment. However, the law does not elaborate on specific circumstances which would qualify as 'significant'.

If a Company Official Chop is misplaced, the company must report the incident to the PSB immediately and wait for its approval to have a new Company Official Chop made. If this is made without prior PSB approval, both the company and the chop maker can be charged with forgery of a Company Official Chop.

## Internal controls to safeguard the chops and protect companies from fraudulent use

As chops are some of the most important pieces of company property, it is important that sufficient internal controls are put in place in order to protect their security and proper use. Weak controls over company's chops can have far reaching consequences for companies.

There are some key areas which are essential for protecting the appropriate usage of chops:

- It is important that chops are physically safeguarded by the authorised custodians with clear policies in case of the absence of the custodian for leave or any other reason.
- The authorised use of a specific chop should be delegated to a custodian whose function is relevant to the use of such chops, for example the Finance Officer should have access to the Finance Chop but not the Human Resources Chop.
- A log should be developed and maintained by the authorised custodian to keep record of any use of the chop in his or her possession. The log should contain the information of each use including the date and time, user's name, signature and purpose of use.

- The company should have clear written policies in place which define the following:
  - the circumstance and/or purpose for the use of each chop
  - the authorised custodian for each chop
  - the custodian's responsibility for the chop
- The chop should not be used or passed onto anyone without proper approval from authorised personnel.

A specific area where problems can arise is in relation to an outgoing legal representative. As a legal representative plays a key role in representing the company in all business activities, he will also be responsible for approving his own termination related documents. To mitigate the possibility of this situation arising, it is sometimes good practice to have the legal representative sign and chop termination related documents on appointment.

## Consultation

The experts from the area Forensic Services at PricewaterhouseCoopers can assist you in stopping business crime in companies – in China and in Germany. Using targeted detection procedures, they support companies in the discovery and prevention of fraud, money laundering, theft of intellectual property, as well as other offences.

If you have any questions or would like to seek advice, please feel free to contact us by phone or e-mail.

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## Renewable energy in China: tax perspectives and incentives

As China's economy grows, so does its hunger for energy. As a result the Chinese leadership is becoming increasingly interested in renewable energy. In the face of the current financial crisis the Chinese government has announced a stimulus package of around 430 billion euros to boost the economy. These additional funds will finance programmes over the next two years in ten main sectors, including investments in renewable energy. The following article takes a closer look at the measures being undertaken in China to promote green energy and the tax advantages available to producers.

Economic growth of 11.4 percent in 2007 increased China's electricity requirements by 14.4 percent. In the same year, the generating capacity of the power stations rose by 91 gigawatts, or 14.6 percent, to 713 gigawatts. The steady increase in demand for energy, the increasing dependence on energy imports and worsening environmental problems caused above all by the disproportionately high share of coal-powered generators (well above 70 percent of total electricity generated) are prompting debates on how to meet energy requirements in the long term. As early as 2006, China overtook the United States as the largest emitter of carbon dioxide worldwide with approximately 6.2 billion tonnes. This has led in recent years to a remarkable increase in the Chinese government's interest in the use of renewable energy. It is given high priority today in the debate over energy policy. The government implemented the efforts announced in the 11th Five-Year Plan (2006 to 2011) through a range of measures and resolutions, which are presented in the sections below.

The law promoting renewable energy, which took effect on 1 January 2006, is a milestone on the path to a more ecologically sustainable policy. The law requires electricity generators to source all the electricity available from renewable energy sources within their respective grids. Tax incentives offered by the government aim to boost investor confidence in this energy segment. During the start-up phase investors are eligible for tax holidays and can also benefit from reduced rates of corporation tax and VAT. A variety of state subsidies are also to be used to stimulate the Chinese renewable energy market.

This article reviews the current tax-related investment conditions and shows what tax concessions and other incentives companies can claim.

### This article explains ...

- why China has been offering huge incentives for renewable energy over the last few years;
- the tax advantages available to companies in this sector;
- what foreign investors should be aware of if they intend to enter the Chinese market for renewable energy.

### Renewable energy in China: an overview

Renewable energy is defined in various Chinese laws and administrative decrees. Since the following description mainly refers to the tax provisions, the most important regulations are the new corporate income tax law and the administrative directives on the assessment of new and high technology enterprises (NHTE Guokefahuo, 2008, No. 172). These classify the following energy types as renewable and eligible for incentives:

Sector	Technology eligible for incentives
Solar energy	<ul style="list-style-type: none"> <li>• Thermal solar plants</li> <li>• including photovoltaic plant</li> </ul>
Wind energy	<ul style="list-style-type: none"> <li>• Production of wind power plants over 1.5 megawatts</li> <li>• including maintenance, monitoring and analysis of wind power plant</li> </ul>
Bioenergy	<ul style="list-style-type: none"> <li>• Generation of energy from biomass</li> </ul>
Geothermal energy	<ul style="list-style-type: none"> <li>• Production of energy from geothermal sources</li> </ul>

Tab. 1 Renewable energy technologies eligible for incentives

The Western world's perception may be different on account of the environmental disasters in the recent past, but China has actually become one of the world leaders in renewable energy. China's investment in renewable energy amounted to twelve billion US dollars in 2007, with the country taking second place behind Germany globally.

According to the plans of the National Development and Reform Commission (NDRC), the share of renewable energy in the People's Republic of China's primary energy supply is expected to rise 15 percent by 2020 and by a huge 30 percent by 2050. Table 2 shows the detailed targets the NDRC has set itself.

### Investment in renewable energy: Promotion through tax advantages

In order to achieve these self-imposed targets, government estimates state that an investment of just under 180 billion US dollars (approximately 142 billion euros) is needed. Industry and commerce are expected to provide a significant amount of this sum. In return, the Chinese government will grant investors in renewable energy a range of tax concessions. These include '2+3 tax holidays', reductions in corporate income tax and VAT refunds. These tax advantages are explained further in the two sections below.



	2006	2010	2020
Large-scale hydroelectric power	approx. 83	120	215
Small-scale hydroelectric power (plants up to 30 mW)	approx. 47	60	85
Wind power	2.5	5	30
Photovoltaic	0.08	0.3	1.8
Capture of thermal power from solar energy (in millions of square metres)	approx. 85	150	300
Electrical energy from biomass	approx. 3	5.5	30
Biogas (in billions of cubic metres)	approx. 9	19	44
Bioethanol	approx. 1	2	10
Biodiesel	approx. 0.05	0.2	2
Percentage of primary power generation (including large-scale hydroelectric power)	approx. 8	10	16
Percentage of electricity generating capacity (excluding large-scale hydroelectric power)	approx. 8.5	n/a	n/a

Source: Frank Haugwitz, *Der Markt für erneuerbare Energien in China* [The market for renewable energy in China], in: *Deutsch-Chinesischer Business Guide* [German-Chinese Business Guide], October 2007, r3

Tab. 2 Renewable energy growth targets as at 2006, targets for 2010/2020 (in gigawatts)

## Corporate income tax

You will be aware that the new Chinese law on corporate income tax envisages a basic tax rate of 25 percent. Once most of the previous regional tax allowances have lapsed, the majority of the remainder will be limited under the new regime to recognised enterprises in the new and high technology sector.

The renewable energy sector is one of eight industries granted the privileged status of an NHTE. Alongside the areas of activity defined in Table 2 the general status requirements apply too – in other words, global licences, particularly for core IP, must be assigned to the Chinese subsidiary.

NHTE companies in the renewable energy sector which were founded after 1 January 2008 in the five Special Economic Zones (Shenzhen, Zhuhai, Shantou, Xiamen and Hainan) or in the New Area of Pudong in Shanghai, known as the '5+1 Zones' (Guofa 2007 No.40), will be granted an extra '2+3 tax holiday' by the tax authorities. In the first two years, a zero tax rate will apply and in the subsequent three, half the basic rate of tax or 12.5 percent. When the tax holiday expires a reduced tax rate of 15 percent will apply.

	2008	2009	2010	2011	2012	2013
Tax rate	25%	25%	25%	25%	25%	25%
Tax holidays	zero tax rate	zero tax rate	50%	50%	50%	reduced rate of tax
Effective rate of tax	0%	0%	12.5%	12.5%	12.5%	15%

Tab. 3 Taxation of NHTE companies in the renewable energy sector

Please note that, unlike the old rule, the new '2+3' rule no longer applies from the first year in profit but from the first year in which revenues are generated.

In addition, companies in the renewable energy sector may claim a new type of allowance under the new corporate income tax law: the 'super deduction'. This allowance permits expenditure on research and development of new technologies, new products and new processes to be deducted up to 150 percent.

## Value added tax

There are far-reaching consequences for the development of new plants as a result of the current Chinese VAT reform, which came into force on 1 January 2009. Following a test phase restricted to certain regions and industries, China has since been offering input tax deductions on procurement of plant assets (with a small number of exceptions) country-wide. The input tax cannot, however, be deducted immediately. Instead, input tax credit is offset against any VAT liability and brought forward as necessary. Please note that, in this respect, although the new rule is advantageous in itself it will disadvantage companies which do not have General VAT Payer status or do not process sufficient transactions with VAT to be able to offset their input tax at all or only on a deferred basis. The new rule also disadvantages companies in favoured industries which previously benefited from an import VAT exemption on fixed assets, such as plants used to produce wind power. This special rule has now been dropped and not been replaced. From 2009, this group, which includes many investors in the renewable energy sector, will only be entitled to offset input tax in lieu of this exemption, something which must be taken into consideration when planning cash flow.

VAT refunds provide further investment incentives for renewable energy. Under the Caishui Circular, 2001, No. 198, which has not been affected by the Chinese VAT Reform, the following apply:

- Energy captured from biowaste is initially subject to VAT. However, VAT paid by the company will be instantly refunded in full.
- A reduced rate of VAT of 8.5 percent and not the basic rate of 17 percent will apply to wind energy

## Other activities and incentives

Alongside the tax measures listed above the Chinese government has launched a series of state activities and programmes to promote the development and use of regenerative energy. One important milestone is the law on promoting renewable energy referred to at the start of this article. This law is based in part on



## Tax and legal

the corresponding German regulation. For example, it also requires electricity grid operators to source electricity from registered providers of renewable energy. The feed-in tariff for electricity from biomass, for example, is legally guaranteed at 0.25 renminbi (equivalent to approximately 2.5 cents) per kilowatt/hour above the local electricity tariff (in Germany, by way of comparison only, the feed-in tariff is on average 45 cents). To provide suppliers and investors with some stability in planning, this special supplement is to be paid for a period of 15 years. The 15-year feed-in period starts as soon as electricity is generated.

Other state measures are:

- the planning and development programme for rural energy supply;
- the programme for rural electrification with pilot projects concentrating on the development of small-scale hydroelectric power plants;
- the electrification programme for communities;
- the concession programme for wind energy.

The dramatic development in and importance of green energy in China has been especially enhanced in recent years by the electrification programme for communities and the concession programme for wind energy in conjunction with financial assistance through special government bonds.

With regard to state funding, please note that allocation procedures vary from region to region. A critical aspect here is the tendency for the authorities to shield the domestic market by favouring local investors. Foreign investors are therefore well advised to obtain binding agreement on support measures at an early stage.

### Conclusion

On the basis that the market in renewable energy has developed dramatically, and that the country has a huge demand for appropriate technology and is offering structural and tax incentives, China, even in the current economic crisis, represents an interesting location for German companies working in this sector.

The fact that tax allowances have survived the VAT reform is confirmation that investors in the regenerative energy sector – unlike many other sectors – continue to be valued and welcome.

At the same time, investors should not underestimate the importance of ‘soft factors’ (such as questions of interpretation regarding laws and regulations) when state funds are allocated. Timely preparation and the early involvement of the responsible authorities is often the key to success here.

Do you have any questions or are you interested in more details? If so, please call us or simply send us an e-mail.

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Do you know how many registered taxis there are in Shanghai?

About 45,000. There are probably around 20,000 unregistered mini cabs. The figure might seem disproportionate compared to European cities, but trying to find a taxi at rush hour, or when it rains, is a laborious business.

(Shanghai Cityweekend, 14. August 2008; [www.travelchinaguide.com/cityguides/shanghai/transportation/taxi.htm](http://www.travelchinaguide.com/cityguides/shanghai/transportation/taxi.htm))

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## Update on Chinese foreign exchange law: new requirement for outgoing payments

To facilitate the administration of tax collection and foreign exchange administration, from 1 January, companies are required to attach a tax clearance certificate issued by the tax authorities to their instructions submitted to their bank for payment for services. – This article explains the background and describes the new requirements.

On 25 November 2008, the State Administration of Foreign Exchange (SAFE) and the State Administration of Taxation (SAT) jointly issued a Circular (Huifa, 2008, no. 64) entitled 'Notice concerning the requirement for a Tax Clearance Certificate for various foreign currency payments for services'. This 'Tax Clearance Certificate' is a certificate endorsed by the tax authorities by which the foreign currency payer documents to the bank instructed to make payment that the payer has duly paid tax on the payments to be sent abroad. The bank may only carry out the transaction once it is in possession of this certificate. The Tax Clearance Certificate is mandatory from 1 January 2009 for foreign currency payments exceeding 30,000 US dollar to payees outside China for services and certain other payments.

Circular 64 applies to payments for services in the following fields in particular:

Transport, Tourism, Telecommunications, Construction/installation and labour contracting, Insurance, Finances, Computer and IT services, Licensing of proprietary rights, Sport, culture and entertainment, 'Other business services', Government services.

The Tax Clearance Certificate is mandatory for the following payments to payees outside China where a single payment exceeds 30,000 US dollars and where the payer is a Chinese entity or individual:

- Service trade income received from China by foreign entities and individuals;
- Remunerations received by foreign individuals from employment in China; earnings such as dividend, direct loan interest, guarantee fee, etc. as well as income from transfer of current items received from China by foreign entities or individuals; and
- Rental from finance lease, proceeds from transfer of immovable properties and equity transfer received from China by foreign entities or individuals.

Circular 64 replaces the following earlier Circulars:

- Huifa (1999) no. 372
- Guoshuifa (2000) no. 66
- Guoshuifa (2008) no. 8
- Guoshuihan (2008) no. 219
- Guoshuihan (2008) no. 258

### This article explains ...

- what the mandatory tax clearance certificate from the tax authorities is all about;
- which payment instructions are affected, and which are not;
- what else has changed in the field of capital items and transfer of current items.

### Exceptions to the requirement for a Tax Clearance Certificate

In the following cases, a Tax Clearance Certificate from the tax authorities is not mandatory:

- Overseas expenses for business trips, meetings, sales exhibitions, etc., incurred by the Chinese entities;
- Operating expenses for overseas representative offices of the Chinese entities, and fees paid by the Chinese entities as contractor for overseas contracting projects;
- Trade commissions, insurance and compensation payments relating to import and export which are incurred by the PRC entities in overseas;
- International transportation fees received by overseas entities under import trade;
- Expenses such as maintenance, fuel and harbour costs, etc. incurred by Chinese transportation enterprises on overseas transportation operations;
- Personal forex payments incurred by Chinese individuals for studying, travelling, visiting abroad;
- Other payments to be stipulated by the State.

### Background

Since Huifa (2006) no. 19, Chinese payers making payments in excess of 50,000 US dollars for services are always presented with the necessity of first paying the relevant taxes and thereupon receiving a Tax Clearance Certificate from the tax authorities before a foreign currency payment can be made to a payee overseas. Huifa (2008) no. 8 and Guoshuihan (2008) no. 219 and 258 then set up (from April 2008) a trial tax record filing system in six regions: Tianjin, Shanghai, Jiangsu, Sichuan, Fujian and Hunan. In these regions, the state loosened foreign exchange controls for service payments, simplified the transfer procedure and allowed Chinese payers to make most kinds of service payments (even foreign currency payments over 50,000 US dollars) before taxes were settled. This trial of a simplified method has now been canceled. The legislators have thus returned to imposing the condition of a Tax Clearance Certificate, although the former variety of non-standardised forms is now to be replaced by one standard procedure. The new regulation differs strikingly in one respect from the old: a Tax Clearance Certificate from the tax authorities must now be presented for payments of above 30,000 US dollars (and not 50,000 US dollars). Subsequently, the SAT has issued another Circular regulating the details of the application procedure for the Tax Clearance Certificate namely Guoshuifa (2008) no. 122.

## Tax and legal

### Other innovations

In the field of capital accounts, the SAFE has yet to adopt a new position on the subject of cash pooling. The SAFE's 'Notice on the Relevant Questions Relating to the Internal Operation and Administration of Foreign Exchange Fund of Multinational Corporations' (2004) continues to apply, permitting cash pooling for qualified multinational corporations in China. Identical regulations were published in 2005 and 2006 for the Shanghai Pudong New Area and the Tianjin Binhai New Area.

For drawing accounts a special bank account must be opened to 'park' export revenues prior to their conversion into renminbi. The amount permitted to be converted will be set by an amount of foreign currency determined and controlled by quota.

If you have any questions or would like to seek advice, please feel free to contact us by phone or e-mail.

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Do you know where China stands on the international Big Mac index?

At 1.83 US dollars (July 2008), the China is close to the bottom. The hamburger index measures relative purchasing power using the price of a Big Mac in 120 countries.

(<http://de.wikipedia.org/wiki/Big-Mac-Index>)

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## China pushes through reform of turnover taxation system

China is in the process of gradually reforming its turnover taxation. This reform holds out the promise of tax reductions for enterprises. We present here an account of the intentions of the Chinese legislators, the context in which these measures are to be seen and what companies need to know.

On 10 November 2008, the Chinese government enacted three new Provisional Regulations containing new rules on turnover taxation:

- Regulations on Value Added Tax (VAT)
- Regulations on Business Tax (BT)
- Regulations on Consumption Tax (CT)

Detailed Implementation Rules (DIR) were issued for these regulations on 17 December 2008.

All three Provisional Regulations came into force in all regions and for all spheres of business on 1 January 2009. All changes brought about by these regulations are explained in the following sections.

### Purpose of the reform

The turnover taxation system as it currently applies was introduced in the context of the Chinese Turnover Tax reform of 1994. It is based on the threefold division of Turnover Tax into an original VAT on sales of goods and provision of services related to the processing of goods and of repair and replacement, a BT on services (excluding services subject to VAT) and sale of intangible assets and immovable assets, and a CT on selected luxury goods.

The current taxation of turnover, with considerable restrictions on the deduction of input VAT and the export of goods, places a substantial burden in terms of taxation and administration on foreign enterprises located in China.

Against the background of the global financial crisis, the current turnover taxation reform serves four purposes. It seeks

- to lower the tax burden on enterprises as they acquire new fixed assets, and thereby to stimulate investment and domestic demand;
- to assist enterprises in implementing technological upgrades;
- to optimize industrial structure;
- to halt the decline in economic growth.

Observers expect a probable tax reduction amounting to 120 billion renminbi (approx. 13.9 billion euros).

### This article explains ...

- the goals China is aiming to fulfil with this accelerated reform;
- the impact of the current provisions on corporate taxation;
- what enterprises need to know in order to be prepared for further reform measures.

### Significant changes to VAT regulations

The most important change introduced by this reform is the shift from the present, production-based system to a consumption-based system enabling input tax deduction on acquired fixed assets.

The new Provisional Regulations confirm the three most important changes that were being discussed in the run-up to the reform.

These concern:

- the nationwide application of the regulations;
- the abolition of industry-specific restrictions;
- the full claim of input tax credits.

The following section describes which significant changes will potentially impact your business activities in China.

### Extension of input tax deduction to certain fixed assets

The input tax deduction applies to VAT-liable enterprises which have registered as General Taxpayers and which, on or after 1 January 2009 (invoice date), acquire certain 'fixed assets', provided that these are used for production. General Taxpayers are manufacturing or commercial enterprises, and similar business operations, including accounting, whose annual turnover exceeds 0.5 or 0.8 million renminbi (approx. 53,300 euros or 85,280 euros). – Please also take note of the further discussions of this article in the section Changes arising from DIRs on the following page.

'Fixed assets' are machinery, equipment, transport vehicles and other movables and tools serving production and business operations. Input taxes on fixed assets which serve either product manufacture or service provision are principally could be claimed as VAT credits. In this context, immovables do not come under the category of 'fixed assets' which are eligible for claim of input VAT credit, even if they serve the enterprise's production activities. Hence, input tax credits on building materials acquired for the construction of operational buildings are not allowable. Small cars, motorcycles and yachts, which are subject to CT and may be used for private purposes, are also excluded from input tax refund.

### Carrying forward of the 'input tax surplus'

According to the current practice, the claim of input tax credit is limited to the extent that the claimed amount of input VAT for the current year may not exceed the output VAT to be paid. Where accrued input taxes exceed the VAT amount for a period of assessment, the surplus amount is transferable to subsequent periods of assessment, in accordance with usual practice in China. Thus, refund of input taxes is not allowed.

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According to information available to the authors, however, the Chinese financial administration is considering easing the strict ban on refunds in the future, once certain as yet unknown conditions are fulfilled.

## Abolition of exemption from import VAT for imported fixed assets

Fixed assets acquired abroad have hitherto been exempt from import VAT. Because this tax concession benefited foreign enterprises at the expense of domestic enterprises, this tax concession has now been abolished. No transitional regulation is provided.

## Abolition of the special regulation for Foreign Invested Enterprises for input tax refund on domestically manufactured equipment.

As the reform of the turnover tax system generally enables input taxes to be offset against output taxes, this tax concession automatically ceases to apply. In the new turnover tax system, Foreign Invested Enterprises (FIEs) will in this respect be treated on equal terms with Chinese enterprises.

## Reduction of VAT for Small-Scale Taxpayers

The special VAT rates applicable to Small-Scale Taxpayers and freelancers will be reduced from 4 percent (for commercial and distribution enterprises) or 6 percent (for manufacturing and other enterprises) to 3 percent across the board. For the purposes of turnover tax law, 'Small-Scale Taxpayers' are all those not fulfilling the criteria as 'General Taxpayers'. Since such enterprises receive no input tax deduction and hence cannot profit from the system reform, they are to receive relief through this reduction in the tax rate.

The Chinese Ministry of Finance (MoF) and State Administration of Taxation (SAT) have also announced that the threshold for charging VAT and BT will be raised in order to promote the development of smaller enterprises.

## Raising of VAT rates on mineral products

Minerals have hitherto been subject to a reduced VAT rate of 13 percent, with the purpose of promoting the mining industry. The reform of the turnover tax system will reduce the total tax burden on mining enterprises. Because the Chinese government has recently been paying greater attention to the safeguarding of resources and the protection of the environment, the standard rate for VAT on minerals will be raised to 17 percent.

## Changes to assessment regulations for VAT, BT and CT

Salient changes to the provisions on business and consumption taxes pertain to assessment regulations, which in the final analysis correspond to the equivalent regulations in the VAT provisions.

According to the current BT regulations, a BT payer is obliged to submit the business tax declaration in the location where the services were performed. The new Provisional Regulation states

that, in future, BT payers must make their tax declaration in the location where they have their registered office or where they are registered for tax purposes. There are exceptions for construction enterprises and other enterprises specified by the MoF and SAT.

The following situation is regulated similarly to the VAT regulation: If foreign enterprises, subject to Chinese BT, but having no permanent facilities in China, have BT liabilities, then these must be paid through a business agent or the consumer of the provided services. The same also applies for CT.

For all three tax types, a period of assessment of three months has been introduced alongside the existing 5, 10 and 15-day and one-month periods. The payment deadline for tax liabilities has also been increased from 10 to 15 days after the submission of the monthly or quarterly declaration.

## Changes arising from DIRs

### 1. Authorities' determining of VAT-liable turnovers

As before, the taxpayer is obliged to declare incomes that are subject to VAT and BT separately. If the taxpayer did not do this or was not able to do this, the entire turnover was, under the old regulations (previous DIR on VAT), subject to VAT. According to the newly-introduced DIR on VAT, the relevant tax authority is now authorized to allocate turnovers and to determine what turnovers are VAT-liable.

### 2. Ascertainment of non-deductible input VAT

For enterprises that perform both VAT-taxable and VAT-exempt or non-VAT-taxable activities, input VAT associated with the VAT-exempt consignments or non-VAT-taxable services is not creditable. If the non-creditable input VAT has not been identified, the following formula is to be used to determine a 'deemed' non-deductible amount:

non-creditable monthly input VAT	=	unidentified monthly input VAT	•	$\frac{\text{sum of VAT-free and BT-taxablemonthly turnovers}}{\text{total monthly turnovers}}$
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Unlike the old formula, the new formula relieves taxpayers in that it replaces the former basis of measurement 'total monthly input VAT' with 'unidentified monthly input VAT'.

### 3. Lowering of threshold for General Taxpayers

To assist small and medium-sized enterprises, manufacturing or commercial taxpayers with annual turnovers in excess of 0.5 or 0.8 million renminbi (approx. 53,300 euros or 85,280 euros) – replacing the former 1 million or 1.8 million renminbi – may register as General Taxpayers and thus benefit from input tax deduction.



## 4. Introduction of new definition of 'services performed in China'

Services performed within China are subject to BT. The new, detailed BT introduction guidelines define a service as 'performed in China' if the provider or recipient of that service is based in China. Thus, offshore services, which have not hitherto been subject to Chinese BT, will be subject to Chinese BT as of 1 January 2009.

Conversely, the new regulations indicate that where neither the provider nor the recipient of a service are based in China, that service is not subject to Chinese BT. Please note: this assumption is subject to confirmation by the tax authority. The table shows the various cases of the taxation of services:

Case	Service provider/ Service recipient		Service provided		Business Tax on onshore/offshore services
			within China	outside China	
A	within	outside	BT taxable	BT taxable	onshore
B	outside	within	BT taxable	BT taxable	offshore
C	within	within	BT taxable	BT taxable	onshore
D	outside	outside	non-BT taxable	non-BT taxable	–

### Onshore or offshore taxation of services

#### Tax consequences

##### 1. System reform generally reduces turnover tax burden

In view of the optimization opportunities provided under the new regulations, the Chinese financial administration anticipates a flood of turnover tax declarations claiming significant input VAT credits. Therefore, offsetting will not take place without prior auditing. As yet, there are no transitional provisions or implementation regulations.

Enterprises would therefore be very well advised to prepare in advance for these new regulations and for the possibility of an audit by the financial administration. Such preparations should cover the following items:

- scrutiny of all acquisitions and/or the allocation of acquired assets to the fixed asset category
- ensuring that entitling invoices are present for the claim of input VAT credit
- ensuring that invoices have been issued for the correct period
- documentation of contracts connected with acquisition or other business documents with reference to purchase date of fixed assets
- ensuring correct entries in company accounts

Enterprises which have not registered or not been able to register in China for turnover tax purposes as General Taxpayers will be disadvantaged by the abolition of the import VAT exemption for imported assets, as they will now no longer be able to deduct accruing input tax from output VAT.

This will also affect enterprises contracted to further process or refine imported assets (contract processing) and then export the processed goods. As their processing fees are VAT-exempt, they have no VAT obligations to offset against the input VAT allotted to the fixed assets. However, under certain circumstances, the tax authority will allow tax refunds whose refund rate depends on the product to be exported. It also remains to be seen whether the exemption from customs duty hitherto guaranteed alongside the exemption from import VAT will be retained.

For FIEs, the abolition of the special regulation for input tax refund on domestically manufactured equipment will lead to an extra cost factor if no sufficient offsetting potential is available from taxable output turnover. Although input tax amounts will remain allowable in principle under the new regulation, they will however remain limited to the level of the concurrently-accruing VAT liability according to current law. In such a case, it is also likely that a refund tax will be granted at a rate dependent on the export product.

Enterprises performing offshore services for clients based in China will be affected by the newly-introduced BT taxation of such services. As BT will still not be deductible as an input tax, the relevant services will increase in price, which will mean extra costs for recipients of offshore services. Existing onshore-offshore splits should therefore be re-examined.

The current reform is another step in the direction of an internationally-standardized turnover taxation system. However, substantial reforms will need to follow in order to create a system imposing a neutral burden. These include the reform of the BT to make it an input tax allowance system, thus avoiding cascade tax. It should also be noted that services, transfers from intangible assets and the sale of immovables in China continue to be subject to BT, and that no changes are currently planned.

##### 2. Further rise in tax refund rate for exports

Since 1994, turnover tax law in China has imposed a zero tax rate for exports. It is in principle possible to claim tax credit or tax refund on input VAT incurred related to exports, but such credit/refund will be limited by separate administrative regulations insofar as different tax refund rates are set for different groups of products. Resulting non-creditable/refundable input taxes will burden the costs of export enterprises.

Two further regulations have come into force to raise the rate of tax refund in the light of the financial crisis and slackening growth in the export market.

On 21 October 2008, the MoF and SAT issued Circular [Cai Shui] (2008) No. 138, raising the Chinese export VAT refund rate on the export of a total of 3,486 categories of goods. For the most part, these are labour-intensive goods and technologies, e.g. textiles, clothing, toys, furniture and AIDS treatments. These changes

## Tax and legal

came into force on 1 November 2008 (date of customs declaration).

Circular [Cai Shui] (2008) No. 144, which also deals with the adjustment of export VAT refund rates for products from the labour-intensive sectors, raised refund rates on a further 420 categories of goods as of 1 December 2008.

There are now six tax refund rates: 5, 9, 11, 13, 14 and 17 percent. The effect of the new regulations is to lower effective VAT on all export goods categorized within the catalogues concerned.

The Chinese government is using the adjustment of export VAT refund rates to control the development of its foreign trade. Unlike 2006 and 2007, when some export VAT refund rates were lowered and some entirely abolished, China has issued a number of circulars since 1 August 2008 raising the export VAT refund rates for certain products in order to stimulate exports. Given the current turbulence in the global economy and in China itself, further adjustments in this sphere are to be expected.

The constantly-evolving conditions will continue to impact on the financial viability of investing in China. – For foreign investors, and in particular those using China as a production location primarily for export goods, this will bring new challenges, but also new opportunities. PricewaterhouseCoopers will support all enterprises both in Germany and in the field in China in making use of these opportunities.

If you are interested in detailed information or would like to seek advice, please feel free to contact us by phone or e-mail.

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## New developments affecting the taxation of partnership enterprises

In recent weeks and months the Chinese authorities have passed four administrative regulations on partnership enterprises, one at a national level and three at a local level, in Tianjin and Shanghai. As a result, a partnership enterprise is to be formally treated as transparent for tax purposes and not as an independent tax subject. This means that the income of the partnership enterprise is attributed to the partners and then taxed. In addition, local administrative regulations in the two named cities allow foreign investors to set up a private equity fund in China in the legal form of a partnership enterprise. – The accompanying article provides an overview of the content and consequences of these regulations, and illustrates the opportunities available to German investors.

### Civil law and tax law principles for partnership enterprises

In principle, the new act governing partnership enterprises (Partnership Enterprise Law, Zhuxiling, 2007, No. 55) allows foreign investors to use a partnership enterprise as a form of investment in China as of 1 June 2007. Both natural and legal persons can form a partnership enterprise. As in Germany, there is a legal form corresponding to a common partnership whereby all partners have unlimited liability. There is also a legal form corresponding to the limited partnership involving at least one partner with unlimited liability and at least one with limited liability. In addition, the fully liable partner can also be a limited liability company, which would be similar to the German 'GmbH & Co. KG' (limited partnership with a limited liability company as general partner).

While the form of a partnership enterprise is now relatively clear under corporate law, the taxation of the partnership enterprise is still unclear. It seems to be clear that a partnership enterprise is not an independent tax subject. According to Art. 6 of the Partnership Enterprise Law, the income of a partnership enterprise is attributed to the partners and then taxed.

### New regulations at national and local level

Following the promulgation of the new act governing partnership enterprises, no implementation order has yet been passed that sets out clear procedures for forming a partnership enterprise by foreign investors. Furthermore, there were previously no concrete rules – neither formal act nor national administrative regulations – covering the taxation of income from a partnership enterprise at the level of the enterprise partners, also leading to great uncertainty.

The cities of Tianjin and Shanghai gave the first indications of transparent taxation of a partnership enterprise with the implementation of local administrative regulations governing the taxation of a private equity fund (Jindishuisuo, 2007, No. 17 from 24 October 2007; Hujinrongbantong, 2008, No. 3 from 11 August 2008). The Chinese Ministry of Finance and the State Administration of Taxation then confirmed the transparency

### This article explains ...

- how basic taxation is applied to a partnership enterprise in China;
- the significance of the national and the local administrative regulations in Tianjin and Shanghai;
- how German investors can optimise their tax.

principle at a national level with a common administrative regulation (from 23 December 2008, Caishui, 2008, No. 159). As a result, the partners in the partnership enterprise are now the tax subjects. The incomes from the partnership enterprise attributed to them are subject to income tax (for a natural person) or corporate income tax (for a legal person). For an enterprise partner, the losses from a partnership enterprise must be determined separately and are not offset against his or her own profits. The national administrative regulation is valid not only for the taxation of private equity funds, but for all partnership enterprises. This regulation is effective retrospectively from 1 January 2008.

According to the local administrative regulations, the income attributed to a natural person are qualified as business income and taxed at the progressive tax rate of 5 to 35 percent for a partner with unlimited liability. In contrast, if a natural person is a partner with limited liability, the income is treated as dividends and taxed at a standard tax rate of 20 percent.

With corporate entities as stockholders, the local administrative regulations do not differentiate between partners with limited and unlimited liability. The incomes from the partnership enterprise should be subject to standard corporate income tax at the stockholder level.

As the legal form of a partnership enterprise can offer interesting opportunities for tax planning, this development in China is being followed with interest by many investors. And although the local regulations refer to private equity funds, these are the first indications of how other non-PE funds could be taxed given an investment in a partnership enterprise. The following section illustrates the tax advantages that could be achieved from forming a partnership enterprise.

### Tax planning opportunities from forming a partnership enterprise

From the viewpoint of a German investor, there could be tax benefits to forming a partnership enterprise instead of a corporate by entity. To limit liability, a natural person can also be a partner with limited liability. If a German corporate entity makes an investment in China, the German corporate entity can be a fully-liable partner in a Chinese partnership enterprise, in other words, a legal form that is comparable to the German 'GmbH & Co. KG'. The following comparison of the tax burden should clarify the tax advantages an investor can achieve by forming a Chinese partnership enterprise.

## 1. Initial situation

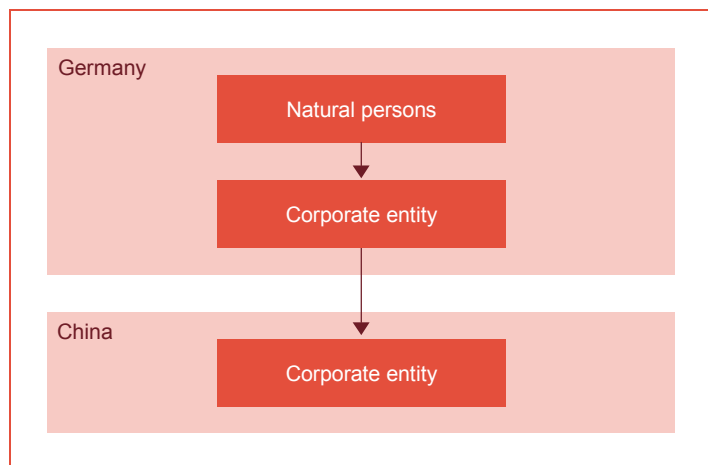


Fig. 1 German corporate entity is a stockholder in a Chinese corporate entity

If a German corporate entity invests in China by setting up a Chinese subsidiary, the following tax consequences arise:

- In China from 2008, the profits of the Chinese corporate entity are subject to corporate income tax at a rate of 25 percent (if no tax rate reductions are applicable – for example, for high-tech companies that meet particular requirements).
- From 2008, the profit distributions from the Chinese subsidiary to the German parent company are subject to Chinese withholding tax of 10 percent.
- In Germany, 5 percent of the Chinese dividends are subject to corporate income tax and trade tax at the parent company (sec. 8b of the Corporate Income Tax Act). The Chinese withholding tax cannot be credited in Germany.
- Assuming that natural persons are stockholders in the German corporate entity, from 2009, the profits distribution from the German company to its stockholders is subject to the 'partial income' procedure ('Teileinkünfteverfahren') or flat rate withholding tax ('Abgeltungsteuer').

## 2. Formation of a partnership enterprise in China

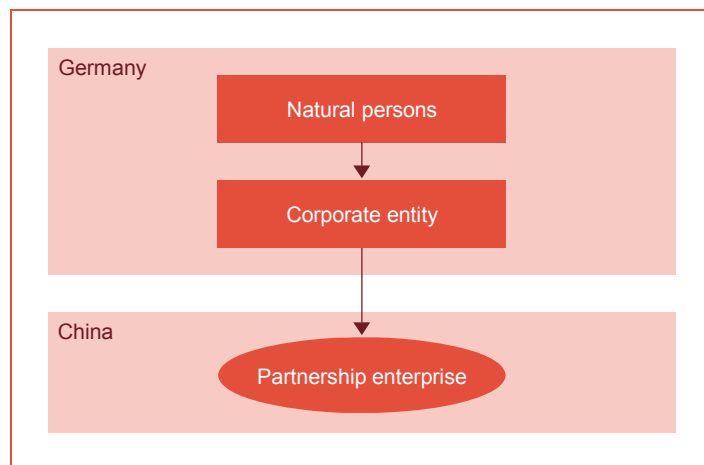


Fig. 2 German corporate entity is a partner in a Chinese partnership enterprise

If a German corporate entity invests in China by setting up a Chinese partnership enterprise, the following tax consequences may arise:

- The Chinese partnership enterprise is not an independent tax subject in China. The profits of the Chinese partnership enterprise are taxed immediately at the partner level. This means that the income attributed to the German corporate entity as a partner are subject to corporate income tax of 25 percent in China.
- With the distribution of profits from the Chinese partnership enterprise to the German parent company, the dividends may not be subject to withholding tax.
- In Germany, like income from a permanent establishment abroad, the incomes from the Chinese partnership enterprise should be exempt from corporate income tax and trade tax under the activity restriction provided in the Double Taxation Agreement between Germany and China.
- If natural persons are stockholders in the German corporate entity, from 2009, the profits distribution from the German company to its stockholders is subject to the 'partial income' procedure ('Teileinkünfteverfahren') or flat rate withholding tax ('Abgeltungsteuer').

### 3. Tax burden comparison

The following table shows the various tax burdens that may result from the above two investment structures:

Tax burden		Structure Fig. 1	Structure Fig. 2
In China	Profits from Chinese company	100	100
	Chinese corporate income tax (25 percent)	25	25
	Withholding tax on dividends in China (10 percent)	7.5	0
In Germany	For German corporate entity (assumption: taxation 5 percent on dividends, corporate income tax and trade tax rate is 30 percent)	1.13	0
	For German partner (assumption: company is natural person, flat rate withholding tax is 25 percent plus solidarity surcharge)	19.49	19.78
Total tax burden		53.12	44.78
Net income after taxes		46.88	55.22

Comparison of tax burden with participation of a German corporate entity in a Chinese corporate entity or partnership enterprise

#### Conclusion and outlook

For foreign investors, an investment in the form of a Chinese partnership enterprise can be advantageous, particularly as the 10 percent Chinese withholding tax on dividends, which would be applied for the profits distribution by a corporate entity, may be avoided with participation in a Chinese partnership enterprise. Depending on the individual case, there are also further opportunities to reduce the total tax burden.

The most recent administrative regulations firstly define taxation of a Chinese partnership enterprise at a national level and, secondly, define the formation and taxation for private equity funds in the form of a partnership enterprise at the local level. The associated increase in planning security has already led to over 40 private equity funds moving to Tianjin and Shanghai since these regulations were passed.

In spite of this positive development in the taxation of a partnership enterprise, there is still a high level of uncertainty regarding the formation process and the permitted investment areas for a partnership enterprise with foreign investment until a regulation is passed at the national level to clarify and define these areas.

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## New notice of special tax adjustments and the trend towards more stringent measures to combat tax abuse

On 8 January 2009, the State Administration of Taxation in China published the long-awaited notice of special tax adjustments. The previous edition of your *German pwc:china compass* included information on the general content of this notice – which was based on the draft version published on 1 April 2008. However, the final version of this notice differed in some details from the draft. The following article specifically highlights these differences and also illustrates how the Chinese tax administration wants to introduce more stringent measures to combat tax abuse.

### Significant differences between the notice and draft version

For more detailed information on the draft version from the State Administration of Taxation (SAT), see the article on page 8 of the autumn/winter 2008 issue of your *German pwc:china compass*.

### This article explains ...

- how the final version of the notice differs from the draft version and the consequences for foreign companies;
- about the situations in which tax is adjusted based on the general ruling for combating tax abuse;
- how a practical case in Chongqing represents a new trend in combating tax abuse.

This current article, however, concentrates on the fundamental differences between the notice and the draft version. –The table gives you an overview of the most important points.

### A practical case in Chongqing and the trend towards more stringent measures to combat tax abuse

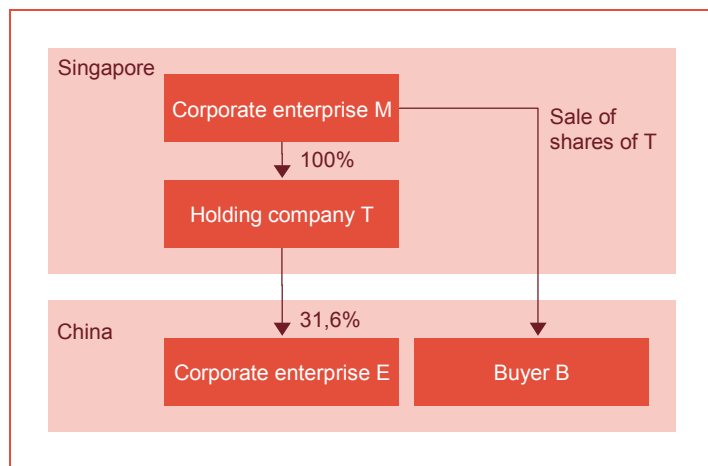
A ruling issued in October 2008 by the State Tax Bureau (STB) in Chongqing illustrates the trend towards more intense measures to combat tax abuse in fiscal practice in China in the future. The following passage summarizes the case and its consequences:

Subject	Draft	Final Version
Definition of associated company in the context of sec. 41 Corporate Income Tax Law	Sec. 7 subsec. 1 of draft Minimum shareholding amount: 20 percent With indirect shareholding: The number of shares held in the subsidiary by the intermediate company is significant if the controlling company holds more than 50 percent of the shares in the intermediate company.	Sec. 9 subsec. 1 of notice Minimum shareholding amount: 25 percent With indirect shareholding: The number of shares held in the subsidiary by the intermediate company is significant if the controlling company holds more than 25 percent of the shares in the intermediate company.
Prerequisites for the exemption from contemporaneous transfer price documentation	Sec. 14 of draft 1st exemption option: Companies whose total annual volume of group-internal transactions (without differentiating between supply and services) does not exceed 20 million renminbi (RMB). 2nd exemption option: Companies which only carry out transactions with domestic associated companies.	Sec. 15 of notice 1st exemption option: Companies whose total annual volume of group-internal transactions in the form of supplies does not exceed 200 million renminbi (RMB) and whose annual volume of other group-internal transactions (for example, services, licensing) does not exceed RMB 40 million. 2nd exemption option: Companies who only carry out transactions with domestic associated companies and for whom less than 50 percent of shares are foreign-held.
Simplified transfer price documentation	Sec. 13 of draft Companies whose annual volume of group-internal transactions is between RMB 20 and 100 million.	No simplification option.
Prerequisites for an Advance Pricing Agreement (APA)	Sec. 49 of draft Minimum transaction volume of RMB 100 million; actual operating business life is over 10 years; no tax evasion in previous years; compliance with documentation obligations.	Sec. 48 of notice Minimum transaction volume of RMB 40 million and compliance with documentation obligations.
Prerequisites for group-internal Cost Sharing Agreement (CSA)	Sec. 67 of draft Verification/approval by SAT only necessary for service-related Cost Sharing Agreements.	Sec. 49 of notice Verification/approval by SAT necessary for all types of Cost Sharing Agreement.
General combating of tax abuse	'Substance-over-Form principle' is not explicitly mentioned.	Sec. 85 et sqq. of notice 'Substance-over-Form principle' for tax authority investigations. Fiscal repudiation of the existence of a company without economic substance.

Fundamental differences between draft and notice

## Tax and legal

The corporate enterprise M based in Singapore is a shareholder of a Chinese corporate enterprise E via a holding company T which is also based in Singapore. The interests in T are now transferred by M to a Chinese buyer B.



Shareholding relationships in a case in Chongqing

Although both the share vendor M and the transferred company T are based abroad, the STB Chongqing has ruled that the profits from the transfer of the shares in T are subject to Chinese withholding tax at a rate of 10 percent. This conclusion was reached because the activities of the holding company T are restricted to holding the shares in E and, from an economic point of view, the transfer of shares in T is comparable to a transfer of the shares in the Chinese corporate enterprise E. In the opinion of the STB Chongqing, it is essential to apply the substance-over-form principle here.

The ruling of the STB Chongqing and the taxation of capital gains in this type of 'off-shore case' came very soon after the introduction of the new law. A trend towards increased measures to combat tax abuse is almost certain in China in the future.

### Conclusion and outlook

The publication of the new notice of special tax adjustments provides more legal security and clarity for taxpayers, mainly with regard to the documentation of the transfer prices and the group-internal cost allocations. However, one must assume that with the notice of tax abuse regulations, a tougher stance will be taken against tax abuse in the future and higher requirements in regards to substance will be placed on international tax planning.

If you require more information or advice, please call us or simply send us an e-mail.

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## The European Union and China: increased recognition of trade partnership programmes

There are now as many companies from the European Union investing in China as there are Chinese companies active in Europe. The two economic powers have signed agreements to regulate and facilitate the cross-border activities of these companies. This article describes the special procedures used within European-Chinese cooperation in recent years and the benefits for participating companies.

Cross-border trade in goods or capital is now subject to circumstances which are affecting and transforming goods traffic around the world. Safety and risk management are becoming increasingly important aspects of global supply chains. The aim is to identify risks at an early stage in order to minimise them as far as possible. Legislative authorities, particularly in the United States and the European Union (EU) have responded to these new challenges with a set of rules and regulations. These concentrate mainly on the fight against terrorism, prevention of fraud and theft and the safety of goods. Although the regulations are primarily designed to improve the security of business transactions, they also increase administrative costs. And anyone failing to comply with the regulations faces stiff penalties or fines.

International co-operation under the auspices of the World Customs Organisation promotes mutual recognition of security measures and is intended to contribute towards facilitating trade flows. A key element in this process is the Framework of Standards to Secure and Facilitate Global Trade (SAFE Framework), which contains guidelines on securing the international supply chain from the manufacturer to the end consumer.

### SAFE

The global organisation on harmonisation and simplification of customs procedures and administration of international customs conventions (World Customs Organization) launched the global Framework of Standards to Secure and Facilitate Global Trade (SAFE) in 2005 in response to the Container Security Initiative launched by the US Bureau of Customs and Border Protection (CBP) in January 2002 following the attacks on September 11 2001.

The EU's overall priority in its international co-operation is the mutual recognition of customs inspections and security standards and relevant trade partnership programmes. The underlying intention is clear: if important trade partners and the EU mutually recognise security standards, duplication of customs controls is avoided, customs authorities can deploy resources more efficiently and trade is facilitated.

### This article explains ...

- the areas in which the European Union and China have been increasing their co-operation since 2005;
- the criteria companies must meet to be awarded the recently introduced status of particularly reliable economic operator;
- why the lengthy preparations are worthwhile for companies.

### EU/China co-operation on customs and trade flows

As early as 2005, the EU and China signed an agreement on cooperation and mutual administrative assistance in customs matters. Under the 'Smart and Secure Trade Lanes Pilot Project' the European and Chinese customs authorities exchanged information electronically on containers loaded in specific EU and Chinese ports. The aim of the pilot project was to test end-to-end supply chains from the point of packing containers, through the entire container journey, to the point of final destination.

Through this enhanced cooperation the EU and China intend to increase security in the transport of goods and to boost trade between their regions in the long-term. Important milestones on this path are mutual recognition of:

- security standards;
- results of customs controls;
- the status of the Authorized Economic Operator (AEO) under the relevant customs laws.

The latest techniques are also to be used to enhance the security of the supply chain.

In this respect China undertook a sweeping reform and modernisation of its foreign economic and customs laws in April 2008, a particularly important element of which was the introduction of the new AA classification used to assess economic operators. Further details are given in the sections below.

### Five-stage classification

The recently introduced AA classification used to assess economic operators is the Chinese equivalent of the EU's Authorized Economic Operator (AEO). By way of background, the assessment system for companies that export or import goods to China has been in existence since 1999. A number of assessment criteria – such as internal company control standards, business performance, compliance documentation and other information – are used by the Chinese customs authorities to divide importers and customs agents into categories A, B, C and D and, most recently, AA.

### AEO

The status of Authorised Economic Operator (AOE) is awarded on application to companies involved in foreign trade. Companies with this classification are considered particularly trustworthy and reliable.

Importers in category B continue to be treated as before and are subject to routine checks. Importers in categories C and D can

expect multiple and more comprehensive checks and controls. Importers in categories A and AA, on the other hand, benefit from considerable simplifications to customs regimes. These relate particularly to:

- transferring goods at port of entry;
- customs controls on the importer's factory premises;
- advance processing of customs declarations before goods arrive at the port of entry;
- waiving of the obligation to provide a cash bond or deposit.

### Category AA: preconditions and benefits

If a company decides to participate in the programme it is classified under category B on initial registration. Reclassification to category A is possible on application after twelve months but is dependent on certain preconditions being met: for example, no customs law should have been violated or trademark or copyright infringed in the last twelve months. China also insists on prompt payment of import duties and requires that the company's annual report be lodged with the customs authorities.

Companies aiming for category AA must meet the highest requirements. The company applying must:

- have annual import and export sales volumes over 30 million US dollars;
- have passed inspection by the customs authorities and fulfil all compliance, control and security-related obligations;
- submit the relevant annual company report, provide evidence of an annual audit, provide the annual report from the company's internal control department and the half-yearly import and export reports.

The lengthy preparation and application process pays off in terms of the benefits enjoyed by a company with AA status. In addition to the benefits of an A classification already referred to, it benefits from rapid customs clearance and direct transfer of consignments following electronic inspection. The customs authorities also do not expressly inspect goods under normal circumstances, which saves a considerable amount of time for the company. It is also allocated a contact person at the Chinese customs authorities who is available to answer any questions that arise.

The benefits are clear and AA certification is likely to be high in demand among Chinese exporters and importers. Certification is a considerable vote of confidence in the company by the Chinese authorities, which adds to its value, since certification shows that the Chinese authorities view the company as secure in relation to customs law because its internal customs and logistics process management effectively rules out negative effects.

### Outlook

The EU and China are working on mutual recognition of the AEO and the AA classification, which should mean that importing in China and the EU will be significantly easier in future, making this classification even more attractive. It can therefore safely be assumed that an increasing number of companies will be aiming for it.

To optimise their logistics processes, companies would therefore be well advised to set a target for all companies involved in their supply chain – from the manufacturer to the logistics service provider to the end client – to set their sights on obtaining this certification (AEO or AA). With the certification, traffic lights along the supply chain are always at green, giving goods flows from and to China a smoother, quicker and above all more secure ride. Both procurement and sales of goods are simplified and accelerated, bringing the company time and cost benefits and thus long-term competitive advantages.

Do you have any questions, or would you like us to advise you on AA status? If so, please call us or simply send us an e-mail.

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## Greenfield investments: your ticket to the Chinese market

Setting up foreign-invested enterprises (FIEs) in China is a route often taken by Western companies in order to gain a foothold in the Chinese market. China's attraction lies in its potential as a huge sales market, with an enormous repository of raw materials and labour, and a steadily improving legal framework. However, experience shows that the risks involved in entering the Chinese market by setting up an FIE are often underestimated. This article discusses how to limit potential risks and how an FIE is ideally set up. Practical examples are used to illustrate the text.

The increasing globalisation and networking of markets in recent years has led to increasingly tough competition in supply and sales markets. Manufacturing in Western industrialised economies is also facing the challenge of higher environmental and safety standards, as well as a long-term rise in energy costs. At the same time clients are increasingly demanding innovative, high-quality products at lower prices.

Companies are responding by creating new supply markets, opening production sites in low-wage economies and setting up distribution structures oriented towards global growth markets. The companies are undertaking long-term foreign direct investments (FDI) to improve their competitive position, to avoid being bound to local regulations and conditions, and increase operational flexibility. But the over-riding imperative is to create new growth markets outside hotly contested established markets where there is little potential. Experts refer to the long-term buildup of new companies abroad (for example as purchasing or sales companies, production sites, warehousing centres) as 'greenfield investments' (GFI).

### Foreign direct investments

The Organisation for Economic Co-operation and Development defines foreign direct investments (FDI) as foreign investments undertaken in order to develop a long-term strategic relationship with a specific company. Investors use them to ensure they retain influence over the way the company is run. FDIs include international M&As, GFI and a range of other forms of investment. The defining characteristic of GFIs is that they involve setting up FIEs, their structures and systems from scratch.

### China: a market with great opportunities but also risks

China's expanding economy is often seen as a market with endless possibilities for this type of activity. Media and trade events constantly emphasise the benefits of long-term investment in China. A steadily improving legal framework, continued progress in building up the infrastructure, and favourable conditions for production, in addition to enormous resources of raw materials and labour, all suggest that conditions are ideal for purchasing and production. At the same time there is huge potential for domestic demand as per-capita income rises and interest in Western products grows.

### This article explains ...

- how you can successfully set up FIEs in China as greenfield investments;
- the factors and risks you need to bear in mind;
- how you can use a specialised approach to integrate the FIEs in China in your network globally and locally.

Aside from the opportunities and potential, however, doing business in China also involves risks that are often underestimated. Along with the general national and economic risks, the following deserve special mention:

- The restrictive bureaucracy with its countless rules and exceptions is an obstacle to investment as it creates increasing levels of complexity and complicates planning.
- High levels of corruption create problems with compliance and hold significant financial, legal and personal risks.
- Non-transparent structures, ill-defined legal relationships and covert activities hinder day-to-day business and drive up the costs required to obtain information and insure against risks.
- Theft of intellectual property, industrial espionage and product piracy lead to technology loss and disadvantages vis-à-vis local and international competitors.
- Confiscation of goods without compensation and arbitrary state interventions have a huge impact on business activities and make it very difficult to create a sound basis for planning.
- Underlying cultural differences in values can cause conflicts with employees (high staff turnover, unreliability and disloyalty to company management, for example).

Although the effects of the global financial and economic crisis are certain to have a significant impact on the number of FDIs over the next few years, this will not reduce China's attractiveness as a target country for FDI investment.

Given that many foreign investors are unaware of Chinese market conditions and that the number of success and risk factors to be considered is steadily growing, GFI initiatives in China may well fail or fall far short of expectations. Ultimately this causes unnecessary losses of resources and efficiency along with risks that are next to impossible to foresee (such as losses associated with cost, quality, image or technology). As a result there are more and more reports in the press of companies that fall short of expectations in China and are now shifting production sites back to their home country.

Setting up FIEs in China successfully is always a challenge for companies as it requires expertise and resources, and ties up capacities over the long term. On the other hand, this also means that once established, companies that have learnt to control these risks have an appreciable competitive advantage and can succeed in the Chinese market.



## Nine-item to-do list for successfully setting up FIEs in China

1. Strategy: build a clear understanding of the future role and function of the FIE in China with a long-term development plan
2. Responsibility: assign responsibilities clearly, as well as performance assessment criteria at all levels
3. Success factors: carry out a detailed analysis of variables, basic conditions and risks (national and local)
4. Organisation: adopt a targeted and consistent approach by setting up an organisation that is in line with the strategic objectives, includes key factors and allocates available resources efficiently
5. Transparency: set up and maintain the highest possible level of transparency whilst simultaneously simplifying any complexities as they emerge
6. Communication: encourage comprehensive communication between the various interest groups at an early stage to identify and resolve any differences in expectations
7. Network integration: systematically integrate FIEs into local and global networks while concentrating on key strategic contacts
8. Culture: nurture cultural sensitivity and the inclusion of culture-specific aspects in business activities and organisational development from an early stage
9. Management and controlling: set up and permanently improve systems for management reporting and controlling to purposefully manage the FIEs and limit risks from the beginning

## The structured GFI approach: the basis for a company's success

The correct approach is crucial to the success of a FIE in China's market entry and long-term performance. A structured and comprehensive GFI approach to outsourcing helps you ...

- formulate clearly the objectives and expectations behind market entry in China;
- provide the necessary expertise, capacity and resources;
- identify and limit risks from an early stage;
- prevent costly mistakes and losses of resources or efficiency.

The GFI services approach used by PricewaterhouseCoopers provides you with a structured and comprehensive methodology. Starting at the strategic level, all important issues involved in preparing and implementing market entry are taken up and discussed with the interest groups during the preliminary stages of the project. The necessary decisions are then made in stages, from strategic planning to operational implementation. The approach starts in the head office country and then builds a bridge to China before developing the required structures further there.

The following sections list the individual steps within the GFI services approach in detail and illustrate them with examples.

## Internationalisation strategy

The internationalisation strategy is developed on the basis of the company's internal vision and identifies the markets and regions in which future foreign activities are to take place, as well as defining these activities. The internationalisation strategy thus provides the basic framework for the long-term development of the international group of companies and assigns the roles to be taken on by the various FIEs. This defines the future role of the

FIE in China, the local strategy and operational framework, the various stages of development and the required capacity and resources.

It is clear from all this that the internationalisation strategy must be comprehensive, contain clear definitions and be designed for the long term. This is the only way to ensure that the GFI project takes all relevant success factors and risks into consideration and that the right decisions are made.

Given the increasingly dynamic nature of the markets, companies will also be well advised not to base strategies and their defined objectives on short-term static conditions. Instead they should develop a logical, consistent and long-term entry and growth strategy for China, which can succeed even if global and local conditions change. In addition in some cases a strategy of small steps, initially only involving the establishment of small external offices, may be useful for the company to familiarise itself with the Chinese market. Here a first step might 'only' involve gathering information and keeping financial investment and risks to a minimum.

Whatever strategy is adopted and whatever the scope of the external commitments, clear objectives and realistic, measurable variables are useful in order to accurately steer the activities of the FIE and create the necessary transparency, so that the success of the market entry can be measured in the short and medium term.

## Selecting locations

China is a country of geographical and cultural contrasts and offers a huge range of investment and location options. The overarching internationalisation strategy, future objectives, the development plan and resource requirements are used by companies within the GFI services approach to draw up a catalogue of criteria to identify the most suitable location. This allows any decision on location to reflect the best mix of location characteristics in view of individual priorities. In particular, these include existing infrastructure, production conditions and input factors (such as, energy, labour, supply of raw materials), state incentives, as well as tax and legal aspects. The operating environment and the location characteristic can vary significantly between regions, so that specific criteria should be subjected to detailed analysis and the locations carefully weighed.

The following examples make these differences clear:

- Example 1: In some parts of China the concept of 'connecting to the infrastructure' must be understood in broader terms than in Western countries. The significant contrast between the Eastern coastal strip and the Western provinces in particular shows that it is not enough to consider connection to traffic routes, energy, telecommunication and water services. Companies need to realise that infrastructure also includes the presence of public institutions and private service providers,

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since in many cases the 'hard' infrastructure may be adequate, but the 'soft' infrastructure required to run the FIE is lacking. This includes for example financial institutions, service providers, subcontractors (such as, accounting, HR services, logistics, facility management, security, IT), authorities or institutions. If this 'soft' infrastructure is missing, support functions along the value chain that were originally to be outsourced must now be prepared, implemented and coordinated in-house, increasing investment costs and administrative expenditures.

- Example 2: State incentives and Special Economic Zones or Special Administrative Regions are intended to create particularly favourable investment conditions for foreign investments. Within these zones the authorities apply a special economic policy that permits tax allowances and specific forms of state incentives. These factors should therefore be included when selecting a location and their effects should be weighted accordingly (see figure 2).



Special Administrative Regions (SAR) and Special Economic Zones (SEZ) in China

- Example 3: In various regions of China sufficient data transmission capacity (bandwidth) and in particular protection of data from hackers (industrial espionage) cannot be guaranteed. Connections to global company intranets and systems such as SAP are either not possible or only possible at enormous cost.
- Example 4: Local networks are significant factors in successfully setting up an FIE in China. The authorities, public institutions and influential individuals have enormous discretion and thus are able to influence location criteria at your location

positively or negatively. This results in decisions that have unpredictable consequences and sometimes may even become obsolete. For this reason companies should first ascertain how open the local network is to foreign investors and what local regulations are imposed on investors and their FIE.

## Corporate governance

The internationalisation strategy determines the future role of the FIE and forms the basis for corporate governance. Whilst the internationalisation strategy still provides a broad definition of roles and responsibilities at strategic level, the corporate governance policy defines interaction with the parent company and integration within the global group of companies in detail down to the level of functions. Particularly in complex GFI projects involving intercultural, cross-border cooperation, this creates the transparency required to steer the start-up and subsequent operational phases. Many GFI projects in which PricewaterhouseCoopers has been involved have shown that defining the corporate governance policy at an early stage and the transparency this creates have been major factors in successfully establishing the FIE.

Four examples taken from practice make the connection clear.

- Example 1: For a long time, companies setting up an FIE in China were required by law to find local partners and to establish joint ventures with them. Although this rule has been relaxed there are still many advantages in forming a joint venture. However complex the formal agreement on future cooperation may be, partners may in fact have diverging interests. Thus the Chinese side may for example be more interested in investment and technology whereas the foreign investor views the FIE as more sales-oriented and intends to open up the Chinese market. Those familiar with Chinese (business) culture know that there is often only a limited understanding of the interests of the Chinese partners at the point of signing the contract. It is therefore important to take suitable measures to achieve maximum transparency if the company is to control and steer the activities of the local partners and its FIE.
- Example 2: Employees in many Western companies have mixed feelings about setting up an FIE in China. In the long term, staff in the parent company fear that this will lead to uncontrolled technology transfer and the loss of jobs in the future. This means that the Chinese commitment is viewed as internal competition within the company. The reaction of parent company staff to a GFI project often range from indifference and passivity to active resistance. Here too practice shows that a clear and transparent definition of the future role of the FIE within the group of companies fosters the willingness to cooperate in the organisation, breaking down unfounded resentment and anxieties about the future.
- Example 3: A characteristic of many Chinese organisational models and work culture is their hidden, non-transparent structures and processes. Diverging views of transparency and regulations require precise rules to be put in place for the

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decision making process, which include all the relevant mandates, as well as transparent financial controlling and reporting of key company activities and performance indicators. When the FIE starts up business operations this transparency should be put into action, so that any risky business activities and developments can be identified and addressed at an early stage.

- Example 4: Adherence to international rules and internal guidelines on compliance and corruption is only possible if clear rules are set for the FIE in China. Particularly where the company is working in close cooperation with Chinese people and companies, clear rules are essential, even if they are perceived to be somewhat inflexible practically and formally. Recent developments in regulation however have made one thing clear: there has been a change in mentality in China in favour of greater transparency and more responsible business methods. The Chinese government has been publicising the fact that compliance with the 'responsible business conduct' guidelines is widespread. These include the creation of greater transparency by including more financial and non-financial information in the annual financial statements, improving protection of intellectual property and improving provisions for employees and the environment.

## Organisational development

Once the strategy is in place, the location is found and the corporate governance policy has been defined, a company can start to develop the organisation. This includes designing the various company functions, core and non-core processes, setting up systems and defining roles and responsibilities.

However experience shows that the organisation is all too often not set up in a structured, targeted manner within many GFI initiatives. All too often the responsible decision makers are left alone with the task on site and given insufficient resources and capacities. In this way a target-oriented organisational development becomes a random product based on demand and the FIE growth can hardly, if at all, be controlled. This leads to communication, coordination and cultural problems, as well as causing performance and efficiency losses. Depending on available capacities, expertise and resources, the success of the GFI project will then hinge on a small number of decision makers, and their own abilities and networks.

The organisation should be set up in a targeted and efficient manner, so the FIE doesn't become autonomous and isolated. A recommended first step towards this is to benefit from standardised basic business processes ('company in a box' approach). Such standard processes (for purchasing or sales companies, for example) provide a good overall framework. They are subsequently aligned with the parent company's processes and systems, accordingly modified, and adjusted to reflect local requirements in China. Processes and systems developed in this

way can be used as reliable blueprints for the FIE's organisational development.

The advantages of this approach are clear: structures, processes and systems with a good track record can be copied, modified and then implemented. Communication problems and efficiency losses can be identified and dealt with in advance. Both establishing the new FIE and ramping up its performance are significantly faster, than if the organisation were left to itself to grow in an uncontrolled manner.

## Examples:

- Example 1: As a result of cultural factors, cooperation, whether internal to the organisation or across organisations, functions differently in China than in Western organisations. This manifests itself in a different approach to work motivation and loyalty to the company, the way in which Chinese employees deal with conflicts and criticism, and the amount of freedom they expect in terms of decision-making and creativity. It is precisely these cultural factors and differing expectations on both sides that lead to friction and a significant loss in efficiency. To avoid this, Western investors should appoint local advisers and staff when setting up the organisation to adapt systems and processes to local conditions together with the parent company's experts.
- Example 2: The organisation's staffing structure should contain a balanced ratio of expatriates and Chinese employees. For historical reasons, top and middle management levels staffed exclusively by expatriates can create resentment and a negative attitude in local staff.
- Example 3: Special care should be taken in China to develop and control systems and processes that impact on liquidity and payments. The required levels of transparency are often lacking when payment transactions are prepared and processed, leading to risk that endangers liquidity (duplicated entries, incorrect calculations, fraud, corruption, incorrect money transfers, for example).
- Example 4: Guaranteeing international quality standards is one of the biggest challenges facing foreign investors since there are no reliable independent institutions or certificates. However the processes and systems of the FIE must fulfil these basic conditions and must therefore prevent any quality-related risks that can lead to significant financial losses in home-market sales. In recent years problems relating to this have been the subject of press reports that focus mainly on the use of poisonous materials or inappropriate working conditions (corporate responsibility). These risks can be effectively restricted by the use of appropriate systems for quality and risk management. These ensure that suppliers and partners can be carefully audited, assessed, selected or rejected.
- Example 5: It has become clear in recent years that technology and intellectual property are among the major, yet most vulnerable, competitive advantages for any company. One of the organisational development priorities for an FIE in China is

# Investment and financing

therefore to ensure that these assets are not stolen or imitated. This does not just involve securing property rights but also includes setting up organisational and procedural precautions against industrial espionage and theft.

## Taxes, law and regulation

Whilst the future strategic and operational objectives of the FIE may be the priority, tax and legal aspects should not be neglected. Incorrect decisions relating to tax can later lead to substantial restrictions on business operations or significant financial losses, for example. It is therefore important to take tax and legal aspects into consideration and comply with international and national or local statutory requirements at all phases of a GFI project. This begins at strategic level when developing the investor's international tax strategy, selecting the location for the GFI or intermediary holdings, choosing the tax-optimised business entity, and deciding which operational capacities and risks will be transferred. It is also necessary to appoint experts on Chinese tax law at the operational level, when developing and implementing operational processes or sending staff to China, for example.

Those responsible within the GFI project should therefore make sure that the necessary legal compliance is secured for the FIE and make the right long-term tax decisions. They should design the organisation in accordance with legal and tax requirements, as well as adapt it to local conditions and international requirements.

The following three examples illustrate the challenges.

- Example 1: The actual tax load varies to such an extent between Hong Kong and mainland China that a significant factor in any decision between the two locations will be the post-tax profitability of any businesses activities planned there. At the risk of over-simplifying, one could say that business transactions where the location is flexible (such as, trade or services) often take place in Hong Kong. For less mobile activities like production, other location factors are more important (proximity to the market, wage costs). Here investment in the mainland is often favourable.
- Example 2: Any investment in China should be integrated into a pan-Asian tax strategy with regional holdings or service centres or so-called principal structures. This reduces the tax rate for profits achieved in Asia. The tax costs of domestic profit repatriation, such as withholding taxes or Chinese business tax, are also reduced.
- Example 3: Regional differences and the wide latitude on decision-making given to local authorities mean that regulations differ depending on which region you are in. Contracts are also often only given on a local levels, making local knowledge regarding location selection decisive.

## Localisation and start-up of business operations

The localisation and start-up of the FIE's business operations is the final step in setting up an FIE in China.

During the localisation stage the home company staff works on-site with local support to prepare and test the fledgling organisation and all systems and processes. If further local adjustments are required these can then be undertaken quickly and flexibly. At the same time the infrastructure is installed, the required material and tools are procured and the new staff recruited and trained. After successful testing and training the FIE is put into operation and the network set up.

Examples:

- Example 1: Appointing local staff and external support is essential if business operations are to be launched quickly and without any technical or organisational hitches. Local contacts familiar with the Chinese language and customs and who have a good personal network are particularly indispensable when overcoming problems rapidly and developing flexible solutions.
- Example 2: When setting up local networks, a sufficient level of inter-cultural experience is required, particularly with local business partners and local authorities. The Chinese concept of 'guanxi' makes this clear and translates broadly as 'relationship'. This refers to the network of personal relationships. It also includes the way in which people deal with each other and the manner in which negotiations are conducted. These networks are based on trust over the long term, require constant maintenance and rely on give and take. FIEs without the relevant cultural experience find it very difficult to set up these networks in accordance with the Chinese rules of the game. During negotiations, for example, Chinese people tend to be more concerned with the way the negotiation is conducted rather than – as with Western companies – the outcome. Chinese people therefore tend to view contracts and firm agreements as valid in principle, but departures from these agreements are acceptable if required. There is a similar view in China of donations and favours, which are not seen as bribes but rather as investments in personal relationships.
- Example 3: Certain cultural rites can be very important, as shown by the so-called dragon dance. At the ceremonial opening of the FIE appropriately high-profile representatives should be on-site to emphasise the importance of the international venture or the FIE. A high-profile German politician or a high-ranking personality will then be met by a Chinese politician of equal rank. The more prominent the company's own representative is, the more recognition the foreign investor will be given from the Chinese side. This form of mutual respect and the corresponding gesture of esteem also have an impact on cooperation and integration with local networks.

# Investment and financing

## Conclusion

As we have seen, a structured and planned approach is needed within a GFI project for a successful, speedy and efficient market entry in China. An organisation and infrastructure is required that is able to deal with the size of the FIE, the scope of its tasks and the complexity of interactions between the international and local network. The FIE must therefore be of sufficient maturity and have the required capacity and structures. Depending on the schedule and amount of resources available, one or more FIEs can then be set up at the same time in China, either operationally and turnkey ready or developed through a clearly defined series of stages.

The GFI approach makes it possible to set up large-scale projects across national borders and to establish and equip the FIE(s) efficiently. For this, the required activities, expertise, capacities and resources are coordinated in a holistic manner across borders and implemented in a targeted manner. Experience from a wide variety of successful GFI project is just as important in this process as a reliable global network with local contacts with their own local networks. This reduces unnecessary complexity and creates the transparency needed to enable the company to concentrate from an early stage on the right success and risk factors.

Do you have any questions, or would you like to benefit from the GFI services approach? – If so, please call us or simply send us an e-mail.

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### Renewable energies: good opportunities for German companies

For most Europeans, the most impressive aspect of China is its size. And these dimensions can be applied to almost all of its markets too. Today, the best opportunities are to be found in renewable energies – particularly given the history of gross failures in environmental protection and the distortions caused by the current financial crisis. German companies have an excellent reputation and can profit from the accumulated demand in spite of the increasing numbers of Chinese providers. However, they must first adapt to conditions specific to China. While the first article on this subject in *pwc:china compass* covers fiscal aspects and national subsidies (please see the article *Renewable energy in China: tax perspectives and incentives* on page 17), this article looks in detail at relations in the two heterogeneous market segments of solar and wind energy.

China continues to expand even in the current crisis, albeit, at a slower rate than in 2007 when the gross domestic product was over 11 percent. If 9 percent was achieved last year, as the National Office for Statistics announced in January, the forecasts for 2009 predict a 'mere' increase of between 5 and 7.5 percent. However, irrespective of all projections, the demand for power will certainly continue to grow. Additional measures to provide electricity in rural areas will further boost development. The governmental guidance catalogue for foreign investments seizes on the aims of the 11th Five-Year Plan and promotes the efficient use of resources and environmental protection. For environmental reasons, but also to satisfy demand, the government is increasingly looking to renewable energies. There is already talk of a boom in the area of solar and wind energy. In contrast, power generation from the thermal utilization of waste, energy from biomass, and the utilization of geothermal energy are still emerging sectors and experts predict a huge growth market. At the same time, Chinese suppliers are increasingly pushing into foreign markets.

#### Wind energy

According to estimates by the Global Wind Energy Council, the major areas of international growth in wind energy in the coming years will be the USA, India, and China. No other country in the world has seen more wind energy plant construction over the past two years than China. Almost 80 percent of the available capacity has been constructed in the last two years: after more than 3.3 gigawatts (GW) of wind capacity were installed in 2007, expansion in 2008 grew sharply with the installation of an additional 6.3 GW. According to data from the World Wind Energy Association, the installed wind energy capacity by the end of 2008 was 12.2 GW. China has thus climbed to fourth position in the world after the United States (25.2 GW), Germany (23.9 GW), and Spain (16.8 GW). However, experts are convinced that the real growth in this huge country is still to come and in the next two years, China could become the largest market in the world for wind energy systems. Based on updated planning data, the

#### This article explains ...

- what distinguishes the wind energy and solar energy markets in China;
- in which segments China is a stronger provider than consumer;
- what German providers should clarify before committing to an engagement in China.

Chinese Central Government has defined their expansion targets as 20 GW by 2010 and 100 GW by 2020.

For many years, international manufacturers have been active in joint ventures, including the German companies Nordex AG and REpower Systems AG. In franchise projects, however, only turbines with a domestic production share of at least 70 percent can be used. As a result of strong political support, numerous Chinese companies have been set up in recent years. There are at present approximately 70 Chinese manufacturers who are actively working towards expanding their market share. Two Chinese companies, Goldwind Science and Technology Co. Ltd. and Sinovel Wind Co. Ltd., joined the top ten global manufacturers in 2007. With 830 megawatts (MW) of installed capacity and a global market share of 3.7 percent, Goldwind is slightly ahead of Nordex and REpower (without Suzlon).

The majority of Chinese manufacturers deploy Western technology in their wind energy systems. At the beginning, the new manufacturers tended to use licences from established European companies. As a result, the majority of systems that are manufactured today are licensed products of western manufacturers. For example, since November 2004, there has been a licence agreement between REpower and the Dongfang Turbine Co. Ltd in the Szechuan province. This company manufactured its 1000th wind power system on a licence basis at the end of 2008. However, Chinese companies are increasingly developing their own systems. Yet to do this, they still draw on the proven know-how from Europe by commissioning companies – mainly engineering companies – with the development of wind energy systems.

As well as licences from Fuhrländer AG, Sinovel is utilizing developments from Windtec and Goldwind is using technology developed by Vensys Energy AG in addition to the existing licenses from REpower. In their own words, the Rendsburg engineering company aerodyn Energiesysteme GmbH, which has been concentrating its activities on the Chinese market for some time, supervises 'a good handful' of companies who want to develop their own systems. These include the emerging Guangdong MingYang Wind Power Technology Co. Ltd, which soon hopes to manufacture over 1,000 systems per year: systems certified by the German Lloyd Group. At present, German companies in the wind energy sector are mainly profiting from the sale of licences and the development of products for Chinese companies, in other words, from the transfer of knowledge to China.

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With the sharp rise in domestic manufacturers, international companies are increasingly losing market share. Although they used to be able to compete with Chinese companies on the basis of their advanced quality, the global market leader Vestas Wind Systems from Denmark, for example, suffered a decrease in market share from 23.4 to 11.2 percent. By providing 55 MW of capacity, Nordex could only achieve a market share of 1.7 percent (after 3 percent in 2006). Two simple figures illustrate the clear trend: whereas, in 2006, only 28 percent of the systems installed in China were supplied by Chinese companies, by 2007 this had already risen to 55 percent. And the current expansion efforts by the domestic manufacturers will boost rather than slow down developments.

China offers huge potential for using wind energy. With the expansion of domestic production capacities, the country is trying to meet the huge demand itself. This is being achieved increasingly. Up until now, the market has been predominantly domestic as Chinese systems are not yet exported on a large scale. As of 2009, this could change as an export offensive targeting Japan and Great Britain has already been launched. And MingYang is to supply Montana in the United States with 72 turbines. Whereas the indications in the wind market tend to point to a strong breeze, the barometer for the solar energy market shows that a storm is brewing.

### Solar energy

In spite of little government support, the solar energy industry in China has grown by at least 50 percent each year over the past five years. Power generation generally takes place using photovoltaic systems. At the end of 2008, the total installed power, mainly in remote rural areas, was approximately 150 MW. These remote regions also offer the best potential for future growth.

Some companies have already made an international name for themselves. Of the estimated 1,000 Chinese solar energy companies, a leading group of around one dozen has emerged. Most of these companies are now listed on international stock exchanges and must comply with international standards. By going public, they can guarantee sufficient available capital. In the meantime, Chinese companies have advanced into Europe and Japan. According to a survey, enough crystalline modules were manufactured in 2008 for a capacity of 5,630 MW. In comparison: for Japan, the figure was 1,664; in Germany it was 1,798, and for the whole of Europe it was 4,390 MW. The bottleneck caused by the silicon shortage has eased. Chinese growth rates were significantly higher in recent years than in Japan and Europe and today six of the ten largest solar energy companies probably come from China.

While most systems manufactured in Germany are intended for the German market, over 95 percent of Chinese products are exported, mainly to the United States and Europe. The entire solar energy industry is geared towards exports. China still plays

a minor role as a sales market for solar energy but has become a world leader in production. For this reason, Chinese suppliers have been hit hard by the financial crisis and the global slowdown in demand. A considerable number of smaller companies have already left the market and larger companies have reduced production. The Central Government is considering subsidy measures that will foster the consolidation of the sector at the same time.

The celebratory signing of an agreement in Xining at the start of the year seems fitting in this context. Together with the China Development Technology Group Corp. and the Qinghai New Energy Group Co. Ltd, the government of the Mongolian-Tibetan Autonomous Prefecture Qinghai Haixi approved the construction of a photovoltaic power plant with an initial capacity of 30 MW. When completed, it is expected to generate 1,000 MW of electricity, which would make it the largest solar energy plant in the world.

According to estimates from market experts, the Chinese solar industry still has to import 80 percent of its production technology; however, it is currently working towards reducing its dependence on components from abroad. Japanese and Western manufacturers still benefit from the quality of their products and new innovative technologies, for example, thin-film technology. Thus: the solar energy industry offers opportunities to become active in the market through technology transfer. As you are no doubt aware, the solar market is structured differently from the wind energy market and German companies are advised to thoroughly examine whether it makes sense for them to get involved.

### Opportunities for German companies

With a number of new and amended laws, China has tried to improve the framework conditions for investors in the areas of energy and the environment. The German Agency for Technical Cooperation has advised China on important aspects. German companies enjoy an excellent reputation in China and, in spite of the generally muted perspectives for economic growth at present, have good prospects especially in the area of renewable energy.

However, before engagement, some important preconditions should be fulfilled: essential is to analyse the market and its players carefully, to develop a comprehensive strategy for industrial legal protection, and to acquire a solid knowledge of fiscal and legal framework conditions. Last but not least, the Chinese culture is completely different from European cultures and this includes the ways and means in which business is conducted. Advice heeded from one of the many guides on business etiquette for German managers should soon pay off. At home, we automatically look to an expert consultant when faced with complicated issues or important decisions. This rule of thumb is no less valid when planning to enter the promising but difficult Chinese market.

## Investment and financing

Are you interested in further details on the subject of renewable energy or are you planning an investment in China? PricewaterhouseCoopers has effectively consolidated its industry expertise in the competence centre Renewable Energy.

If you require more information or advice, please call us or simply send us an e-mail.

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Do you know how many plastic bags are used every day at peak times in China?

Two billion. To reduce the impact on the environment, supermarkets have been forbidden to provide their customers with free plastic bags since 2008.

(Hans Hauenschild, China Takeaway, *Econ* 2007, page 146. The ban was introduced after publication of this book.)

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## Claus Schürmann

Since 2006, Claus Schürmann has headed the PricewaterhouseCoopers (PwC) European Tax Desk in Shanghai, which advises European enterprises on investment in China and Asia. He is supported in this by local Chinese teams and by colleagues from the China Desks in Beijing, Shanghai, Hong Kong and Singapore. – This function demands profound expertise in European tax law in order for advice given on the Chinese side to accord with the enterprise's position in Europe.

Claus Schürmann has worked in PwC's Asia Practice since 1993. He began in the Düsseldorf office and at the time mostly advised Japanese enterprises on their business dealings in Germany and Europe. Key themes were providing advice on setting up in Germany and Europe, auditing, VAT, transfer prices and financing. Claus Schürmann developed two other areas of consultancy expertise here: VAT and financing. In these fields, he was an active member of the European specialist groups on VAT and Finance & Treasury.

Claus Schürmann took over the German Tax Desk in Singapore in 2003 and held this post until 2005. Duties in this position entailed the support of European clients in their activities in Singapore and Asia. – When asked what he took away from his first stay in Asia, he cites tough negotiations on price and poor payment habits. He found the opportunity to travel widely, from Korea to Australia, in connection with the many regional projects to be an added bonus of these activities.

For him, a usual task in providing consultancy on China is conveying to the client that although tax law is somewhat detailed, its application depends to a high degree on its reading and interpretation by the particular tax authority. Some variation in German tax practice is, of course, not entirely unheard of to German taxpayers. But Schürmann finds the virtuosic creativity with which the Chinese tax authorities apply laws and regulations to be without peer.

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### Personal details

Claus Schürmann, Director, European Desk, Shanghai; born 1966, at PwC since 1993; member of the China Business Group since 2006, author *for pwc:china compass* since early 2006; married, one child, hobby: endurance sports

### Emerging markets' intensifying interest in Western Europe

Investors from emerging markets are trying to increase their presence in Western Europe. In 2008, investors from these countries paid a record 45 billion euros for Western European enterprises. The number of deals rose to 256 completed transactions. Acquirers from the Middle East top the ladder, but Chinese enterprises, in particular, have intensified their commitment to Western Europe. Chinese bidders paid almost 30 percent of the total invested by emerging economies in 2008, compared to just around 11 percent in 2006.

As a recent study by PricewaterhouseCoopers reveals, European enterprises can gain a strong partner here, not only for funding, but also for providing much-needed support in international growth markets. However, conflicts of interest and cultural differences can often hamper collaboration. Clearly, many emerging market acquirers wonder if they are just the last port of call after negotiations with European businesses have failed. – PricewaterhouseCoopers' just-published study *Eastern Approaches ... Maximising Success with Emerging Markets Acquirers* highlights the opportunities offered by collaboration with, for example, Chinese and other Asian enterprises, and also pinpoints the stumbling blocks Western Europeans should expect to encounter.

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#### Eastern Approaches ... Maximising success with Emerging Markets acquirers

Published by PricewaterhouseCoopers UK, February 2009

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### Impact of the economic crisis on China

The shockwaves of the global economic slowdown have spread at remarkable speed, catching most countries off guard. But like most volcanic eruptions, this crisis first reared its head many months in advance: Property prices in the United States were already giving cause for concern in 2007. Then almost all share values fell through 2008, reaching record lows in January 2009. Many enterprises have been forced to cut jobs, and no end is yet in sight.

Like dominoes the crisis has spread in all directions from the United States, rapidly reaching the rest of the world – Europe, South America and Asia ... including China.

In their informative analysis, *The economic crisis poses new challenges to China's wisdom on economic growth*, authors from PricewaterhouseCoopers China shed light on the beginnings of the crisis and its impact on the Chinese economy. They also analyse the raft of measures enacted by the Chinese government late last year.

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#### The economic crisis poses new challenges to China's wisdom on economic growth

Published by PricewaterhouseCoopers China, December 2008, 12 pages

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[www.pwccn.com/home/eng/cn\\_econ\\_crisis\\_dec2008.html](http://www.pwccn.com/home/eng/cn_econ_crisis_dec2008.html)

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## German business hubs as locations for Chinese companies

Urban centres with good infrastructure, excellent transport connections, large numbers of national and international companies, and a wealth of cultural offerings are particularly attractive to Chinese enterprises. – But how well prepared are the metropolitan regions? What conditions do Chinese companies and investors find in these locations? What actions are communities taking to appeal to Chinese investors? – To answer these questions, PricewaterhouseCoopers conducted a study comparing the business hub of Hamburg with others in Germany, namely Berlin, Düsseldorf, Frankfurt and Munich.

Chinese companies place great value on support services offered by a community. They want to be courted and any region aiming to win a bid should pay particular attention to this. Maintaining city partnerships in order to raise your profile in China and create a positive image is just as important as measures taken to encourage Chinese companies to locate in an area.

Chinese companies are very interested in Germany and its metropolitan areas. The crisis will not change this, although Chinese companies are certain to exercise more caution than before and be more careful when choosing locations. Each of the metropolitan areas analysed in the study is well positioned in relation to China. Maintaining and building on their strengths is, particularly in the current economic climate, the best way for locations to retain and, if possible, develop their attractiveness to Chinese companies.

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**Hamburg – die richtige Adresse. Attraktivität deutscher Metropolen für chinesische Unternehmen**

Published by PricewaterhouseCoopers Germany, *April 2009*

### Download

A download of the study will be available begin of April 2009.

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### Restructuring investments in China

The global financial and economic crisis is forcing many enterprises to rethink and restructure their investments in China. – Together with SJ Berwin LLP and Fiducia Management Consultants, PricewaterhouseCoopers (PwC) is therefore addressing this subject on 26 March 2009 in the halls of the Cologne Chamber of Commerce and Industry (IHK-Köln), at an event hosted by the German-Chinese Business Association (DCW).

In light of the crisis, experts will begin by discussing possible challenges to Joint Ventures (JV) in China, from sales slumps to cancellation of loan contracts and consequent financing shortfalls to corporate insolvency. Specialists will debate possible exit strategies – and possible survival strategies (such as the sale or purchase of JV shares, foundation of a new JV, exploration of new business areas) – and pinpoint the opportunities and challenges which the new conditions pose to German investments in China.

As you will have read on page 22, the Chinese Corporate Tax Reform also included a redesign of the Chinese reorganisation tax law. – PwC will clarify tax aspects of restructurings and present you with an overview of the forms of restructuring. You will receive information on special (tax-free) restructuring opportunities and the conditions for tax exemption, on accounting and valuation questions and on related documentation requirements. – Regulations on cross-border restructuring will be addressed, as will the tax treatment of liquidations and the so-called 'Chongqing Case'.

There will be a chance to talk to the speakers after the event over refreshments.

#### Venue/date

IHK Köln, Merkens-Saal  
26 March 2009, 4-7 pm

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