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cutting through complexity

Investment in the People's Republic of China

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Contents

Introduction

The People's Republic of China remains an attractive investment destination for overseas investors, but the next five years (2011 – 2015) will become increasingly complex as the business landscape continues to evolve.

In 2011, China released its 12th Five-Year Plan, which is the nation's blueprint for the next five years. New laws and regulations will impact how companies do business. Nearly every aspect of the economy will see changes, including tax law, environmental regulations, and investment incentives. In line with the Plan's key themes, business opportunities will expand in key sectors, such as renewable energy.

The country has in recent decades established itself as a leading manufacturing centre, the world's factory. However, its attractiveness as a consumer market and location for R&D has been growing in recent years and these are focus areas of the 12th Five-Year Plan.

Investment success requires an understanding of China's different regions, business practices, history and culture. In addition, in light of the government's strong involvement in many aspects of the economy, prospective investors should take the time to learn how central legislation will affect business activities in their particular sector.

This guide has been designed as an introduction to investment issues in China, drawing from KPMG's decades of business experience here. The information in this publication is not intended to address specific business situations you may face. For assistance with China-related issues, it is recommended that you seek professional advice.

For more in-depth analysis of individual industry sectors in China, please read our latest publications, available on KPMG China's web site. Further details about KPMG in China can be found in chapter six, KPMG in China and Hong Kong SAR.

Best regards

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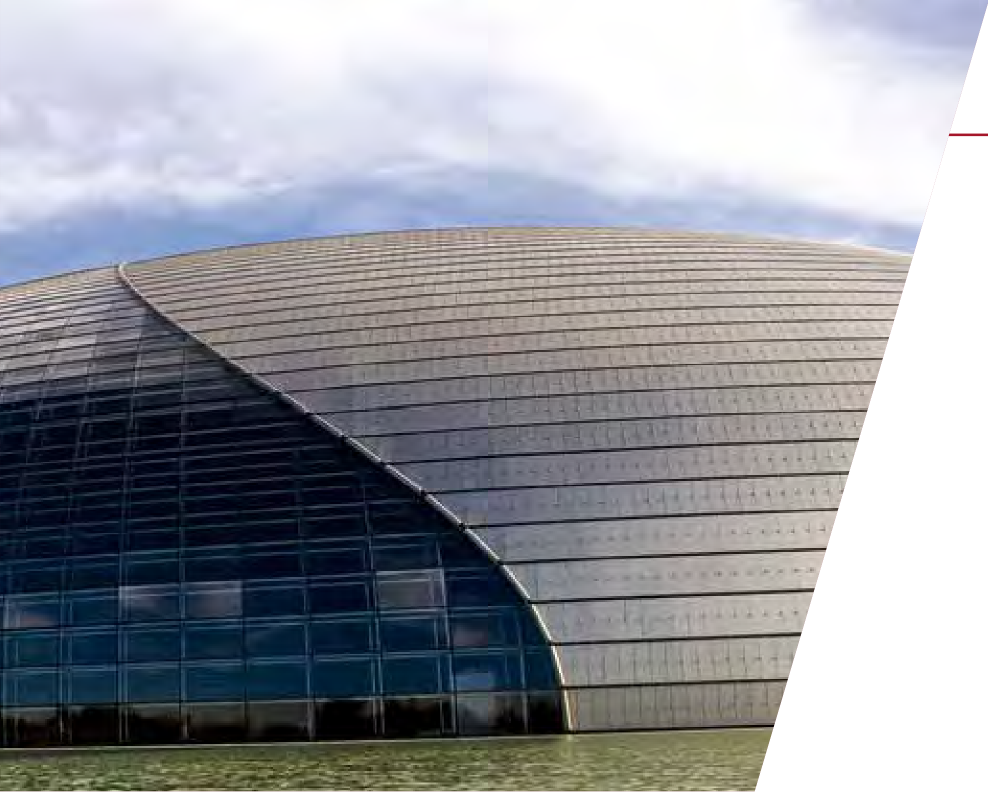
Important disclaimer

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavour to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.

Country outline



Review of the last five years

The last five years in China have been particularly noteworthy: China not only hosted the Olympic Games in 2008 but also the World Expo in Shanghai in 2010. During this period, the country also engaged in a major reconstruction effort after the May 2008 earthquake (Richter scale 8.0) in Sichuan province.

The period 2008-2009 underscored the interconnectedness of today's global economy, as financial turmoil originating in developed countries spread quickly throughout the world. China responded with a massive RMB4 trillion (US$586 billion) stimulus program that stabilised the economy.

In 2010, China became the world's second largest economy; Chinese companies have prospered as well, and now 61 Chinese companies are ranked in the Global Fortune 500.[1] Together with this ascent, wages levels have been increasing across the country, contributing to inflationary pressure.

One key development is China's progress with currency reform as the yuan was again allowed to trade more freely, beginning in mid-2010.

At the time of this publication, worldwide economic concerns are again rising to the forefront, so China faces important challenges heading into the period of the next five-year plan.

China Map

1. CNN Money, 2011 Global 500 list

Geography

The People's Republic of China (PRC), with a land mass of 9.6 million square kilometres, is the third largest country in the world, after Russia and Canada.[2] It borders Mongolia in the North; Russia and North Korea in the Northeast; Vietnam, Laos, Myanmar (Burma), India, Bhutan, Nepal and Pakistan in the South; and Kazakhstan, Kyrgyzstan, Tajikistan and Afghanistan in the West. Beijing, in the Northeast, is China's capital and the seat of government.

The PRC comprises 22 provinces, five autonomous regions, four municipalities and two Special Administrative Regions (SARs) – Hong Kong and Macau. Taiwan is officially recognised as part of China by most governments around the world.

China is home to some of the longest rivers in the world, including the Yellow River to the North and the Yangtze River to the South. These divide China into three distinct regions as they flow from the Tibetan and Qinghai plateaus to the eastern seaboard.

Climate

The PRC's climate varies considerably. The land to the north of the Yangtze is subject to severe seasonal variations, with hot summers and bitterly cold winters. South of the Yangtze conditions are more temperate, and Hainan Island is mild and tropical throughout the year. Average rainfall ranges from 50 millimetres per year in the North to 2,000 millimetres per year in the South. The southern coastline is often affected by typhoons, mainly in summer and autumn.

History

With a recorded history of nearly 4,000 years, and with artefacts over half a million years old still being uncovered, China is one of the world's cradles of civilisation.

The first empire based on hereditary transfer - the Xia Dynasty - was created in the 21st century BC. In 221 BC, Qin Shihuang unified China and became the first emperor of the Qin dynasty. He standardised China's currency, weights and other units of measurement and imposed a unified writing system. In addition, he introduced political and military reforms which increased the power of the central government. During his reign, the nation undertook groundbreaking projects such as the Great Wall and a national road system.

In the ensuing years, China's borders have repeatedly contracted and expanded as successive dynasties rose and fell. The last dynasty, the Qing, fell in 1911, and the Republic of China was established. By this time, Europeans had established trading enclaves in many coastal cities, including Tianjin, Qingdao, Shanghai, Xiamen and Guangzhou.

China's history in the 1930s and 40s was marked by conflict – both between Chinese and invading Japanese forces, and internally between the Chinese

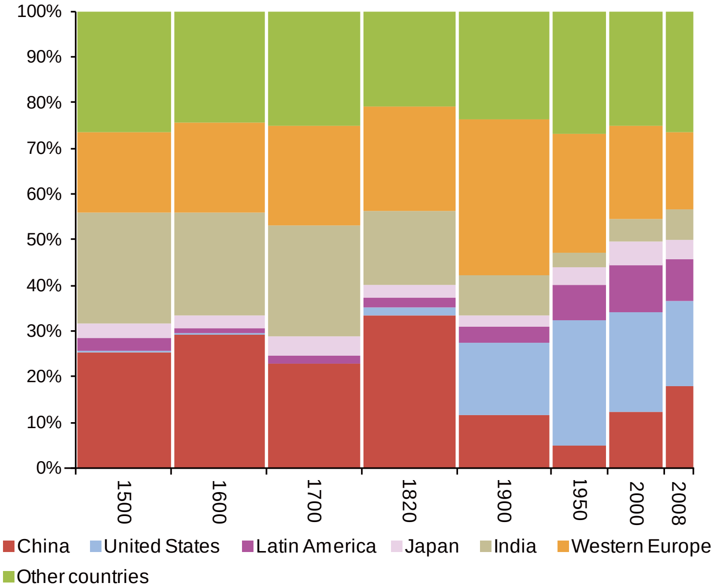
2. This ranking only takes land mass into account. If interior bodies of water are included, the United States is the world's third largest country (CIA Factbook)

China's return

In the early 1800s, China had the largest economy in the world.[3] Its GDP accounted for 30 percent of the world's total. At that time the combined GDP of Western Europe and the United States was just over 20 percent of worldwide GDP.

By 1900, China's GDP had fallen to around 11 percent of the world's GDP and declined further in ensuing years as the nation struggled with internal and external conflict. The chart below gives a glimpse of the world's economy over the last 500 years. From a historical perspective, China's rapid economic ascent in recent decades is not a new phenomenon but a return to its past status as a leading economy.

Relative size of major economies during the last 500 years



Note: comparison is based on "international dollars" which take into account purchasing power parity
Source: Angus Maddison, Historical Statistics of the World Economy, University of Gröningen

Communist Party led by Mao Zedong and the Nationalists (Kuomintang). Following the defeat of Japan, and victory by the Chinese Communist Party in 1949, the People's Republic of China was established.

The period from 1949 to the early 1970s was defined by internal restructuring of the economy, with politics and a succession of ideological campaigns impacting heavily on all facets of life. There was limited contact with the outside world, and no private businesses.

From the mid 1970s onward, under the leadership of Deng Xiaoping, the PRC re-established diplomatic and trade relations with the world. The economy has been substantially re-oriented towards a market-driven system (with Chinese characteristics), and while state-owned enterprises still dominate some sectors, the rise of private businesses has been a feature of China's recent economic growth.

Over the past decades, China has emerged as a major industrial and exporting nation. With a permanent seat on the United Nations Security Council, and membership in numerous international and regional bodies, China is taking a more active role in international trade and diplomatic affairs.

As part of this transformation, since the early 1980s the government has established a number of Special Economic Zones, to facilitate economic development and serve as a test case for wider economic liberalisation. The PRC has also expanded to incorporate Hong Kong and Macau which had been administered by Britain and Portugal respectively. Hong Kong reverted to the PRC as a Special Administrative Region on 1 July 1997 and Macau followed on 20 December 1999.

China's entry into the World Trade Organization (WTO) in 2001 was another milestone in the country's history and opened the borders to global trade. Conditions for China's WTO entry included lowering import tariffs and allowing foreign firms greater access to the Chinese market.

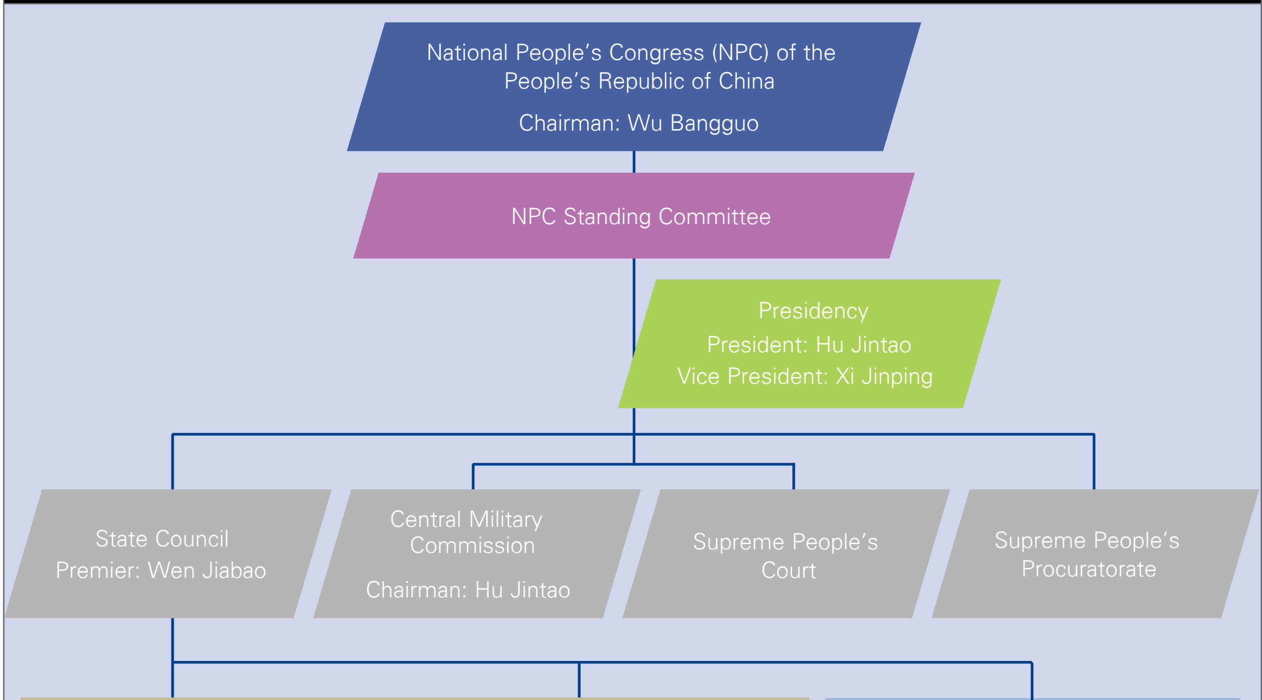
Selected WTO commitments
Non-discriminatory treatment to all WTO members in trade matters
Eliminate dual pricing as well as different treatment for goods produced for domestic sales vs exports
Price controls will not be used to protect domestic companies
Revision of existing domestic laws and passing new legislation to comply with the WTO Agreement
Within three years of accession, all companies can import and export all goods (subject to certain exceptions)
No export subsidies on agricultural products
Source: WTO Press Release, WTO successfully concludes negotiations on China's entry, 17 September 2001

3. Angus Maddison, Historical Statistics of the World Economy, University of Gröningen

Government

The National People's Congress (NPC) is the highest organ of state power. About 3,000 delegates are elected by provincial people's assemblies. The NPC includes representatives from all the provinces, autonomous regions, municipalities and Special Administrative Regions, as well as from the People's Liberation Army. It sits for five years and meets once each year. When not in session, its powers are exercised by a Standing Committee assisted by a number of special committees working under its direction.

PRC Government Structure



Ministries and Commissions

- Ministry of Foreign Affairs
- Ministry of National Defense
- National Development and Reform Commission
- Ministry of Education
- Ministry of Science and Technology
- Ministry of Industry and Information Technology
- State Ethnic Affairs Commission
- Ministry of Public Security
- Ministry of State Security
- Ministry of Supervision
- Ministry of Civil Affairs
- Ministry of Justice
- Ministry of Finance
- Ministry of Human Resources and Social Security
- Ministry of Land and Resources
- Ministry of Environmental Protection
- Ministry of Housing and Urban-Rural Development
- Ministry of Transport
- Ministry of Railways
- Ministry of Water Resources
- Ministry of Agriculture
- Ministry of Commerce
- Ministry of Culture
- Ministry of Health
- National Population and Family Planning Commission
- People's Bank of China
- National Audit Office

Other organisations under the State Council

- General Administration of Customs
- State Administration of Taxation
- National Bureau of Statistics
- State Intellectual Property Office
- China Securities Regulatory Commission
- China Banking Regulatory Commission
- China Insurance Regulatory Commission
- Xinhua News Agency
- State-owned Assets Supervision and Administration Commission
- State Administration for Industry and Commerce

Note: As at October 2011

The NPC and its Standing Committee amend the constitution, enact decrees, interpret laws, appoint ambassadors, ratify treaties, and approve economic plans and state budgets. They are also empowered to appoint and remove the country's premier and vice premiers, who collectively comprise the State Council.

The State Council is the highest organ of state administration and operates through various ministries. Local People's Congresses and standing committees assist with implementation of policies at the provincial, regional and municipal level.

The 12th Five-Year Plan

"We should not only make the cake of social wealth as big as possible, but also distribute the cake in a fair way and let everyone enjoy the fruits of reform and opening up" – Premier Wen Jiabao, 27 February 2011

National development policies are formulated every five years. These plans set the direction of the country, and have implications for the private sector as well as the government and state-owned industries. The ensuing legislation is guided by the themes set forth in each five-year plan. The twelfth and most recent plan was issued in March 2011 and applies to the period 2011-2015. It includes policies to boost domestic consumption, improve living standards, develop western and central regions, and protect the environment.

The plan identifies seven strategic industries which are expected to benefit from special incentives and funding:

- Energy conservation and environmental protection
- Next generation IT
- Biotechnology
- High-end equipment manufacturing
- New energy
- New materials
- Clean energy vehicles

Consistent with these priorities, some sectors will see a more open investment environment, whereas others – especially heavily polluting industries – will become more restricted.

For additional information about China's 12th Five-Year Plan, please visit KPMG's Insight Series available on: http://www.kpmg.com/cn

KPMG Insight Series

China's 12th Five Year Plan: Overview

China's 12th Five-Year Plan: Consumer Markets

China's 12th Five-Year Plan: Energy

China's 12th Five-Year Plan: Sustainability

China's 12th Five-Year Plan: Tax

China's 12th Five Year Plan: Transportation and Logistics

The Communist Party of China is a parallel authority run by a Central Committee. The Politburo of this Central Committee is the most powerful political body in the country. One of its functions is to give advice to the NPC and its Standing Committee concerning the appointment and removal of the premier and vice premiers.

The country's president, Hu Jintao, is appointed by the above bodies.

When undertaking business activities, it is important to realise that the central, provincial, regional and municipal governments may each have an interest in an issue and may each have the power to create regulations and take relevant decisions. These interrelationships lend additional complexity to doing business in China; KPMG can advise overseas investors concerning these stakeholders.

Population and demographics

The PRC has the largest population in the world. At the end of 2010, the PRC's population stood at 1.34 billion.[4] This vast population is unevenly distributed, with most people living along the eastern seaboard, in southern China, and on the central plains.

In recent years, many rural residents have been migrating to cities in search of better paying jobs. Urbanisation statistics vary, but most sources place China's current urbanisation rate at nearly 50 percent.[5] The chart below gives China's urbanisation trend from 2006 to 2010.

Leadership transition

President Hu Jintao and Premier Wen Jiabao will retire as China's leaders after completing their terms.

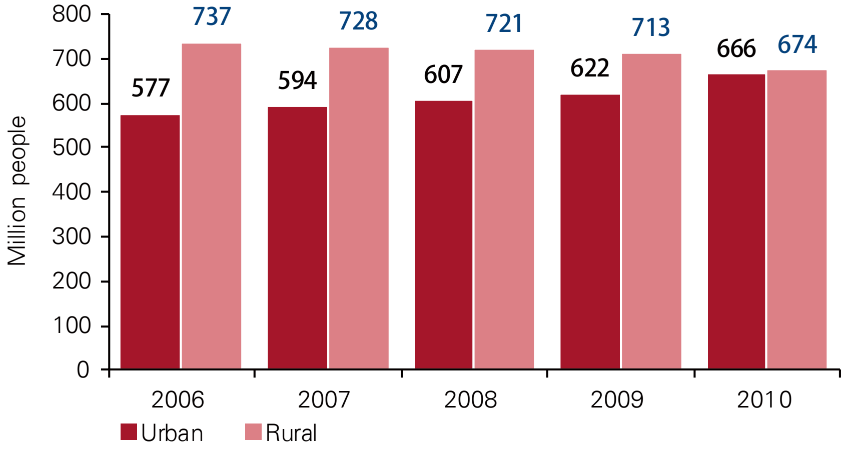
The leadership transition first involves handing over power within the Chinese Communist Party (CCP), scheduled for late 2012 when the CCP's 18th congress meets. Next, the country's new leaders will assume their roles as President and Premier of the PRC in early 2013.

According to political analysts, Vice-president Xi Jinping is expected to be the next president; and Vice-premier Li Keqiang is likely to take over as the next premier.

Source: EIU ViewsWire, 1 July 2011

4. China's 2010 Population Census
5. China Statistical Yearbook (2006-2009 data); National Bureau of Statistics, Sixth Population Census (2010 data)

China's urban and rural population (2006-2010)



Sources: China Statistical Yearbook, 2006-2009; Sixth Population Census (November 2010); KPMG analysis
Note: 2010 data as of 1 November 2010

Where the people are: China's 2010 census

During China's 2010 census, 10 million workers had the daunting task of counting China's people.

Key findings from the census:

- Mainland China's total population is 1.34 billion people, an increase of 5.84 percent from the previous census in 2000
- Citizens aged 60 or more account for 13.26 percent of the population
- The number of migrant workers stood at 221.4 million people[6]
- Urban residents account for 49.7 percent of the total (compared to 36.09 percent in 2000).

In the last decade, people have been moving to the country's eastern region, where the population expanded to 37.98 percent of the total (up from 35.57 percent in 2000).

Source: Reuters, China's 2010 Census, 28 April 2011

6. Migrant workers include people living away from their registered address for more than six months

Relative population size and GDP of China's cities

Chongqing, Shanghai and Beijing are China's largest cities based on population.

China's largest cities (ranked by population)

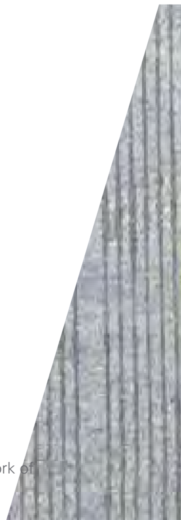
	Population (million)	2009 GDP (RMB billion)
Chongqing	29.6	652.9
Shanghai	19.2	1490.1
Beijing	17.6	1186.6
Chengdu	12.9	450.3
Tianjin	12.3	750.1
Guangzhou	10.3	911.3

Many of China's "smaller" cities (ranked below) have populations exceeding five million people.

Other large cities (ranked by population)

	Population (million)	2009 GDP (RMB billion)
Harbin	9.9	325.8
Shijiazhuang	9.9	311.5
Suzhou	9.4	774.0
Wuhan	9.1	462.0
Shenzhen	8.9	820.1
Qingdao	8.5	489.0
Xi'an	8.4	271.9
Hangzhou	8.1	509.9
Shenyang	7.9	435.9
Nanjing	7.7	423.0
Ningbo	7.2	421.5
Jinan	6.7	335.1
Changsha	6.6	374.5
Kunming	6.3	180.9
Wuxi	6.2	499.2
Dalian	6.2	434.9
Hefei	5.1	210.2

Note: these two tables are based on 2009 data and include urban and non-urban residents in each city
Source: China provincial statistical yearbooks, 2010



Language

Written Chinese consists of ideographic characters and it is necessary to know thousands to be able to communicate effectively. Written Chinese is the same throughout the country. In 1956, as part of the government's programme to improve literacy, Chinese characters were simplified. Schools in mainland China use these "Simplified Chinese" characters, while Hong Kong SAR, Macau SAR and Taiwan continue to use the original "Traditional Chinese" characters.

China is home to 56 distinct ethnic groups, and spoken Chinese is subject to many regional variations. The official language of China is Putonghua, commonly known as Mandarin. Major regional dialects are Northern and Southern Wu (which includes local dialects such as Shanghainese), Cantonese (Hong Kong and parts of Southern China), Fujian dialect and Hakka.

Knowledge of overseas languages can sometimes be limited, especially in the inland provinces. While this usually does not pose too many problems for travellers, it may be advisable for business travellers to seek translation and interpretation services when visiting.

Currency and banks

The official currency of the PRC is the renminbi (RMB), issued by the People's Bank of China. The base unit of the renminbi is the yuan (often referred to colloquially as kuai), and banknotes are available in denominations of 1, 5, 10, 20, 50 and 100 yuan.

The PRC government supervises the foreign exchange market through the State Administration of Foreign Exchange (SAFE). Current account foreign exchange receipts and disbursements can be conducted largely without restriction, while capital account foreign exchange receipts and payments are still subject to strict control.

Businesses, including foreign invested enterprises, may buy and sell foreign currency for trade and non-trade current account receipts and payments through designated banks.

The RMB is not a fully convertible currency, and limits are imposed on the amount of currency which may be carried in and out of the PRC. Foreign travellers may obtain RMB within the PRC at banks and authorised currency exchanges. If not used, a limited amount of RMB originally purchased can be converted back to foreign currency when leaving the country.

Having been closely aligned to the United States dollar for much of the previous decade, the RMB was most recently allowed greater trading flexibility on 19 June 2010.

RMB exchange rate flexibility

On 19 June 2010, the People's Bank of China (PBoC) announced the continuation of its currency reform, allowing the RMB more freedom to fluctuate based on market forces. Under the current system, the RMB is allowed to rise or fall by 0.5 percent from the central parity rate which is set every day.

At the time of this publication, 1 United States dollar = 6.31 Chinese yuan, which represents an approximate 8 percent increase from the date of the PBoC's announcement.

China has expressed reluctance to allow a rapid rise of the RMB which could hurt the nation's export sector. However, China's leaders recognise that a stronger RMB is a tool to combat domestic inflation.

Source: Bloomberg

RMB liberalisation

China first allowed RMB to be used to settle international transactions in 2009. The program began in a limited number of regions but was extended worldwide in 2010. The offshore RMB market has grown quickly, with RMB deposits in Hong Kong reaching RMB548.8 billion at the end of May 2011, up from RMB90 billion a year earlier.[7]

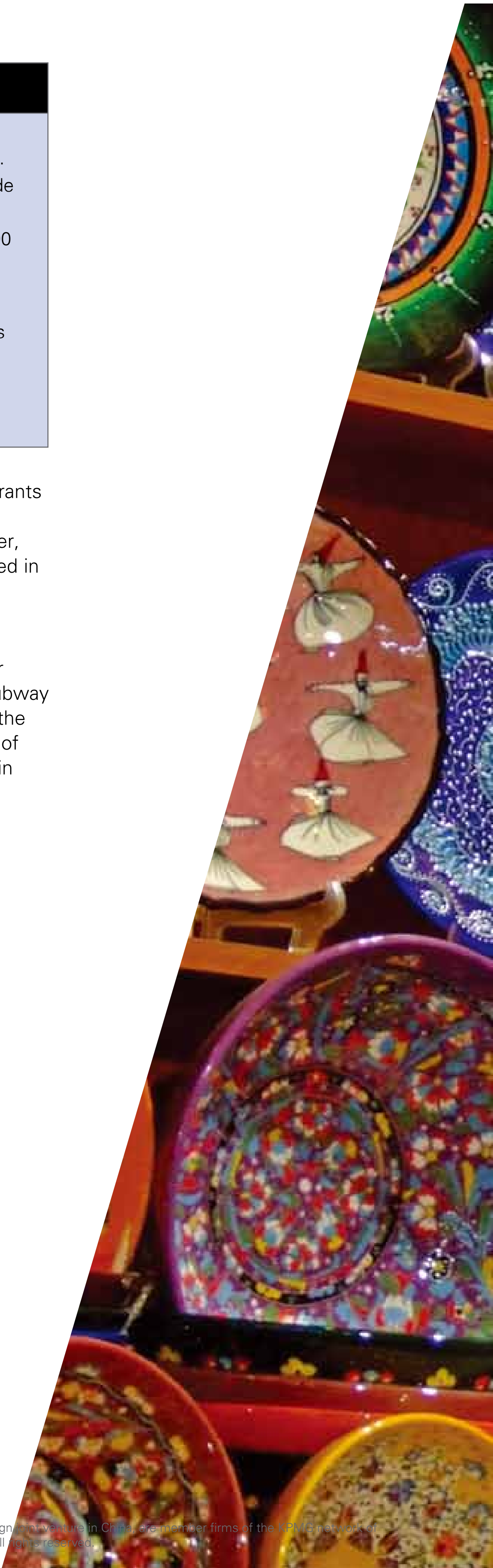
Restrictions are still in place to prevent "hot" money flows from entering mainland China, so a fully convertible RMB appears to be at least several years away.

Source: The Wall Street Journal, Time for Next Move on Yuan Liberalization, 28 February 2011

Visitors can use major credit cards at an increasing number of hotels, restaurants and shops in major cities. ATMs are widely available, with English menus. Cash advances against credit cards are also possible in some cases. However, overseas visitors should be aware that credit cards are not as widely accepted in the PRC as in other Asian countries.

Infrastructure and transport

The PRC's infrastructure has improved dramatically in recent years. Its major airports meet international standards. Eleven Chinese cities had operating subway systems at the beginning of 2011, and over 30 cities had subways either in the planning or construction stage.[8] China's major cities are linked by a network of expressways, and by high-speed rail: China has the world's largest bullet train network and is continuing to invest in rail, road and air transport upgrades.



7. Xinhua's China Economic Information Service, RMB offshore market to keep explosive growth, 19 July 2011
8. Straits Times, Jitters over China's rush for subways, 15 January 2011

Macroeconomic overview

Size of the economy

China's economic growth is one of the success stories of the last three decades. China's economy during the last 30 years has evolved from a centrally planned system that was largely closed to international trade to a more market-oriented economy with a rapidly growing private sector.

In 2010, its economy edged past Japan to become the world's second largest. The chart below provides a forecast of China's growth for the next five years (2011-2015) compared against the annual target (7 percent) in its recently issued 12th Five-Year Plan. In the period 2006 to 2010, the country enjoyed double-digit growth in most years.

China's manufacturing (industry) sector is currently the largest contributor to the nation's GDP, followed by the service sector; agriculture contributes a relatively small share.

Although China's total economy ranks second worldwide, its GDP per capita is still low by western standards, at around US$4,400.[9] By comparison, the GDP per capita in the United States is more than 10 times higher at US$47,360.

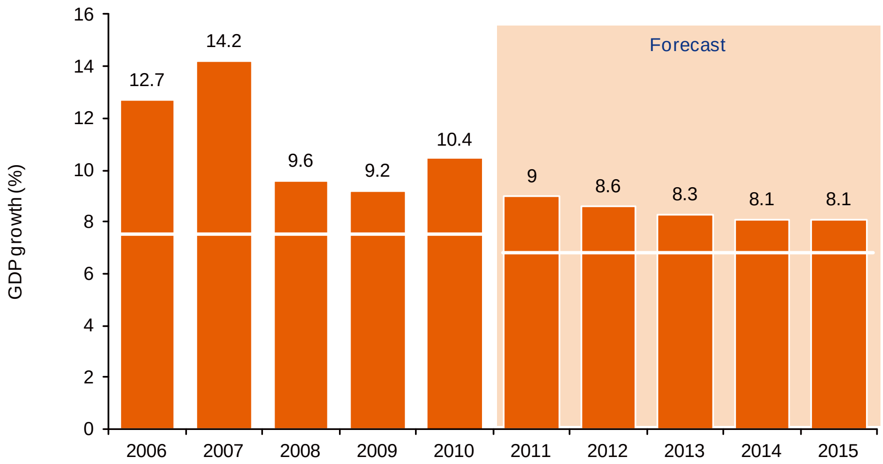
China key economic indicators
2010
GDP: RMB39.80 trillion (US$5.88 trillion) [10]
GDP per capita: RMB29,038 (US$4,403)
Foreign direct investment: US$105.7 billion

We're number two

In 2010, China officially became the second largest economy in the world, moving ahead of Japan. China's 2010 GDP was US$5.88 trillion, on a nominal dollar basis, compared with US$5.47 trillion for Japan.

Source: The Wall Street Journal, China Overtakes Japan as World's No. 2 Economy, 15 February 2011

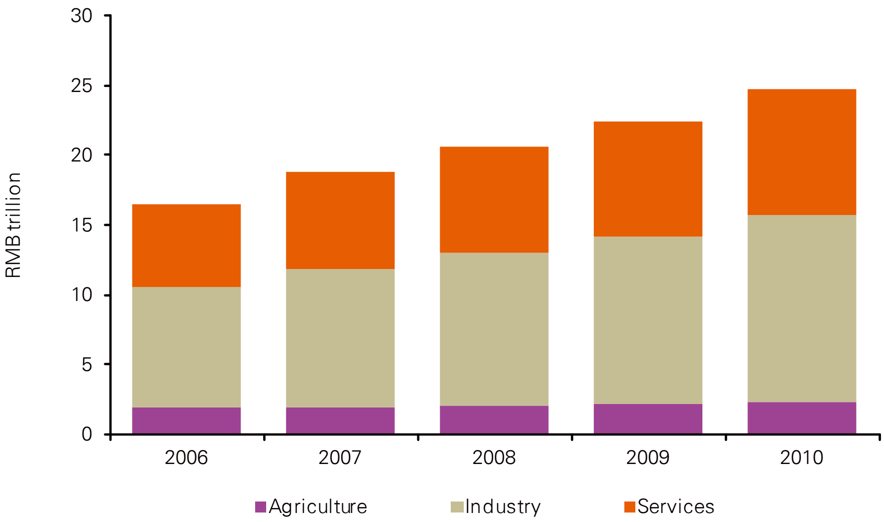
China's GDP growth (2006-2015)



Note: data accessed in October 2011; horizontal lines represent target GDP growth rates under China's 11th and 12th Five-Year Plans
Source: Economist Intelligence Unit 2011; KPMG analysis

9. National Bureau of Statistics
10. Conversion to USD using the average USD:RMB exchange rate for 2010 (USD 1 = RMB 6.77)

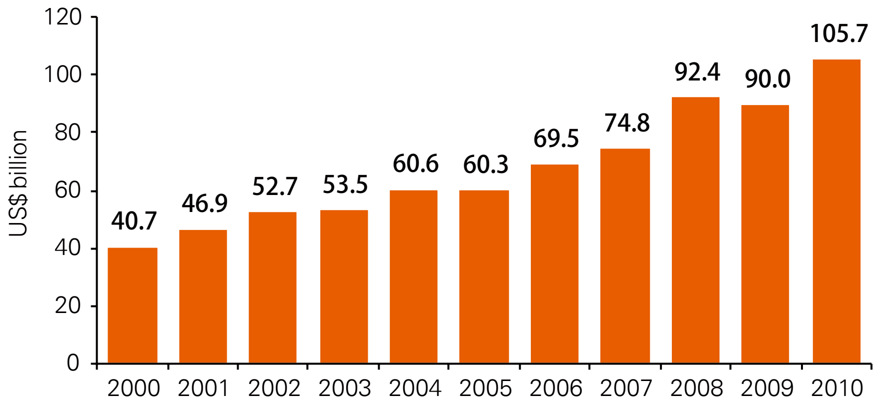
China's GDP breakdown (2006-2010)



CAGR	
Agriculture	4.4%
Industry	11.8%
Services	11.3%
Total	10.8%

Note: RMB trillion at constant 1995 prices
Source: Economist Intelligence Unit 2011; KPMG analysis

Inbound FDI in China, 2000-2010



Success in China

Business success in China is not guaranteed, but companies with a robust China strategy and commitment to the market are more likely to see results.

- Yum Brands Inc, which owns KFC and Pizza Hut, derives around 40 percent of overall profits from China.[11]
- In 2010, Volkswagen sold over 1.8 million vehicles[12] in China, representing about 26 percent of its worldwide sales.[13]
- Nokia's net sales for devices and services in Greater China were 16.7 percent of the company's total.[14]
- Boeing, which commands a 52 percent market share in China, expects Chinese airlines to add 4,330 airplanes worth US$480 billion by 2029.[15]

Opening up

Since the early 1980s, the PRC has implemented an "open door" policy aimed at attracting foreign investment. Its objective is economic development through overseas participation, particularly in areas where modernisation is required: agriculture, science and technology. These areas will continue to provide significant opportunities for international investors.

The PRC has further opened its markets to foreign investors since joining the World Trade Organisation (WTO) in 2001. Restrictions on foreign investment in the tertiary sectors, such as banking and finance, and accountancy and legal services have been reduced. Certain industries in which foreign investments are restricted, such as telecommunications and internet services, are also being opened up. State-owned companies continue to dominate some industries such as banking, telecommunications, railways, oil, and power. However, state ownership of industry has been trending downward within the last 30 years, from close to 100 percent in the late 1970s to under 10 percent today.[16]

11. Reuters, Yum posts profit beat, raises 2011 estimate, 14 July 2011
12. The number of vehicles sold (1,871,000) differed slightly from the number of vehicles delivered (1,923,000)
13. Volkswagen Annual Report, 2010
14. Nokia Q2 2011 Interim Report, 21 July 2011
15. Associated Press, Boeing lifts 20-year China jet sales forecast on economic growth, stronger airlines, 2 November 2010
16. Reuters, 3 August 2011, China's state-owned sector

Central government Chinese state-owned companies report to the State-owned Assets Supervision and Administration Commission (SASAC). At the end of 2010, SASAC was responsible for overseeing 122 centrally-owned companies, down from 196 in 2003.[17] In spite of the privatisation trend, central state-owned companies are major players in the economy. These companies posted combined net profits of RMB849 billion in 2010 and had total assets of RMB24.3 trillion at the end of 2010.[18]

Counting state-owned companies outside of SASAC's control, a total of 154,000 SOEs operated in China at the end of 2008.

Evolving statistics

Similar to the nation's infrastructure which is continuing to improve, statistical methodology and data collection are also developing. Companies operating in China are sometimes surprised when official statistics are later revised.

In addition to revised statistics, the country periodically changes statistical methodology, meaning that numbers in one time period are not directly comparable to numbers announced earlier.

For example, in 2011 the National Statistics Bureau reduced the weighting of food prices in the consumer price index (CPI), while increasing the weight for rent.[19] This change reflects China's evolving economic profile and brings China's CPI calculation closer to that of developed countries which give a higher weighting to rent. The basis for the new calculation method is valid but introduces additional complexity.

Other changes in 2011 include: [20]

- The National Statistics Bureau changed the income threshold of "large-scale" industrial enterprises to RMB20 million annually (up from RMB5 million under previous methodology)
- In relation to fixed-asset investment statistics, China will begin counting rural projects. In addition, only projects with total investment exceeding RMB5 million will be surveyed (up from the previous threshold of RMB500,000).

Sources: Agence France Presse, Data tweaks reflect a changing China, 23 February 2011; China Daily, China raises statistics criteria for indicators, 9 March 2011; Xinhua, China's GDP growth in 2010 revised up to 10.4% y-o-y, 7 September 2011

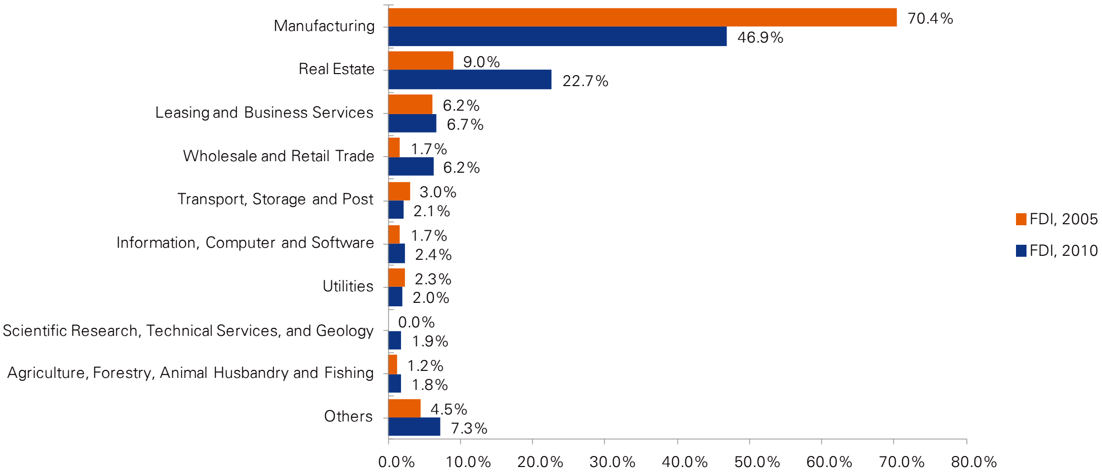
17. Beijing Review, A New Manager for State Assets, 13 January 2011
18. Reuters, China's state-owned sector, 3 August 2011
19. Agence France Presse, Data tweaks reflect a changing China, 23 February 2011
20. China Daily, China raises statistics criteria for indicators, 9 March 2011

Key investment sectors

FDI patterns have been changing during the last several years. In 2005, manufacturing represented the majority of FDI in China, comprising over 70 percent of the total (total FDI in 2005: US$60.3 billion). By 2010, the proportion of manufacturing FDI had fallen to around 47 percent (total FDI in 2010: US$105.7 billion).

The proportion of real estate FDI in China more than doubled from 2005 to 2010, rising from 9 percent to 22.7 percent.

FDI breakdown in China, 2005 vs. 2010



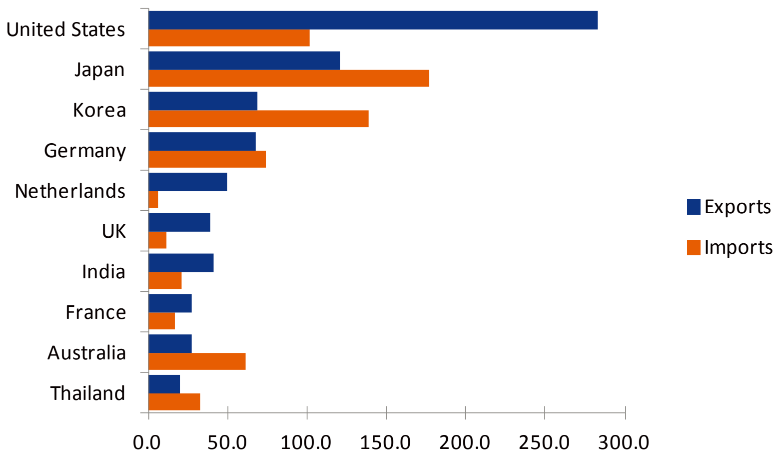
Source: China Statistical Yearbook 2011; KPMG analysis

In 2010, China was a net exporter to developed countries such as the US, the UK, France, and the Netherlands. Two notable exceptions are Germany and Australia where imports exceeded exports; imports from Germany reached US$74.3 billion (compared to exports of US$68 billion) and imports from Australia reached US$61.1 billion (compared to exports of US$27.2 billion).

The US remains the largest export market, with export value amounting to US$283.3 billion in 2010. The next largest export destinations are East Asian countries Japan and Korea.

Neighbouring countries Japan and Korea are the largest import sources, accounting for US$176.7 billion and US$138.3 billion of imports, respectively. The US is the third largest import source, with import value amounting to US$102.1 billion.

China import and export snapshot, US$ bn (2010)



Source: China Statistical Yearbook 2011; KPMG analysis

Macroeconomic overview

Energy

Clean energy is a key industry identified in China’s 12th Five-Year Plan, which is expected to translate into incentives and other measures to facilitate investment.

The majority of China’s energy (around 90 percent) currently comes from coal and other carbon-intensive fossil fuel. The nation intends to push the use of non-fossil fuels to 15 percent of the country’s total energy use by 2020, creating a favourable investment environment for renewable energy.

Business opportunities also exist in power generation. China plans to invest RMB11.1 trillion in the power industry in the next 10 years, with RMB5.3 trillion invested from 2011 to 2015.[21] RMB2.75 trillion will be invested in power plant construction, and RMB2.55 trillion will be invested in power grid construction. Sub-sectors where home-grown technologies are still being developed (i.e. nuclear and smart grid) could be promising.

According to Bank of China forecasts, renewable energy will generally see double-digit growth rates during the next five years, with the exception of hydropower, which already has a large base.[22]

China’s energy outlook

Energy (gigawatts)	2010	2015	CAGR
Coal and gas	707	985	6.9%
Hydro	213	299	7.0%
Nuclear	11	39	28.8%
Wind (on-grid)	31	94	24.8%
Biomass and others	6	15	20.1%
Solar power	1	5	38.0%
Total installed capacity	962	1,437	8.4%

Source: BOCI Research, China Utilities, 24 Jan 2011; KPMG analysis

Healthcare

China’s aging population is an important driver of the healthcare sector, which is predicted to face severe challenges in the coming decades. According to China’s 2010 population census, 177.6 million people are in the 60+ age bracket, which is 13.26 percent of the total population.[23] By 2050, the number of older citizens is forecast to reach 437 million, or about one-third of the population.

21. Xinhua, Five power groups to benefit from RMB11.1 trillion investment in power in next 10 yrs, 23 December 2010
22. BOCI Research, China Utilities, 24 January 2011
23. China Daily, Aging population a challenge, 19 May 2011

Environmental pollution and lifestyle factors (e.g. smoking) are also expected to contribute to the need for healthcare services and medicine. Recognising the pressing healthcare needs, the government revised the Catalogue Guiding Foreign Investments so that "medical institutions" now fall within the "permitted" category.[24] This change opens the doors for foreign companies in a previously "restricted" category.

Consistent with this, the State Council announced in December 2010 that wholly foreign-owned medical institutions would be allowed for the first time on a pilot basis.[25] Previous healthcare regulations limited foreign companies to joint ventures.

Infrastructure

Increasing urbanisation under China's 12th Five-Year Plan and continued development of western and central regions are expected to support infrastructure-related sectors. However, infrastructure needs are likely to be balanced against higher priority given to environmental issues, suggesting that growth rates in this area may slow in coming years. Some input sectors, such as cement and steel, are facing controls on capacity expansion as part of the country's efforts to reduce pollution and energy use.

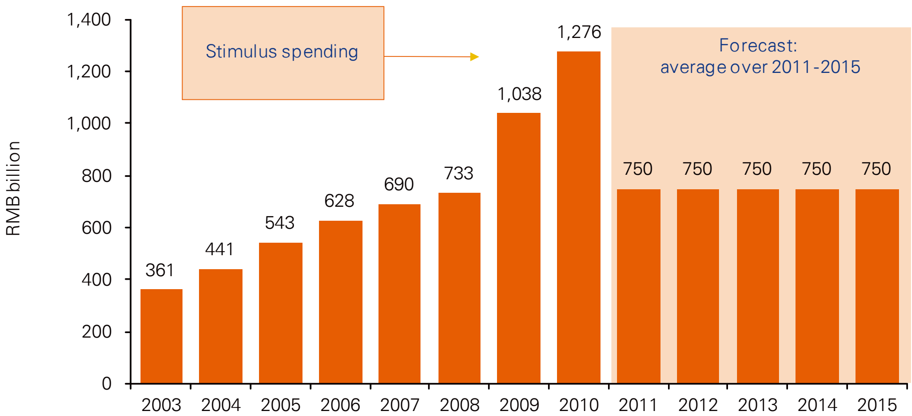
The PRC has approved numerous joint venture projects allowing foreign participation in the development of its infrastructure. Of particular note are:

- Construction of numerous hotels and office complexes
- Construction of highways connecting major cities and provinces
- Environmental improvement projects in major cities

Infrastructure industries are likely to continue to provide opportunities for overseas investors. In 2009, real estate accounted for 18.7 percent of foreign direct investment, compared to 9 percent in 2005.

Highway building is one of the largest infrastructure investment categories over the next five years. The current plan calls for an investment between RMB3.5 trillion to RMB4 trillion (RMB700-800 billion annually).[26] Investment levels are expected to slow from the peak stimulus-driven spending of 2009 and 2010, but are still substantial.

Road: fixed asset investment (2003-2015)



Source: Wind database 2011; KPMG analysis

China's RMB 4 trillion stimulus package

In November 2008, China announced a RMB 4 trillion stimulus package to counter the effects of the global financial crisis. A significant component of this funding was channelled into infrastructure:

- RMB1.5 trillion for public infrastructure, including railway, road, irrigation, and airport construction
- RMB1 trillion for post-earthquake reconstruction
- RMB370 billion for rural development, including building public amenities, supporting agricultural works, and providing safe drinking water.

This financial package was viewed as an effective response to economic turmoil, as it instilled investor confidence and enabled China to recover quickly.

Source: National Development and Reform Commission, March 2009

24. Amendment to the Catalogue Guiding Foreign Investments, 2011
25. China Daily, Foreign firms get slice of China medical market, 6 December 2010
26. China Daily, China to spend $1.3t on new rail, road infrastructure, 21 February 2011

China faces challenging environmental issues, including pollution and shortage of clean water. Environmental priorities under the country's 12th Five-Year Plan should create business opportunities in the following infrastructure segments:

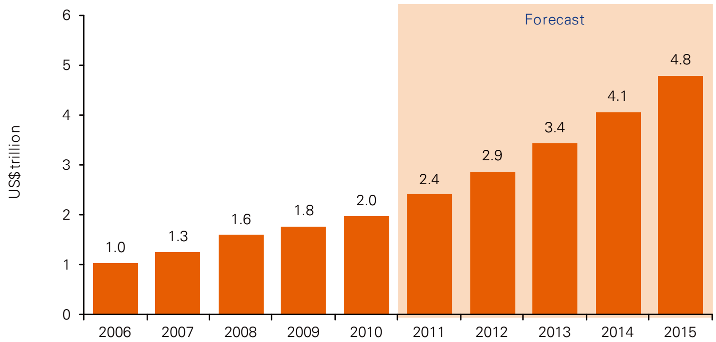
- Sewage treatment
- Water treatment
- Solid waste treatment

The government aims to build 200,000 km of new sewage pipelines and add sewage treatment facilities with a combined capacity of 90 million tonnes.[27] The need for construction is particularly pressing in smaller cities where sewage infrastructure is less developed.

Consumer markets

China's consumer markets sector is predicted to benefit from an expanding middle class and rising disposable income. According to EIU, private consumption in China will more than double from around US$2 trillion in 2010 to US$4.8 trillion in 2015.

Private consumption in China (2006-2015)



CAGR	
2006-10	17.6%
2011-15	18.9%

Source: Economist Intelligence Unit 2011; KPMG analysis

The consumer markets sector is broad and can roughly be broken down into the following major categories:

- Food and beverage
- Retail
- Consumer products (e.g. FMCG and durable goods)

27. US Commercial Service, China Business Handbook, 2011

Despite the vast size of consumer markets in China, success is not automatic. Companies need to manage a range of issues, including:

- Ensuring quality and safety of one's supply chain (especially in the food and beverage segment)
- Food price volatility / inflation
- Intense competition in more developed regions
- Inefficient logistics infrastructure contributing to costs
- Counterfeit products

China's retail sector is fragmented with the top 100 retailers accounting for 11 percent of total retail sales.[28] Small independent stores currently dominate the retail landscape.

Competition in the consumer markets sector is set to intensify as multinationals raise the stakes in China. Recent developments include:

- Coca Cola's planned investment of US$4 billion in China from 2012 to 2014.[29]
- McDonald's expansion of its store count in China to over 2,000 stores by 2013, up from the current 1,300 stores.[30]
- Nestlé's US$1.7 billion purchase of a 60 percent stake in Chinese candy maker Hsu Fu Chi (2011).[31]

The luxury segment of China's consumer markets has been especially promising in recent years, driven by an increasing number of wealthy individuals. According to the Hurun Report, China has more than 960,000 people with wealth over RMB10 million and 60,000 people with wealth exceeding RMB100 million.[32]

Wealthy Chinese consumers	
Number of residents with wealth exceeding RMB10 million	
Beijing Municipality	170,000
Guangdong	157,000
Shanghai Municipality	132,000
Zhejiang	126,000
Jiangsu	68,000
Fujian	36,000
Shandong	33,000
Liaoning	29,000
Sichuan	24,000
Henan	16,500

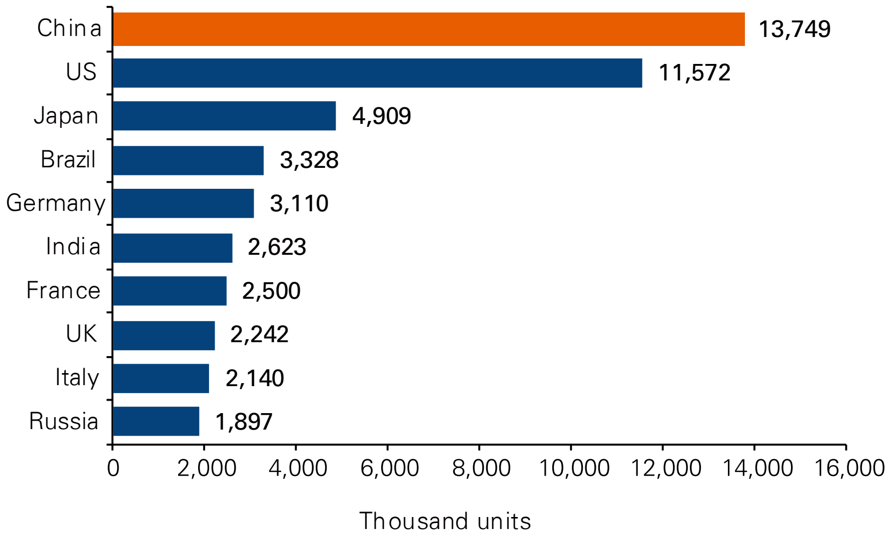
Source: Hurun Report 2011

28. Economist Intelligence Unit
29. China Daily, Coca-Cola to invest $4b in China in 3 years, 18 August 2011
30. China Daily, McDonald's seeking a new menu for mainland success, 31 August 2011
31. The Wall Street Journal Europe, Nestle Writes Recipe for China With Its Offer for Hsu Fu Chi, 12 July 2011
32. Rupert Hoogewerf, Hurun Report

Automotive

China is currently the world's largest automotive market, having surpassed the US in 2009. The market is fragmented, but a few foreign brands are leading players; these include Volkswagen, GM, Hyundai, and Toyota. Chinese companies currently dominate the small vehicle market (cars with engines below 1.6 litres) but are expected to expand their share of the overall market during the next several years. Major Chinese players include Chery, Geely and BYD.

Worldwide light vehicle sales (2010)



Source: Macquarie Research, Global Auto Horizons, February 2011

Trends in the automotive industry include: [33]

- Demand for auto replacement parts
- Government push for the development of new energy vehicles (which has not yet translated into consumer demand)
- Introduction of smaller cars to serve certain segments
- Declining margins for auto dealerships
- Growing used car market
- Development of different revenue streams (e.g. vehicle financing, after-sales service).

Highlighting the favourable status of new energy vehicles, the Catalogue Guiding Foreign Investments now classifies as "encouraged" two activities related

33. Business Monitor International, China Autos Report, Q3 2011

to automotive infrastructure: construction and operation of (a) electric vehicle charging stations and (b) battery changing stations. This shift is likely to pave the way for new incentives to develop these areas.

Although China's automotive market has developed rapidly in recent years, the sector also faces headwinds.

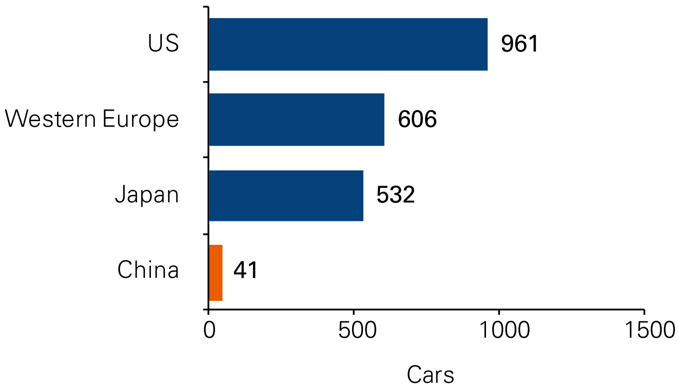
In large, congested cities, the government's efforts to reduce the number of vehicles on the road could have a negative impact on some automakers. In Beijing, for example, authorities reduced annual passenger vehicle registration by 70 percent to 240,000, down from around 800,000 in 2010.[34] Similar measures in other congested cities could pose a challenge for the automotive sector.

Another development that could impair profitability of automakers is overcapacity, which is a risk in coming years.

Offsetting the negative factors is China's low car ownership rate in relation to the population. This low market penetration implies significant long-term potential for China's auto industry.

The luxury segment of China's auto industry has fared well, buoyed by spending from wealthy individuals. Audi and BMW are the dominant players in this segment, selling 158,000 (42.5 percent) and 81,000 vehicles (21.8 percent) respectively in 2009.[35]

Cars per 1000 adults (2010)



Sources: AutoForesight; CAAM; JD Power

34. Credit Suisse, China Auto Sector, 17 January 2011
35. JP Morgan, Asia Pacific Equity Research, 3 April 2011

M&A security review

In March 2011, China introduced a new M&A security review for foreign acquisitions, which analysts believe may slow down or deter inbound M&A in some sectors.

However, this new regulation has not had any significant negative impact on FDI in 2011; according to the Ministry of Commerce, FDI increased 18.6 percent year-on-year in the first seven months of 2011 to US$69.2 billion.

Under the new system, foreign inbound M&A in specified areas is subject to an additional layer of review on national security grounds:

- National defence
- Agricultural products
- Energy
- Natural resources
- Infrastructure
- Transportation
- Equipment manufacturing
- Technology

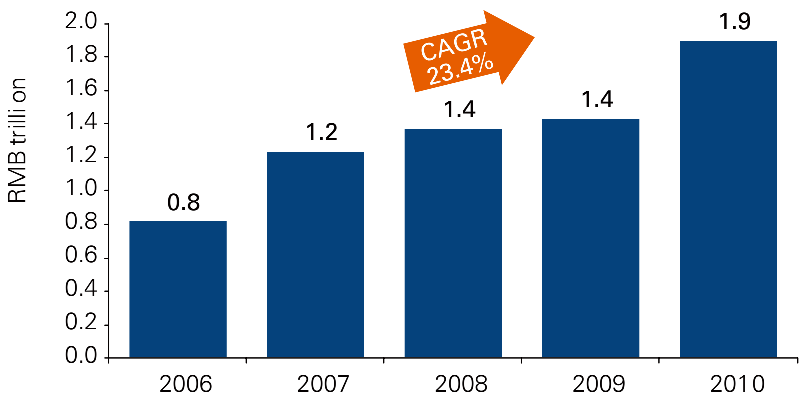
Source: Dow Jones Chinese Financial Wire, China Outlines Rules for National Security Review of Foreign M&A, 14 February 2011

Financial services

China's financial sector is dominated by four state-owned banks: the Agricultural Bank of China (ABC), Industrial and Commercial Bank of China (ICBC), the Bank of China (BOC) and China Construction Bank (CCB). China's state-owned banks account for over half of all banking assets,[36] with the remainder shared between city commercial banks, privately owned banks and credit cooperatives.

Foreign banks first incorporated in China in December 2006, and by the end of July 2010, 37 foreign banks had a presence in the country. Some regulations are making the operating environment more challenging for foreign banks, for example the 2011 deadline to reduce the loan to deposit ratio to 75 percent.[37] In spite of hurdles, the assets of foreign-funded banks in China still increased from RMB800 billion in 2006 to RMB1.9 trillion in 2010, representing a compound annual growth rate of 23.4 percent.[38]

Assets of foreign-funded banks in China, 2006-2010



Source: China Statistical Yearbook 2011; KPMG analysis

36. China's state-owned banks accounted for 56.54 percent of all banking assets in 2009, compared with 61.78 percent in 2006.
37. KPMG Mainland China Banking Survey, 2010
38. China Statistical Yearbook 2011

For additional information about China's banking sector, please visit the following site and access KPMG's latest China Banking Survey:

http://www.kpmg.com/CN/en/IssuesAndInsights/ArticlesPublications/Pages/Mainland-China-Banking-Survey-201109.aspx

China's insurance, pensions and fund management sectors are also being opened to foreign investment. Foreign companies can hold a stake of up to 49 percent in a fund management company joint venture.

The venture capital sector in China is relatively new, but one the country would like to develop. To this end, it is listed as an "encouraged activity" in the 2011 edition of the Catalogue Guiding Foreign Investments.

Outsourcing

China's "1,000-100-10" Project was launched in 2006 to develop 1,000 domestic companies with outsourcing capabilities; encourage 100 multinational companies to establish outsourcing operations in China; and build 10 outsourcing hubs. As of 2010, the country has met all of these goals, having established over 9,000 domestic outsourcing companies; welcomed over 500 multinational companies to set up outsourcing operations in the country; and built over 25 outsourcing hubs.[39]

In 2009, China's outsourcing industry revenue totalled US$13 billion and is projected to grow to US$44 billion by 2014, more than tripling over a five-year period. Around 65 percent of the revenue is derived from IT outsourcing services and the remainder from business process outsourcing.[40]

Catalogue Guiding Foreign Investments, 2011 Amendment

China's Catalogue Guiding Foreign Investments is an important document for foreign companies to review since a sector's classification influences the ease or difficulty of investment. It sets out business activities that are "encouraged", "restricted" or "prohibited" for foreign investors.

The 2011 catalogue is likely to see a number of changes to the previous version published in 2007:

Newly Encouraged Activities

- Vocational training
- Venture capital enterprises
- Construction and operation of vehicle charging stations and battery changing stations
- Construction and operation of water treatment plants
- New types of high-technology glass and optics products
- Alternative energy

Newly Restricted Activities

- Heavy energy users
- Polluting activities
- Resource-related projects

Newly Prohibited Activities

- Domestic express parcel service
- Construction and operation of villas

Source: British Embassy Beijing, China - Inward Investment, May 2011

39. KPMG China Outsourcing Summit, 13 July 2010
40. KPMG China Outsourcing Summit, 13 July 2010

In the early days of China's "reform and opening up", a few hotspots were favourite destinations for outsourcing or shared services facilities. These included the Yangtze River Delta, Bohai Rim, and Pearl River Delta. Rising wages and land costs in China's key economic zones are forcing companies to look at other options to remain competitive.[41]

In general, China's central and western regions have a lower cost base compared to more mature coastal areas. However, the infrastructure in many areas is still being developed. Choosing an appropriate offshoring solution requires careful city-by-city analysis to determine whether a city's resources meet your requirements.

For more detailed information about China's outsourcing landscape, please see our publication Inside the Dragon: Outsourcing Destinations in China.

http://kpmg.com/CN/en/IssuesAndInsights/ArticlesPublications/documents/Outsourcing-destinations-201010.pdf

Capital market development

China's stock exchanges in Hong Kong and Shanghai are among the largest in the world, ranking six and seven respectively by market capitalisation (in H1 2010). The New York Stock Exchange in the US is the world's largest stock market by a wide margin, with a market capitalisation of around US$12 trillion; by comparison, the stock markets in Hong Kong and Shanghai have market capitalisations of US$2.2 trillion and US$2.05 trillion respectively.

The number of domestically listed companies has been increasing steadily over the last decade and stood at 2,229 as of June 2011 (shown in the chart below). In addition to domestic listings, many Chinese companies have pursued IPOs in the US. However, overseas listings could decrease in coming years in light of accounting concerns that have diminished investor appetite for Chinese IPOs.[42] In the aftermath of these issues, Chinese companies may increasingly turn to domestic stock markets to raise capital in the future.

China introduced the Qualified Foreign Institutional Investor (QFII) system in 2002 to permit institutional investors to buy into Chinese equity and debt markets. The QFII system has already allowed more than 100 foreign investors access to China's markets; these investors include banks, trust companies, securities firms, sovereign wealth funds and pension funds.

Institutions that receive approval under the QFII system are allowed to invest in China's stock and bond markets up to a quota which is set for each institution.

41. World Federation of Exchanges, 2010
42. The Wall Street Journal, Stung, Chinese Firms Now Look to Go Private, 2 September 2011

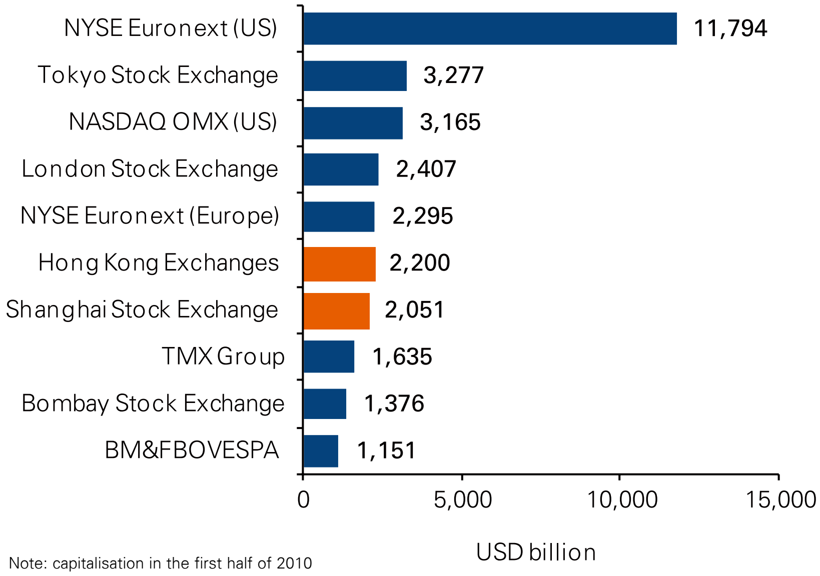
Macroeconomic overview

This system is a way for institutional investors to participate in China's growth without worrying about complex operational or human resource issues.

Institutions need to meet at least the following criteria to apply for QFII status:[43]

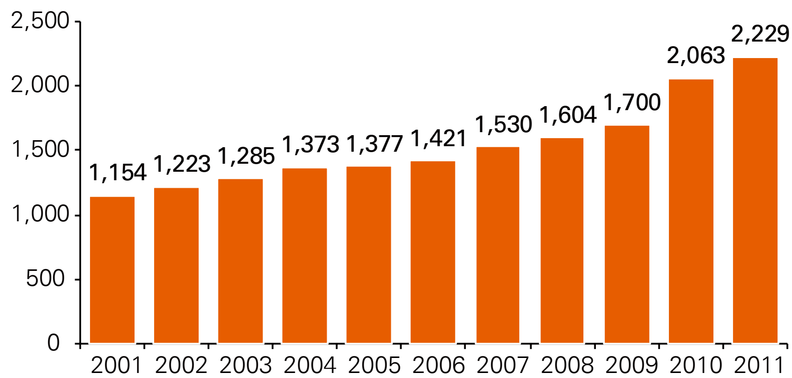
- Stable financial status, good credit rating, and adequate assets
- Staff with appropriate qualifications
- Sound corporate governance, adequate internal controls, and absence of serious regulatory violations in the last three years
- The applicant's home country has sound legal and regulatory systems; and securities regulatory bodies in the applicant's home country have signed a memorandum of understanding with the CSRC
- Other unspecified requirements consistent with the prudence principle.

Market capitalisation of leading stock exchanges (H1 2010)



Note: capitalisation in the first half of 2010
Source: World Federation of Exchanges 2011; KPMG analysis

Number of domestically listed PRC companies, 2001-2011*



Note: 2011 data up to June 2011
Source: WIND database 2011; KPMG analysis

43. China Daily, What is QFII? 2 August 2010

At the end of 2010, the total amount / quota approved by the State Administration of Foreign Exchange (SAFE) had reached US$19.7 billion, and the government has pledged to expand the amount to US$30 billion. Foreign investors include leading global banking and investment firms, leading US universities, the Bill and Melinda Gates Foundation, and a number of sovereign wealth funds.

In early 1993 the State Council established the Securities Commission and China Securities Regulatory Commission (CSRC). The Securities Commission is responsible for determining securities policies, planning the development of securities markets, directing, coordinating and supervising securities-related institutions in China. It also administers the CSRC, which acts as its regulatory arm and supervises listing, trading and clearing activities.

Since the 1990s both technical and institutional improvements have been introduced to China's stock markets. The Chinese authorities have emulated many of the practices of western stock exchanges, including standardising disclosure requirements, extending the administrative network of the CSRC across the country, increasing monitoring of companies and intermediaries serving the securities industries, and promulgating detailed laws and regulations.

An increasing number of foreign companies view listing in Hong Kong as an attractive option to listing on their home stock exchanges, in spite of global market volatility that put IPO prices under pressure in 2011. A few high profile cases are provided below:

- French cosmetics company L'Occitane raised US$707 million in Hong Kong in April 2010.[44]
- Italian luxury goods company Prada SpA raised US$2.14 billion in its IPO in Hong Kong in June 2011.[45]
- American luggage retailer Samsonite raised US$1.25 billion in its Hong Kong IPO, also in June 2011.[46]

At the time of publication, the Hong Kong Stock Exchange is the only Chinese stock market open to foreign companies. However, Shanghai is planning to open an International Board, in line with its goal of becoming a global financial centre.

44. The Wall Street Journal Online, L'Occitane Raises $707 Million in Hong Kong IPO, 30 April 2010
45. Reuters, Prada edges up in trading debut after $2.14 bln IPO, 24 June 2011
46. Reuters, Samsonite falls 7.7 pct in HK debut, 16 June 2011

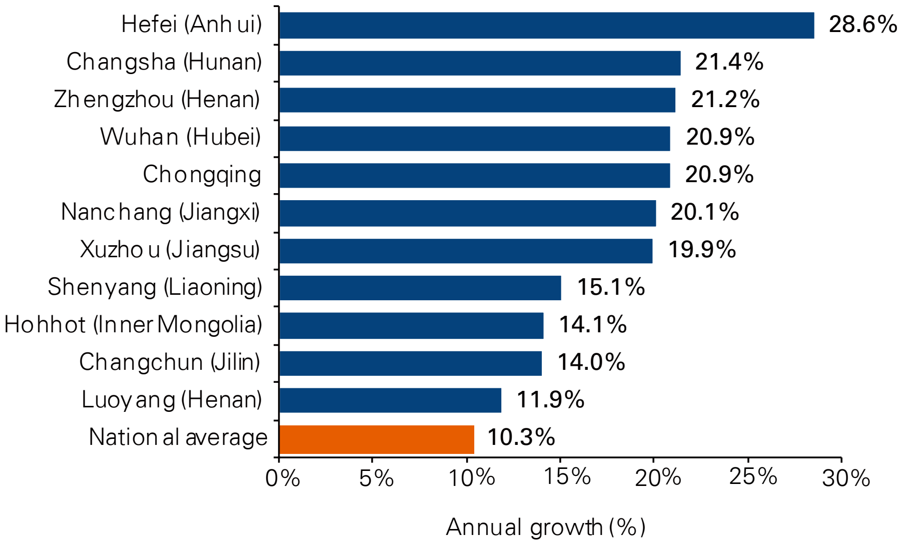
Economic disparities

China can be viewed as a collection of large regional economies, each at different stages of development. The average standard of living varies greatly from one province to the next.

In 2010, Shanghai's GDP per capita was around two and a half times the national average. The Yangtze River Delta, comprising Shanghai, Jiangsu and Zhejiang provinces, is one of the country's most developed and prosperous regions. With around 11 percent of China's total population, it contributed over 20 percent of the national GDP in 2010 and around one-third of total foreign trade volume.[47] The main industries in the region include finance, light industry, services and agriculture.

During the country's 30 years of market reform, coastal cities have led the way, but 2007 was a tipping point when interior regions started growing at a faster pace.[48] The Northeast, Central and Southwest regions and vast Western frontier remain generally poorer, but the government's plan to develop central and western provinces is expected to lessen disparities over time.

GDP growth (%) in selected cities (2010)



Opportunities in China's emerging cities

Less developed cities in China are also potential entry points for companies exploring investments. In many sectors, the competitive landscape is less saturated in comparison to the country's major cities.

A partial list of rapidly growing cities is given on the left.

GDP growth rates in cities such as Changsha, Zhengzhou, Wuhan, and Chongqing are around double the national average of 10.3 percent. Hefei, located in Anhui province, grew at nearly three times the national average in 2010.

Note: province names in brackets
Sources: EIU, China's fastest-growing cities, 2010; China provincial statistical yearbooks

47. China Statistical Yearbook; China Regional Import and Export Statistics
48. EIU, China's fastest-growing cities, 2010

China outbound investment

China's economic growth has led to a rise in outbound investment by PRC companies, a trend that is expected to continue.

High profile outbound investments in recent years include:[49]

- Sinopec's US$7.2 billion acquisition of Swiss oil explorer Addax Petroleum Corp, which gave the company access to oil resources in West Africa and Iraq (2009)
- Geely Automobile's US$1.8 billion acquisition of Volvo, completed in 2010
- Industrial and Commercial Bank of China's acquisition of an 80 percent stake in Standard Bank Argentina for US$600 million, announced in 2011.[50]

Three main drivers underpin China's outbound investment:

Access to natural resources

The government has encouraged state-owned companies to acquire stakes in energy and mining projects. China's large state-owned oil companies have led the way, buying up stakes in oil and gas fields in Africa, Latin America, and throughout Central and Southeast Asia.

A selected list of natural resources in which Chinese companies are investing is provided below. This represents an opportunity to sell to the world's second largest economy.

Selected list of China's natural resource aspirations

Resource	Use
Iron ore	Raw material for making steel
Coking coal	Raw material for making steel
Potash	Key ingredient in fertilizer
Thermal coal	Electricity production
Platinum	Used in catalytic convertors for vehicles
Gold	Viewed as a "safe haven" investment during economic uncertainty
Uranium	Nuclear energy
Rare earths	Used in electronic devices and electric vehicles

Source: China Daily, Resources hunt fuels global mining M&A, 30 Aug 2011

Diversifying into new markets

This is particularly true for manufacturers, who may face saturation and fierce cost competition in their home market. Mergers and acquisitions provide Chinese companies with an opportunity to acquire a global brand identity and circumvent conventional market barriers.

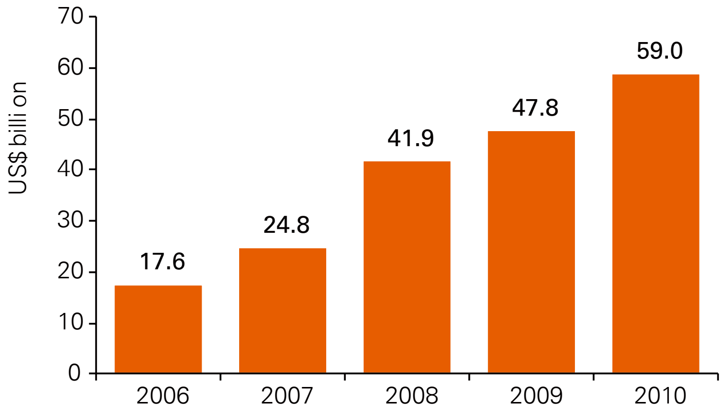
49. Reuters, China's mixed success in global acquisitions, 7 January 2011
50. Associated Press, China's ICBC to buy 80 percent of South Africa-based Standard Bank's Argentina unit, 5 August 2011

Technology and know how

Overseas investment can provide access to technology and international management skills. China's state-owned banks are developing new financing and foreign exchange services, to support the growing number of Chinese companies investing abroad.

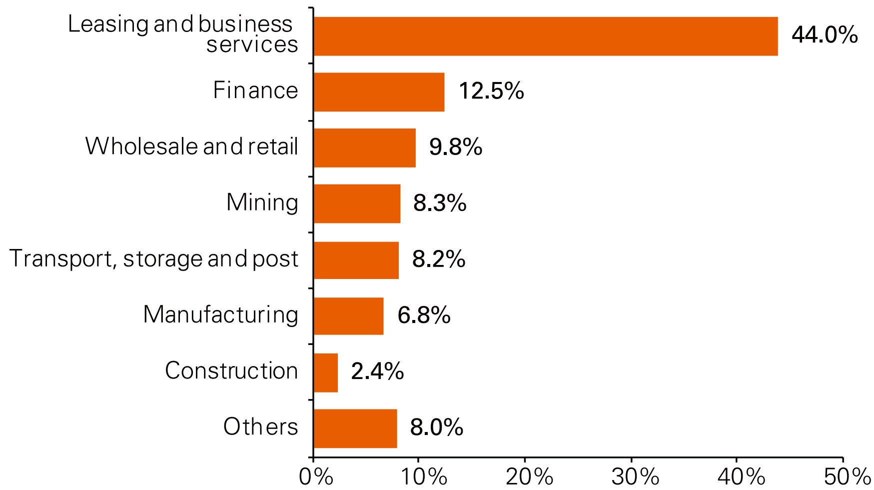
The trend of China's non-financial outbound investment over the last five years is provided below.

China non-financial outbound investment, 2006-2010



Source: Ministry of Commerce 2011; KPMG analysis

China's outbound investment by segment, 2010



Source: Ministry of Commerce 2011; KPMG analysis

Key investment considerations

Overall philosophy and approach

The government has adopted liberal policies to attract foreign investment. While investment in certain industries needs to be approved by central government authorities, such as the Ministry of Commerce, the authority to approve most foreign-invested enterprises, where total investment is less than US$300 million, has been delegated to provincial, regional and municipal governments. Some investment projects, which exceed the US$300 million threshold, but do not require overall state planning control, can also be approved at the local level.

In line with WTO commitments to create a level playing field, the PRC government has extended equal tax treatment to all enterprises, whether foreign-invested or domestic. However, in order to continue encouraging technological development, new concessions have been introduced to high technology industries.

Laws and regulations

The PRC has introduced a framework of commercial law to encourage foreign investment. At provincial, regional and municipal levels, regulations also exist to meet this objective.

The PRC's commercial laws are still evolving. KPMG China regularly issues thought leadership and alerts documenting recently introduced regulations likely to affect companies doing business in China.

Contracts and negotiations

Contracts, including foreign economic contracts, are governed by the Contract Law, which took effect in October 1999.

Foreign investors in China often encounter the mindset that contractual documentation should be kept to a minimum and that all business matters can be resolved if both parties adhere to the basic concepts of equality and mutual benefit. The assumption is that business decisions should be the subject of prior discussion and agreement by both parties and that all differences should be settled by a process of conciliation without recourse to third party arbitration or to the courts of law.

Ease of doing business in China

China ranks number 79 for "ease of doing business" among 183 countries. This indicates that China is not an easy place to do business, but it is still the top ranked economy among the BRIC countries.

Ranking	
Singapore	1
US	5
Australia	10
Japan	18
Mexico	35
China	79
Russia	123
Brazil	127
India	134

Source: The World Bank, Doing Business 2011: Making a Difference for Entrepreneurs

In practice there is a growing recognition among investors of the importance of including an arbitration clause when drafting a contract. Arbitration can provide a structure for investors and local partners to resolve their differences while continuing to work together, thereby avoiding more expensive litigation procedures. A popular option is to agree to refer any dispute to the China International Economic and Trade Arbitration Commission (CIETAC). This is the permanent arbitration body of the China International Chamber of Commerce.

Foreign businesses usually find that their counterparts in the PRC are knowledgeable about the potential investor or trading partner's company, its competitive position and the worldwide situation of the industry concerned. Negotiations are likely to be long and detailed, and it is important for foreigners involved in the negotiation process to demonstrate patience, tact and politeness. Aggressive negotiation tactics are likely to fail, and exerting excessive pressure in a negotiation may result in a "false positive" outcome, where the counterparty appears to agree, but is doing so just to save face.

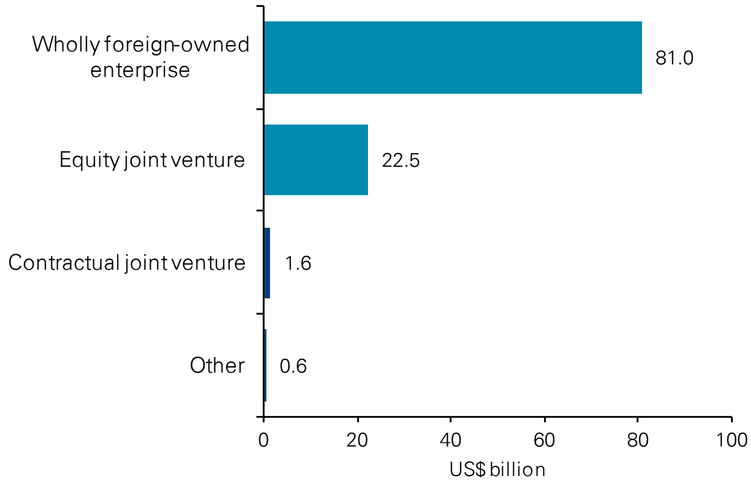
Many Chinese are exacting negotiators and will continue to examine all their options before signing any agreement. The key to success is to identify relatively few negotiating points on which to concentrate and to adopt a flexible attitude on minor contractual issues; the foreign party should accept from the outset that not all its normal terms and conditions will be acceptable. It should also ensure that an agreement exists, rather than merely a statement of intent.

Forms of foreign investment

The PRC offers a number of different ways to facilitate foreign investment, as detailed below. The most common form is a foreign-invested enterprise. These are established wholly or partly within China, with at least 25 percent foreign ownership. They may be Sino-foreign equity joint ventures, Sino-foreign cooperative joint ventures or wholly foreign-owned enterprises.

KPMG member firms have considerable experience assisting in the establishment of operations for overseas investors in the PRC, including all of the investment forms described below.

Foreign direct investment categories, US$ bn (2010)



Source: China Statistical Yearbook 2011; KPMG analysis

Anti-monopoly law

China's anti-monopoly law took effect in 2008 and contains provisions that investors need to bear in mind, especially for larger acquisitions that might be construed as "anti-competitive."

The country's anti-monopoly law covers three key areas:

- Prohibition of anti-competitive monopoly agreements
- Prohibition of the abuse of a dominant position
- Merger control

Source: Freshfields, China finally enacts Anti-monopoly Law, September 2007

Processing and assembly agreements

The simplest arrangement is a processing and assembly agreement where the foreign company supplies raw materials or parts on a consignment basis to a local entity in the PRC. A fee is paid to the PRC entity for its work and the processed goods are returned to the foreign company.

In most cases, the foreign company will have to supply the necessary production technology, equipment and supervision. The foreign investor is not allowed to sell any of the goods produced on the domestic market without the approval of the PRC authorities.

Equity joint ventures

Equity joint ventures are limited liability companies with joint PRC and foreign ownership set up for a specific purpose, such as the establishment of a new manufacturing concern. In general, the foreign partner provides the capital investment, technical expertise and management skills and arranges for technology transfer. The PRC entity provides land, buildings and labour and facilitates the smooth operation of the joint venture. The two parties' equity contributions to the joint venture determine their share of the results.

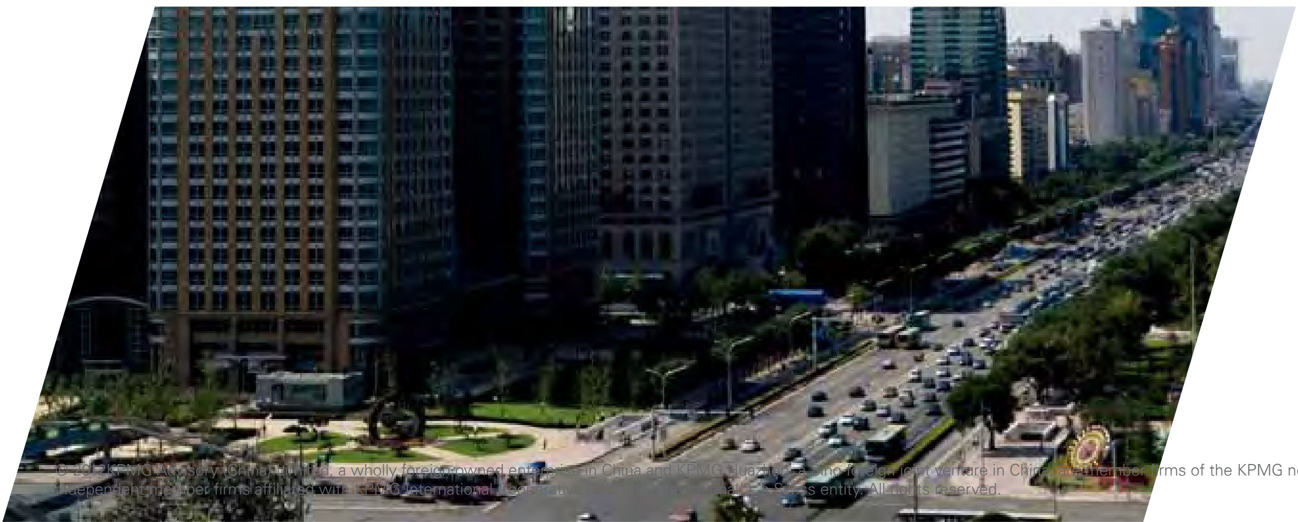
Cooperative joint ventures

Cooperative joint ventures are sometimes referred to as contractual joint ventures. They are similar to equity joint ventures but differ in that the obligations of each party are detailed in a contract. These contracts typically specify the minimum registered capital and capital contributions of each party at various levels of investment and their respective share of the results of the joint venture. A cooperative joint venture can be a legal person with limited liability, if registered as such.

Wholly foreign-owned enterprises

Wholly foreign-owned enterprises (WFOEs) are legal entities in China and are wholly owned by one or more foreign investors. The 2011 edition of the Catalogue Guiding Foreign Investments, published in December 2011, identifies the industries that are "encouraged", "restricted", or "prohibited" for foreign investors. It took effect on 30 January 2012, replacing the 2007 edition.

The advantage of a wholly foreign-owned enterprise is that the foreign investor has full autonomy in managing the company. In some cases, a foreign investor may prefer a wholly-owned structure as it can better protect its trade secrets and other intangible assets.



Some sectors still restrict the establishment of wholly foreign-owned enterprises, but these restrictions are gradually being relaxed. For example, in December 2004 the government lifted restrictions on foreign investment in wholesale, retail and distribution enterprises. Overseas parties are now allowed to set up wholly-owned entities known as foreign-invested commercial enterprises (FICEs), which may act as a retailer, wholesaler or commission agent and engage in franchising activities.

PRC holding companies

If certain conditions are satisfied, foreign investors may establish holding companies in the PRC to hold equity interests in foreign invested enterprises. A PRC holding company may trade goods manufactured by investees and also render some shared services such as marketing, staff recruitment and consulting work.

PRC holding companies and subsidiaries are taxed as separate entities and do not file a consolidated tax return. A holding company can further apply for "Regional Headquarters" status, which allows a broader scope of services and certain tax benefits.

Representative offices

Foreign companies may set up representative offices in the PRC. Such offices are not separate legal entities and their permitted business scope is generally very limited. A representative office is prohibited from engaging in business operations.

Branches

Foreign companies in certain industries such as banking, insurance and shipping may set up branches in the PRC. These branches are not separate legal entities in China.

Construction and installation projects

With effect from April 2004, foreign contractors are no longer allowed to carry out new construction or installation projects in the PRC on a contractual basis. Instead, they need to set up foreign-invested construction companies in China, which are subject to the same licensing administration as domestic construction companies.

Subcontracted business

A foreign company may manage and operate all or part of the business of a domestic enterprise or a foreign invested enterprise as a subcontractor. Foreign companies may find opportunities to subcontract some of the operations of state-owned enterprises, subject to approval of the PRC authorities.

Intellectual property

Foreign trademarks registered in the PRC are protected by law. Since 1988, the PRC has officially adopted the international system for commodity classification and the Vienna system for design elements classification, thus internationalising the PRC's trademark registration and administration.

The registration of trademarks is governed by the Bureau of Trademarks. Trademark applications of foreign enterprises are handled by agents approved by the Bureau of Trademarks. For example, the Trademark Registration Agency of the China Council for Promotion of International Trade in Beijing or by the China Patent Agent (HK) Limited in Hong Kong.

The PRC is facing increasing international pressure to provide greater legal protection for intellectual property rights (IPR). The PRC's Copyright Law, which came into force in June 1991, aims to protect literary, musical, dramatic, audio and visual property.

The PRC is a signatory to the Berne Convention and the Universal Copyright Convention, the two main multilateral copyright conventions. In order to protect the rights and interests of copyright holders of foreign works, the PRC issued the Regulations on Implementation of International Copyright Treaties in September 1992.

International agreements

China is a signing party to the following international conventions which have intellectual property implications:

- Paris Convention
- Madrid Agreement Concerning the International Registration of Marks (Madrid Union)
- Nice Agreement Concerning the International Classification of Goods and Services for the Purposes of the Registration of Marks
- Protocol Relation to the Madrid Agreement Concerning the International Registration of Marks (Madrid Protocol)
- WIPO (World Intellectual Property Organization)
- Berne Convention
- Geneva Convention for the Protection of Producers of Phonograms against Unauthorized Duplication of their Phonograms
- WTO Agreement

Source: Blank Rome LLP

With increased outsourcing of multinational companies' manufacturing activities and distribution of goods to China, managing the associated IPR is critical. While many cases in the PRC involve local companies infringing the IPR of international partners, domestic companies are also starting to defend their brands and IPR more vigorously.

Environmental regulations

Rapid economic growth has led to growing pressures on China's environment, and environmental pollution has become a major concern to the Chinese government.

Since the mid 1990s the government has passed a number of environmental laws and regulations. For example, under legislation passed in 1998, construction projects are now required to conduct up to four separate environmental impact assessments. The 2002 Law on the Promotion of Clean Production extended the scope of environmental impact assessments to other manufacturing processes, to promote more efficient resource practices.

The State Environmental Protection Administration (SEPA) is the main national agency monitoring environmental performance and formulating national standards. It has asked the government for greater powers, for example to shut down heavily polluting factories. It has also called on the government to create tax breaks and financial incentives, to encourage better environmental performance. The possibility exists for increased environmental regulations of businesses in coming years. For example, the new CIT Law, effective from 1 January 2008, grants preferential treatment to qualified environmental protection and energy or water conservation projects.

Transfer pricing

Transfer pricing issues have become increasingly important in recent years. CIT Law requires companies to conduct "arm's length" transactions with related parties. Companies are required to maintain transfer pricing documentation in accordance with CIT Law; the level of documentation is based on the volume of related party transactions. If tax authorities discover that transfer pricing problems have led to unpaid taxes, they will take corrective action, which includes collecting back taxes, charging interest and imposing penalties.

Business Taxation for Enterprises

The Ministry of Finance (MOF) is responsible for formulating economic policy and developing tax legislation. The National People's Congress enacts China's income tax laws, while the State Council promulgates supplementary and provisional regulations. The State Administration of Taxation (SAT) interprets and applies enacted tax laws and regulations, with the publication of regular Tax Circulars.

Income tax

In March 2007, China promulgated the new Corporate Income Tax Law (CIT Law), which replaced the Foreign Enterprise Income Tax (FEIT) Law applicable to foreign invested enterprises and foreign enterprises and Enterprise Income Tax (EIT) applicable to domestic enterprises (DEs), with effect from 1 January 2008. The Implementation Rules of the CIT Law were issued by the State Council in December 2007.

On 1 January 2008, the CIT rate for DEs and Foreign Invested Enterprises (FIEs) was unified to 25 percent. Companies entitled to a reduced tax rate under the FEIT law will be transitioned to a full 25 percent CIT rate over a five-year period.

In addition, the FEIT holiday of "two-year exemption and three-year half rate reduction" has been removed in the new CIT Law. Companies which are eligible for FEIT holiday will be eligible for a five-year grandfathering provision. The new CIT Law also offers some preferential income tax treatment to qualified investments, which are no longer restricted to FIEs or DEs.

Double taxation treaties

The PRC has signed agreements with most of its major trading partners to avoid double taxation of income. Most of these agreements closely follow the Model Treaty of 1977 prepared by the Organisation for Economic Cooperation and Development (OECD), but vary in their particulars. By the end of 2011, the PRC had entered into tax treaties with over 90 countries. It also has tax arrangements with Hong Kong and Macau, offering equivalent double tax protection.

Value added tax

Value added tax (VAT) is charged on the supply of goods, and the provision of repair, replacement and processing services in the PRC as well as on the importation of goods into the PRC. VAT is charged at each stage of the production of goods and services, with each supplier receiving credit for the relevant VAT paid so that VAT is actually borne by the final consumer.

VAT is normally accounted for on a monthly or quarterly basis. Where input VAT exceeds output VAT in a period, the excess should be carried forward to offset the output VAT in the following periods. Since 2009, input VAT credits have been available for VAT paid in the purchase of fixed assets. However, goods or services purchased for the production of non-taxable and exempted goods, or for employee welfare purposes, are not eligible for VAT credits.

The standard VAT rate is 17 percent but certain products are taxed at 13 percent, or are exempt. Certain small scale businesses, as defined by the authorities, may be entitled to a lower rate, but they are not eligible for VAT credits.

Exports are generally free of VAT. However the refund of VAT incurred on the purchase of goods used for exporting may be limited.

Business tax

All entities and individuals who provide services (except for processing, replacement or repair services), or who transfer intangible assets or immovable property in the PRC, are subject to business tax (BT). Taxable services for BT purposes include transportation, construction, finance and insurance, post and telecommunications, cultural activities and sports, entertainment businesses and services. The general BT rate is 5 percent. For industries such as transportation

Key investment considerations

and construction, the BT rate may be reduced to 3 percent. However, entertainment services may be subject to BT of up to 20 percent.

BT is a form of turnover tax, in that no credits are allowed throughout a supply chain. Moreover, BT applies if either the service provider, or the service recipient, is in China.

The government is proposing to reform the business tax in the near future, likely by merging BT with VAT to create a Goods and Service Tax that will apply to all turnovers. That process started with the commencement of a pilot scheme in Shanghai on 1 January 2012 and will progressively implement these reforms across all sectors in mainland China. The Shanghai pilot scheme applies to the transport and modern services sectors which created two new VAT rates of 11 percent and 6 percent.

Other taxation

Additional consumption tax is charged on the production, processing and importation of certain luxury goods. The tax rates vary from 3 percent to 45 percent for different categories of goods. Consumption tax is levied in addition to value-added tax.

There is a vast array of other forms of taxation applicable to various business or investment activities in China, including the Urban Maintenance & Construction Tax, Education levy, Stamp Duty, Cultural Business Levy, Deed Tax, Real Estate Tax, Land Appreciation Tax, together with various mining taxes, motor vehicle taxes and social security contributions.

In addition, foreign companies that do not have establishments in the PRC are liable for withholding tax on their PRC-sourced income including interest, dividends, rental, royalties and capital gains. Dividends received by foreign investors from foreign-invested enterprises are subject to withholding tax for profits derived after 1 January 2008.

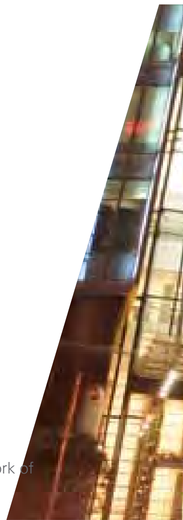
The PRC tax laws are complex and it is recommended that professional advice is taken prior to entering into any business or financial arrangements.

Customs

The PRC General Administration of Customs administers the import and export of goods into or from the PRC. The Customs offices collect customs duty and import taxes (including value added tax and consumption tax) for goods imported into the PRC. To comply with WTO requirements, China Customs has gradually reduced the import duty rate since 2002. The average duty rate is now approximately 10 percent. Goods imported from a country that has a reciprocal preferential tariff agreement are subject to preferential rates.

Importing raw materials into the PRC to produce goods for export purposes is not subject to customs duty and import taxes, subject to approval by the Customs authorities. In addition, the PRC has 16 Bonded Zones (or Free Trade Zones) and more than 60 Export Processing Zones as of 2011 which are separate customs areas. Goods imported from overseas into these Bonded Zones and Export Processing Zones are not subject to any customs duty and import taxes.

According to current China legislation, for goods which appear on the "automatic import license goods" list, importers or their brokers must apply for an automatic import license from the Ministry of Commerce or the local Foreign Economic



Relations and Trade Commission in advance. Goods imported from certain areas or countries, such as Hong Kong SAR, Korea, or the Association of Southeast Asian Nations (ASEAN) may be taxed under preferential tariffs for certain types of goods.

Export duties only apply to a few commodities, such as certain scarce minerals. Depending on the political climate, there may be considerable disparities in the imposition of import and export tariffs on trading with different countries. On 1 January 2006, China customs ceased export duty collection on textiles exports.

Accounting regulations

The accounting methods adopted by joint ventures with foreign investors are specified in the Accounting Regulations of the People's Republic of China for Enterprises with Foreign Investment. The MOF issued these regulations in June 1992, with the intention of further safeguarding the legal rights of both the joint venture enterprise and its investors. In November 1992 the MOF also issued the Accounting Standards for Business Enterprises (ASBE) and the Financial Regulations for Business Enterprises (FRBE), both of which were designed to be applicable to all types of enterprises in the PRC, including foreign-invested enterprises.

Since the early 1990s, the MOF has continued efforts to establish standard accounting practices across different kinds of enterprises and organisations. While the PRC's generally accepted accounting principles (GAAP) are nominally a principles-based system, in practice they are governed by many different regulations and a large existing body of interpretations. Some discrepancies still exist between regions and across sectors.

In November 2005, the PRC decided to move towards convergence with International Financial Reporting Standards (IFRS). While Chinese standards will remain separate in their legal basis, the aim is to create a materially equivalent financial reporting system. The International Accounting Standards Board has offered to work with the MOF to find common agreement in areas such as treatment of goodwill and business combinations.

As part of this transition, the MOF released new accounting standards for business enterprises in February 2006. The new standards comprise a general standard and 38 specific standards. All listed companies in China will need to prepare financial statements in accordance with the specific standards, from January 2007, while the general standard is applicable to all business enterprises. Companies not adopting the specific standards will still need to comply with all previous standards and regulations, including ASBE and FRBE.

Key investment considerations

It is important for foreign investors to ensure that their joint venture contracts contain provisions for adequate financial control over the joint venture, including an independent external audit of the enterprise's accounts. The annual accounts of foreign companies must be audited by certified public accountants registered in the PRC. The government has allowed international accounting firms to establish joint venture firms to perform statutory audits. In 1992, KPMG Huazhen, a KPMG member firm, was the first of the "Big Four" accounting firms to receive such approval in China.

Insolvency

Insolvency reform will be an important factor in improving investor confidence in China, particularly for minority shareholders and corporate lenders. After a decade of consultation and drafting, the Enterprise Bankruptcy Law of the People's Republic of China was enacted in August 2006 and took effect on 1 June 2007, to bring China in line with international practice.

The Law requires the creation of an administrator, who reports to creditors and the courts. It establishes clear processes for filing claims and establishing their seniority. The Law also shows that some SOEs and banks are likely to be exempt from the full scope of the law, at least initially. The government is negotiating treaties to establish cross-border recognition of insolvency proceedings.

Land and buildings

Land

In the past, land in the PRC has been widely allocated under a system of land use arrangements. No money was payable to the government by those holding an allocation. Entities and individuals would not hold the title to the land, only the right to use it.

Land use rights are becoming more transferable, through business agreements, open bidding or auction. The PRC's laws were amended in April 1990 to regulate the transfer and retransfer of land use rights for state-owned land in the cities. The laws also introduced provincial regulations governing the use of state-owned land for large scale development projects. Under these amendments, both domestic and foreign enterprises can obtain land use rights for fixed periods. These are 70 years for housing, 50 years for industrial use and 40 years for commercial use.

The State Land Bureau coordinates overall plans for land development and its local offices administer the process of land transfers and extensions.

Payments for land use rights vary considerably throughout the country. Costs for industrial land are comparatively low, depending on the location and facilities available, although payments have increased substantially over the last decade. Land use transactions in the PRC can be complicated by matters such as legal titles, the availability of utilities and tax on value appreciation. Foreign investors should take professional advice before entering into any land use transactions.

Buildings

The PRC's construction industry is well developed throughout the country and is capable of operating at international standards. Most building construction for foreign invested enterprises is carried out by locally incorporated contractors. In the case of large projects and special purpose buildings, a foreign investor will commonly seek the assistance of a foreign invested construction enterprise to act as the main contractor or the project manager to ensure building quality.

Renting industrial, commercial and office space

The Special Economic Zones and certain other cities offer industrial, commercial and office space for rent under arrangements similar to industrial parks and export processing zones in other countries. In the main cities, a range of office options are available, from small office units to international "grade A" office space.

Development zones

Special Economic Zones

Since 1979, five Special Economic Zones have been established in southern China: in Shenzhen, Zhuhai, Xiamen, Shantou and Hainan. In 2010, a new Special Economic Zone was established in Kashgar, Xinjiang Province.

The authorities of the Special Economic Zones have been given a great deal of freedom to govern the activities within their zones, especially in encouraging investment through special centrally approved investment incentives. However, the reduced FEIT rate of 15 percent granted to foreign invested enterprises and foreign enterprises in these zones has been cancelled under the new CIT Law.

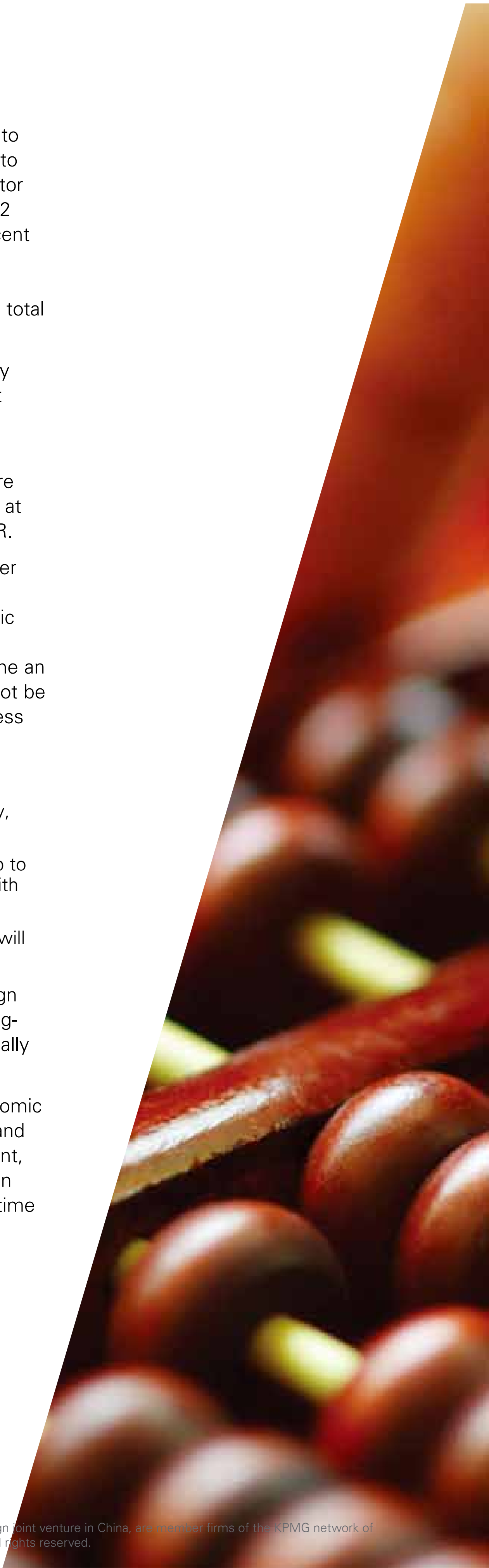
New and High Technology Development Zones

At present there are over 60 New and High Technology Development Zones that offer various subsidies to the enterprises located in these zones. One of the objectives of the zones is to promote the industrialisation of technologies owned by regional universities and research institutes.

Bonded Zones and Export Processing Zones

As of 2011 there were 16 Bonded Zones (sometimes referred to as Free Trade Zones) and more than 60 Export Processing Zones in the PRC. Goods imported into these zones from outside the PRC are not subject to PRC customs duty. In addition, the import license and quota system does not apply to goods imported from outside the PRC into these zones.

In addition to these customs policies, special foreign exchange and taxation policies are also available.



Hong Kong and the Closer Economic Partnership Agreement

Hong Kong companies have several decades of direct experience entering into arrangements with the PRC. Many overseas investors find it to their benefit to take advantage of this knowledge and experience. The financial services sector in Hong Kong is a catalyst in raising funds for large scale projects. In 2010, 72 mainland enterprises staged their IPOs in Hong Kong, an increase of 50 percent over that of 2009, and the funds they raised accounted for about 50 percent of the total IPO funds raised in Hong Kong.[51] At the end of 2011, mainland enterprises accounted for nearly 56 percent of Hong Kong Stock Exchange's total market capitalisation and 66 percent of its average daily turnover value.[52]

With effect from July 1997, the government of the PRC resumed sovereignty over Hong Kong. Prior to that time Hong Kong had been a British Dependent Territory. It has now been officially renamed the Hong Kong Special Administrative Region of the People's Republic of China (HKSAR).

The basic policies underpinning the existence and operation of the HKSAR are set out in the Sino-British Joint Declaration, an international treaty registered at the United Nations, and in the Basic Law, the mini constitution of the HKSAR.

The Joint Declaration, ratified in 1984, set out the basic rules of post-handover Hong Kong. It provided a 13-year transition period for establishing the way forward and it was during this period that the more detailed plans of the Basic Law were compiled. The key message from the Joint Declaration was the principle of "one country, two systems." Although Hong Kong was to become an inseparable part of the PRC, the PRC's socialist system and policies would not be adopted. Hong Kong's capitalist system, autonomy as an international business centre and open culture would continue unchanged for 50 years.

Specifically this means:

- The HKSAR maintains its free trade policy with an open independent economy, finances and its own legal system and laws.
- The HKSAR remains a separate customs territory. It has separate membership to trade associations and is governed by the rules of international trade. Trade with the mainland is deemed to be international.
- There are free flows of capital and no foreign exchange controls. The HKSAR will continue to use the Hong Kong dollar as its official currency.

The HKSAR therefore continues to be an accessible stepping stone for foreign entities seeking investment in and trade with mainland China. The Hong Kong-PRC partnership has a good track record; the two sides have a proven, mutually beneficial relationship.

In June 2003, the PRC and Hong Kong governments signed the Closer Economic Partnership Agreement (CEPA) to accelerate the development of economic and trade relations between Hong Kong and mainland China. Under the agreement, Hong Kong firms enjoy certain trade and economic benefits when investing in China. Supplementary interpretations and revisions are made to CEPA from time to time.

51. Hong Kong Exchanges and Clearing Ltd. Annual Report 2010; www.hkex.com.hk
52. Hong Kong Exchanges and Clearing Ltd. Annual Report 2011; www.hkex.com.hk

Key investment considerations

Working and living in China

Visa requirements

All foreign visitors to the PRC require visas. These are issued by China embassies and consulates in most countries and can also be obtained through the China Travel Service in Hong Kong.

Foreigners accepting employment need to apply for employment visas from the PRC embassies and consulates. They should also apply to the Public Security Bureau for residence permits and will need evidence of sponsorship from their employing organisations in the PRC. Visitors are usually required to undergo a medical examination before receiving the residence permit. It is not advisable to have this examination overseas, as the authorities rarely recognise such paperwork.

Foreign visitors can generally travel freely within the PRC. However, for some remote cities and special locations, such as Tibet and Inner Mongolia, supplementary authorisations may be required from the Public Security Bureau. Visitors using private modes of transport or travelling in western provinces should seek advice before they depart. When travelling between cities or provinces in China, visitors should carry their passports with them.

Medical care and emergencies

In general, China has good medical and hospital facilities and, in line with most countries it no longer requires overseas visitors to carry health certificates. Most overseas visitors only consider precautionary vaccinations necessary if their itineraries include remote locations. It is not advisable to drink tap water.

Unlike Western countries with general practitioners, most medical conditions require the patient to visit a hospital. In major cities, such as Shanghai and Beijing, foreign-invested medical facilities may be available as the first port of call.

China's hospital network is vast, with nearly 60,000 hospitals, but facilities and services vary greatly.[53] Visitors to the PRC suffering medical problems should carry sufficient medication with them for the period of their stay.

In the event of an emergency, ambulances may be summoned by dialling 120. However, even in the major cities, these may be slow, due to traffic congestion, and other means of transport may be considered. For police dial 110, and to report a fire, dial 119.

53. National Bureau of Statistics; this number includes both hospitals and "health centres" as of 2009

Housing

The domestic property market in China has experienced rapid growth and liberalisation in recent years. Foreigners can now easily locate suitable residential property for rent or sale in the major cities, with apartments, service flats or houses / villas available to fit a range of lifestyles.

Large cities have real estate agents catering to both foreign and local customers, and offer properties with a range of prices – from cheap studio apartments to deluxe penthouses and villas. It pays to conduct research and explore a number of options – and be prepared for some high prices at the top end of the market. Ask for quotes from a range of sources, or ask a local person to negotiate the price on your behalf.

Education

The PRC provides a full range of primary, secondary and tertiary education and has a number of leading global universities. Foreign pupils are allowed entry to a number of schools, but it should be borne in mind that all teaching is in Chinese. Chinese schools have a different style of teaching than equivalent schools in Western countries.

Major cities have international schools that cater to the foreign business community. Such schools can be expensive, so many multinational companies cover enrolment fees as part of their expatriate packages. Some local schools have international divisions with English instruction which can be an alternative to an international school. Most cities have a range of Chinese, international and bi-lingual kindergartens and nursery schools.

Taxation of foreign individuals

Individuals in the PRC may be liable for Individual Income Tax (IIT) on their income.

The principal regulations governing the taxation of individuals are the PRC Individual Income Tax Law and the related Implementation Rules. Where the individual is a resident of a country which has a tax treaty with the PRC, the provisions of the tax treaty will prevail where there are differences between the treaty and the IIT Law.

Residence

Individuals who maintain a permanent home in the PRC are considered residents of the PRC and are liable to IIT on their worldwide income. Individuals who have lived in the PRC for one year or more are considered residents for tax purposes. However, with the approval of the tax authorities, individuals who have resided in the PRC for five years or less will be taxed on their PRC-sourced income only.

A foreign individual residing in the PRC for less than 90 days during one calendar year is not taxed on income received from a foreign employer, provided that the individual's salary is not borne by a permanent establishment inside the PRC. The 90 day period increases to 183 days if the individual is a tax resident of a country with an income tax treaty with the PRC.

Foreign individuals without a fixed residence within the PRC are exempt from tax on their foreign source income provided that they stay in the PRC for less than five years.

Taxable income

Income subject to tax includes wages and salaries, business income for sole proprietors, income from contracting or leasing an operation, compensation for personal services, royalties, interest, dividends and bonuses, income from transfer of property and other kinds of income specified as taxable by the MOF.

New individual income tax rules took effect on 1 September 2011. Key changes are:

- Elimination of two tax brackets (15 percent and 40 percent)
- Raising the monthly tax exemption threshold from RMB2,000 to RMB3,500 (the monthly tax exemption for foreign employees will remain at RMB4,800)[54]
- The tax rate for the lowest tax bracket will be reduced from 5 percent to 3 percent.[55]

These changes are intended to provide tax relief to lower income earners while imposing a higher tax on employees with high incomes.

The amended 2011 individual income tax rates are provided below.

China individual income tax rates, 2011

Bracket	Monthly taxable income (MTI) in RMB	Tax rate (%)
1	MTI ≤1,500	3
2	1,500 < MTI ≤ 4,500	10
3	4,500 < MTI ≤ 9,000	20
4	9,000 < MTI ≤ 35,000	25
5	35,000 < MTI ≤ 55,000	30
6	55,000 < MTI ≤ 80,000	35
7	MTI > 80,000	45

Source: Sixth Amendment to the Individual Income Tax Law of the PRC

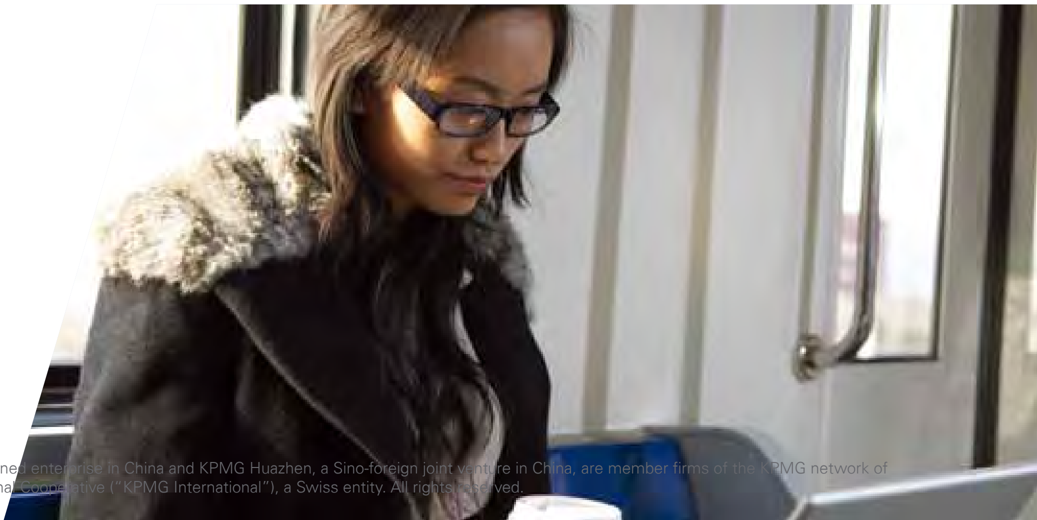
A few sample tax calculations are provided below to offer a rough idea of the tax one might be expected to pay every month. These calculations do not take into account meal, housing, or transportation allowances which are based one's employment contract and can significantly alter the monthly tax. An employee's income tax is generally withheld from each month's salary; those earning more than RMB120,000 annually need to file a tax return with the government.

54. The draft tax law initially proposed an exemption of RMB3,000 but this was raised to RMB3,500 after input from tax experts and the public.
55. Xinhua, China announces enforcement regulations for amended personal income tax law, 27 July 2011

Example 1: expatriate employee earning RMB10,000 per month	
Item	RMB
Monthly gross income	10,000
Exemption	4,800
Monthly taxable income	5,200
Tax rate	20%
Preliminary calculation	1,040
Quick deduction	555
Tax payable	**485**
Effective tax rate	4.85%

Example 2: expatriate employee earning RMB20,000 per month	
Item	RMB
Monthly gross income	20,000
Exemption	4,800
Monthly taxable income	15,200
Tax rate	25%
Preliminary calculation	3,800
Quick deduction	1,005
Tax payable	**2,795**
Effective tax rate	13.98%

Example 3: expatriate employee earning RMB50,000 per month	
Item	RMB
Monthly gross income	50,000
Exemption	4,800
Monthly taxable income	45,200
Tax rate	30%
Preliminary calculation	13,560
Quick deduction	2,755
Tax payable	**10,805**
Effective tax rate	21.61%



New Social Insurance Law

China’s new Social Insurance Law became effective on 1 July 2011 and introduces new compliance requirements for employers. Specifically, employers need to pay into social insurance funds on behalf of foreign employees; the fund categories are pension, medical, unemployment, maternity and injury. The employee contribution to social insurance covers fewer categories: pension, medical and unemployment.

Implementation of the new law will begin on 15 October 2011. Social insurance rates vary from location to location. Two sample calculations (Beijing and Shanghai) are provided below to give an indication of monthly premiums.

RMB	Beijing				Shanghai			
Salary cap	**12,603**				**11,688**			
	Employee		Employer		Employee		Employer	
Retirement	8%	1,008	20%	2,521	8%	935	22%	2,571
Medical	2%	255	10%	1,260	2%	234	12%	1,403
Unemployment	0.2%	25	1%	126	1%	117	2%	234
Maternity	N/A	N/A	0.8%	101	N/A	N/A	0.5%	58
Injury	N/A	N/A	1%	126	N/A	N/A	0.5%	58
Total	10.2%	1,289	32.8%	4,134	11%	1,286	37%	4,325

For additional information about foreign employees’ participation in China’s social security system, please see the following materials:

http://kpmg.com/CN/en/IssuesAndInsights/ArticlesPublications/Newsletters/ChinaAlerts/Documents/china-alert-1109-33.pdf

Sources: Dow Jones, Chinese Social Insurance: Will Foreigners Be Able to Opt Out? 10 August 2011; Reuters, Foreigners to bolster China’s social insurance coffers, 5 July 2011; KPMG China, China alert, Issue 33 – September 2011

China facts

- China is the world’s largest gold producer.[56]
- Around 200 Chinese cities have populations greater than one million people.[57]
- Less than 10 percent of Chinese employees pay income taxes.[58]
- Chinese inventions include the compass, gunpowder, paper and printing (China’s “Four Great Inventions”).
- China is the world’s largest tobacco producer and consumer.
- China’s gender imbalance: China currently has around 34 million more males than females.[59]
- White is the Chinese colour for mourning and funerals.[60]
- China has only one time zone (Beijing Time, set at GMT +8) in spite of its vast land mass.
- The 2010 World Exposition in Shanghai had a price tag of around US$58 billion, if infrastructure projects are included in the total.[61]
- China’s workforce will begin to shrink in the decade 2015-2025 as aging employees retire.
- China has 485 million Internet users, ranking number one in the world (end of June 2011).[62]
- China is the world’s third largest country when only land mass is taken into account, and the fourth largest when lakes and rivers are tallied.[63]

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Glossary

BT: business tax

CCP: Chinese Communist Party

CIT Law: Corporate Income Tax Law

CSRC: China Securities Regulatory Commission

CNY: Chinese yuan (renminbi)

DE: Domestic Enterprise

EIT Law: Enterprise Income Tax Law

FIE: foreign invested enterprise

FDI: Foreign Direct Investment

FEIT: Foreign Enterprise Income Tax

FMCG: fast moving consumer goods

HKSAR: Hong Kong Special Administrative Region

IIT: individual income tax

IPR: intellectual property rights

MOF: Ministry of Finance

MOFTEC: Ministry of Foreign Trade and Economic Cooperation

NPC: National People's Congress

PBoC: People's Bank of China

QFII: Qualified Foreign Institutional Investor

SAFE: State Administration of Foreign Exchange

SAR: Special Administrative Region

SASAC: State-owned Assets Supervision and Administration Commission

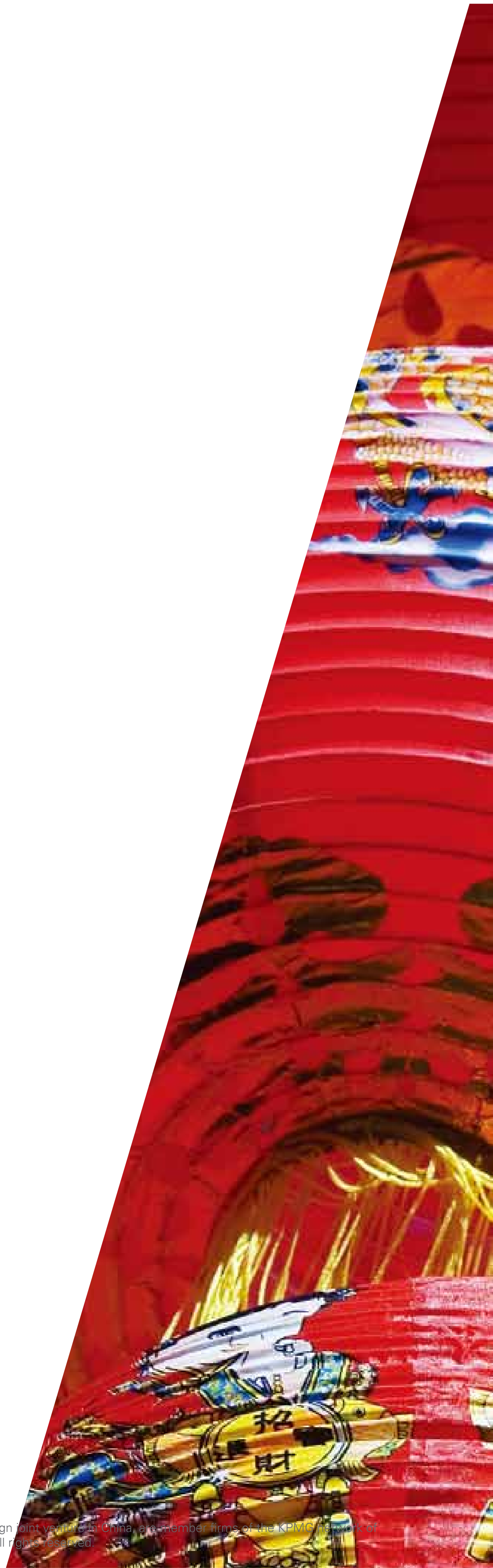
SAT: State Administration of Taxation

SEPA: State Environmental Protection Administration

VAT: value added tax

WFOE: wholly foreign-owned enterprise

WTO: World Trade Organization



KPMG in China

About us

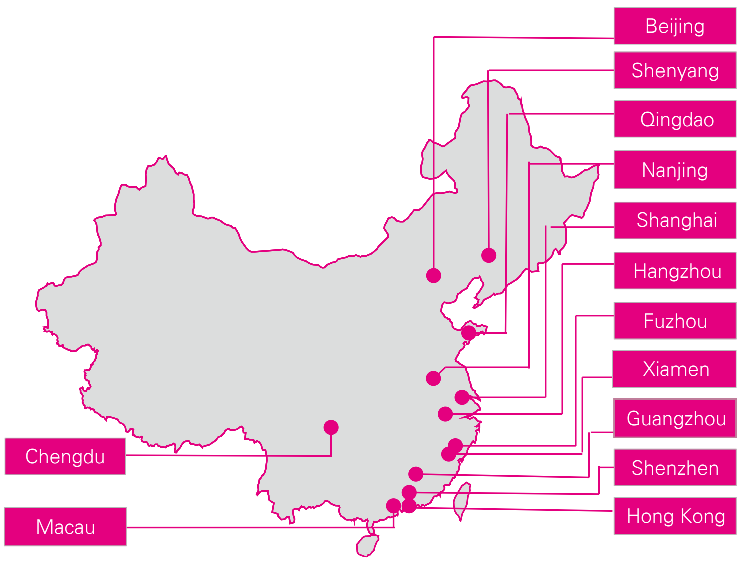
KPMG is a global network of professional firms providing Audit, Tax and Advisory services. We operate in 150 countries and have 138,000 people working in member firms around the world.

KPMG China has 13 offices located in Beijing, Shenyang, Qingdao, Shanghai, Nanjing, Chengdu, Hangzhou, Guangzhou, Fuzhou, Xiamen, Shenzhen, Hong Kong and Macau, with around 9,000 professionals.

Our business in China has established industry groups, enabling targeted, industry-specific experience to be delivered where needed. This industry focus runs alongside a more traditional discipline-based structure of audit, tax and advisory services. For our clients it means we can deliver exceptional people with an intimate knowledge of your specific business issues, as well as an overriding commitment to provide first class service.

Global China Practice (GCP) network

The KPMG Global China Practice is comprised of member firm professionals in China and key locations around the world with the technical, regulatory and industry experience – and the commitment – to deliver insights and integrated solutions for multinational companies entering or expanding to China and to outbound Chinese companies, helping enable clients to achieve their internationalisation and globalisation strategy.



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KPMG Global China Practice Locations

① 荷兰 Netherlands
② 比利时 Belgium
③ 瑞士 Switzerland
④ 奥地利 Austria
◎ 代表区域中心 Regional Centre
⑤ 卢森堡 Luxembourg


加拿大
Canada
美国
US
墨西哥
Mexico
哥伦比亚
Colombia
委内瑞拉
Venezuela
厄瓜多尔
Ecuador
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How KPMG can help

Our professionals are located throughout the world and can help you with a range of business matters, including:

- Market entry and location studies
- Support in preparing a business plan
- Business structure and tax planning
- Assistance in establishing a legal entity
- Capital verification report for capital injection
- Research in relation to acquisition target or joint venture partner
- Financial, tax and commercial due diligence for acquisitions
- Negotiation support for acquisitions
- Post deal services, including business integration and process restructuring
- Transfer pricing planning and dispute resolution
- Foreign exchange and customs duty issues
- International Executive Services
- Forensic investigation
- Market optimisation strategy

Market entry considerations

When developing a market entry strategy for China, a number of tough questions need to be answered.

Market demand

- Is the level of market demand sustainable?
- Is our company focused on the right market segments?
- Does the government want to develop / restrict this market?

Customers

- How strong are relationships with key customers?
- Will their purchasing patterns alter in coming years?
- Are customers willing to pay a premium for quality?
- Is further customer penetration achievable through existing sales channels?

Products

- How do our products compare with those of competitors?
- Does our product need to be tailored to the local market?

Business plan

- How sound are the underlying assumptions?
- Do we have contingency plans?
- Have we examined different scenarios of forecast growth?
- Which location gives us the best platform for growth?
- How saturated is the competitive landscape?
- If the sector we want to enter is saturated or overinvested, do we have a way to differentiate ourselves?
- Have we mitigated key risks?
- Have we conducted enough research, either in-house or through professional advisors?

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Appendices

List of selected business chambers and organisations		
Countries	Address and telephone contact	Selected web links to chambers of commerce
Australia	21 Dongzhimenwai Dajie Chaoyang District Beijing 100600 Tel: +86 (10) 5140 4111	China-Australia Chamber of Commerce www.austcham.org
Canada	19 Dongzhimenwai Dajie Chaoyang District Beijing 100600 Tel: +86 (10) 5139 4000	Canada China Business Council www.ccbc.com
European Union	15 Dongzhimenwai Dajie Chaoyang District Beijing 100600 Tel: +86 (10) 8454 8000	EU Chamber of Commerce www.euccc.com.cn
France	3 Dongsanjie Sanlitun Chaoyang District Beijing 100600 Tel: +86 (10) 8532 8080	French Chamber of Commerce and Industry www.ccifc.org
Germany	17 Dongzhimenwai Dajie Chaoyang District Beijing 100600 Tel: +86 (10) 8532 9000	German Chamber of Commerce www.china.ahk.de
Hong Kong	22/F United Centre, 95 Queensway, Hong Kong Tel: (852) 2529-9229	Hong Kong General Chamber of Commerce www.chamber.org.hk
Italy	2 Dongerjie Sanlitun Chaoyang District Beijing 100600 Tel: +86 (10) 8532 7600	China-Italy Chamber of Commerce www.cameraitacina.com
Japan	7 Ri Tan Lu Jianguomenwai Beijing 100600 Tel: +86 (10) 6532 2361	Japanese Chamber of Commerce and Industry in China www.cjcci.biz
Sweden	3 Dongzhimenwai Dajie Chaoyang District Beijing 100600 Tel: +86 (10) 6532 9790	Swedish Chamber of Commerce in China www.swedishchamber.com.cn
United Kingdom	11 Guanghua Lu Jianguomenwai Beijing 100600 Tel: +86 (10) 5192 4000	British Chamber of Commerce in China www.britcham.org
United States	55 An Jia Lou Lu Chaoyang District Beijing 100600 Tel: +86 (10) 8531 3000	American Chamber of Commerce in the PRC www.amchamchina.org

Useful links	
Government of the PRC	www.gov.cn (English pages available)
Ministry of Commerce	www.mofcom.gov.cn (English pages available)
Ministry of Finance	www.mof.gov.cn
People's Bank of China	www.pbc.gov.cn (English pages available)
General Administration of Customs	www.customs.gov.cn (English pages available)
China Daily newspaper	www.chinadaily.com.cn (in English)
Xinhua News Agency	www.chinaview.cn (in English)
China Council for the Promotion of International Trade	www.ccpit.org (English pages available)
National Tourist Administration	www.cnta.gov.cn (English pages available)

Tips for visitors

- Carry business cards printed in both Chinese and English, to hand out on all business occasions. These cards should be presented and received with both hands, as a sign of respect. If you receive a business card, do not write any notes on it as this is considered disrespectful. You will need more cards than you think – bring plenty.
- Courtesy and good manners are appreciated by the Chinese and are fundamental in any business discussions and negotiations. In addition, patience is a great asset in dealing with life in China. The barriers of language and culture mean it can be easy to get frustrated. However, rudeness and signs of frustration will rarely get things done any quicker and may end up being counterproductive.
- Tipping is not encouraged. By law PRC officials are forbidden to request or accept any gifts, except for items such as technical materials, journals, samples, awards or souvenirs.
- English and other foreign languages are becoming more widely understood and many people will be keen to practice their language with you. Nevertheless, it is always useful to have place names written down for you in Chinese so that you can show this to, for example, a taxi driver. Most hotels have a stock of cards printed in Chinese indicating its name and address.
- Dress codes in the PRC tend to be conservative – although local businesspeople and government officials rarely wear ties with their suits. The laws of the PRC apply equally to residents and visitors and disciplinary action will be taken if laws or accepted standards of morality are breached.
- Western business dress is usual in working life and for business functions while smart casual, conservative style clothing is recommended for social occasions. Temperatures vary considerably from season to season and throughout the country, so it is advisable to check what the weather will be like during your trip.
- In accordance with PRC Customs regulations, visitors should declare precious metals, jewellery and other valuable items at the customs point on arrival. If these are not declared on arrival, there could be problems in taking them out of the country on departure.

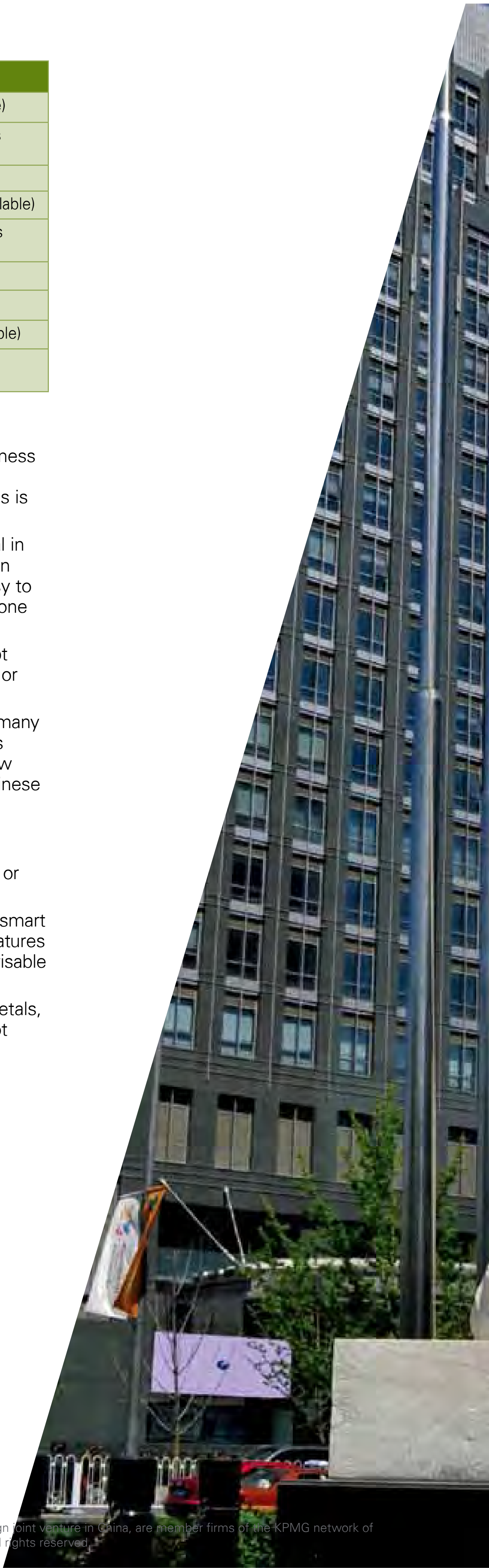
Importance of numbers

Many Chinese people pay attention to numbers in their daily lives.

"Four" is considered unlucky because its pronunciation in Mandarin is similar to the word for "death". Many apartment complexes and office buildings omit certain floors: 4, 14, 24, 34 and so on.

"Eight", "six" and "nine" are lucky numbers and Chinese are often willing to pay a premium to have these numbers in their vehicle license plates as well as office and residential addresses.

- The pronunciation of "eight" in Mandarin sounds similar to the word for financial success and prosperity
- "Six" sounds similar to "flow" and thus indicates smooth progress
- "Nine" suggests "longevity", again owing to the similarity in pronunciation.



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