

pwc: china compass

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Hot topic Talent wanted! Recruiting and retaining top talent for China • Acquisitions and the human factor: a critical relationship **Reporting and controlling** Financial centre Shanghai: Opportunities for Swiss companies • PwC survey: number of shared service centres on the rise in China **Tax and legal** Offshore indirect equity transfer challenged by SAT • Hong Kong: international transfer pricing rules have arrived • Social security in China: an alternative to insurance at home? • Representative offices in China: New regulations tighten conditions **Investment and financing** Private equity funds: Beijing provides incentives for foreign corporations • IPOs in Hong Kong: one option for Swiss companies **Publications** Study helps to find the right business partner • Trade in China in international comparison

Swiss edition

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Editorial

Dear Reader,

The hot topic in this, the summer 2010, issue of *pwc:china compass* is talent management, specifically finding the right talent to serve in China. Recruiting qualified, motivated staff and creating a sustainable HR development programme to retain them over the long term has become an art form for many companies. For only when companies are committed to developing their workers' skills will they be able to secure the very ones who can ensure successful engagement in China. This is only possible if the justifiably high expectations on the part of these secondees, or so-called expatriates, are in sync with the objectives of the company. Thorsten Barth und David Rooney, people and change specialists in our global human resources practice, describe just how important it is to choose the right employees in "Talent wanted! Recruiting and retaining top talent for China" on page 4. They also highlight some of the challenges specific to China. The lead article discusses success criteria, trends, challenges and solutions in the search for employees for China, from two different perspectives – that of the company and that of the employee.

As you have probably experienced, when setting off to a foreign country, you enter a world of unknowns where you can't always anticipate what awaits you. It is thus immensely helpful when you can at least count on social security.

In response to recent events, we have also included an article on the new guidelines for representative offices in China. In "Representative offices in China: New regulations tighten conditions" on page 22 Stefan Schmid and Lea Gebhardt analyse the new legal and tax rules for representative offices – a development that many think will cause companies to seriously question this popular form of investment.

And in case you are considering an IPO, our authors have gathered important information for you. Be sure to keep an eye on Hong Kong as a financial centre; in 2009, the number of IPOs in Hong Kong alone eclipsed that in the traditional industrial nations. On page 28 you can read about the fundamental elements that speak in favour of an IPO in Hong Kong and which companies should be considering one.

We hope you enjoy this issue and wish you continued success in your global activities.

Stefan Schmid Ralf C. Schlaepfer
Leader China Business Group Head Consulting

Talent wanted! Recruiting and retaining top talent for China

Companies doing or planning to do business in China will inevitably face the question of which employees are most suited for the job, and also willing to stay for the long haul. Making the right selection is important, as PwC's people and change and human resources services teams can tell you. This article outlines critical success factors, trends, challenges and solutions in the search for employees to serve in China. And it does so from two perspectives – that of the employee sent to China and that of the company sending him.

China's economic goals are very ambitious. To keep its economy on the path to growth, China not only needs raw materials; it also needs the right people. The demand for a qualified and talented workforce is thus growing steadily. At the same time, highly qualified employees are decisive in ensuring a company's success. That is why next to finding top Chinese talents the deployment of qualified employees to China is increasingly a matter of interest – all the more so for Swiss companies wanting to secure key staff positions so they can build up business there and, in turn, stay close to the market.

However, while recruiting these pivotal employees is high on their agenda, finding them is just part of the story. Only companies that can provide their top talent with sustainable professional development in China will be able to keep them.

Employee development a priority for management

Talent management has been at the top of the CEO agenda for a number of years. However, the global economic crisis has led to a shifting of priorities. Nevertheless, PwC's "13th Annual Global CEO Survey" makes clear that CEOs want to place a stronger focus on HR management. This would require new approaches and investment to ensure that company growth remains central.

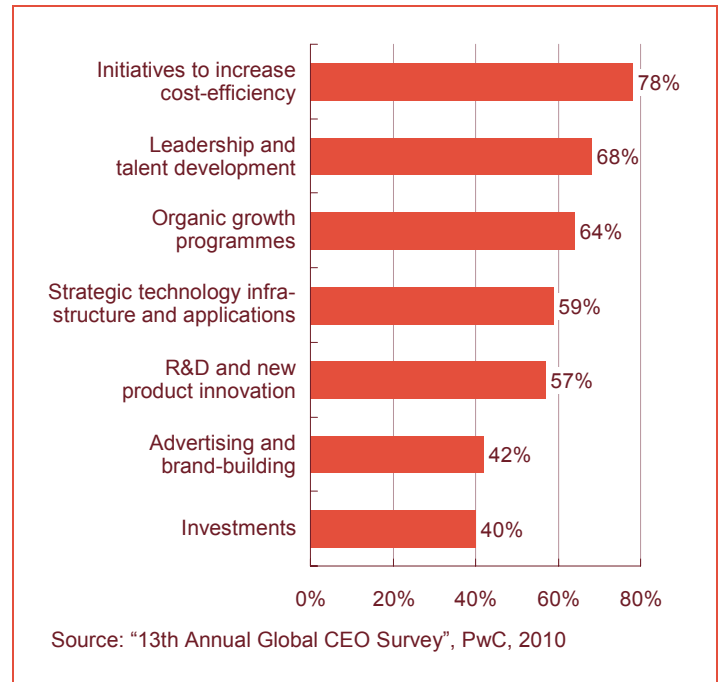
At 68% in the survey, renewed investment in leadership and trainee development was second on the CEOs' agenda. However, this figure needs to be put in context, as 78% of CEOs stated that initiatives to realise cost efficiencies are their main focus, now as ever. As is often the case, a balance must be struck between promoting talent on the one hand and tightening the purse strings on the other.

Definition: talent management and secondments

Talent management is the umbrella term used to describe a strategic, employee-driven approach to HR management. The primary aims are recruiting the most talented candidates, training them, developing their potential further and retaining them at the respective company. The appropriate groundwork must be laid by the HR department in a systematic and structured way.

This article explains ...

- what "pivotal employees", "secondtees", "localised" employees and "returnees" are in the Chinese context,
- what tasks are combined to produce successful talent management and
- what staff who move to China should clarify with their employers.



Percentage of participants agreeing

A secondment is defined as the transfer or assignment of an employee to an office away from home (for instance a Chinese branch of the company), usually for a set period of time. These assignments are often an integral part of talent management, as they help employees' careers along and are thus an important instrument in HR development and career planning. From another perspective, secondments also enable companies to fill talent gaps at their Chinese branch.

These overseas assignments are increasingly sought after by ambitious, motivated employees. As companies expand to become global players, the competition to recruit high achievers will become increasingly fierce. As a result, secondments are going to become all the more important as an instrument for talent management and HR development in the future.

The employee's perspective

Moving to the Chinese subsidiary of a Swiss company is an attractive prospect for Swiss employees, as it opens up both career prospects and personal development opportunities. However, attracting potential secondees to China continues to pose a number of challenges. Because of the cultural differences between Switzerland and China, numerous issues face the secondees, and should be resolved before a secondment begins.

Some of the key concerns are:

- a change in environment,
- social factors,
- accommodation,
- being able to adapt to a new culture and
- opportunities for the secondee's partner to work at the new location.

These concerns are exacerbated when the secondment location is not one of China's tier-one cities. When the Swiss secondee and the company work together to overcome these challenges, both sides benefit from the arrangement. To make a successful placement possible, the company needs to address any questions about the secondment in advance.

Localising employees

Companies are increasingly seeing longer assignments as a way to keep employees in China for substantial amounts of time and "localise" them there. In other words, the aim is that over time, the secondees will become permanent employees in the overseas branch of the company. From the secondee's point of view, there are additional issues that need to be addressed to ensure his quality of life. The company, too, must reflect on what incentives it has to offer to convince the secondee to stay overseas. Three possible issues are:

1. Education for the secondee's children

The language used in schools in China is Mandarin Chinese. Therefore, children who do not speak Mandarin fluently are going to have a hard time attending these schools. Employees with children attached are only going to be able to localise if the company is willing to continue to cover the relatively high cost of sending the children to international school.

2. Localised salary level

There is a substantial pay gap between a tier-one city like Beijing and a tier-two city like Chongqing. According to government statistics, the discrepancy between salaries can be as high as 70%. It is important to consider this factor when comparing secondees' pay with that of local employees.

3. Retirement savings

Localised Swiss workers in China have limited access to the state pension system and one has to take care that the different Swiss pension benefits are not impaired during the time abroad.

The company's perspective

Swiss companies with offices in China depend on employees who are willing to work there on a long-term basis. It is these employees who will build a strong bridge between Chinese operations and the Swiss headquarters, and ensure the required transfer of knowledge to local Chinese operations. In 2009, PwC China conducted the survey "Managing International Assignments in China During the Downturn", which

focused on the impact the economic crisis has had on the movement of high achievers into China. The survey revealed some important points:

- 26% of the companies asked were trying to deploy talent to China on a more cost-effective basis.
- 24% have reduced the total number of employees sent abroad.
- 12% have investigated tax planning options that could reduce costs.
- Only 13% have reviewed their secondment policy entitlements to cut costs.
- 50% cited business needs as the key factor for deciding to localise secondees earlier, while 44% cited the cost to the company.
- 45% are looking to localise secondees between the first and third years of the assignment. In previous years, secondees have been assigned abroad for five years or more before the localisation process gets underway.
- Many companies questioned in the survey offer a package of additional incentives, meaning that secondees receive regular local employment entitlements for their work in China, as well as a host of other benefits such as tax assistance and accommodation and school fees being paid for. This compromise sweetens the deal for an employee who is considering localisation, but also mitigates the costs of a full expatriate financial package for the company.

Returning Chinese citizens

Given the high costs of sending Swiss employees on secondment, companies may well find that a more sustainable solution is to employ Chinese workers who have had an international education and who have their own reasons for wanting to return to China. Now that the Chinese market is rapidly expanding and expertise and leadership skills are in high demand, more Chinese nationals have opted to return to China after studying or working abroad. According to a 2008 PwC study ("International Mobility Trends in Asia") with more than 100 companies participating, 61% anticipated that they would recruit more Chinese returnee talent into their organisations over the next two years. Three main reasons for the increasing preference for Chinese returnees were cited:

- Language ability (65%)
- Transfer of skills and knowledge (62%)
- Familiarity with the culture (59%)

Chinese returnees are able to bring a fresh perspective on business issues as compared to their Chinese counterparts. At the same time, they have an advantage over foreign employees in that they fully appreciate and relate to the unspoken rules of doing business in China, such as the importance of building relationships – the art of *guanxi* and networking.

HR divisions are regularly confronted with the following issues when it comes to returnees:

Hot topic

- Managing high expectations: many returning Chinese employees expect a more senior position and higher remuneration than their local Chinese counterparts. The 2008 survey indicated that 32% of companies pay returnees in line with local benchmarks, while 50% pay returnees more than their local counterparts.
- High turnover: returnees change employers frequently. Only comprehensive talent management programmes put companies in a position to retain qualified Chinese employees on a long-term basis.

The category “lessons learned for HR” contains the following points, which are worth considering for companies aiming to keep high-achieving employees in the company over the long-term.

- Targeted local talent management: companies should step up efforts to identify and develop their high-performers locally and then give them international exposure.
- Policy benchmarking: HR divisions should review existing secondment entitlement policies to ensure they reflect current market norms. Only after comparative analysis can HR be confident that the company’s policy is up-to-date.
- Tax planning: companies may be able to make savings by exploring tax planning options for expenses and any other secondee compensation.
- Pension planning: international pension plans or other financial vehicles could be considered as alternative retirement plans, which would facilitate global mobility and localisation.
- It helps to clarify any additional benefits, such as offering tax advice and offering expenses towards a flat and education. Secondees consider it very important to maintain their standard of living, particularly the standard of education that their children receive.

Conclusion

As we have shown, there are various ways of recruiting high-achieving employees to work in China. This has led both to a complex hierarchy within the workforce and to employees having a whole host of needs and diverse expectations of the company. So HR now faces a great challenge, since it is HR who works with the business departments to support them in implementing this strategy. It is HR’s role to find a suitable – and most importantly, sustainable – framework for all employees. If the strategy for managing employees is not in line with company strategy and the various requirements of the Chinese market, then there is a risk of high turnover in the medium to long term. A high turnover of staff would mean a greater loss of expertise, which in turn could put the success of the company’s Chinese venture at risk.

Therefore, it is important to guard against any such trend. HR departments would thus be well-advised to keep an eye on the basis for and development of talent management in the company. Only by doing this will HR be able to ensure that the decisions they take are reasonable and appropriate.

If you have any questions about the human aspect of a successful Chinese venture, or about how to choose your employees and develop their potential, please call or e-mail one of the contacts below.

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Acquisitions and the human factor: a critical relationship

As China becomes an increasingly open and attractive market, foreign investors are increasingly interested in local expansion, primarily by acquiring companies or engaging in other related transactions. While the prospects for success in such projects are certainly promising, they are regularly pitted against considerable risks. Indeed, analyses of previous transactions reveal that more than 70% of deals fail to meet expectations. The experience of PwC's team of experts shows that resolving HR issues early on can be decisive for the success of a deal. Ideally, these issues should be identified and evaluated before the transaction is completed. The following case study describes the practical challenges Western companies face when undertaking acquisitions in China and the best solutions for overcoming them.

The transaction

After numerous successful acquisitions around the world, a Swiss market leader ("Company A") decided to look to China for the manufacture of certain building materials. Part of its strategy was to gain entry into the Chinese market by acquiring a local company, thus making it possible to assume an important role there quickly. During its due diligence review, Company A identified several potential target companies. It then decided to acquire 100% ownership of a privately owned cement manufacturer with more than 400 employees. The target company was located near an emerging, second-tier city in China. In the run-up to the transaction, a thorough assessment of the target's economic, legal and financial situation was carried out. However, an analysis of potential strategic HR issues was deemed unnecessary. After the formal conclusion of the acquisition, Company A sent a team of high-ranking European staff to China to supervise the acquisition, in addition to keeping daily business running smoothly. The team was immediately confronted with the following challenges:

Non-compliance with regulations had created legal and financial risks, and could have damaged reputation

As is not unusual in privately managed Chinese companies, labour, social security and tax regulations and requirements were often partially or wholly neglected in the acquired company. Since Company A purchased the company through a share deal, it assumed responsibility for past infringements, and suddenly the company's past history raised some considerable risks.

For example, the non-existence of written contracts with more than 30% of the workers meant the right to permanent employment in these cases according to the new Employment Contract Law. In addition, the former owners had not paid the required social security contributions, which include not only pension contributions but also health, unemployment, occupational injury and maternal leave insurances. The total amount owed retroactively exceeded \$1m.

This article explains ...

- what HR challenges buyers of state-owned enterprises should expect to face,
- how poorly organised networks can overcomplicate company structures and
- why a strong and independent HR department is decisive for the success of an acquired company.

To make matters worse, an employee had been involved in a work accident, and because the occupational injury insurance payments were in arrears, the insurance company did not provide coverage, thus leaving the company to pay for treatment and make additional compensation payments.

In addition to the direct negative financial impact, the situation was highly dangerous for Company A's reputation: as a global commercial enterprise, compliance with employment laws is a fundamental part of the group's business philosophy. This apparent disregard of such a basic element of corporate social responsibility could have seriously damaged the brand strategy of the entire enterprise. These considerations led to the decision to pursue due diligence in human resources after the fact in order to assess and address all potential risks.

A so-called HR Health Check includes a thorough analysis of the personnel situation, an evaluation of the sources and amount of risk, and the development of an efficient risk management strategy.

'Bad' networks and overcomplicated structures were hindering communication and transparency of decision-making

The social ties and hierarchical relationships within the company were disproportionately complex. Different interest groups at the company had created an inner circle that excluded employees who were seen as outsiders. The employees complained about these unofficial centres of power and felt that decisions on corporate policy were often unclear and inconsistent as a result. Even external consultants often did not dare express their opinion for fear of endangering their reputation in the network.

An examination revealed that the organisational structure and allocation of competences for certain positions did not reflect the official responsibilities of those positions. In order to secure their own positions, the two local senior managers had filled all the central positions with relatives and close friends. For the secondees arriving from Company A's head office, there were two main issues that required immediate action:

- The lack of clearly structured competences
- The unclear management of the company's internal decision-making processes

Their assessment of the situation is consistent with the experience of the HR experts on PwC's people and change team: streamlining overcomplicated organisational structures and

breaking up informal circles of power are decisive factors for a successful transformation process. This also includes identifying and abolishing ineffective networks and “pseudo-positions” created solely for the purpose of controlling and maintaining power.

Cultural differences and language barriers inhibited the development of trust

Staff secondment from the European parent company to the newly acquired company in China revealed a potential conflict between the different cultural perceptions of operational decisions. Often, the differences arose in approaches to comparatively trivial matters (as judged from the Western standpoint) that led to significant disturbances in both the work environment and operational processes. For example, the Western managers relocated all administrative functions to a separate building in compliance with safety regulations prescribed throughout the group. As a result, employees who did not work in this building were required, just like visitors, to sign in when they entered.

While such a measure is considered routine in the West, it was incomprehensible to the Chinese employees. In their view, the security guard knew exactly who they were, and for that reason it was unnecessary to have to sign in. They thought that only external visitors should have to do so. Even individual members of the Chinese management thought that this measure was excessive and some even considered it akin to harassment.

As blatantly ignoring the requirement would have been a violation of the rules, an increasing number of employees simply decided to find a way around the problem: they began to avoid going to the building whenever possible. It did not take long for the effect of this development to be felt: internal communication suffered even more and the prescribed reporting lines were no longer observed.

Cultural differences were further heightened by the language barrier. The secondees did not speak any Chinese and the majority of the company's staff, including those in managerial positions, hardly spoke English. Naturally this restricted communication, and even minor misunderstandings that would otherwise be easily cleared up turned into enduring hindrances and generated an atmosphere of mutual mistrust.

Inadequate compensation models were frustrating employees

Prior to Company A acquiring the company, pay structures had not been changed by the previous owners for a number of years. As a consequence, the employees had not received a raise for quite some time. Accordingly, the employees had high expectations of their new employer, and their expectations were all the higher because the investors were foreign. Chinese employees generally assume that they will receive higher pay from foreigners, since, from the Chinese perspective, such

investors come from a country with high labour costs and are used to paying their domestic staff higher wages and salaries.

The employees were also unhappy with the old pay structures for another reason: pay decisions made by the former management were in no way based on a transparent system of compensation. The level of pay was determined at the discretion of the owner. The dependent relationships within the aforementioned inner circles of power had in some cases given rise to enormous pay discrepancies between employees who were officially of equal rank. Some employees in the sales department even went so far as to hand in their notice because of the unfair compensation structures.

Management thus decided to establish a new compensation model that would reflect both the employees' individual contributions and external competitive factors. However, because the company was located in an emerging economic region and there was a small number of comparable competitors, it was difficult to find an appropriate benchmark. In addition to this challenge, management also had to find a way to align the high expectations of the employees with the newly developed compensation model.

The solutions

The HR experts at PwC first conducted a post-deal due diligence appraisal from an HR perspective (HR organisation, processes, guidelines, etc.) to identify important HR issues and analyse the associated risks and their impact on operations. This was followed by the development of a 100-day plan that prioritised the issues and tackled them step by step, according to their defined level of urgency. As part of the prescribed measures, the organisational structure was adapted and a compensation model was developed for the sales department.

Management now saw clearly that a strong HR department equipped with the appropriate competences was crucial for the further development of the company. This stocktaking also led to another conclusion: the current department would not be able to cope with new challenges and additional expectations as is. This in turn prompted the decision to temporarily outsource certain HR areas of responsibility in order to overhaul the existing HR department.

Regional and structural characteristics: each case is different

It is important to keep in mind that the regulatory environment in China is a decidedly regional one (ie, at the province level). Local regulations and the implementation of national provisions will give rise to different requirements based on a company's location. For example, there are different rates for social security contributions and special regional regulations concerning housing allowances. Therefore, before acquiring a company, buyers should be well-informed about the relevant regulations and the prevailing methods of implementation.

Hot topic

The type of company acquired (private or state-owned) as well as its legal form also have an effect on HR issues. The buyer of a state-owned enterprise faces completely different challenges compared to the buyer of a privately owned company. The following list names a few of the common problems that can arise during an acquisition:

- Ties to other companies and business units can lead to further critical HR questions. Often, for instance, the company is not able to retain key employees – that is, employees who make a significant contribution to the success of the company.
- Because of the special social responsibility of state-owned enterprises, staff may have been with the company for an above-average period of time. The length of service has a huge impact on severance.
- The (early) pension entitlements that currently exist under Chinese law often put a considerable strain on companies, and can continue to do so for a long time.
- Compensation systems are often difficult to understand and are not necessarily related to operational key performance indicators.
- The HR management information system is frequently unable to meet modern requirements, and for this reason there is a lack of transparency.

Conclusions

The human factor is often neglected during due diligence, a decision that regularly results in the emergence of unknown risks and problems during subsequent integration into the group. Reviewing the HR situation and the relevant processes before the deal aids in identifying potential issues early on, quantifying them and factoring in these risks into negotiations with the seller. Furthermore, this knowledge makes it possible to take immediate action after the acquisition in order to prevent HR-related conflicts. As the case study shows, even when HR due diligence is initially neglected, it's better late than never.

An implementation plan with clearly formulated objectives and simple and realistic measures that can be carried out during the first 100 days can make a world of difference, and ultimately create the basis of trust among employees necessary for longer-term restructuring measures to be successful.

If you have any questions or would like further information, please call or e-mail one of the contacts below.

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Do you know how long China has been sending students to study abroad?

The Qing government sent 120 young people to study in the USA in 1872. More than 50 of them went to renowned universities like Harvard, Yale and Columbia. One of them was Zhan Tianyou, who had a pioneering role in building China's rail system. In 1881 at just 20 years old, he completed his studies in civil engineering at Yale University, returned to China and became the head engineer of the rail line between Beijing and Zhangjiakou.

Source: Hans Hauenschild, *China Takeaway*, Ullstein Verlag

你知道了吗

Financial centre Shanghai: Opportunities for Swiss companies

Shanghai's dream of becoming a financial centre has yet to take shape, and there are still quite a few questions that need to be answered in the super metropolis on the Yangtze. But it will happen, and that offers some outstanding chances for companies who are able to seize the opportunity now. The following article provides a run-down of the current state of Chinese planning, what future developments are on the horizon, what benefits Shanghai offers and other key information that potentially interested companies need to know.

The city's potential

The Municipality of Shanghai (more than 17m residents) is one of the most significant economic engines in China. It includes the city of Shanghai, which, with over 13m residents is the largest and most densely populated city in China and generates the highest gross value per capita. Shanghai, together with the surrounding areas in the provinces of Jiangsu and Zhejiang, has the largest percentage of foreign direct investment of any region. The seaports of Shanghai and nearby Ningbo handle the highest volume of goods in the country. In terms of trading volume and market capitalisation, Shanghai's stock exchange is among the top five in the world, even though it has only listed Chinese companies up until now.

Even today, Shanghai is considered the national trading, finance and service capital in China. In March 2009, the Chinese State Council made the decision to build Shanghai into an international financial centre by 2020, and this intention was publicly announced in April 2009. In addition, Shanghai will also strive to become an important international hub for shipping traffic.

But to be a truly international financial capital, the city has to attract a large percentage of non-Chinese financial activity. London, for example, has 34% of the world's foreign exchange, 70% of all Eurobonds, 20% of interbank loans worldwide and 254 branches of foreign banks (figures for 2006). The other indisputable centre of international finance is New York, which, in contrast to London, has the benefit of a much larger domestic market.

Shanghai still has quite a way to go in becoming an international financial metropolis. And there are still too many restrictions in the financial sector – the Great Financial Wall, as it were – that need to be lifted before this objective can be achieved. The following list highlights the most important ones.

This article explains ...

- what hurdles Shanghai still has to clear on its way to becoming an international financial centre,
- what targets the Chinese government intends to reach in Shanghai by 2020 and
- which companies have already been listed on the Shanghai Stock Exchange.

- A freely convertible currency for international transactions: currently there are countless foreign exchange controls that restrict the convertibility of the Chinese yuan. China has already announced its intention to make the yuan fully convertible when the time is right. Recent remarks about reconsidering the significance of the US dollar as a base and reserve currency, as well as the naming of the concrete 2020 target for the completion of the development into an international financial centre, may be good indicators that the time is finally right to make the yuan fully convertible.
- Free capital transactions: until now, there have been significant restrictions for foreign investors in the financial sector, which has prevented many financial institutions, including banks, insurance companies, brokers and credit rating agencies, from expanding their business operations in China.
- Unrestricted product range: many financial products that are commonplace in Western industrial countries cannot be offered or traded in Shanghai. The recent announcement listed financial products that will in the future be authorised for trading, including, among others, different derivatives and futures, over-the-counter securities, asset-backed securities and products in interbank trading.
- Creation of an institutional investor base: institutional investors currently face a number of obstacles to investment. Insurance companies, for example, can only invest a maximum of 15% in shares; the majority of the investment must be made in debenture bonds and time deposits. There are indications that these restrictions will be relaxed for insurance companies.
- Taxation disadvantages: other international financial centres like Hong Kong and Dubai offer lower income and corporation tax rates. This could pose one disadvantage for the city when trying to attract financial institutions.

These obstacles are not going to disappear overnight. It is far more probable that the current restrictions will be gradually relaxed as certain rules are loosened functionally or locally, like those already implemented in the use of the yuan in international payments. This easing of regulations opens up a range of diverse opportunities for foreigners:

- Foreign companies are to be granted the opportunity to list their shares on the Shanghai exchange. This is an advantage for companies, which can then naturally safeguard their investments against currency fluctuations with capital that has been in part raised locally. Yet the main reason for listing in China for most consumer goods companies will be the commitment to the local market. Such a commitment can lead

Reporting and controlling

to a positive impact on the market and therefore on consumers, but also on the authorities and the company's own employees. The only limitation that remains is that the money earned on the exchange may only be invested in China.

- The State Council also explicitly mentioned the issuing and trading of corporate bonds listed by foreign investors in yuan. At this time, the market for corporate bonds is not very developed and essentially closed to foreign companies. If this idea is further developed, it is possible that bonds from Chinese companies may in the future be traded internationally as well.
- Access to the largely closed stock markets (Shanghai and Shenzhen) is planned.
- Until now, foreign financial institutions wanting to develop their business have been largely blocked by various regulations. Investment banks, fund management companies and leasing companies, among others, have been affected. This could also change in the future.
- Reinsurance was also explicitly mentioned, and Shanghai will also be developed into an attractive location for these enterprises.

The magnitude of the impending changes for China's financial sector casts some doubt on whether the project can be completed by 2020. But at the same time, China is known for its pragmatic solutions. The transitional phases will definitely result in some grey areas that foreign companies can use to their advantage. Experience with previous reforms gives a good indication of how the administration will go about tackling the reforms in the financial sector:

- Precedents will be created and tested, even if they violate current national law, as long as it can be reasonably assumed that these regulations will be changed in the near future. Companies that support Shanghai's development in this manner will most likely need to apply for special authorisation.
- Additional special economic zones will be created for transactions that would otherwise be unauthorised. One example of a previous case is the free trade zone of Waigaoqiao, which was exempt from national regulations for 10 years until they were liberalised. Another example is the reduced tax rate in Pudong, which aims to attract investors to this district in Shanghai.
- Since this is an initiative of the central government, cumulative national and municipal benefits may be available as well. If the interests and ambition of foreign investors are brought in line with the political intentions of the government, this could potentially open doors in other areas that have stood in the way of growth up until now.

Foreign listings on the Shanghai exchange?

Currently, no details are available about what requirements foreign companies will have to fulfil to list on the Shanghai exchange. According to announcements, a special segment for the shares of foreign companies traded in yuan is to be established this year. In all likelihood the first companies will be state-owned "red chips". These Chinese mainland companies

have already developed a foreign holding structure to list on the Hong Kong exchange: they conduct their business on the mainland but are incorporated outside mainland China. However, a listing in Shanghai could also become attractive for foreign companies in the medium and long term. HSBC, the biggest bank in Europe, is currently engaged in discussions on this point.

The biggest advantage of a listing in Shanghai at this time is being able to use the global recognition of the city's brand name to elevate a company's own recognisability. A listing might also be portrayed in the media as a commitment to the Chinese market, people and culture, which would likely have a positive effect on consumer behaviour and brand loyalty. And since the Chinese are currently unable to purchase foreign shares without obtaining special permission from the authorities, a listing on the Shanghai exchange would also expand the shareholder base – a sufficient level of liquidity is at least available in China at the moment. As in past years, market capitalisation in China continues to show a price-to-earnings ratio of more than 30, which is very high compared to the European stock markets. In connection with the fact that it is currently extremely difficult for Chinese investors to gain access to international markets, this may result in arbitrage effects: the price of shares traded on the Shanghai exchange may be higher than those shares which are bought and sold on Swiss stock markets. This price difference can already be observed in Chinese companies that are listed in both Hong Kong and Shanghai. If a positive price difference should occur with the IPO of an additional listing in Shanghai, this would result in additional earnings compared to a listing in Switzerland.

At the moment, the only companies allowed to list on the Shanghai exchange are those which have been established as a joint stock holding company in accordance with Chinese law. In addition, they must also fulfil the following requirements:

- The company must have been in existence for at least three years and there is a minimum capital requirement of 50m yuan (or 30m yuan for a first listing).
- The cumulative annual net profit of the three years prior to the intended listing must be at least 30m yuan.
- Business operations must be conducted independently of the principal shareholders (both the company and the management must exist independently of the shareholders).
- No significant changes in the business activity or the majority shareholders have taken place in the three years prior to the intended listing.
- At least 25% of shares must be tradeable; or at least 10% if the registered capital exceeds 400m yuan.
- The earnings from the listing may only be invested in business operations in China.
- The corporate governance regulations of the China Securities Regulatory Commission must be observed. These include the application of Chinese Generally Accepted Accounting Principles – and in the future, probably regulations on the development of internal control systems and risk management as well.

The existing regulations would most likely require extensive legal restructuring of the company in China. This type of restructuring has far-reaching consequences for the entire group (in particular the task of monitoring the business in China) that may not be desirable and thus make a listing in Shanghai unattractive. By virtue of this fact alone, changes to the existing regulations are absolutely necessary before foreign companies can make the move to the future financial centre of Shanghai.

If you are considering a listing in Shanghai for your company, it is essential to stay abreast of new regulations that the Chinese authorities will enact in the future. You can count on *pwc:china compass* to keep you up to date.

If you have any questions or would like further information, please call or e-mail the contact listed below.

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PwC survey: number of shared service centres on the rise in China

Shared service centres have been a standard feature of Western economies for many years. Now demand for them is increasing in China. However, the goals and priorities of these centres in China are sometimes completely different from those in Western industrial countries. This article sets out the reasons behind this development and presents the results of a survey of existing shared service centres in China conducted by PwC.

This article explains ...

- which services are outsourced to a shared service centre,
- what challenges companies have to master before they can use or establish their own shared service centre in China and
- what those who took part in the PwC survey considered to be the main purposes of shared service centres.

Shared Service Centre

In a company or organisation, a shared service centre typically consolidates and centralises processes so that they are available across the organisation. Similar services used by different areas of a company or organisation are bundled together and provided by one or several central offices. The location providing these services is generally known as a shared service centre (SSC).

In recent years, foreign companies have benefited greatly from the favourable investment conditions in China. After low production costs initially attracted them to China to establish manufacturing locations for exported goods, foreign companies also increasingly looked to China as an outlet market. This shift implied the need to diversify work sites. Because of administrative obstacles and the provincial and municipal subsidy system, as well as the fact that China is a huge country, it is not always advantageous to concentrate all activities in one single company in one single location. Because of these factors, business operations in China have always been expanded via additional investments in existing entities, the founding of subsidiary companies or joint ventures, or acquisitions of Chinese companies. The dramatic expansion within existing business structures in China continued over many years, often resulting in increasingly complex organisations consisting of many legally and regionally distinct subgroups. Activities in China were chiefly led by the desire to boost sales and market share figures, with little attention being paid to keeping costs down and monitoring business processes.

Challenges to integrating different parts of companies

Assuming that the ongoing positive economic development continues in the coming years, the GDP will also continue to grow considerably, which is likely to result in increased business activity on the part of Swiss companies. However, managing the different company entities is clearly becoming increasingly complex.

Reporting and controlling

Below are some examples of this:

- Different legal entities in the group usually develop different processes. Acquisitions often also have an existing organisational structure, which is seldom compatible with the processes that have already been developed within the larger group. It is thus necessary to adapt the organisational structure of the acquired companies to achieve consistency in the processes used across the group. However, attempts to standardise processes across a group are generally haphazard or else neglected completely. Consequently, many business practices have arisen that contradict Western ethics or run counter to legal regulations (for example, against the Foreign Current Practices Act, a federal law in the United States to fight corruption in business transactions).
- The level of staff training and education in rural areas, and sometimes even in large second- and third-tier cities, is often insufficient to ensure that processes are of a consistently high quality. In Chinese bookkeeping departments, for example, there is often a lack of knowledge of complex accounting requirements like hedge accounting or deferred taxes, and general knowledge of the International Financial Accounting Standards is also to be found wanting.
- The IT environment is confusing, unclear and not unified. Different IT systems are used from company to company and the percentage of manual work in China is considerably higher than it is in Western industrial countries. This is because local Chinese applications, such as those for bookkeeping or for enterprise resource planning, are not able to satisfy the requirements of a multinational company.
- Chinese joint venture partners generally have different expectations in terms of transparency in companies, the implementation of modern management practices or the quality of internal process standardisation and the associated costs. There are often different joint venture partners involved in the different joint ventures of the group, which makes coordination all the more complex.
- In most cases, there is a need for improved communication and formalised reporting procedures. Naturally, cultural hurdles and the language barrier play a role here, as do the different objectives set out by the individual joint venture partners. In some extreme cases, operational risks have not fully been recognised or have not been spotted early enough, meaning that the necessary precautionary measures were not taken or were taken too late.

This is not a comprehensive list by any means. Nevertheless, owing to these and other difficulties within an organisation, attempts to achieve optimal cost-effectiveness and to set benchmarks for efficient processes in the company will only be met with limited success.

PwC's survey: the most important questions and answers

As the above-mentioned examples have shown, organisations that wish to introduce an SSC in China cannot focus on the cost factor alone. In this survey, which PwC conducted in 2009, we asked companies what advantages SSCs offered for organisational structures in China. The answers are as follows:

More and more SSCs are being established in China. PwC China's survey aimed to pinpoint the latest trends and to help companies considering establishing an SSC in China by showing them how others have done it. The respondents were all companies that already operate at least one SSC in China.

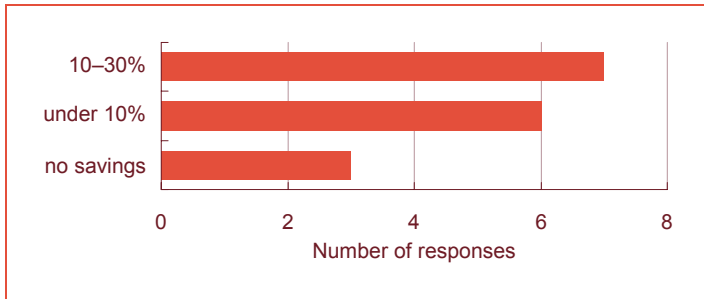


The biggest benefits of SSCs according to the participants in the survey

Our survey respondents said that in addition to controlling costs, unifying processes and ensuring the sufficient and consistent quality of work results, as well as fulfilling group-wide control and transparency requirements, stood at the top of the list of reasons to introduce a SSC.

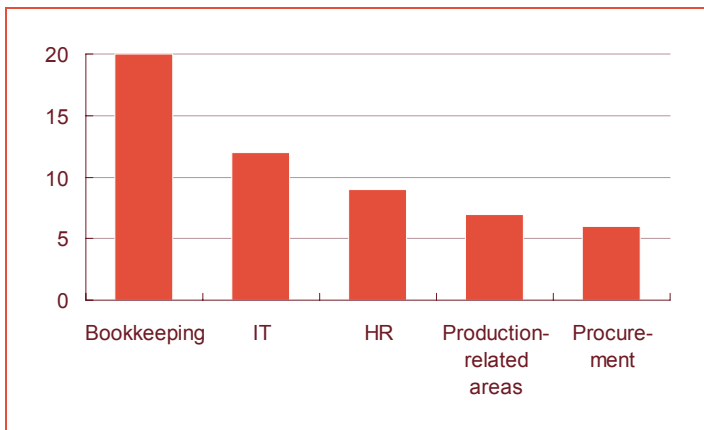
Almost everyone is familiar with the idea that in a rapidly growing market, the rise in operating costs should be disproportionately low compared to the rise in sales revenue. An SSC can help companies avoid having to double up on necessary but expensive resources. According to the results of the PwC survey, costs can be cut by more than 10% in 44% of cases.

Reporting and controlling



Amount of cost savings among respondents

In principle, all activities related to administration can be incorporated in an SSC. Typically, this includes the following areas:



Functions covered by SSCs according to our respondents

An SSC can either be operated within the group or externally – the latter case is known as business process outsourcing. Continuous process optimisation is an important aspect of running an SSC, as almost all of the organisations that participated in the survey confirmed. In an SSC, continuous learning processes can be implemented more easily than is the case when processes are run locally. Thus, it is not surprising that the majority of the respondents said that they also intended to include more areas in the SSC in future.

In 66% of the cases, the group had fewer than 10 companies in China; in 17%, the group had over 20. What's more, an SSC is not limited to serving companies in China. Approximately half of the SSCs surveyed also supplied services to a median of 6 other countries, although these additional countries were generally confined to the Asia-Pacific region.

Outlook

SSCs have become an important topic in China and for companies that do business in China. In the past, foreign companies were concerned merely with gaining access to the Middle Kingdom. However, they are now focusing more and more on ensuring the optimal implementation of their processes and preventing redundant structures and unnecessary complexity in

organisational structures. SSCs are a central component of effective process, cost and not least HR management.

PwC's survey has clearly shown that despite all of the various difficulties in implementing a SSC in China, the existing centres are operating with great success. Since China's economy will continue to maintain its course of growth, and SSCs will become both more well known and more refined as time goes on, we don't need a crystal ball to see the future. It is clear that the number of SSCs in China will continue to grow considerably in the coming years. The experts at PwC are happy to assist you in finding the ideal model for your organisation.

If you are interested in the complete results of the survey or if you have any questions, please call or e-mail one of the contacts below.

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Do you know when crossword puzzles first came to China?

In 2003. But the founder and editor of the *Southern Weekend* newspaper doesn't call his invention a crossword puzzle, using a literal translation instead: "Little strong one fills it out".

Source: Hans Hauenschild, *China Takeaway*, Ullstein Verlag

你知道吗

Offshore indirect equity transfer challenged by SAT

Non-China Tax Resident Enterprises (Non-TREs) [literally “foreign companies”] that hold their equity interests in Chinese companies indirectly via an overseas holding company located in a country with a favourable tax regime can gain tax advantages. However, extreme caution is required when setting up tax structures of this kind. To prevent tax avoidance, the State Administration of Taxation (SAT) has now issued instructions to tighten controls on such arrangements under certain conditions which may, in extreme cases, lead to their derecognition. For non-TREs with indirect equity interests in China this may mean additional costs and increased uncertainties when restructuring. The instructions also provide a general clarification of the taxation regime applicable to transfers of equity interests in Chinese companies by non-TREs. This article summarises some important aspects of the new rules.

It is not uncommon for multinational corporations to hold equity interests in Chinese subsidiaries indirectly via intermediate holding companies (Offshore special-purpose vehicles, or SPVs). Tax considerations are often a factor. For example, income from the disposal of a direct equity interest in a company based in China is in principle subject to Chinese taxation. Whereas the disposal of an indirect equity interest (Figure 1) does not generally incur any tax liability within China.

To identify and prevent tax avoidance via such arrangements, the SAT has, under certain conditions, imposed special reporting obligations on the company responsible for the equity transfer. These generally concern the investor labeled A in Figure 1. These guidelines are contained in the Circular Guoshuihan (2009) 698 (Circular 698/2009) published on December 10th 2009. If the SAT identifies tax avoidance arrangements on the basis of such information (or if abuse cannot be ruled out in the absence of information to the contrary), the SAT reserves the right to tax the income from the transfer even though formally speaking, this income is subject to taxation outside China.

Although Circular 698/2009 may at first sight appear to contain entirely new guidelines, it actually originates in the new CIT law that has been in force since 2008. Moreover, some recent decisions by local tax authorities have evidenced a similar trend.

Recent examples

In the recent past, the SAT has reported on a number of cases where the state has assumed the right to tax transactions that are not formally subject to Chinese taxation. These decisions arose from suspicions of tax avoidance, based on the principle of “substance over form”.

This article explains ...

- cases where the Chinese state is likely to impose further taxes in the future,
- what provisions the circular contains on indirect transfer of company equity and
- why Circular 698/2009 will continue to have an impact on taxation practice.

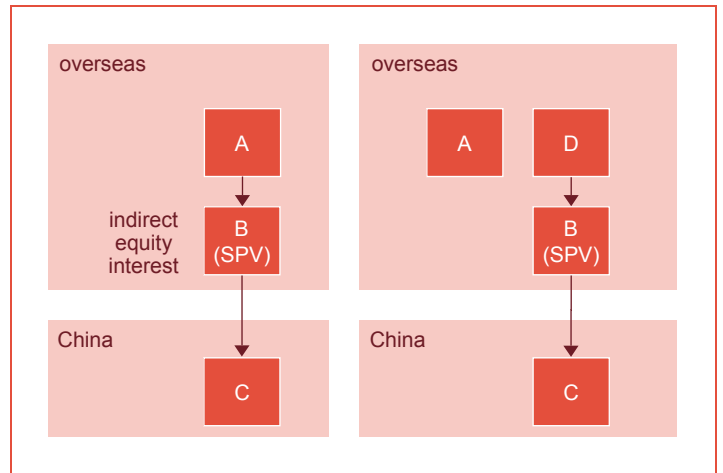


Fig. 1 Transfer of indirect equity interests

The Chongqing case

The Chongqing State Tax Bureau released a report in November 2008 of a case where the disposal of a Singaporean SPV with a 31.6% equity interest in a Chinese joint venture was re-characterised as a direct disposal of the equity interest in the joint venture. This case is similar to the transfer of an SPV as sketched out above.

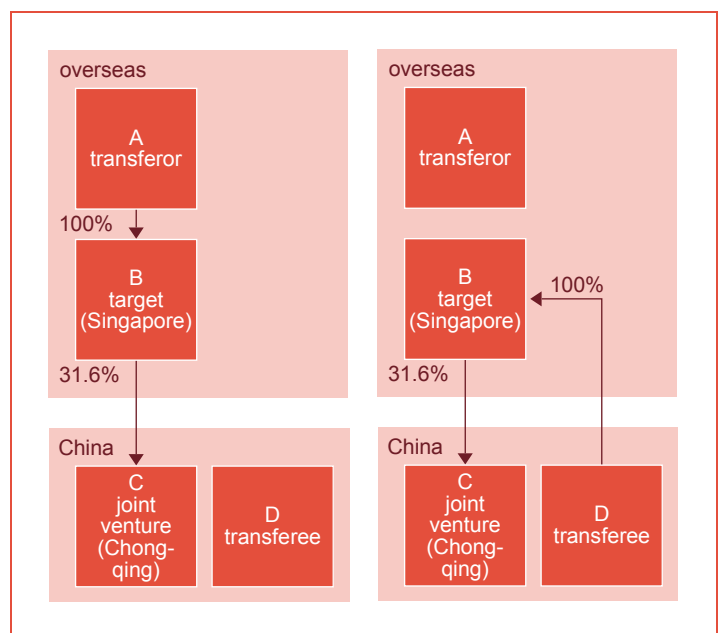


Fig. 2 The Chongqing case: disposal of a Singaporean SPV

A decisive factor in the re-characterisation of this case was that the target did not carry on any business activities except for holding the equity interest in the Chinese joint venture. Pursuant to Section 3(3) of the new CIT law and Section 13(5) of the Singapore-China double-taxation agreement (DBA), the SAT collected withholding taxes of 980,000 yuan (equivalent to about €105,000) on the capital gain derived from the transfer. Proceedings were initiated in May 2008 and the dispute was settled the following October.

The Xinjiang case

In another case, a Barbados-based SPV was used in 2006 and 2007 to avoid Chinese withholding tax on capital gains from a disposal amounting to \$45.97m under Section 13 of the Barbados-China DBA. The Urumqi State Tax Bureau objected to the timing of the transactions, the SPV's lack of substance and the apparent lack of business purpose of the structure; and conducted exchange of information with the competent authorities in Barbados. The SAT came to the following conclusion based on the findings from its investigation: it disregarded the SPV's entitlements under the agreement in Barbados and imposed a Chinese withholding tax of 9.2m yuan (approximately €980,000). This case found its way into the SAT circular of December 30th 2008 (Guoshuihan [2008] 1076).

Although the details are different, both cases underline the trend towards a more stringent application of the "substance over form" principle in relation to underlying transactions. The purpose is to prevent abuse and tax avoidance strategies.

Significance and general contents of Circular 698/2009

Circular 698/2009 is primarily an internal administrative directive that the taxpayer need not follow to the letter. In practice, Chinese tax circulars have a stronger impact, since the application of laws in China depends largely on how they are interpreted by local tax offices. Taxpayers should try to work with the tax authorities to find a solution agreeable to both parties, ie, they should consider the tax authorities' perspective. In administrative terms the instruction merely comments on the applicable laws by fleshing out the provisions already in place in Section 47 of the Chinese CIT law regarding the combat of tax avoidance. It is, however, not clear to what extent Section 47 actually authorises the detailed rules on documentation contained in Circular 698/2009.

Circular 698/2009 mainly comments on general issues of taxation relating to equity transfer income gained by non-TREs from the disposal of equity interests in companies resident in China. This concerns income from the disposal not only of indirect equity interests but also (primarily) direct equity interests.

Thus Section 3 of the circular defines the calculation basis for the relevant equity transfer income, including specific issues. Section 4 states that when calculating the equity transfer income, the currency to be used is the one used when the non-TRE

originally purchased the equity (which will be used to calculate the equity transfer price and the deductible equity transfer cost). There had previously been widespread uncertainty on this point and thus also on the impact of exchange rate fluctuations on the calculation of equity transfer income. Finally, Section 7 of the circular indicates – hardly surprisingly – that an appropriate transfer pricing policy is required in transfers between related companies in accordance with the arm's-length principle.

However, experts were most interested in the passages dealing with the indirect transfer of company equity interests referred to earlier. The following sections therefore go into this in more detail.

Indirect equity transfer via offshore SPVs

When a foreign company disposes indirectly of equity interests in Chinese TREs via an offshore SPV, this is covered by the special rules in Circular 698/2009 provided that

- the actual tax rate is lower than 12.5% in the region where the transferred SPV is located or
- the region where the transferred SPV is located does not levy income tax on overseas income (such as Hong Kong).

Under these circumstances, according to Section 5 of the circular the transferring company must provide extensive documentation and information to the tax office where the indirectly transferred Chinese resident enterprise is registered within 30 days of signing the equity transfer contract. This documentation and information comprises

- the equity transfer contract or agreement;
- documents relating to the relationships between the foreign investor and the SPV (financial, organisational and operational ties);
- documents relating to the SPV's size, personnel and assets;
- documents relating to the relationships between the SPV and Chinese resident subsidiary (also financial, organisational and operational ties);
- documentary proof that there is a reasonable commercial purpose in setting up the SPV;
- other relevant information required at the SAT's discretion.

It is clear that the SAT intends by these requirements to identify and prevent potential tax avoidance structures. The documentation and information that needs to be submitted in this regard will involve overlaps with the requirements on transfer pricing documentation, which have themselves been tightened up recently.

If, on the basis of the documents submitted, the SAT suspects that an SPV has been set up for tax avoidance purposes, Section 6 of the circular entitles the tax administration to tax the income from the indirect equity transfer. In such cases, the Chinese withholding tax rate of 10% or a lower rate of tax if stipulated under a DBA shall apply.

A particular problem for the companies concerned is that no detailed definition has been provided of the term “commercial purpose” for the tax structure under scrutiny. As a result, there is a great deal of uncertainty over what tax structuring options are still acceptable and what evidence is to be submitted.

It should also be noted that the rules in the circular are to be applied retrospectively from January 1st 2008. This means that all relevant equity transfers since the new CIT law came into force are affected. In all probability, local tax offices will already have launched investigations in advance of the circular being published and will now be gathering further information based on the new documentation and reporting obligations.

The re-characterisation of income derived from the transfer of equity in the companies involved may lead to double taxation.

Section 8 of the circular comments on the application of the documentation obligations for large restructuring arrangements involving multiple companies or SPVs. In such cases, all relevant information must be provided to the Chinese tax authorities, and the total remuneration has to be allocated to the participating enterprises. Interestingly, in this case it is not only the foreign company transferring the equity interest that has a reporting obligation, but also each Chinese company involved.

It remains to be seen how the Chinese tax authorities will compel the transferring company to fulfil its documentation and reporting obligations, particularly after the transfer of its (in any case purely indirect) equity interest in the Chinese company. In this respect, information exchange with foreign tax authorities may play an important role. In December, the first new bilateral Tax Information Exchange Agreements (TIEA) were concluded with the Bahamas and British Virgin Islands. China and Barbados also signed a memorandum in February revising the terms of the existing DBA, which also contains amendments to this effect (cf. the Xinjiang case outlined above). In addition, most of the Chinese DBAs already contain exchange of information articles.

Conclusion

Circular 698/2009 places additional documentation and reporting obligations on those affected, especially in relation to the transfer of equity interests held indirectly via holding companies in countries with favourable tax regimes. These new obligations are likely to involve considerable administrative burdens and tax risks, in particular in the case of major corporate restructurings with an impact on Chinese equity interests, even if their equity interest holding is only very low.

Despite all the disadvantages, it is important not to lose sight of the fact that these regulations are part of China's rapprochement with the international standards on codification of anti-avoidance measures.

A circular issue, or the perfect way to manage yourself

One might be tempted to think that that august body, the State Administration of Taxation (SAT), feels sorry for us, the taxpayers, who are so cruelly tormented by poorly drafted administrative directives. For why else would they issue Circular 20/2010, which covers administrative procedures to be used when issuing tax regulation documents?

This circular takes effect from July 1st and is in principle only binding on the tax authorities themselves. It is essentially a redrafted version of a similar circular from 2005 (Guoshuifa [2005] No 201).

The circular covers many topics, one of which is of particular interest: how to improve the allocation of responsibilities when drafting administrative directives between the various levels in the tax authority hierarchy. Exploring ways to do this will reduce the number of inconsistent and often downright contradictory administrative directives. Music to taxpayers' ears!

The circular also requires the SAT to remove documents no longer needed and publish a list of administrative directives no longer applicable every two years. New administrative directives are also to contain references to the old directives that they are superseding.

There is another regulation that appears to be aimed at protecting the taxpayer (but perhaps also the tax official who has to implement new directives directly). This states that new tax administrative directives shall generally only come into force 30 days after publication. Until now, the general rule was that the key date was the date of publication, except in particularly important cases.

We shall see whether the new circular has any practical effect. In any case, the China Business Group looks forward to informing you about even better Chinese administrative directives in future.

There remains, however, a fear that the new documentation obligations could cause Chinese tax authorities to launch a plethora of investigations of this kind. Only time will tell whether the new approach precludes all structuring arrangements, or whether the tax offices will in fact exercise restraint when choosing whether to use the financial instruments available to them over the coming months and years. Moreover, it is unclear how companies will be able to provide evidence that an SPV has a reasonable commercial purpose in individual cases. In view of this and the various other uncertainties and outstanding issues surrounding the regulation, we urge the companies affected to keep a close eye on future developments. It would not hurt to undertake a critical review of the structures in place and to adjust them if required.

If you would like to clarify where you stand or would like advice, please call or e-mail one of the contacts below.

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Hong Kong: international transfer pricing rules have arrived

On December 4th, the Hong Kong Inland Revenue Department (IRD) issued long-awaited rules on transfer pricing in its Departmental Interpretation and Practice Note (DIPN) No 46. It lays out, in the IRD's view, the legal framework for transfer pricing in Hong Kong, the methods to be employed, documentation requirements and anti-avoidance measures. While the new rules do not go so far as to endorse the OECD's guidelines, they do indicate that the latter should be followed, except where incompatible with local tax law, especially the Inland Revenue Ordinance (IRO). The following article describes how the new rules might affect taxes from day to day and what all finance and tax departments should know.

Hong Kong and the international practice of transfer pricing

The three tables below show the major differences in transfer pricing rules in various countries:

Criterion	Hong Kong	China	UK	CH	Japan
Arm's-length principle	yes	yes	yes	yes	yes
Transfer pricing methods specified	yes	yes	yes	no	yes
OECD guidelines to be followed	generally	no	yes	yes	no
Own documentation requirements published	yes	yes	yes	no	no

Regulation of transfer pricing in different countries

Criterion	Hong Kong	China	UK	CH	Japan
Requirement to report related-party transactions yearly	yes	yes	no	no ¹	no
Contemporaneous documentation requirement	no	yes	no	no	no

¹ except for extraordinary transactions

Reporting requirements in different countries

Criterion	Hong Kong	China	UK	CH	Japan
Audit activity	low	medium	medium	Low to medium	high
Maximum penalty	300% ¹	50% ¹ plus interest	100% ¹ plus interest	n/a	up to 35% ¹ plus up to 14.6% interest
Likely penalty in event of adjustment	50–100%	0–50% ³	0–20%	n/a	0–35%

¹ of the unpaid tax
² of the income adjustment, up to a maximum of €1m
³ 5% of the unpaid tax a year multiplied by the maximum amount of time the tax is outstanding (10 years)

Experience with audits in different countries

This article explains ...

- what the DIPN regulates,
- what advantages and disadvantages it offers and
- what tax and finance departments will need to take into account.

The following section outlines the main features of the new DIPN, No 46:

Key elements explained

DIPN 46 explains over 52 pages how the IRD will approach and handle transfer pricing in the future. As you may know, a DIPN is an internal directive that does not have the power of law.

Accordingly, the DIPN sets out the legal basis for the new rules on transfer pricing, namely:

- Section 16(1) of the IRO – restrictions on deductible expenditures
- Section 17(1)(b) – deductible expenditures that are not for the purpose of making profits
- Section 17(1)(c) – restrictions on deductible expenditures related to capital investments, and thus to tax-exempt income
- Section 61(a) – abuse rules

Surprisingly, only very little reference is made to Section 20 of the IRO, the main section on transfer pricing.

As such, from the perspective of the IRD, Sections 16(1) and 17(1) of the IRO form the foundation for transfer pricing adjustments. Please note: according to a recent court ruling, the wording of these two sections does not actually provide a legal basis for disallowing deductions just because they do not satisfy the arm's-length principle.

Consequently, the IRD may find it difficult to make transfer pricing adjustments on the legal basis described above. Therefore only Section 61(a) of the IRO can be used as a legal basis for transfer pricing adjustments. But in practice, the following problem can arise: an adjustment might carry the risk of significant penalties, as the aforementioned penalty provisions deal with back taxes on the basis of Section 61(a) of the IRO. This will certainly complicate the resolution of transfer pricing disputes.

It is interesting to note that many areas of DIPN 46 refer only to provisions in double taxation agreements (DTAs), of which Hong Kong has only five, which are effective, namely with China, Belgium, Luxembourg, Thailand and Vietnam. Switzerland is, for example, currently negotiating a DTA with HK, which is however not yet signed.

Also noteworthy is the section dealing with associated enterprises, which makes reference to DBAs and the OECD's Model Tax Convention rather than to local law. There is no requirement of a shareholding relationship in order to be an associated enterprise. Section 14 of DIPN 46 employs, rather, a broad definition of "associated enterprise", taking into account not

only control but whether one enterprise directly or indirectly exerts any influence in the management, control or capital of the other enterprise. Although this definition is vague, it should be clear enough for multinational corporations, since they usually meet all criteria and associated enterprises are therefore said to exist.

DIPN 46 is applicable to both cross-border and domestic transactions. However, it is important to bear in mind that Hong Kong's tax laws do not make provisions for corresponding adjustments, so there is a risk of double taxation in Hong Kong when adjustments are made. In any case, please note carefully: a DTA is not a prerequisite for making transfer pricing adjustments. This is not surprising, however, as a DTA only limits taxation; it does not constitute a basis for taxation.

The taxation of permanent establishments is also done in accordance with the OECD's guidelines. In other words, profits are allocated according to the "functionally separate entity approach". Consequently, profits are allocated to a permanent establishment in Hong Kong when economically significant activities take place there.

The arm's-length principle is set out in Section 39 of DIPN 46, which in turn refers to the OECD guidelines. Companies can implement the arm's length principle by taking the following steps:

- Characterise transactions between associated enterprises and document the characterisation.
- Select an appropriate transfer pricing method and document the selection.
- Apply the selected transfer pricing method, determine the arm's-length price and document this process.
- Implement support processes, including a review process to ensure adjustments for material changes, and document this.

As you can see, this is a relatively detailed description of the required steps and of the documentation to be made. This is particularly true given that, according to Section 85 of DIPN 46, there are no explicit documentation requirements, though documentation is encouraged.

The concept of functional analysis was also introduced to facilitate price comparison. It is helpful to:

- assess the availability of comparables,
- determine the degree of comparability and
- conduct a relative assessment of the functions, assets and risks of the various associated enterprises.

Hong Kong will accept current international transfer pricing methods, with priority given to the three traditional methods, namely, the comparable uncontrolled price method, the resale price method and the cost-plus method. With this prioritisation, DIPN 46 differs from the OECD guidelines. An astounding total of 18 pages of DIPN 46 have been devoted to explaining the methods.

As you have read, Section 85 of DIPN 46 does not explicitly require documentation. However, Section 86 encourages companies, "for obvious reasons", to prepare documentation. In Hong Kong, the burden of proof for the deductibility of expenses is with the taxpayer. Thus, there should be sufficient documentation to demonstrate the deductibility of expenses, especially between associated enterprises. Additionally, according to Section 87 of DIPN 46, adequate documentation with regard to the nature, size and complexity of the business or transaction should be available. A list of suggested documents to meet these criteria is also included in DIPN 46. Please also keep in mind Section 39: it requires documentation to demonstrate implementation of the arm's-length principle.

DIPN 46 serves in part as a control against tax abuse. Specifically, it refers to so-called tax schemes. Whenever this issue arises, it is important for taxpayers to be able to demonstrate the commercial rationale for a transaction or structure with associated enterprises. In such cases, especially with aggressive forms, appropriate documentation is a must.

One more thing you should know: DIPN 46 applies retrospectively. In the IRD's view, DIPN 46 is not a new law but merely a clarification of existing law. This means that DIPN 46 is relevant to all pending cases. This is especially important for provisioning purposes.

Next steps

The good news is that the rules on transfer pricing in Hong Kong do not mirror the detail or the level of requirements increasingly seen in the People's Republic of China. This is especially the case given the general absence of documentation, albeit with exceptions – and even then the preparation of contemporaneous documentation and its filing with the tax return are not explicitly required.

However, to the extent that documentation is necessary, the requirements are rather vague, as the preparation of documentation is merely suggested. For taxpayers, this means reviewing transactions with associated enterprises (according to the DIPN 46 definition) to assess future audit risks. That alone can prove difficult given the uncertainty surrounding the legal basis and given that the burden of proof rests on the taxpayer.

There is a risk that the IRD could use the anti-avoidance provisions of Section 61 of the IRO as a legal basis, thereby triggering substantive penalties of up to three times the tax debt.

Furthermore, there is currently no DTA protection for transactions between associated enterprises in Switzerland and Hong Kong. In other words, in the event of a tax adjustment by one of the two tax authorities, there is no possibility of avoiding double taxation through a mutual agreement procedure.

Given these risks, it is advisable to prepare adequate documentation to identify potential difficulties in this area. Such vulnerabilities can then either be eliminated through good documentation or avoided altogether by restructuring the transaction model.

To summarize, it is good that administrative burden on the part of the taxpayer is kept low. It is left to the tax or finance departments to judge how much documentation they want to prepare, in order to form a sufficient basis of argument for a possible audit.

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Social security in China: an alternative to insurance at home?

In this article provides an analysis detailing which foreign employees are eligible based on China domestic law to participate in the Chinese social security system; what companies and employees should look out for; and whether the compulsory insurance scheme in China is an alternative to insurance in your country of origin.

This article explains ...

- how the Chinese social security system is structured,
- what employee and employer contributions are payable in Shanghai, and
- who stands to benefit from joining the Chinese social security scheme – and who might not.

Existing rules and current trends

Social security regulations are generally issued at the provincial level or in the cities under direct central government. As a result, the particular statutes that apply and whether these make provision for foreign employees will depend on where the foreign employee's workplace is located and officially registered.

Social security provisions for foreign workers do exist, for example, in Beijing, Suzhou, Tianjin and Changzhou. The Shanghai social security office also published a circular in October that extends certain local provisions to cover foreign workers. From now on, all foreign workers officially registered in Shanghai can opt into the same medical and accident insurance and pension schemes that apply for Chinese citizens in the city. As with the compulsory insurance scheme already in place for foreign employees in Beijing, this "opt-in" model could pave the way for a similar compulsory insurance scheme being adopted in Shanghai as well.

Summary of social security provisions

As you have already read, social security regulations are generally determined by the individual provinces or cities. As an illustration, the following sections provide information about the situation in Shanghai.

Foreign workers can decide whether to opt into social security schemes; there are no compulsory contributions. For a worker to join a social security scheme, the foreign company employing that worker must register at his local social security office. The worker's contract of employment should also state in writing that he is participating in the Chinese social security system.

Pension schemes

The official retirement age is 60 for men and 55 for women. Foreign employees are entitled to draw a pension after paying into the state pension scheme for a minimum of 15 years.

Tax and legal

Health and accident insurance

Foreign employees can join the standard health and accident insurance schemes. However, health insurance will not cover any medical care outside the People's Republic of China.

Contribution rates

The table below gives a breakdown of the contribution rates in Shanghai:

Type of insurance	Employee contribution	Employer contribution
Care	8%	22%
Health	2%	12%
Accident	–	0.5%
Total	10%	34.5%

Social security contributions in Shanghai

Contributions are calculated on the basis of the employee's average monthly income over the previous year. The income threshold for contributions is adjusted regularly and is currently around 10,000 yuan (approximately €1,060) a month.

If foreign workers leave China before they reach retirement age, they will only receive a refund of employee contributions (around 30% of the total social security contributions).

Conclusion

Given the financial savings involved, registering employees in the Chinese social security system is certainly an option for companies to consider when signing employment contracts with foreign workers. It also gives workers who either cannot afford or do not want international insurance coverage the opportunity to secure at least a basic level of provision, particularly in health insurance.

However, the Chinese social security system does not necessarily represent a genuine alternative to staying in the system in one's home country. This is partly due to the fact that in practice it is often not possible, at least up until now, to pay social security charges for foreign employees. For example, even in Shanghai, no detailed regulations have been published to explain how the extension of social security coverage is going to be implemented. In Beijing, even the existing compulsory social security scheme for foreign employees has not been fully implemented. Furthermore, the lack of standardised regulations means high administrative costs for the companies concerned, since they have to investigate whether it is even possible to join the local scheme at each location where their workers are registered. They may then need to register at a large number of social security offices – again, at a high cost to the company.

Finally, the standard of provision that can be expected from the various schemes is generally well below the standards that workers are accustomed to at home. While social security

remains optional, or, as in Beijing, compulsory insurance schemes are not implemented, the Chinese social security system is not currently a reasonable alternative to the social security system in the employees' home country.

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Representative offices in China: New regulations tighten conditions

Representative offices have long been a popular way for overseas companies to gain access to the Chinese market. However, at the start of the year Beijing changed the legal and tax landscape for these offices. The new rules tighten conditions, making it more difficult to set up or operate these offices. This article covers the new rules and what you should look out for in the future.

Will representative offices still open doors to the Chinese market? Representative offices have long been a popular form of business adopted by foreign investors to enter the Chinese market. Until now, they have had a number of advantages over other forms of investment. They include:

- a relatively simple registration process,
- less stringent business regulatory requirements,
- non-complex tax compliance and relatively low tax costs,
- no capital lock-up requirement and
- straightforward exit procedures.

The taxation and regulation regime for representative offices in China has remained untouched for a long time. However, this changed abruptly at the start of 2010. In what seem like no time at all, several offices have issued a number of administrative directives that tighten up the legal and taxation rules for representative offices. These regulations now cast doubt over the advantages of representative offices as a means of investing in China.

The following sections present the new rules and assess what impact they might have on your representative office.

New legal regulations on registering and running representative offices

Since 1983, the Measures for Administration of Registration of Representative Offices of Foreign Enterprises have formed the regulatory framework for foreign company' representative offices in China. As of January 4th, new rules apply for the registration and operation of overseas offices. The Notice on Further Strengthening the Administration for Registration of Representative Offices of Foreign Enterprises was jointly issued by the State Administration for Industry and Commerce (SAIC) and the Ministry of Public Security with immediate effect. The new regulations apply to all foreign-owned representative offices in China. The main aim of the new regulations is to tighten supervision and control over foreign-owned representative offices.

A foreign company must now have been established in its home country for at least two years before it can register a representative office in China. This restriction has never previously existed.

This article explains ...

- what new regulations have been introduced for setting up and running a representative office in China, and
- the new legislation covering taxation of existing representative offices.

The prerequisites for establishing a wholly foreign-owned enterprise (WFOE) are less stringent: there is no qualifying period for these groups. In comparison, the waiting time for a foreign-invested commercial enterprise, suitable for purely commercial and sales purposes, is one year.

The SAIC conducts on-site inspections of office premises in the first three months of a representative office being set up. This is because it is required to check that the representative office does actually fit its description on the original application.

Previously, changing the name of the representative office merely required a notarised and attested copy of the head office's articles of incorporation. However, in the future the representative office will also need to provide evidence of creditworthiness, such as a bank reference.

Under the new rules, the registration certificate for a representative office is only valid for one year and must be renewed annually. In order to renew it, the company needs to present a certificate issued by the Swiss authorities, which confirms that its head office is still in existence. A notarised (certified) current excerpt from the Swiss commercial register is likely to suffice, although any such excerpt would also have to be notarised (attested) by the Chinese embassy or a Chinese consulate in Switzerland. It is not yet clear whether representative office permits that were extended by a year before the new rules came into force on January 4th will be honoured.

Foreign investors must have all documentation translated into Chinese by a translation company approved by the SAIC before they can be submitted to the local branch of the SAIC. To avoid problems, it is a good idea for investors to ensure that the representative office's internal procedures are designed to meet the deadlines for extension applications, especially where an office inspection or office closure is concerned.

The number of representatives has now been limited to four, including the chief representative. In the past, cases arose where a representative office was used to employ a large number of foreign staff to by-pass the need to establish a legally independent company. Under China's industrial policies, commercial activities in some business sectors are restricted, and they would therefore have faced a ban on establishing companies. In some instances, a parent company avoided these restrictions by setting up representative offices in China that, in fact, were operating as full businesses. This circumvention of the rules is illegal and Beijing now intends to put a sharp end to

practices of this kind. However, the new rules do not address the question of what is to happen with the representative offices established under the old rules.

For a better understanding of the new regulations, it is useful to recall a general principle when establishing a representative office in China: representative offices in China should, as you may know, be seen as an extension of the parent company. In other words, a representative office is not a legally independent company. The representative offices are still permitted to carry on the following activities:

- Liaison activities (coordination)
- New product entry
- Market research
- Technology exchange

A representative office may not undertake business activities outside of these areas. A violation of these rules will incur embarrassing fines, which can often cause long-term damage to the parent company's image and hinder the firm's continuing business activities.

Income-generating activities in particular are not permitted, such as

- accepting orders,
- provision of services,
- invoicing and
- receipt of sales revenue for in-house or outsourced activities.

Where a representative office is involved in preparing company agreements, these should not be signed by the chief representative, but by the parent company.

Please note that the representative office should only work for the parent company in this respect and not for other companies in the same group, since this could lead to significant tax problems.

In such cases, local branches of the SAIC may regard the representative office as "operating without a business licence" (无照经营). Should this happen, the representative office will be subject to fines – in serious cases up to an equivalent of around CHF 70,000 – and its property may be seized. Changing business premises without notifying the local branch of the SAIC is considered to be a major breach of the rules. The local branch of the SAIC in its capacity as supervisory authority will set up an electronic credibility system that classifies representative offices into different categories and records non-compliance with the rules.

At the moment, it appears unlikely that the Chinese authorities will apply the new rules to representative offices that are not supervised by the SAIC – such as law firms, which are under the supervision of the Ministry of Justice.

New tax regulations for representative offices

During the past two decades, the taxation of representative offices in China has been governed by the former Foreign Enterprise Income Tax (FEIT) regime. This has now been superseded by the new Corporate Income Tax (CIT) law that came into effect on January 1st 2008. However, the new law is very general and the State Administration of Taxation had not issued any new tax rules relating to representative offices in the beginning. As a result, both representative offices and local tax offices have been largely following the former FEIT tax rules. In practice, the only thing that had changed since 2008 has been the rate of corporate income tax.

The Provisional Measures for Tax Collection and Administration of Representative Offices of Foreign Enterprises (Circular Guoshuifa [2010] No 18, referred to hereafter as Circular 18/2010) was released on February 20th. Following the publication of this document, there have been significant changes to the tax rules for representative offices. These took effect retrospectively from January 1st.

Some of the most important changes in the law relate to the methods for determining taxable income in China, expected profit margins and tax exemptions.

Taxation of representative offices in China has long been a topic fraught with difficulty. On the one hand, administrative directives prohibit representative offices from carrying out any business other than preparatory and auxiliary activities. On the other hand, the Chinese tax authorities have taken the view that the representative offices' activities generate income and therefore some of the company's profits must be attributed to the representative offices, which are then subject to Chinese taxation.

Even the previous FEIT rules recognised three methods for the representative offices to use when measuring profits: the direct method (also known as "actual basis", based on actual operating revenue and expenditure) or indirectly by the cost-plus or by the "actual revenue deemed profit method". The methods were by and large accorded equal status. However, in practice, the cost-plus method was applied extensively and the majority of tax offices treated it as their preferred method. The following table illustrates how representative offices' profits and applicability are determined according to the three different taxation methods.

Treatment method		Scope of application	Tax treatment
Direct		Costs and revenue can be ascertained accurately	<ul style="list-style-type: none"> • CIT¹: taxable profits x CIT rate • BT²/VAT³: taxable revenue x applicable BT/VAT rate
Indirect	Cost-plus method	Costs can be ascertained accurately but not revenue	<ul style="list-style-type: none"> • CIT: (costs/(1 – deemed profit rate – applicable BT rate)) x deemed profit rate x CIT rate • BT: deemed gross revenue x applicable BT/VAT rate
	Actual revenue deemed profit method	Revenue can be ascertained accurately but not costs.	<ul style="list-style-type: none"> • CIT: actual revenue x deemed profit rate x CIT rate • BT/VAT: actual gross revenue x applicable BT/VAT rate
¹ corporate income tax ² business tax ³ value-added tax			

Treatment methods: applicability and calculation of profit

Circular 18/2010 now states that, in general, representative offices in China must keep comprehensive financial accounts using the direct method. The circular also states that only if the office has failed to keep the relevant records or is unable to calculate the required operating revenues and expenses, then taxable profits are to be estimated using the cost-plus/actual revenue deemed profit method.

It is generally the tax authorities' responsibility to determine whether it is impossible to ascertain a representative office's revenue using the direct method. The wording of the directive therefore removes the representative office's right to select the taxation method. This regulation will undoubtedly increase representative offices' administrative costs, since internal financial accounts and audits of the reports will be required. It is still unclear what will be considered a suitable method for ascertaining profits in the future, particularly given the lack of market transactions of the representative offices and the previous preference for indirect methods mentioned above. However, it is also possible that the new method for ascertaining profits of representative offices may also bring advantages for the companies in certain cases.

Where representative offices are allowed to continue ascertaining taxable revenue using one of the indirect methods, under certain circumstances a higher deemed profit rate will be considered during calculations for the Chinese representative office than previously. Whereas previously profit margins of 10–40% were usual (with the overwhelming majority of representative offices at the bottom end of the scale), Circular 18/2010 has now set a minimum rate of 15% for the representative office. However,

please note that the resultant increase in profit margins is partly offset by the reduction in the corporate income tax rate to 25% as of 2008 (down from 33%).

There is another significant change hidden in the last sentence of sections 11 and 12 of Circular 18/2010. This relates to tax exemption for representative offices. This clause requires local tax offices to cease approving tax exemptions and to review previously approved tax exemptions "in accordance with this Circular". Since Circular 18/2010 itself contains no regulations on tax exemptions and at the same time explicitly invalidates previously applicable circulars, it is to be expected that the majority of tax exemptions previously approved will not be extended. Only time will tell how the transition will actually roll out.

It is also largely unclear what impact the cancellation of specific tax exemptions will ultimately have for the representative offices. Obtaining exemption from corporate income tax has never been easy for representative offices. Following the cancellation of the old exemption system, the representative offices are now subject to the general rules for tax exemptions within the double-taxation agreements. These were only recently re-specified by Circular Guoshuifa [2009] 124 and could open up access to tax exemption for a larger number of representative offices than before. However, it should also be borne in mind that indirect taxes such as the business tax are generally not covered by the double-taxation agreements.

Another important aspect covered by Circular 18/2010 relates to tax compliance obligations. It requires representative offices to perform tax registration within 30 days of obtaining registration or approval. Detailed documentation requirements are provided in the circular. Changes or closure of the representative offices must also be reported. In the latter case, the representative office must report tax on its liquidation income.

The circular requires representative offices to report tax on a quarterly basis. Since the regulations under Circular 18/2010 take effect retrospectively from January 1st, the first filing period would theoretically be the first quarter of 2010. It will be interesting to see whether not only the taxpayers but also the local tax authorities manage to implement the new rules within such a short timeframe.

Circular 18/2010 does not cover income tax issues. The previous legal position therefore has not changed. For example, the provision by which the chief representative and the other representatives are liable for income tax from the first day of their appointment to the representative office in China continues to apply. The representative office therefore remains obliged to levy income tax. The 183-day rule does not apply in this instance. For local staff employed at the office the income tax function is generally covered by staffing agencies such as Beijing Foreign Enterprise Human Resource Services (FESCO). Also, in the

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future, representative offices will only be permitted to recruit local Chinese personnel via such staffing agencies.

Advice

The new administrative and tax rules place a question mark over the future of representative offices as a means of market entry. It would be worthwhile for companies that currently have representative offices in China to review their current structure, including compliance procedures, and adjust them to reflect the new conditions if necessary.

Do you have questions on the establishment or current tax compliance of your representative office or on closure and the public audit this requires? If so, please call or e-mail one of the contacts below.

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Private equity funds: Beijing provides incentives for foreign corporations

The number of Chinese private equity funds in China is growing rapidly, and the country is becoming attractive for foreign companies. The regulatory frameworks recently introduced by local authorities – particularly in the capital – and the incentives for foreign companies has opened China for foreign PE investors.

An emerging market

On November 1st 2005 the Chinese State Administration of Foreign Exchange issued Circular No 75 (Huifa 2005 No 75), which ushered in a new era. Among other things, it opened up access to the Chinese market to foreign private equity (PE) companies that had previously been de facto barred.

Local government authorities in China have issued a plethora of regulations in the four years since the circular to provide further incentives for foreign PE companies to invest in China. Cities and provinces are attempting to develop regional finance centres through local regulations. For example, the city of Shanghai has permitted foreign PE companies to open branches in the Pudong area, a major finance centre, since June 2009.

Beijing initiative

The capital would also like to see more PE companies settling. To do this, and also to allow them to steer the growing PE market in China, four local Beijing governmental bodies published on January 4th The Interim Measures on Establishment of Foreign-Invested Private Equity Investment Fund Management Enterprises. Under Chinese law, the term “foreign” also refers to the special administrative areas of Hong Kong and Macau as well as Taiwan. The four government bodies involved are:

- the Beijing Municipal Development and Reform Commission,
- the Beijing Municipal Commerce Commission,
- the Beijing Municipal Administration of Commerce and Industry and
- the Beijing Municipal Finance Bureau.

The new regulations apply from January 1st, initially for three years, and are restricted to the Zhongguancun National Innovation Model Park in Beijing, a 430 sq. km high-technology park with over 16,000 small and medium-sized enterprises, 1,500 of which are foreign-owned. The park provides incentives for international cooperation, research and development and now finance using foreign investors’ private equity.

This article explains ...

- since when foreign private equity companies have been permitted in China,
- what incentives Beijing is using to attract investors and
- why corporations should weigh up the advantages and disadvantages of regional provisions.

Guidelines

According to the catalogue, foreign investors may establish PE companies as joint ventures with a Chinese partner or as a wholly foreign-owned enterprise (WFOE). However, they must meet the following conditions:

- Share capital of at least \$2m
- The PE company has at least two senior managers who:
 - can demonstrate at least two years of appropriate professional experience with a PE fund and
 - have had no criminal proceedings against them, are not involved in current commercial court proceedings and have no negative credit incidents in the last five years.

As early as January 2009, a number of Beijing authorities issued a Notice concerning the Facilitation of Development of Private Equity Investment Fund Industry which related only to Chinese PE companies. These facilitation measures are now, according to the catalogue, also applicable to foreign PE companies. The measures include flexibility in selecting the legal form of the company and a reduced tax rate of 20% instead of the 25% otherwise usual for companies. If the fund is registered in Beijing, its paid-in capital is greater than 1.5 billion yuan and other local statutes and laws are complied with, there are further advantages: the company can be exempted from tax for the first two years and only pays half the tax rate for the third through the fifth year. The management can also be exempted from tax and free access is granted to the central database of companies prior to the initial public offering (IPO).

The new regulations also grant foreign PE companies access to the Beijing Municipal Private Equity Development Fund. This was established at the end of 2009 to promote and guide the development of private equity in Beijing as well as investment in such funds. The following conditions are attached to the access to this form of investment:

- Investors must meet the requirements of the People’s Republic of China and the City of Beijing.
- They must have an outstanding management team.
- The PE company must focus on one of the three key sectors defined by the development fund:
 - Science and technology
 - Environmental protection
 - Cultural and creative sector

Shortly after the publication of the rules, the US PE fund Carlyle Group set up a local-currency fund registered under the name Carlyle Asia Partners RMB Fund. A declaration of intent was

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signed on the January 12th with the local authorities promising the company their full support. The objective of this fund is to invest in growing companies on the Chinese market. The Carlyle Group is the first fund to make use of the new rules.

A diverse market

As you have read, the new measures provide foreign funds with the opportunity to establish PE companies in Beijing and thus to gain access to the booming Chinese market. But please note that Chinese economic areas and cities have a very wide variety of regulations, requirements and incentive schemes. For example, whereas in Shanghai at least one investor from the foreign PE company must already have acted as an investor before he can enter, this condition does not exist in Beijing. So it is worthwhile for investors to weigh up the advantages and disadvantages of the different regions before deciding on a location. And please consider that the conditions continue to change constantly. Some investors are put off by what they view as yet another uncertainty when planning. If instead they understood that constant regulatory activity is a peculiarly Chinese trait, they, too, could benefit from the real commercial opportunities there are to participate in China's growth. And, as can already be seen, these are considerable.

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IPOs in Hong Kong: one option for Swiss companies

The Chinese capital market has seen rapid development in the last 10 years. In Hong Kong alone, more companies were listed on the stock market in 2009 than in each of the traditional industrial countries with established financial centres. As things stand now, there is no reason to suspect that this trend might cease. It's high time for Swiss companies to start thinking about how they can benefit from this development.

Both the Chinese capital market and the IPO market are booming. As a study conducted by PwC at the beginning of 2010 shows, Chinese markets were already leaders in this area in 2009. Experts think that the country will be able to strengthen its position even further in 2010.

In fact, stock exchanges in Switzerland and Europe also seem to have recovered from their low points. Consequently, most professional observers expect that the local IPO markets will pick up speed again in 2010 and that the number of IPOs will increase. In the last few months in particular, many companies have decided to delay their planned IPOs in response to adverse market conditions. Now they are making up for lost time. Because of this, the current list of IPO candidates is long indeed. Provided that the environment maintains a certain degree of stability, this trend on the European exchanges is likely to continue.

Nevertheless, the Chinese stock markets have added an important element to the international financial sector that can hardly be ignored by market players. Companies considering IPOs are asking themselves less and less if they should tackle this new development; they are asking how.

The development in China is of particular interest to Swiss companies planning an IPO now or in the near future. These companies should seriously consider going public in Hong Kong.

Of all the Chinese stock exchanges, Hong Kong is the most significant from the European point of view – Hong Kong is currently the only exchange open to foreign companies. In fact, capital market participants in mainland China are not allowed to invest there because the national currency, the yuan, is not convertible. Nevertheless, Hong Kong is a financial centre with an extremely active and also very liquid market, which represents a gateway to the Chinese capital market despite the aforementioned restrictions.

An IPO in Hong Kong is not just a possible option; in light of transaction costs it is also an attractive one. In reality, the financial burden associated with an IPO on China's south coast is by all means comparable with what an issuer has to deal with when going public in Europe.

This article explains ...

- what fundamental factors speak in favour of an IPO in Hong Kong,
- who stands to benefit in particular from an IPO in Hong Kong, and
- what risks companies considering an IPO in Hong Kong need to be aware of.

The enormous strength and liquidity seen in the recent past and present on Hong Kong's exchange speak in the city's favour as a financial centre. These two factors are also the main reason why successful IPOs were possible there while European capital markets were foundering and thus scarcely able to offer a hospitable environment for new issuers.

At the same time, such transcontinental transactions do undeniably imply significant risks. These include the general uncertainties that are connected with taking the first step into a foreign country and culture, such as other customs in both business and private spheres, a new legal system, different time zones and increased travel needs. For this reason, an IPO in Hong Kong is most suited to those Swiss companies that are already cultivating ties to China. Companies should thus reconsider their decision if the potentially large amount of money that can be raised in an IPO is the sole factor in choosing where to list. It is ideal to have some connection to the location of the listing and an appreciation of the country and its people. This can help companies carve out a sufficiently large niche in the stock market in the long term and secure the investor acceptance necessary to be successful on the capital market.

However, companies that have had no mainstay in Hong Kong or China until now should not be discouraged by their distance to the market there. A host of companies that now wish to establish a presence in China have been showing increasing interest in Hong Kong as a stock market and financial centre. Hong Kong will undoubtedly be an interesting alternative in the future, especially for small- and medium-sized enterprises that have had a difficult time generating investor interest in their IPO plans at home. The requirements of individual IPO candidates and the particulars of each stock market make it impossible to give any kind of universal advice. Each newcomer has to find the right exchange that will make it possible to attain the maximum success in the short, medium and long term. And this success can't be sustained by high issue proceeds alone.

But in any case, each IPO hopeful who is drafting plans should still give some serious thought to Hong Kong. Europe and China are moving closer and closer together – and that is excellent news!

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Study helps to find the right business partner

The Chinese market is of great importance as a procurement market for retailers and manufacturers of consumer products. Cheap raw materials, lower labour costs and proximity to new markets are some of the advantages it offers to Swiss enterprises. Amid growing concern over sustainability, however, businesses are increasingly being watched by analysts, investors, NGOs, the media and consumers. These interest groups are asking more and more about the risks Chinese products pose and under what conditions these products are manufactured.

As a strategic measure to ensure the sustainable management of the supply and value chains, retailers and manufacturers have increased their cooperation with one another. That's because many companies do not always have the necessary infrastructure in China to carry out monitoring. Through the integration of third parties, such gaps in the supply and value chain can be closed.

As part of a study, PwC's Retail & Consumer Competence Centre has examined the extent to which cooperation is already taking place, where there is potential for improvement and what approaches can be helpful in choosing suitable partners. The study also provides readers with an excellent overview of best practices and potential partners.

Shoulder to Shoulder: Promoting Sustainability Through Cooperation. Value Chain Management in the Retail and Consumer Goods Sector (Executive summary; full study in German only)

Published by PricewaterhouseCoopers

Download

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Trade in China in international comparison

Trade in China has changed dramatically in the last few years. Economic reforms, further opening to foreign investment and the unchecked growth of cities stimulate the exchange of goods. And as in other Asian markets, such as Vietnam, popular new retail formats are crowding out the old ones. But just how are Chinese enterprises evolving compared to their competitors around the world?

This question, which, given persistent stagnation in many European markets, may be of particular interest to Western retailers, is the focus of a study carried out by PwC China in collaboration with the Chinese retail federation and the Ministry of Commerce. "China Retail Sector. An Empirical Review of Financial Performance" examines 52 Chinese retailers of all sizes for their financial performance – in other words, their sales growth and profitability – and compares them with 32 international retailers.

It shows that Chinese companies continue to report considerable growth, despite the global economic crisis. Although their profitability has declined slightly, the Chinese companies are nevertheless very competitive when compared internationally. This study by PwC China experts is required reading for anyone looking for insights into the local market and opportunities for their own business.

China Retail Sector. An Empirical Review of Financial Performance

Published by PricewaterhouseCoopers China, January 2010

Download

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